Post-Apartheid Southern Africa

Economic challenges and policies for the future

Edited by
Lennart Petersson

Routledge Studies in Development Economics

POST-APARTHEID SOUTHERN AFRICA

After decades of economic decline and political instability, the Southern African region has engaged in a process of rapid and far-reaching political and economic changes. This development has been reinforced by South Africa's transition from apartheid, a transition which has created optimistic expectations not only for that country but also for the Southern African region as a whole. *Post-Apartheid Southern Africa* brings together some of the best-known, most highly regarded academics in the field to present a timely and comprehensive review of the prospects for economic integration and development in Southern Africa, and to analyse alternative strategies and policies for the future.

The volume is divided into three parts. The first section discusses economic policy in contemporary South Africa, and focuses on the many and diverse problems and expectations facing the new government. Part II examines the issues of regional integration and structural adjustment that have been promoted simultaneously as two separate and complementary facets of the revival and acceleration of development. Papers in this section also explore labour market issues and the dynamic role of small enterprises in the development of Southern Africa. The third part of the volume presents in-depth country-specific studies of Botswana, Lesotho, Mauritius, Mozambique and Tanzania, presenting critical analysis of policy and development issues and discussing the experience of each country in pursuing particular development strategies.

Post-Apartheid Southern Africa is a valuable and topical study which offers a comprehensive and much-needed analytical overview of the extraordinary challenges now facing the region. It will have wide appeal to academics and policy-makers.

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ROUTLEDGE STUDIES IN DEVELOPMENT ECONOMICS

POST-APARTHEID SOUTHERN AFRICA

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Proceedings of the 16th Arne Ryde Symposium
23–24 August 1996, Lund, Sweden

Edited by
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London and New York

CONTENTS

v

TABLES

FIGURES

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ACRONYMS

ACP	Africa, Caribbean and Pacific Group of States
ADB	African Development Bank
ANC	African National Congress
APEC	Asia Pacific Economic Cooperation
ASEAN	Association of South-East Asian Nations
BEDCO	Basotho Enterprise Development Corporation
BLNS	Botswana, Lesotho, Namibia, Swaziland (also called BLSN)
BLS	Botswana, Lesotho and Swaziland
BWI	Bretton Woods Institutions
CBI	Cross-Border Initiative
CBL	Central Bank of Lesotho
CEAO	West African Economic Community
GET	Common External Tariff
CMA	Common Monetary Area (SACU members minus Botswana)
COMESA	Common Market for Eastern and Southern Africa
COSATU	Congress of South African Trade Unions
CSO	Central Statistical Office
CSS	South Africa Central Statistical Services
DC	Development Certification
DI	Development Incentives Act
DRLC	Debt Relief Laffer Curve
EGA	United Nations Economic Commission for Africa
ECLAC	United Nations Economic Commission for Latin America and the Caribbean
ECOWAS	Economic Community for West African States
EDT	Total Debt Stock
EFTA	European Free Trade Association
EIU	Economist Intelligence Unit
EMCOZ	Employers' Confederation of Zimbabwe
EMS	European Monetary System
EMU	European Montary Union

EPZ	Export Processing Zone
ERM	Exchange Rate Mechanism
ERP	Economic Rehabilitation Programme, Mozambique
ESAF	Enhanced Structural Adjustment Facility
ESAP	Economic Structural Adjustment Programme
ESRP	Economic and Social Rehabilitation Programme
EU	European Union
FAO	Food and Agriculture Organization
Frelimo	Frente de Libertação de Moçambique
FISCU	The SADC Finance and Investment Sector Coordinating Unit
FY	Fiscal Year
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
GEIS	General Export Incentive Scheme
GEMINI	Growth and Equity through Microenterprise Investments and Institutions
GNP	Gross National Product
GOL	Government of Lesotho
GOT	Government of Tanzania
GSP	Generalised System of Preferences
IBDC	Indigenous Business Development Centre
IBRD	International Bank of Reconstruction and Development
1C	Industrial Council
IDA	International Development Association
IFIs	International Financial Institutions
IGAD	Intergovernmental Agency for Development
IGADD	Intergovernmental Authority on Drought and Development
ILO	International Labour Organisation
IMF	International Monetary Fund
LDC	Less Developed Countries
LHWP	Lesotho Highlands Water Project
LMC	South Africa Labour Market Commission
LNDC	Lesotho National Development Corporation
LPA	The Lagos Plan of Action
LRA	Labour Relations Act
MERG	Macroeconomic Research Group
MFA	Multifibre Arrangement
MFN	Most-Favoured Nation
MNCs	Multinational Corporations
MP	Member of Parliament
MSE	Micro and small enterprises
MT	Mozambique Meticais
NACTU	South Africa National Council of Trade Unions

NAFTA	North American Free Trade Agreement
NP	National Party
NRB	National Remuneration Board
NTBs	Non-Tariff Barriers
NUM	National Union of Mine-workers (South Africa)
NUMSA	National Union of Metal Workers of South Africa
OCA	Optimal Currency Area
ODA	Official Development Assistance
OECD	Organisation for Economic Cooperation and Development
OHS	October Household Survey 1994, South Africa
PF	Patriotic Front (alliance between ZANU and ZAPU)
PPI	Piano Perspectivo Indicativo
PPP	Purchasing Power Parity
PTA	Preferential Trade Area of Eastern and Southern African States
PWV	Pretoria-Witwatersrand-Vereeniging
QR	Quantitative Restrictions
RDP	Reconstruction and Development Programme
RIDP	Regional Industrial Development Programme
SACU	Southern African Customs Union (Botswana, Lesotho, Namibia, South Africa and Swaziland)
SADC	Southern African Development Community (former SADCC plus South Africa and Mauritius)
SADCC	Southern African Development Coordination Conference
SAP	Structural Adjustment Facility
SAL	Structural Adjustment Loan
SALDRU	Southern African Labour and Development Research Unit
SAP	Structural Adjustment Programme
SDR	Special Drawing Rights
SECAL	Sectoral Adjustment Loan
SEDCO	Small Enterprise Development Corporation
SIDA	Swedish International Development Authority (from 1962 to 1 July 1995, then transformed to Sida)
Sida	Swedish International Development Cooperation Agency
SITC	The Standard International Trade Classification
SLICs	Severely indebted low-income countries
SOE	State-owned enterprises
SSA	Sub-Saharan Africa
TEBA	The Employment Bureau of Africa Limited
TRA	Tanzanian Revenue Authority
TZS	Tanzanian shillings
UDI	Unilateral Declaration of Independence (Zimbabwe)
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development

UNDP	United Nations Development Programme
US	United States
USAID	United States Agency for International Development
VRG	Valid Re-engagement Guarantee
WTO	World Trade Organisation
YTCs	Youth Training Centres
ZANU	Zimbabwe African National Union
ZCTO	Zimbabwe Congress of Trade Unions

PREFACE

In view of the past tendencies of economic stagnation and the recent political changes in the Southern African region, the theme chosen for the 16th Arne Ryde Symposium was the prospects for economic integration and development in Southern Africa. This volume contains selected papers presented at the Symposium, 23–24 August 1996, held at the Grand Hotel, Lund, Sweden. The symposium was generously financed by the Arne Ryde Foundation which was established by Valborg and Sven Ryde, the parents of Arne Ryde who was an exceptionally promising young doctoral student at the Department of Economics, Lund University. Arne Ryde died in 1968, only 23 years old, after an automobile accident. Ever since 1973, the Arne Ryde Foundation has financed international symposia and lectures of importance for economic research, stimulating in particular the research of doctoral students, research fellows, lecturers and professors at the Department of Economics, Lund University.

In May 1995 I was asked by Professor Björn Thalberg at Lund University, Chairman of the Board of the Arne Ryde Foundation, to organise the 1996 Arne Ryde Symposium. In the light of recent political changes, I thought that it would be timely to arrange a symposium on South Africa's transition from apartheid and the impact of this change on the region and its individual countries. South Africa's economic and political reintegration has given the whole of Southern Africa a chance of a new beginning and created a precondition for fruitful regional cooperation.

I am very grateful to all who accepted the invitation and produced interesting papers on the various themes that were indicated in their respective invitations. Since the dismantling of apartheid was what made the theme so interesting and brought a large number of eminent economists from Southern Africa, the US, the UK and the Nordic countries to the symposium, I would like to extend special thanks to Ambassador Ignatius P.de Swardt, the South African Ambassador to Sweden, who gave an introductory lecture addressing the issue of economic growth and development for all countries in the region. Furthermore, I would like to express my gratitude to Björn Thalberg, Carl-Johan Belfrage and Göte Hansson, who assisted me in practical matters before

and during the conference. The editor also wishes to express his gratitude to Patricia Wetterberg for improving the English of the manuscripts and, last but not least, to the secretary of the project, Jeanie Petersson, for shouldering a heavy burden in the organisation of the conference and in the preparation of the manuscript for publication.

Lennart Petersson
Lund, April 1997

1

INTRODUCTION

Lennart Petersson

After decades of economic decline and political instability, the region of Southern Africa has engaged in a process of rapid and comprehensive political and economic change.[1] Most countries of the region have introduced structural adjustment programmes with the support of the International Monetary Fund (IMF) and the World Bank or have made their own attempt at reforming their economies. State interventions and controls have been gradually reduced to allow markets to work more smoothly. In the process, the role of public enterprises, which after political independence became the major actors in the economies, has been reduced significantly. There has also been a shift in favour of more export-oriented and less protectionist policies. In the political arena, one-party systems and low levels of popular participation have been replaced by multi-party systems, except in Swaziland.

This development is reinforced by the elimination of apartheid and the end of the destabilisation policy followed by the previous minority government of South Africa. This may contribute to transforming the region from a region of conflict to one of peace, stability and security. The recent development in South Africa has created optimistic expectations not only for that country but also for the Southern African region as a whole. In 1994, the newly transformed frontline alliance, the Southern African Development Community (SADC), welcomed South Africa in its ranks, and one year later Mauritius became the SADC's twelfth member.

There is, however, a real danger that the post-apartheid euphoria conceals remaining antagonistic contradictions and inherent conflicts in Southern Africa. These have roots in the asymmetry between South Africa and the rest of the region and the uneven development within and among the individual countries (see Table 1.1). The region is dominated by South Africa, which accounts for about 30 per cent of the SADC population but for around 80 per cent of the total GDP. South Africa's industrial production is five times greater, and the capacity in sectors such as transport, energy and financial services is greatly superior to the rest of the region. There are also considerable differences among countries in development performance. In 1993, the GNP per capita of Mauritius and South Africa was roughly US$

3,000 each, closely followed by Botswana at around US$ 2,800, while Mozambique and Tanzania with 90 US dollars each are placed at the bottom of the World Bank GNP per capita rankings. The performance of the economies during most of the last two decades has been poor and differs widely from country to country. Since 1980, low growth rates of GDP combined with high population growth have resulted in insignificant increase or even decrease in the growth rates of per capita incomes, except in Botswana, Mauritius and Swaziland.

The changes in South Africa may have a major impact on existing economic and political relations in the region. The key issue will be whether deeper cooperation and integration will lead to higher growth in the region, a reduction of economic disparities and, finally, convergence. In addition, the way in which labour market issues, such as wage policy, migration and the development of human resources, will be tackled at national levels will be critical for future development.

This book is divided into three parts. Part I discusses economic policy in contemporary South Africa and highlights the multitude of problems and expectations facing the new government. Part II examines the prospects for economic integration and development as well as labour market issues in Southern Africa. Finally, Part III analyses critically policy and development issues in some of the countries of the region.

South African transition

The overall development strategy adopted by South Africa and the performance of its economy will have far-reaching implications for the reconstruction of the entire region. A politically equitable, stable and economically prosperous South Africa may strengthen the region internationally and promote its development. On the other hand, a weakened state will obviously be unable to improve existing patterns of regional relations. Even worse, if the regional 'powerhouse' does not succeed in creating and maintaining internal political and economic stability and improving the living standard of the population, the sentiment of the people in the region may swing back to the one of African failures.

For the people of neighbouring countries, South Africa is the land of milk, honey and gold. The country serves as a magnet to those seeking employment, a higher living standard and brighter economic prospects. However, social and economic indicators give an overall picture of a black South Africa that has only moderately better living conditions than its neighbours. The major part of the benefits deriving from the economy still accrue to the white minority. In 1993, an estimated 12.5 million were defined as illiterate, and years of neglect of education and training of blacks has resulted in a shortage of skilled manpower. The vast majority of the black population have no electricity, no running water and no permanent homes.

Table 1.1 Southern Africa: country profiles and economic indicators

Indicators for Southern Africa	Area ('000s of sq.km)	GNP			GDP (US$ millions) 1993	Merchandise		Primary exports as % of total exports 1993**
		Population (millions) 1993	per capita (US$) 1993	per capita growth rate		exports/GDP (%) 1993*	imports/GDP (%) 1993*	
Angola*	1,246	10.3	674	n.a.	7,218	39	20	95
Botswana	582	1.4	2,790	6.2	3,813	50	42	98
Lesotho	30	1.9	650	-0.5	609	19	127	n.a.
Malawi	118	10.5	200	-1.2	1,810	15	16	76
Mauritius	2	1.1	3,030	5.5	2,780	41	49	34
Mozambique	802	15.1	90	-1.5	1,367	9	59	n.a.
Namibia	824	1.5	1,820	0.7	2,109	50	47	95
South Africa	1,221	39.7	2,980	-0.2	105,636	21	16	70
Swaziland	17	0.9	1,190	2.3	938	69	79	n.a.
Tanzania	945	28.0	90	0.1	2,086	13	42	79
Zambia	753	8.9	380	-3.1	3,685	27	27	90
Zimbabwe	391	10.7	520	-0.3	4,986	26	22	56

Sources: *World Bank 1995*; *SADC 1996; **Cassim and Zarenda 1995

The new government inherited an economy in decline and a deepening economic crisis, which contributed to the end of apartheid. After a long period of rapid capital formation and growth, investments and growth have gradually slowed since the 1970s. A main factor behind this is the apartheid system and the international sanctions imposed in the mid-1980s. Most important sectors of the economy faced severe problems and GDP growth slumped to less than 1 per cent in the 1980s.

Critical for South Africa's future is its ability to enter a new phase of growth, to tackle the problems of unemployment and inequality and to give all South Africans the opportunity to improve themselves and their living standards. This will require more public expenditure in favour of the African majority in areas such as education and human resource training, health, water, energy and housing facilities. The need for redistribution is obvious, and the main question is whether the aspiration of the black majority can be satisfied without eroding international competitiveness, foreign investors' confidence and without building a budget deficit that may challenge the transition process and lead to social and political unrest.

In Chapter 2, 'The post-apartheid economy, and after?', Mats Lundahl surveys and discusses the economic legacy of apartheid and different ideas for economic policies and programmes proposed in the 1990s, aimed at internal reconstruction and development for all in South Africa. The focus is on the African National Congress (ANC) and the significant changes that have taken place in its policy orientation from the days of liberation movements to the more market-oriented economic programme for growth, employment and redistribution of 1996. The author also discusses critical assumptions about the difficulties involved in that strategy.

Lundahl's analysis of the apartheid era after the Nationalist takeover of government in 1948 underlines the adverse effects on the economy in terms of increased welfare disparities, significant efficiency losses and declining growth. These effects were the result of various Nationalist government policies: the extended market-distorting regulations, the prolonged import substitution policy and state involvement in industrial production. These policies aimed at self-sufficiency in the face of hostile international opinion. As a result, the legacy of apartheid includes an industrial sector now revealed to be uncompetitive on world markets.

Alternative paths of development have been considered and discussed in the 1990s, all articulated in terms of a growth and redistribution framework. There has been a shift away from proposals of redistribution of wealth supposed to produce an immediate impact on the economy and towards an increased emphasis on economic growth as the means of counteracting the legacies of apartheid. Lundahl relates this change of priority and sequencing to the increasing attention being paid to sustainable redistribution which only growth can generate. The argument is that an increased annual growth rate to 6 per cent at the turn of the century would, even within the target of

a balanced budget, allow for a substantial redistribution in favour of the poor majority. This could be achieved both by the creation of employment and by increased government transfers and other expenditures.

Lundahl addresses a number of weaknesses in the macroeconomic strategy which he concludes may not be easy to implement and may neither produce the anticipated growth and employment nor significantly affect income distribution. The programme of 1996 has more of a supply side than a demand side character with a central role for the private sector, foreign direct investments and exports. The government has, however, no control over these growth-generating forces and few measures left to influence them within the envisaged policy of trade liberalisation and tight monetary and fiscal policies. Another criticism concerns a plan to take the country out of severe unemployment by means of a more flexible labour market, where lower and more varied wages are to be traded against price restraint and job-creating investments. Lundahl concludes that it is doubtful whether a social accord will ever be signed, and also that it is uncertain what could actually be achieved in terms of employment and income creation by the introduction of increased wage flexibility.

In Chapter 3, 'Changing patterns of inequality in the South African labour market', Nicoli Nattrass and Jeremy Seekings explore several dimensions of the labour market in post-apartheid South Africa and the changes which are currently taking place with respect to South Africa's labour market institutions. Finally, they discuss some of the implications of an orientation towards industry-level bargaining.

Nattrass and Seekings begin their paper by surveying the situation in the labour market, where racial discrimination in wages has declined dramatically and—since the transition to democracy—the sectoral system of collective bargaining and minimum wage regulation has been strengthened and the rights formerly restricted to white workers have been extended to all workers. These reforms, they argue, may result in the development of more capital-intensive production and shifts to less regulated and secure forms of employment, thus increasingly serving primarily a shrinking enclave of regulated and protected employment.

Various estimates of unemployment are reviewed and Nattrass and Seekings find that the extreme inequality still prevailing is derived largely from systematic disadvantage, with the rising unemployment falling almost entirely on black South Africans. In line with these findings, they conclude that inequality is best addressed by attacking unemployment, and suggest a re-orientation of economic policies in support of a labour-intensive rather than capital-intensive growth path.

A central issue dealt with is whether the emerging labour market institutions are appropriate for a strategy that facilitates productivity growth without restricting the expansion of lower (labour) productivity employment. The influence on the labour market of trade liberalisation is

discussed.Growing competition may result in either falling unskilled wages or job losses, while skilled labour in short supply may be able to bargain for higher wages. Their conclusion is that this must be accommodated by the labour market which, in turn, means that it will be difficult to reduce inequality by reducing wage differentials. A tight budgetary position with limited government resources for welfare spending is another constraint, with the implication that for the foreseeable future the welfare of the poor and the unemployed is going to depend on economic growth and job creation.

Nattrass and Seekings underline that abolishing minimum wages or lowering existing wages may neither create jobs nor narrow inequality, while a general increase of unskilled wages and further compression of the wedge between wages for different racial groups, sectors and enterprises is likely to slow down job creation and thereby widen inequality. In this context, Nattrass and Seekings show the central role played by the system of industrial bargaining, which takes place in Industrial Councils; they also analyse the effects for non-parties of the extension of agreements on minimum wages and other working conditions. They conclude that the system may favour large high-productivity firms, usually partners in the agreements as members of the councils. The implementation of narrow wage differentials imposed by collective extension may, however, speed up the weeding out of smaller firms which tend to use a more labour-intensive technique and the bargaining system may act as a barrier to new low wage jobs.

In Chapter 4, 'South African trade and industrial policy in a regional context', Colin McCarthy reviews the change in trade and industrial policy in South Africa and discusses the repercussions in the region of policy changes. He describes a long-standing policy of import substitution, supplemented in the 1970s and 1980s by measures to neutralise the inherent anti-export bias of that policy. Then he traces the recent and likely future changes in South Africa's trade and industrial policy in its search for higher growth, international competitiveness and greater domestic equity. Finally he focuses on the likely impact these changes will have on the region.

McCarthy finds that the country's protective attitudes in the past were based on various objectives—such as economic diversification, protection of white workers—aimed at redistributing wage employment and income opportunities and, since the 1960s, the development of strategic industries as a response to an increasingly hostile international environment. The result has been an extremely complex system of protection, but its very selective nature has made it possible to hold back the average level of tariffs.

By signing the Marrakech Agreement in 1994, South Africa committed itself to a policy of trade liberalisation and an outward-looking policy stance. McCarthy's analysis emphasises that, in order for South Africa to achieve the objectives of exploiting the opportunities of enhanced access to regional and world markets, it is important to eliminate the anti-export bias which, he argues, still prevails under the new trade regime and envisaged

industrialpolicy. In the adopted macroeconomic strategy (1996), the General Export Incentives Scheme—to be phased out by the end of 1997 to comply with the rules of the World Trade Organisation (WTO)—will be replaced by a number of supply-side measures. The most important of these, aimed at a labour-absorbing growth, are fiscal incentives to encourage new investments. McCarthy questions the new selective industrial policy based on regional location, job creation and priorities accorded to certain industries and subsectors instead of one based on measures applied uniformly to create an outward-looking economy within a competitive framework.

In the core-periphery relationships of Southern Africa, McCarthy indentifies and analyses the impact of South Africa's policy on two dimensions of polarisation, namely the imbalance in trade and disparities of economic development between South Africa and its neighbours and that existing within South Africa between the major metropolitan areas and the poor, traditionally black rural areas. He argues that the selective policy proposed may bring about a return to the earlier efforts to promote decentralised industrial development in South Africa, working to the detriment of neighbouring countries by removing their cost advantage of cheaper wages and lower labour standards. The new fiscal incentives provided for domestic investments may reduce the cross-border investments by South African firms which are required to bring about a more equal distribution of economic activity in the region. It is also unlikely that South Africa will embrace a free flow of labour in the region. McCarthy concludes that although regional consideration characterises public pronouncements, there is not yet any concrete evidence in policy-making that the creation of a more balanced trade and industrial development in the region as a whole is being seriously considered.

Regional studies

Regional integration and structural adjustment have been promoted simultaneously as two separate and complementary components necessary to revive and accelerate development in Southern Africa. The efforts of regional integration as a means to overcome the deficiencies of small domestic markets have been pursued with renewed interest in the 1990s with South Africa—the regional hegemon—accepted as an integral part of the region. This country's membership of the SADC may strengthen and improve the future policies of the organisation. The emphasis put on cooperation in various sectors, in particular in the area of infrastructure, may be expanded to include trade, labour and monetary integration and macroeconomic convergence. During the 1990s, attention has increasingly been focused on the small and declining amount of wage employment in relation to the size of the rapidly growing labour force in most countries of the region and the large role played by the informal sectors in most economies.

In Chapter 5, 'Trade integration and economic development: some Southern African issues', Gavin Maasdorp reviews the state of trade relations in Southern Africa and the current moves towards establishing a free trade area for the SADC countries. He analyses different views regarding the importance and pace of such a move and a possible way forward towards increased integration. Finally, Maasdorp discusses the pros and cons of regionalism beyond the SADC.

Maasdorp begins his chapter by presenting the present picture of differentiated integration and other intra-regional trade relations within the SADC. Five countries are members of the Southern African Customs Union (SACU consisting of South Africa and the BLNS countries—Botswana, Lesotho, Namibia and Swaziland) and are already at an advanced level of trade integration. Another five countries (Malawi, Mauritius, Tanzania, Zambia and Zimbabwe) are participating in the Cross-Border Initiative (CBI), moving towards the elimination of tariffs on intra-regional trade and the harmonisation of external tariffs. The two remaining SADC countries (Angola and Mozambique) are not involved in any short-term move towards free trade but committed to trade liberalisation under the WTO and the group of fourteen countries in the Common Market for Eastern and Southern Africa (COMESA), which does not include South Africa as a member.

Maasdorp's analysis of the prospects for increased intra-regional trade focuses on South Africa's trade liberalisation since 1989, its commitment to further liberalisation by obligations to the WTO and its programme for restructuring the economy. In some of the other countries within the SADC region, tariffs have been lowered rapidly under the influence of structural adjustment programmes. Between 1992 and 1995, the outcome for South African trade has been a highly increased export surplus with other SADC countries, while a large trade surplus with the rest of the world reversed to become a significant trade deficit. In the light of this development, Maasdorp concludes that a favourable balance of trade with the region is crucial to South Africa but that closer integration may enable South African firms to overrun SADC markets even more than they are already doing, with devasting consequences for de-industrialisation in certain countries of the region.

If the CBI realises its target, there would be two free trade areas within SADC, namely the SACU and the CBI. After tariff reforms both would have similar tariff structures and external tariff rates between 0 and 30 per cent. Maasdorp conludes that there are ways of bringing the SACU and non-SACU groups together in a free trade area. He stresses that the region should not ignore the potential benefits of participating in trade integration and other initiatives within COMESA and even intercontinentally, since steps to achieve greater macroeconomic policy convergence and more efficient sectoral cooperation are just as important as steps to reduce tariffs.

In Chapter 6, 'Regional integration and cereal trade', John Weeks and Turan Subasat investigate the potential for expanding trade in grains

amongthe countries of COMESA. In the absence of measures of comparative costs and disaggregated bilateral data, the method used is to determine whether the consumption and production characteristics of the COMESA countries imply that trade is below its potential.

They find that the countries demonstrate characteristics consistent with greater trade in grains than what is actually the case. The region is not a regular importer of grains, except in years of severe drought. The potential for greater intra-regional trade in grains is indicated by the significantly different structures of consumption and production across countries. Weeks and Subasat conclude that these differences suggest that greater grain self-sufficiency for each separate country might not be efficient, but that it could so be for the region as a whole. Along with the evidence for differences in consumption and production patterns goes strong statistical support for the likelihood that the COMESA countries could absorb each others' surpluses and fill each others' shortages over time. For this to become a reality, investments in infrastructure must be made and the protective policy changed. Tariffs on grains among the countries are frequently high and extremely complicated.

In the light of these findings, Weeks and Subasat argue that movement towards a common external tariff on grains and a low and uniform internal tariff could have substantial trade-inducing effects. In the short and medium term, until investments are made in storage, much of the increased trade between countries will be short-haul cross-border. Lack of transport facilities, especially roads, limits regional grain trade. They conclude that reducing transport costs by improving roads and infrastructure will be an important long-term task, to which donors could usefully contribute.

In Chapter 7, 'The dynamic role of micro and small enterprises in Southern Africa', Carl Liedholm and Donald Mead examine the dynamic role of micro and small enterprises (MSE) in the development of Southern Africa. Using survey data recently collected in Botswana, Lesotho, Malawi, South Africa, Swaziland and Zimbabwe, they present new findings on the turbulent process of MSE creation and closure as well as on MSE expansion and the growth patterns of these enterprises. They look particularly at the role played by gender in this process. Finally, they examine and analyse the interrelationships between MSEs and the macroeconomy and the general policy and assistance implications.

Liedholm and Mead find that MSEs are a major feature of the economies of Southern Africa but with much churning and diversity within the MSE universe, in which all enterprises engaged in non-primary activities are included. For the six countries of Southern Africa surveyed, it is estimated that more than 20 per cent of the labour force is employed in MSEs. This is nearly twice the level of total employment in registered, large-scale enterprises and the public sector. Self-employment is a central element in these economies. They find that the rate at which new MSEs are being createdtypically exceeds

20 per cent per year, a rate much higher than previously thought. The annual closure rate is also high, with most closures occurring within the first three years after start-up. Only about a quarter of the MSEs expand. Yet adding even a few workers can, in the view of Liedholm and Mead, contribute in important ways to increases in economic efficiency, employment and income. They examine the relative contributions and determinants of growth arising both from the expansion of existing MSEs and from new starts and closures.

In the light of these findings, Liedholm and Mead conclude that broad-based macro policy reform aimed at creating a more dynamic economy can be an effective vehicle for fostering the productive expansion of existing MSEs. While they seriously question whether many scarce resources should be allocated to facilitate new starts, Liedholm and Mead emphasise that existing firms that have survived the first three years or that have grown even slightly would appear to be likely candidates for support. They argue that for those enterprises that are not growing or that seek to grow just a little, small amounts of working capital are often all that is required. It is more difficult to provide the required business support and service institutions in a cost efficient manner for MSEs, with extensive and widely dispersed client groups that seek greater growth and a more sizeable expansion. The authors suggest an approach of focus on subsectors to meet this challenge.

The purpose of Chapter 8, 'Is Southern Africa ready for regional monetary integration?', by Carolyn Jenkins and Lynne Thomas, is to assess the appropriateness of proposed SADC initiatives for macroeconomic harmonisation and exchange rate coordination. The chapter is composed of two parts. First, the lessons from theory and experience in the economic literature are reviewed, focusing on the implications for policy coordination of spillover effects and asymmetric shocks, the appropriate conditions for exchange-rate coordination and issues surrounding convergence of per capita income and convergence of macroeconomic stability indicators. The second part concentrates on macroeconomic policy and convergence in the SADC.

After concluding that some degree of macroeconomic convergence is necessary for effective policy coordination, Jenkins and Thomas go on to provide summary information on the macroeconomic policies currently pursued in the SADC and to highlight the areas of key policy weakness. Subsequently, in the analysis of convergence of per capita income in the SADC, they find no evidence of convergence (if anything there is a slight divergence), but they do see a pattern of convergence amongst the SACU countries. The authors then examine whether this result can be explained by divergence in policy variables. Using the Maastricht criteria variables as a starting point, they demonstate that there is significant divergence of key policy and stability indicators among the SADC as a whole, but a degree of convergence among a subsample consisting of the member countries of the Common Monetary Area (CMA), Botswana and Mauritius. Key factors proposed to explain the convergence among the SACU countries are similar

domestic economic policies, which may be due to the currency union of four of the five members of the SACU and the relative openness to international trade in the SACU economies. Jenkins and Thomas conclude that the lack of convergence of the economies over time and the significant divergence of policy and stability indicators suggest that Southern Africa is not yet ready for regional monetary integration.

One problem in measuring the impact of adjustment programmes is that we do not know what would happen in the absence of a programme. One method to deal with this is to compare economies with similar structures, problems and history. This is the approach taken by John Weeks and Paul Mosley in Chapter 9, 'Structural adjustment and tradables: a comparative study of Zambia and Zimbabwe', where the experience of Zambia is compared to that of Zimbabwe. They begin their chapter by a discussion of the basis of comparison and the meaning of structural adjustment in the two countries. Subsequently, they analyse policy implementation and effects on relative prices and output. Finally, they summarise lessons learned from adjustment in Zambia and Zimbabwe and discuss the circumstances under which adjustment programmes work efficiently.

The basis of the analysis by Weeks and Mosley is that adjustment in Zambia and Zimbabwe aims at shifting resources from non-tradable to tradeable sectors with the objective of increased GDP growth. According to the authors, achieving sustainable growth is possible only if exports are encouraged and diversified, and particularly so in Zambia where copper accounts for close to 90 per cent of export revenue. The paper starts with an examination of the possible links between the measures taken and the growth objective. In the context of various policy regimes between 1970 and 1994, Weeks and Mosley seek to identify the extent to which relative adjustment occurred and the response of the real economy to these changes.

The outcome of Zambia's and Zimbabwe's adjustment efforts are well known: while the Zambian experience was one of failure, the situation in Zimbabwe looks more hopeful. Weeks and Mosley provide a wealth of information on what actually happened. They conclude that an unstable reform process in Zambia diminished reform credibility, and thus foreign investments, and that the policy failed to improve the relative prices of exportables, partly because of a fall in the world copper price. Zambia also failed to reduce its copper dependency. Concerning the adjustment result in Zimbabwe, they find that, during World Bank reforms, the growth of non-tradables exceeded that of tradables and that there was no significant relation between the development of relative prices and changes in the structure of output. It is suggested that this may be explained by the output of tradables being demand-constrained. Finally, in tradable sectors, they find only a weak relation between productivity growth and growth of labour costs. They argue that this may be the result of a relatively high degree of labour-market flexibility.

The first lesson drawn from the comparison of adjustment and development in Zambia and Zimbabwe is that history matters; whereas Zimbabwe benefited from a relatively good infrastructure, industrial base and agricultural research, a high-wage enclave in Zambia created a rigid labour market. Second, stability and credibility are important, including maintenance of public investments. Finally, the choice of policy instruments may determine social costs of adjustment which may influence the political feasibility of liberalisation. Overall, the paper finds limited merit in the adjustment programmes of the international financial institutions.

In Chapter 10, 'Labour market policies and outcomes in post-independence Zimbabwe: lessons for South Africa', John Knight examines various aspects of the labour market in Zimbabwe since 1980. These include labour relations, wage policies, education and training, employment policies and the problem of absorbing the growing labour force into the economy, including the problems of unemployment and the informal sector. The analysis has two distinct purposes. The first is to understand the labour market in order to support policy-making in Zimbabwe. The second is to compare the labour market issues and policy choices that faced the Zimbabwean government after the achievement of majority rule with those that now face the South African government, and to consider whether there are lessons to be learned both by South Africa and by other countries with highly regulated and inflexible labour markets.

In 1980, the incoming Zimbabwe government adopted an interventionist approach to the labour market with the objective of redistributing income to the African majority while encouraging rapid growth of the economy. Knight finds that this policy has had some harmful, often unanticipated, general equilibrium effects. When, in the late 1980s, the government recognised the deficiencies of the strategy, a more market-oriented approach was introduced with some liberalisation of the labour market. In his analysis Knight makes the most of this policy reversal to assess the sensitivity of labour market outcomes to policies.

Knight emphasises three lessons that South African policy-makers can learn from the Zimbabwean experience. First, he finds that policies to promote human capital accumulation are crucial to secure both efficiency and equity objectives, but he observes that policies must go beyond education to formal training and to informal skill acquisition. Second, market interventions may result in unintended negative effects. As an example, in the Zimbabwean case, attempts to compress wage structure by decrees created misallocation and disincentives. The third lesson drawn concerns the relationship between the government and the trade union movements, and the issue of protecting the poorest group in the society, namely those outside the formal sector. Knight argues that it would be in the interest of the unemployed and underemployed that real wages should not be allowed to rise sharply in the formal sector. In South Africa this restraint may be difficult to achieve by

government intervention, but trade union acceptance of wage restraint would improve the prospects for long-term alleviation of poverty.

Country studies

Since the mid-1980s, structural adjustment programmes have been adopted and implemented at national levels across the SADC countries. Their main objectives are to achieve macroeconomic balance, to improve international competitiveness and to accelerate growth. The reforms have produced some gains but few cases of rapid growth. Marked economic fluctuations have been experienced by the member states heavily dependent on agriculture and mining as a result of cyclical droughts and depressed prices of most mineral products on the world market. The macroeconomic outlook for the SADC region varies from country to country. Of the countries studied in this section of the book, Lesotho, Mozambique and Tanzania have only achieved partial success in some areas, while Botswana and Mauritius have secured a rapid output growth which have placed them in a sound position to confront the future.

In Chapter 11, 'The impact on Botswana's economic prospects of the ending of apartheid', Charles Harvey addresses the question of whether the demise of apartheid has affected and will affect the economic prospects of Botswana. First, he presents a review of the effects of Botswana's relationships with South Africa over the past twenty-five years. Thereafter, with regard to Botswana's future economic prospects, Harvey focuses on several key subjects and arguments concerning expected changes in the country's economic relations with South Africa.

Harvey starts by presenting some basic statistics which show that an era of rapid economic growth in Botswana concluded at about the same time as the end of apartheid. He argues that the key factors behind the declining growth rates were not related to South Africa but to domestic factors, stagnation of diamond revenue and a large depreciation of the Zimbabwe dollar, which reversed the growth of Botswana's non-traditional exports to that country. The overall conclusion of Harvey's analysis is that Botswana's economy was not seriously disadvantaged by the presence of apartheid South Africa. There were real economic costs but also some benefits, while the important factors of trade and investment were very little affected by apartheid. By the same token, the country is unlikely to be seriously affected by the ending of apartheid. Harvey emphasises, however, that the country may gain enormously from an economic recovery in South Africa, assuming that the current free trade regime within the SACU area is maintained and possibly extended to include new member countries. Because of a small domestic market and stagnating traditional exports, Harvey argues that Botswana's economic prospects depend heavily on the growth of non-traditional exports. In this context, he notes the ambivalence of South Africa

towards enlarging the SACU but emphasises that South Africa, accounting for about 80 per cent of the entire GDP of SADC, is by far the most important market of Southern Africa.

In Chapter 12, 'Localization and integration between unequal partners: policy implications for Lesotho', Lennart Petersson examines Lesotho's economic options. A main question is whether the drawbacks of the country's small size can be overcome by increased integration with South Africa. The analysis is performed in the framework of Krugman's core-periphery model, which is presented. Then, in the light of the long-standing factor- and commodity-market integration between Lesotho and South Africa, Petersson analyses Lesotho's industrial and trade development and the country's options in a renegotiated SACU. Thereafter, he discusses and analyses the question of labour mobility and other issues of closer integration between the two countries.

Petersson finds that an inward-focused stategy of promoting small-scale industries to serve the domestic market, introduced after independence in 1966, was unsuccessful and inconsistent with the condition of the customs union. Concerning this union, he finds that Lesotho was placed at a disadvantage by its larger neighbour's trade regime, and that South Africa was not favourably inclined to assist smaller partners in exploiting opportunities to produce for the customs union area. In response, in the late 1970s, a new outward-oriented stategy was implemented, based on Lesotho's relatively low wages in the region, which turned out to be successful. The growth rates of production and employment in the manufacturing sector increased and a significant shift towards new export markets and investors outside Africa took place. Petersson finds, however, that the success was the result of some favourable conditions for Lesotho that may gradually disappear in the post-apartheid era. He concludes that, in the present situation, Lesotho should consider closer integration with South Africa and in the SACU renegotiation opt for measures aimed at improved access to the South African market. In this alternative, an improved transport system between Lesotho and the core areas of South Africa is central for the development.

Concerning labour mobility, Petersson argues that free labour movements between Lesotho and South Africa would reinforce the core-periphery relation between the two economies. It would lead to reduced wage differentials and a more uniform labour standard in the two countries. This would eliminate Lesotho's advantages of cheap labour *vis-à-vis* South Africa, where the relatively high wage levels, due to an inflexible labour market, do not reflect the abundance of unskilled labour. The principal conclusion is, however, that restrictions on labour mobility do not exclude deepened integration in other areas, usually connected with economic unions.

Mauritius is a small island in the Indian Ocean, which in just fifteen years has moved from structural failure to an extraordinary economic success that has transformed the country and fortunes of its 1.1 million people. In Chapter

13, 'Trade liberalisation in Mauritius: efficiency gains and labour market effects', Chris Milner and Geoffrey Reed investigate the relationship between trade policy reform and labour market policies and adjustment in Mauritius. They begin by presenting their analytical framework. In a specific factor approach to four sectors comprising traditional and non-traditional exportables, importables and non-tradables, they attempt to review expected effects of trade liberalisation on the labour market. Then they describe the process of structural adjustment and trade liberalisation and follow with a presentation of the characteristics and policies of the labour market in Mauritius. Finally, Milner and Reed attempt to relate the evidence on employment and real wage adjustment during the period of liberalisation to their analytical framework.

In a long-term perspective, their analysis emphasises the gradual approach of adjustment within the Mauritian economy. Milner and Reed find that after the initial liberalisation period 1983–85 and until 1991, employment increased in all sectors except traditional exportables. It is argued that the main explanation for a growing labour demand is found in increased external demand for non-traditional export products, followed by increased foreign direct investment and technical and managerial progress. In the traditional export sector, technical progress and largely inelastic demand conditions resulted in falling employment. Real wages—which declined during a period of stabilisation, 1979–83, followed by two years of stagnation—increased significantly and fairly uniformly across sectors after the mid-1980s. In spite of a rapid growth of the non-traditional export sector in a development characterised by a disproportionate growth in female employment in clothing and textiles, it continued to be the sector paying the lowest wages.

Milner and Reed conclude, however, that the growth in employment and real wages cannot be attributed to import liberalisation alone, and 'certainly not to pure "market-based" liberalisation'. They argue that the Export Processing Zone (EPZ) scheme introduced in 1970 and other measures to encourage and promote foreign investment oriented towards increased production of non-traditional exports were important as well, and that a policy of macroeconomic stabilisation and exchange rate adjustment in 1979–83 contributed to the successful outcome of the trade liberalisation in 1983–87. They also emphasise the role of a labour market policy, which, through the implicit assurance of stability in the labour market, contributed to increased foreign investment in the EPZ.

Mozambique is well endowed with natural resources, and the country is strategically situated along the east coast of Africa with harbours that can serve several neighbouring nations. Yet, Mozambique is the poorest country in the world, and the economy has been ravaged by colonial exploitation, a long period of war, South African destabilisation and misguided economic policies. In Chapter 14, 'Mozambique: macroeconomic performance and critical development issues', Finn Tarp and Morten Igel Lau review past

policies and outcomes in order to identify some of the more critical macroeconomic problems facing the Mozambican government in the short to medium term. They begin by presenting the macroeconomic and political developments from independence in 1975 to the introduction of a comprehensive market-oriented Economic Rehabilitation Programme (ERP) in 1987. Thereafter, they give an overview of this programme which was meant to counteract the country's disastrous economic situation at that time. Then, Tarp and Lau examine the outcome of the reform efforts and describe the current imbalances. Finally, they present and discuss some critical development issues.

Tarp and Lau find that the structural adjustment programme (ERP) as originally conceived was fairly standard in design, aimed at increased production, particularly in the dominating agricultural sector of the economy, and at reducing financial imbalances. Although there are indications of positive effects on aggregate production and on real income per capita, they conclude that none of the optimistic objectives set out in the programme were achieved and that official figures on growth rates may be overestimated. They argue that the extraordinary increase in agricultural production in the first year of adjustment may to some extent reflect increasing incentives to sell products through official market channels rather than on informal markets. Industrial performance has been poor, and in spite of exchange rate adjustments and high real growth rates of exports, the trade deficit has increased significantly in absolute terms. The public deficit is huge and the country's dependency on foreign aid and credit has increased. Almost all public investments have been financed by foreign capital inflows and, in 1993, the foreign debt was 4.2 times the size of GNP.

In the light of these circumstances, Tarp and Lau conclude that the government will have to address urgent social needs under tight budgetary controls and pressing macroeconomic imbalances. They emphasise that the debt burden and the country's excessive foreign aid dependency make Mozambique vulnerable to external shocks and have to be reduced. Hence, it will be essential for Mozambique to mobilise private and public net savings. At the same time, recovery of production for domestic consumption and exports means that the supply side of the economy needs to be built up, demanding continued investments at a high level. Tarp and Lau conclude that Mozambique will have to make a concerted effort to increase government revenue and private savings through fiscal and financial sector reforms and to improve the allocation of resources.

Since 1986, the Tanzanian economy has been going through a major restructuring phase. The reform programme includes structural reforms in the public and financial sectors, as well as the gradual elimination of exchange rate restrictions on international transactions. While positive economic growth has been restored, attempts to stabilise the economy have not been successful; the external position is not viable and the fiscal gap is large and

growing. One reason for the unsustainable external position is the country's large external debt. In Chapter 15, 'Debt relief and structural adjustment in Tanzania', Anders Danielson examines whether debt relief may assist in stabilising the macroeconomy. After a discussion of how the debt affects adjustment, he goes on to analyse the impact of debt relief on adjustment efforts. Then he analyses the relation between the fiscal gap, inflation and the external debt under a floating exchange rate regime and discusses the case for large-scale debt relief in Tanzania.

Since the ratio of total debt to GDP in Tanzania has been well over 200 per cent for the 1990s, Danielson concludes that Tanzania faces a severe debt burden. In the context of his analytical framework, the Debt Relief Laffer Curve, this means that the ability rather than willingness to service the debt is the binding constraint. The question is, however, whether a case for debt relief exists when incentive effects are also taken into account. Danielson argues that reduced debt service obligations in the future may result in increased investment incentives in Tanzania through expectations of lower future transfers to the public sector. On the other hand, debt relief diminishes the pressure to adjust which may result in falling investments. This leads him to discuss whether some kind of policy conditionality that penalises reluctant governments and provides incentives to take politically unpleasant decisions should accompany debt relief.

Concerning inflation, Danielson concludes that 'net incentives' are influenced by debt relief because the smaller the external component of debt is, the weaker are the governments incentives for fighting inflation. He argues, however, that if the country does not receive funds because it is not performing, this could lead to a situation in which the withholding of funds might jeopardise reforms already accomplished. A 'matching fund' system is suggested where performance with regard to some quantitative benchmark is matched with some donor disbursal rather than having a system of disbursment in full or nothing at all. It is argued that this system would retain incentives for adjusting while releasing the financing constraints. Finally, Danielson finds that, under a floating exchange rate regime, there is in principle no difference between balance of payment support and budget support: the fiscal and forex constraints merge. Since one of the major problems in Tanzania is high inflation, which in turn can be derived from the country's large budget deficits, Danielson concludes that debt relief may prove to be a powerful instrument for attaining macroeconomic stability.

Note

1 Southern Africa is defined as comprising the countries of the Southern African Development Community (SADC) in January 1996: namely Angola, Botswana, Lesotho, Malawi, Mauritius, Mozambique, Namibia, South Africa, Swaziland, Tanzania, Zambia and Zimbabwe.

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Part I

SOUTH AFRICAN TRANSITION

2

THE POST-APARTHEID ECONOMY, AND AFTER?

Mats Lundahl

Since the title of this chapter may appear somewhat ambiguous, it seems necessary to begin with an explanation of the term 'post-apartheid economy and to indicate what I understand by the word 'after' in this context. Essentially, 'post-apartheid economy' will be used to designate an economy in transition from the situation that prevailed during the period of Nationalist government from 1948 to 1994 (or perhaps 1990 is a better end-year) to a situation that is still somewhere in the not-so-well-defined future. Since the beginning of the 1990s, the 'post-apartheid economy' has been one of the hottest discussion topics in South Africa. One way or another all South Africans are concerned with the issues of growth and redistribution. The apartheid era is over and the country finds itself in a period of transition, the post-apartheid period, but to what? Here, 'after' will be defined as the period when, if ever, the government led by the African National Congress (ANC) will have reached its development objectives.

We will begin by sketching the situation that the ANC-led government inherited—a picture of the state in which the economy was left as a result of apartheid. Thereafter, we will provide an account of how the economic programme of the ANC developed from the vague *Freedom Charter* to the *Reconstruction and Development Programme* (RDP) in 1994 and the related *Growth, Employment and Redistribution* strategy in 1996. Finally, we will discuss some of the most important difficulties with the strategy that finally emerged—obstacles that must be overcome if the goals are to be attained, i.e. if the 'after' stage is ever to be reached.

The legacy of apartheid: inequality and inefficiency

The economic legacy of apartheid was twofold: on the one hand income and welfare disparities that were among the largest in the world (Wilson and Ramphele 1989, McGrath 1983, 1990a, 1990b, McGrath and Whiteford 1994, Christopher 1994), and on the other hand an inefficient resource allocation that had severe adverse effects on the growth rate as well (Hutt 1964, Lipton 1985, Lundahl *et al.* 1992, Lundahl 1992, Moll 1990, 1993,

Lewis 1990). This was the result of a long historical process. Even though the term 'apartheid' was new in 1948, when the Nationalist party triumphed in the parliamentary elections, racial discrimination and far-reaching government intervention in the economy were not. In fact, the unequal treatment of Africans and Europeans began with the very advent of the latter in South Africa in 1652 (Lundahl and Ndlela 1980, Lundahl 1982) and, viewed in this light, the detailed legal codification that took place after 1948 (Bunting 1969) constituted the end of a process rather than the beginning of one. Government intervention was not a new phenomenon. In its 'modern' form this dated back to the mineral discoveries during the last third of the nineteenth century and the need to obtain a labour force at the lowest possible cost; and to the emergence of a class of 'poor whites' around the turn of the century, in the wake of deteriorating economic conditions in the countryside in combination with the devastations of the Boer War (Wilson 1975:126–36).

Still, it cannot be denied that the extent of market-distorting regulations grew substantially after 1948. What the Nationalists created was perhaps not the product of the premeditated 'grand plan' noted by scholars like Pierre van den Berghe (1967), Brian Bunting (1969) or Willem de Klerk (1976), but rather a system born in an environment characterised by opposing views, conflicts and compromises, as argued by Deborah Posel (1991). Nevertheless, 'There was clearly some method in the madness of Apartheid' (Posel 1991:5). Posel herself summarises its extent:

> Building on the foundations laid by previous segregationist regimes, the National Party (NP) government built Apartheid into a monstrously labyrinthine system which dominated every facet of life in South Africa. From its election victory in 1948, the NP steadily consolidated its hold on the state, with a greater degree of ideological fervour than any previous ruling party. Long-standing state controls over the African labour market were restructured and greatly intensified. A national system of labour bureaux, introduced in the 1950s to monitor and control African employment, placed increasingly severe constraints on Africans' freedom of movement and occupational choice. The Population Registration Act (1950), Group Areas Act (1953), Bantu Education Act (1953), Reservation of Separate Amenities Act (1953), and others laid the groundwork for a more rigid and thoroughgoing system of racial domination than had existed to date. Buttressed by a large and powerful arsenal of security laws, the Nationalists also mounted an unprecedented assault on their political enemies. By the early 1960s organised black opposition had been smashed, and would take over a decade to recover. The 1960s then saw the launch of an ambitious and ruthless programme of social engineering, which stripped the majority of

> Africans of their South African citizenship, and forcibly removed over three and a half million from allegedly 'white' areas of the country to putative ethnic 'homelands'.
>
> (Posel 1991:1)

The apartheid system increased the degree of distortion in the labour market. Wage rates differed between racial groups performing the same tasks, non-whites were crowded out of skilled and semi-skilled occupations and the homelands system made it impossible for the market for unskilled labour to clear (Porter 1978, Lundahl 1982). Finally, the very creation of the apartheid bureaucracy imposed new costs on the economy, both directly and in the form of rent-seeking by the bureaucrats:

> There are few countries that can compare with South Africa in this regard. By 1985 the political system had given birth to 13 Houses of Parliament or Legislative Assemblies, as well as a President s Council with quasi-legislative functions. Occupying seats in these 14 bodies were 1270 members. Each of these legislative organs has executive structures, which by 1986 had spawned 151 departments. These included 18 Departments of Health and Welfare; 14 Departments of Education; 14 Departments of Finance & Budget, and Agriculture and Forestry; 13 Departments of Urban Affairs or Local Government; 12 Departments of Works and Housing; 9 Departments of Economic Affairs or Trade and Industry; 5 Departments of Foreign Affairs, Transport, Post & Telegraphs, Labour & Manpower, Law & Order, Defence or National Security; 3 Departments of Justice, and 1 Department of Environmental Affairs & Tourism. Finally, these Departments were responsible to 11 Presidents, Prime Ministers or Chief Ministers in South Africa.
>
> Such a network is not cheap to run, not least because it provides security of income and privileges for those who work in it. As time went by, its incumbents developed a powerful interest in keeping the whole system going, whatever ideological goals were being pursued.
>
> (van Zyl Slabbert 1992:20; cf Lundahl 1989: appendix)

Dirigisme was by no means new in Apartheid South Africa, nor was it limited to the labour market. The land market had been formally regulated since the beginning of the century. The 1913 Natives Land Act and the 1936 Native Trust and Land Act limited dramatically the land area at the disposal of the African majority, confining around 70 per cent of the population to about 14 per cent of the land area, and by no means to the best soils (Christopher 1994:32–35, Mbongwa *et al.* 1996). White farmers received considerable

financial subsidies from the government, amounting at times to almost one-fifth of their total income. State marketing boards intervened in the distribution of agricultural produce from producer to consumer (close to 90 per cent in the late 1960s) operating various price stabilisation schemes in the process (Nattrass 1981:119–231).

The industrial sector was affected as well. Beginning in 1928, a number of state-owned corporations were created in strategic areas of manufacturing, such as ISCOR (steel), SASOL (fuel), FOSCOR (phosphate) and ARMSCOR (arms), and the state also took on a direct producer responsibility in such areas as transportation and electricity (Hobart Houghton 1976:203–08, Reekie 1993). These enterprises, which after the Nationalist takeover of government in 1948 increasingly aimed at self-sufficiency in the face of a hostile international opinion, generally produced inefficiently—at a cost which was higher than the level prevailing in the international market.

This inefficiency was to a large extent the result of tariff protection begun in the 1920s, supplemented by quantitative import restrictions after World War II. From 1925 until the beginning of the 1970s, South Africa's foreign trade policy was essentially an inward-looking one, with concentration on import substitution instead of on export promoting measures (Nattrass 1981:270–71). In addition, for political reasons (keeping Africans out of white areas), in the 1960s a costly attempt was made to partly decentralize the manufacturing sector into areas bordering the homelands (Bell 1973), and in 1982 a Regional Industrial Development Programme was introduced, with special incentives, to promote growth and development in nine so-called 'development regions' *(Report of the Panel of Experts* 1989). Nothing in terms of employment and development came out of the former (Black *et al.* 1991), and with respect to the latter Servaas van der Berg (1991:80) offered the following verdict after a decade of operation: 'a clear case of spending that could be slashed by immediately terminating the incentives for all new applicants and giving notice to existing entrepreneurs that these incentives are to be phased out'.

Murali Iyengar and Richard Porter (1990) have quantified the impact of apartheid on the efficiency of the South African economy with the aid of a five-sector model of a small, open economy. In this model, which is based on data for 1980, apartheid first of all takes the form of an influx control from bantustans (homelands), where unskilled Africans cultivate the land, to the rest of the (white) economy. Second, a certain percentage of all (unskilled) jobs in mining and in the skilled labour categories of manufacturing and other urban jobs is reserved for whites. (The fifth sector is white agriculture, where only unskilled labour is used.) Third, unskilled white workers are guaranteed full employment at a wage rate which exceeds the African unskilled wage by a given percentage.

The model indicates that the removal of all apartheid restrictions would have increased real GDP by 6–9 per cent, depending on how fast Africans

were assumed to be able to move into skilled jobs. African bantustan agriculture would have disappeared altogether and the output of white agriculture would have declined as well, since labour would have moved out of that sector into the high-productivity urban pursuits. Mining output would have displayed a slight increase, with Africans taking over jobs from whites, but the main 'winners' would have been manufacturing and other urban production, once the influx control had been removed for both skilled and unskilled African labour.

To the efficiency losses caused by apartheid we must add those resulting from other government policies. What their quantitative impact may have been is impossible to say, but the experience of South Africa with respect to import substitution resembles that of other developing countries (Little *et al.* 1970, Bhagwati 1978, Michaely *et al.* 1991) strongly:

> poor industrialisation and trade policies in the glorious post-war era nullified an important potential link between industrial exports and economic growth in SA. Economic policy was internally oriented, rather than aimed at success in ballooning world markets, industrial exports received pathetically little attention, and the rand was too strong for industrial exports to be profitable. Hence an array of inefficient direct controls over imports and primary sector wages was needed to keep the balance of payments healthy, while the tariff structure became one of the most complex and intractable in the world. Above all, glorious opportunities for manufacturing export growth and technical progress were frittered away.
>
> (Moll 1993:11)

During the quarter-century following World War II, between 50 and 90 per cent of all imports were made subject to quantitative restrictions (Levy 1992:9). Between 1974 and 1986, the structure of South African protection imposed an implicit export tax averaging 71 per cent on all export goods (34 per cent if gold is excluded). 'Given the strong incentive to produce for the domestic market, many exporters failed to produce and firms concentrated on the domestic market,' summarizes Merle Holden (1992:320). The results in terms of efficiency left plenty to be desired:

> The import-substitution programme was weakened by the lack of export strategy, and the reliance of industry on protection and ever-more advanced machinery imports, hence entrenching the international non-competitiveness of local production, the typical patterns for developing countries with natural resources which have attempted import substitution behind tariff walls. Real manufacturing import levels as percentage of GDP failed to fall, as South Africa moved 'up' the imports scale, requiring increasing inputs

of imported machinery, transport equipment and technology to keep industry going. The 'easy' stage of import substitution in local consumer goods, some durables and simpler machinery was basically complete by the early 1970s, with further scope for import-replacement limited to capital and intermediate goods and high-technology sectors.

(Moll 1989:146–47)

A number of government commissions in the 1970s pointed to the desirability of making the industrial sector less dependent on tariff protection and more internationally competitive. Little came out of this, however. It was decided to keep the protection and only half-hearted, selective measures were implemented with respect to export promotion (McCarthy 1988:22).

Also,

the post-1950 state flops into the incompetent category—witness its efforts to control and steer labour and capital markets which favoured low-productivity sectors (and firms) like agriculture at the expense of modern manufacturing and services, grandiose parastatals aiming at self-sufficiency (led by the troika—Sasol, Iscor and Armscor), poor technology policies, expensive industrial decentralisation failures, ballooning government spending and bureaucracy, and so on.

(Moll 1993:11)

In particular, the policy with respect to the parastatals appears to have been a clear failure:

The empirical evidence suggests that policy-makers in South Africa responded to sanctions by adopting a proactive, inward-looking strategy. The state interventions in developing Sasol, Atlantis Diesel, and Mossgas are extreme examples of the distorting effects of this inward policy on the structure of production, and the extreme costs which have been incurred. The impositions of sanctions in and of themselves would have led to price signals in the economy which would have encouraged import substitution anyway. With the benefit of hindsight it could be argued that state intervention was unnecessary, given the selective applications of sanctions and the inability to enforce them globally. The premium paid by South Africa for the sanctioned imports reflected part of the cost of the import substitution which occurred.

(Holden 1992:321)

Turning to the equality issue, the legacy of apartheid is even clearer. No matter which indicator is used, a completely unequivocal picture emerges, with white living standards far above those of all other races, notably those of the Africans. Thus, in 1980, the per capita income of Asians was around one-fourth of that of whites, that of coloureds one-fifth and that of Africans one-twelfth (van der Berg 1989:37). The Gini coefficient of South Africa for 1978 was the highest among those countries for which data were available: 0.66 (Wilson and Ramphele 1989:18), and the figures reported between 1970 and 1993 consistently lie between 0.65 and 0.71 (Whiteford and McGrath 1994, Whiteford *et al.* 1995:21).[1] In the latter year 47 per cent of all African households found themselves below the poverty line, against a mere 2 per cent of the white households.[2] The African group also accounted for no less than 95 per cent of the shortfall between actual incomes and the level which the absolutely poor households would have had to reach for all households to rise above the poverty line (Whiteford *et al.* 1995:5, 8–9).

Other welfare indicators convey exactly the same impression. Malnutrition is a big problem within the African group—both for children and for adults, in spite of the fact that the country regularly produces enough food to ensure a calorie intake which is more than twice as high as the recommended level (Wilson and Ramphele 1989:100–06). Housing conditions are often appalling, with overcrowding, lack of running water, energy and elementary sanitary facilities being quite common in township areas and homelands (ibid.: 124–34). The incidence of and causes behind mortality and morbidity differ markedly among the various ethnic groups, with whites being best off and Africans worst, diseases related to poverty being far more prevalent among the latter and 'welfare-related' illnesses dominating the picture among the former (ibid.: 106–20). When it comes to education, finally, the Bantu Education Act, 'by far the most important and by far the most deadly in its effects' of all the apartheid laws passed during the first years of Nationalist rule (Huddleston 1956:160), and related legislation made it virtually impossible for Africans to progress further than the primary stage in low-quality schools, and usually not even that, while the vast majority of the whites at least passed through the secondary stage as well and more than one in four (in 1990) had some kind of tertiary education (Spangenberg 1991:18, Wilson and Ramphele 1989:138–49).

After the transition: the goals

When Nelson Mandela left prison as a free man in February 1990, the ANC did not have much of an economic programme to present to the world (Nattrass 1992a:623). The struggle had been mainly political, the leaders had been either in exile or in jail and few advances had been made on the vague and contradictory formulations of economic strategy presented in the *Freedom Charter* (1988), a document which was by then thirty-five years

old. The *Freedom Charter* called for the nationalisation of mines, banks and monopoly industries and for a transfer of land from whites to Africans. At the same time, however, it established the principle of free competition in all sectors and private ownership was by no means ruled out. The vision seems to be that of a mixed economy, with the state playing an important role both as a policy-maker and planner and as a direct producer.

The *Freedom Charter* should be read as a general statement of aspiration rather than as a coherent view of how the economy should be run (Davies 1988:173). However, the lifting of the ban on the ANC in February 1990 and the beginning of negotiations with the Nationalist party made an economic strategy increasingly necessary. As a result, during the next four years an economic programme was born—a programme which was taken over by the government of national unity after the 1994 elections and which, with some changes, remains in place at the time of writing, after the resignation of the Nationalists from government.

The first steps were taken during two workshops held by the ANC and COSATU (Congress of South African Trade Unions) in Harare in 1990. These, however, produced a document (ANC 1990) that was as preliminary, vague and contradictory as ever the *Freedom Charter* (Nattrass 1992a). In this document the state still plays the role of an efficient guardian that will put the economy on a growth path, boost incomes and employment and enable the satisfaction of basic needs. Although the demise of communism in Eastern Europe had created increased confidence in markets as important tools for creating an efficient economy, the market mechanism (according to this document) has to function within an environment created by state-led development planning, and considerable emphasis is still put on nationalisation and collective ownership. Redistribution is seen both as conducive to growth, via a restructuring of demand leading to a creation of mass markets, and as a way of satisfying the basic needs of the population.

During 1990 and 1991 nationalisation was gradually put into the background. As it seems, it did not take Mandela more than a few months after being released from prison to change his mind on the subject (Lundahl *et al.* 1992:338–39). Nationalisation was seen as one of many possible means that could be used to increase efficiency in the economy, if the circumstances justified it. By and large, however, confusion continued to prevail with respect to the eventual general economic course of the ANC. In 1991 and 1992 another shift took place—away from the idea that growth could be generated through a redistribution of income and wealth that would serve to boost the demand of a vast segment of the population to a belief that it would have to be put at the very centre of attention to make redistribution sustainable (Nattrass 1994). The latter year saw the publication of a document that laid down the political guidelines of the ANC (1992) where the mixed economy and the private sector received more attention than hitherto and where, by and large, a spirit of pragmatism prevailed.

At the same time, an academic network, the Macroeconomic Research Group (MERG), sympathetic to the political goals of the ANC, was carrying out a series of investigations of various aspects of the South African economy. These investigations—after a long political process—formed the basis for a report which covered all aspects of the economy and which was intended as an input in the policy-making of the ANC (MERG 1993). The document was hardly coherent, which was no surprise, given the wide-ranging differences in ideological outlook of those involved. Moreover, it displayed some important analytical defects, for example in the discussion of productivity increases, their possible dependence on imported inputs and the possibility that this could lead to a balance-of-payments crisis, as well as in the argumentation in favour of a minimum wage, where it was not taken into account that minimum wages may have negative effects on employment and investment (Nattrass 1994). Still, the MERG document had much in common with what eventually became the official economic strategy of the ANC: the Reconstruction and Development Programme (RDP) (ANC 1994).

Fundamentally, the RDP is a basic needs programme. The main targets are: ten years of compulsory education for everybody, at least one million low-cost houses in the next five years, provision of electricity for an additional 2.5 million households by the year 2000, clean water and adequate sanitation for everybody, improved and affordable health, particularly preventive and primary health care for all, and a substantial redistribution of land to the landless in rural areas. Public investments in inexpensive housing and infrastructure in backward areas are envisaged to stimulate economic growth and create employment.

The foundation upon which the satisfaction of the basic needs rests is economic growth. A strategy for industry and trade which includes, among other things, liberalisation of imports, increased competition, support to small and medium-sized firms as well as technological development is envisaged to enhance the productivity and competitiveness of the South African economy with the aid of an improved stock of human capital, achieved mainly through education. It is foreseen that this policy will be conducive to increased private investment.

How the RDP is to be financed is not completely clear, but it is stressed that in the longer run the programme must be made to fit into the regular budget, i.e. it entails a reallocation rather than an expansion of government expenditure. Tax increases that will distort the resource allocation must be avoided and an effort will be made to make tax collection more efficient. Populist inflationary methods of finance are to be avoided.

The RDP ran into trouble from the very beginning. Its implementation was scheduled to take place through a special RDP fund, financed fundamentally by a reallocation of expenditure from the regular government departments. For 1994–95, 2.5 billion rand were budgeted, to be increased gradually to 12.5 billion in 1998–99. However, due to a lack of spending

capacity, especially at the local level, where the administrative machinery was not yet in place, 1.7 billion rand had to be carried over to 1995–96 and it was calculated that at least 20 per cent of the RDP budget for the following fiscal year would be spent in 1996–97, at the earliest (*Business Day* 1995).

Far more serious, however, was the discovery that the RDP was not feasible in terms of investment (Ministry in the Office of the President 1996). A quantification of the infrastructure requirements in the fields of energy, water, transport, communications, housing, land reform, health, education and security revealed that if the RDP targets were to be met over the five-year period envisaged, public investment in infrastructure would have to grow by 21 per cent per annum—a figure above any historical precedent in the country—and the local authorities (mainly the municipalities) would have to increase their funding of infrastructure by no less than 39 per cent on average every year. A (likely) scenario where real GDP grows at 3 per cent, the government budget deficit is reduced by 0.5 percentage points every year and private investment increases by slightly more than 7 per cent would allow for a yearly growth of public investment in the order of 7.5 per cent. Meeting the RDP targets over a period of five years would clearly be impossible.

Plans for a new National Strategy for Growth and Development were announced (Naidoo 1995:3) and work was begun on it (Inter-Governmental Forum 1995). Before these plans could be presented to parliament, however, the RDP office was overtaken by events. In February 1996, the South African Foundation, a lobby for big business, presented its own growth strategy (South African Foundation 1996) calling for rapid and concerted action in five areas: legislation, macroeconomic policy, government, markets and foreign trade and investment. The approach is largely a supply-side one. In particular, investor confidence has to be boosted through a number of measures if real GDP is to grow by 5–6 per cent per annum and employment by 3.5–4 per cent. Firm action is needed against crime, the budget deficit has to come down quickly through expenditure reduction, state-owned enterprises must be privatised as soon as possible, the labour market has to be rendered more flexible and regulation must be avoided. Exports should be promoted through the labour market policy, through an exchange rate that makes South Africa competitive internationally and through tax rates that do not differ from those prevailing internationally. Redistribution in favour of the poor, according to this view, comes through increased employment and the increased social spending that is made possible by increasing government revenue in an expanding economy.

The trade unions did not take long to respond with a document stressing job creation and social equity, favouring a much more interventionist policy with concentration on the demand side (*Social Equity and Job Creation* 1996). The South African Foundation document was seen as a way of dividing society by strengthening the already rich and letting the poor pay for it. The alternative approach suggested by the unions rests on six 'pillars':

1 Jobs can be created through public works, housing programmes, expansion of domestic demand, productivity-enhancing training measures, land reform, etc.
2 Social spending on the poor must increase, the rich (including the corporations) must be taxed harder and the value added tax must be lowered on goods consumed by poor people.
3 Anti-trust legislation must be introduced to break up concentration and the monopoly on major economic decision-making.
4 Workers' rights must be promoted.
5 Industrial democracy must be established.
6 Equality and development must be promoted internationally.

The labour movement argues in favour of a slower reduction of the budget deficit so as to avoid deflationary pressure and concomitant reduction of growth and employment creation. Instead, the government should pursue a moderately expansive fiscal policy with expenditure concentrated on redistribution and infrastructure. High wages serve to keep demand up, and training the workers makes them more productive which, in turn, serves to increase output as well, so that inflationary pressure can be kept under control. Once growth is under way private investment will also respond favourably.[3]

In the meantime, the RDP office had been closed and the Department of Finance had taken the lead in the elaboration of a new macroeconomic strategy. This strategy was ready in June 1996. The long-run vision it projects is that:

As South Africa moves towards the next century, we seek:
a competitive fast-growing economy which creates sufficient jobs for all work-seekers;
a redistribution of income and opportunities in favour of the poor;
a society in which sound health, education and other services are available to all;
and
an environment in which homes are secure and places of work are productive.

(Department of Finance 1996:1)

The government strategy looks a lot more like the South African Foundation approach than like the one suggested by the trade unions (Department of Finance 1996). The emphasis is on growth, which is considered as a prerequisite for both employment and redistribution. Unless the growth rate can be increased from 3 to 6 per cent per annum at the turn of the century, the unemployment rate will increase substantially, and real

aggregate spending on social and community services will grow at a pace barely above that of the population. On the other hand, it is argued, the implementation of the new strategy will make implementation of the RDP 'in all its facets' possible and 400,000 new jobs will be created per annum by the year 2000 (ibid.: 1).

The *Growth, Employment and Redistribution* strategy is for the medium term, as defined up to the year 2000. The supply-side orientation is as evident there as in the *Growth for All document*. Such signals with respect to government behaviour that are believed to be received favourably by investors are sent to the private sector. Thus, the fiscal deficit is to be brought down to 4 per cent of GDP during 1997–98, instead of to the 4.5 per cent envisaged in 1994, to help keep inflation under control. Monetary policy will remain restrictive. Public assets will be 'restructured', i.e. state-owned enterprises will be privatised. In the labour market, a 'structured flexibility within the collective bargaining system', i.e. mainly increased wage flexibility, is aimed for. These are more or less the measures that the business sector has been asking for. The package also attempts to stimulate supply directly, by tax incentives and support to small and medium-scale enterprises. At the same time, however, the speed of tariff reduction will be increased, the real exchange rate will be maintained at a level that ensures international competitiveness and competition policy will be strengthened.

To appease the wage earners, the document points to 'a social agreement to facilitate wage and price moderation, underpin accelerated investment and employment and enhance public service delivery' (Department of Finance 1996:5), i.e. in exchange for wage restraint employees should receive guarantees that firms will keep price increases down and increase investment so as to create more jobs, and the government should accelerate spending that increases 'its contribution to social and community living standards' while providing 'a combination of real exchange rate management and tax incentives aimed at encouraging private sector investment' (Department of Finance 1996:20).

The 'integrated' scenario sketched in the government macroeconomic strategy envisages gradually increased GDP growth, as a result of increased domestic and foreign private investment, until a rate of 6.1 per cent is reached in 2000, 'increased formal employment until the 400,000 new jobs per annum target is met the same year, coupled with a yearly real wage growth of 1 per cent growth in the private sector and less in the public sector', real non-gold export growth above 8 per cent on average, a slight increase in gross private savings and a substantial reduction in government dissaving. Altogether this would allow for a fourfold increase of RDP-related spending as compared to the scenario where the present low-growth policy continues.

Pausing for a moment to sum up: on a general level the new economy envisaged (or at least hoped for) by the ANC in the long run is one with a growth of real GDP per capita which is high enough to allow for a substantial

redistribution in favour of the poor majority both via the creation of employment and via the expenditure side of the government budget. This economy should be an open one, allowing for a free flow of both goods and factors across the national border. Exports and foreign direct investment are to play a central role when it comes to generating growth, in the setting of a mixed economy dominated by private enterprise. Sound government finances, with expenditures under control and a balanced budget, are projected.

The transition[4]

The new macroeconomic strategy of the South African government may not be easy to implement. On the most general level, the strategy is based on an econometric model (actually a model taken from the Reserve Bank and devised as a model for monetary policy) and, like all models, the answers it provides to policy questions are simply an outcome of what has been put into it. It may or may not inform the debate. In the worst case, reality may be completely different, something which is important to keep in mind in a country where there are almost as many macroeconometric models as there are economists. It may be very imprudent to base a macroeconomic strategy on one particular model in this situation.

The strategy document puts growth ahead of employment and redistribution, acknowledging that unless the economy grows, no employment will be created and there will be nothing to redistribute to the poor. However, it is precisely on the growth side that we find problems with the strategy. The growth-generating forces—investment and exports—are not under the control of the government, and government stabilisation policy could easily come into conflict with the growth objective. It is also doubtful whether the strategy will manage to create employment to the extent set out in the document and whether employment will have much effect on poverty.

As is well known, the determinants of investment are difficult to model, and the strategy document of the South African government does not constitute any exception to this rule. In fact, investment does not appear to be based on any explicit investment function but simply on extrapolation of past trends and guesses based on these, both for the private and for the public sector. Public investment in infrastructure is assumed to 'crowd in' private investment to some extent, but more important when it comes to stimulating private investment would appear to be such 'positive' signals as determined and coherent macroeconomic policy-making, not least increased fiscal discipline, and continued liberalisation of the economy. The latter could be achieved through privatisation of government-owned enterprises and, on the trade side, through continued and accelerated tariff reduction and the maintenance of an exchange rate which does not overvalue the rand and undermine international competitiveness. A tightening of the fiscal stance,

however, also tends to reduce demand and with that the size of the markets for goods and services in which at least those who produce for domestic consumption will have to operate. Unfortunately, whether prospective domestic and international investors pay enough attention to such signals as the size of the budget deficit to guide them in determining their actions or continue their wait-and-see attitude until they see actual sustained growth in the economy is a completely empirical matter and—to make matters even more complicated—one where the South African past has little guidance to offer. History will not absolve the policy-makers on this point.

The new strategy foresees that gross domestic investment will increase from 20 per cent of GDP to almost 26 per cent in the year 2000. For this, it is stated, a capital inflow of close to 4 per cent of GDP is required (Department of Finance 1996:6). Again, however, this is a variable outside government control. The crucial decisions are made abroad, in the light of how the South African economy performs in a comparative perspective.

The new macroeconomic strategy envisages a growth in non-gold exports of over 8 per cent per annum on average (Department of Finance 1996:7). This is seen as one of the most important growth-generating forces. It is, however, far from clear that the export objective will be attained. Export forecasts are almost as tricky as forecasts of investment in macroeconomic modelling, for the simple reason that small, open economies, like the South African one, by definition have no control over international markets. Thus, exports are an inherently exogenous variable in such models. It is difficult to know to what extent this variable can be affected by conscious policy measures. Since South Africa accepted the GATT (WTO) principles in 1993, demand-side measures like direct producer subsidies, which worked by raising producer prices to compensate for the lack of competitiveness, are ruled out and what remains is, on the one hand, general economic policy measures and, on the other, supply-side interventions to stimulate exports by increasing competitiveness.

The macroeconomic framework to support exports is already in place. During the first half of 1996, the rand depreciated to the point where it was no longer overvalued, as was the case at the end of 1995, and perhaps even beyond that point, and the tight monetary policy has prevented a rapid real appreciation of the currency through increases in the domestic price level. In addition, as part of the GATT agreement, South Africa has undertaken to scrap quantitative import restrictions and reduce and unify tariffs, an undertaking that the country has fulfilled even faster than scheduled, and 'compensating' tariff reductions have been introduced in the government strategy to nullify the windfall gain made by exporters as a result of the rand depreciation—a gain which could otherwise erode the effort to reduce costs. This is fine, as far as it goes, but South Africa must also develop a comparative advantage in some manufacturing branches. This is not an easy task in an economy where the price system has been badly distorted in the past, to the

point where it provided more or less completely useless information to producers about their inherent international strength or weakness.

Here is where the supply-side export promotion measures come into the picture. These measures include support in export marketing and schemes directed specifically at small and medium-sized firms, e.g. by facilitating credits, either generally, or specifically to enable them to meet export orders directly, and by subsidising the employment of consultants for marketing or technology development. New measures include an accelerated depreciation scheme and a tax holiday for a maximum of six years.

To what extent supply-side measures will be effective is, however, very difficult to guess. Critics argue that measures have so far supported mainly larger firms and that there are hardly any schemes running which can be effectively approached by small businessmen.[5] Moreover, the incentives tend to pull in too many directions simultaneously, and it is not at all certain, for example, that tax holiday criteria with respect to location, labour intensity and 'priority industries' will stimulate exports. Once criteria get too vague or too contradictory the risk arises that everything, and hence nothing in particular, is supported, and this may be even more true for the export promotion programme as a whole than for the individual sub-programme. The money may be spread across too wide a spectrum of activities and too many and too diverging criteria may be used. Basically, the supply-side exercise is an exercise in finding areas where South Africa may have a comparative advantage, but then some concentration is needed. Picking winners *ex ante* is never easy, and supporting too wide a range of activities will not do the trick. Hence, we should not expect too many results to come out of the supply-side incentives.

The growth path envisaged by the *Growth, Employment and Redistribution* document could also be undermined by stabilisation efforts. The way stabilisation policy has been carried out in the past points to a possible trade-off between growth and price stability. Monetary policy has been very tight during the past few years. This has, however, led to a situation where both nominal and real interest rates are so high that it can be argued that they tend to choke growth. It is not easy for companies to pay nominal rates of, say, 25 per cent and remain competitive. Naturally, this has in the past put a heavy burden on companies to finance their investment out of their own profits and hence has also acted as a deterrent to growth. In the new strategy, increased tariff reductions are employed to put competitive pressure on South African companies and it is possible that this will contribute to containing inflation, but if this is not the case, restrictive monetary policy will remain the main instrument to combat inflation, whatever effects this may have on growth.

The trade-off could come into play in different ways. One such way is through the skilled labour market. South Africa suffers from a severe lack of skilled labour. This constraint was one of the factors that put a brake on growth from about the mid-1970s (Lundahl *et al.* 1992:312–17), and once

growth gets going, this constraint may begin to operate again. The market for skilled labour will become increasingly tight and skilled wages will begin to increase which, in turn, may have 'contamination' effects on other parts of the labour market to the extent that agreements between employers and employees stipulate a certain relation between skilled wages and other wages. Thus, the wage-price spiral could be set in motion, the Reserve Bank would tighten monetary policy, the Department of Finance would have to follow suit and policy-induced recessionary tendencies would result.

Growth may also lead to a tightening of the monetary policy via the balance of payments. When GDP grows, in the South African case this results in increased imports. To the extent that the latter consist of producer goods or intermediate products used by the export industry, or import-competing branches, the deficit on the current account will only be temporary. However, since increased incomes tend to boost imports of consumer goods and inputs used by sectors producing non-tradables as well, the likelihood is high that monetary policy will be used to defend the rand to prevent inflationary pressures coming from the import side. Hence growth may be aborted before it becomes sustained.

Fiscal policy may choke growth as well. One of the pillars of the *Growth, Employment and Redistribution* strategy is its emphasis on prudent, restrictive fiscal policy and a rapid reduction of the government budget deficit. This means that expenditures will have to be cut back quickly. Ideally, such cut-backs should be undertaken where they do least damage from the efficiency point of view. However, today South Africa is not in the position where this ideal can be met. The necessary administrative structures are not in place and, in addition, each department will tend to think that cuts should primarily take place elsewhere. In this situation, the likely outcome is that expenditure cuts will take place across the board, at more or less the same rate everywhere, and that productive public spending will be hurt as much as less productive.

The desire to cut the budget collides furthermore with the use of tax holidays to stimulate investment. A tight fiscal discipline will be difficult to maintain if the tax holiday policy becomes successful in the sense that many companies respond to it, since then fiscal revenue will be adversely affected. In fact, a tax arbitrage will be created which lends itself to all kinds of abuse. Thus it is, for example, difficult to avoid a situation where a company, once the tax holiday expires, creates subsidiaries that can be used *de facto* to prolong the period during which the company may take advantage of the incentives. This outcome lowers government revenue and hence, provided that the budget deficit is not allowed to grow, also government expenditure, and may thus jeopardize both growth and redistribution. The tax holiday may even delay a general lowering of the company tax rate, which, from the growth point of view, might perhaps be a better idea.

Another critical assumption is that flexibility in the labour market will generate employment and worker incomes and hence be an important weapon

for combating poverty. The background to the emphasis on flexibility is to be found in a feeling that the recent growth increase in the economy has not resulted in employment creation to a corresponding extent,[6] and without increased labour absorption it will not be possible to provide the projected 400,000 new jobs per annum in 2000. Flexibility could assume different forms, but presumably the most important one has to do with wages. Different sectors, regions and firms need different wage levels to be competitive. As could be expected, however, the unions are not in favour of flexibility, fearing that it will be expressed mainly in layoffs and reduced wages, so that as a condition for endorsing flexibility they will require something else in return.

This problem has been addressed by a presidential commission on labour market policy *(Restructuring the South African Labour Market* 1996). The solution advocated by this commission, and endorsed in the government strategy document as well, is one of a tripartite social accord involving employers, unions and government. The idea is that each of these three parties should put forward their own specific interest and opinions at the negotiating table; the unions would stress wages, the employers prices and investments and the government those expenditures on social programmes and infrastructure that affect the welfare of the workers and enhance their productivity. Lower and more varied wages would be traded against price restraint, job-creating investment and different welfare measures. In this way, firms would gain competitiveness, workers a higher standard of living and government the freedom to embark on a more expansive course of economic policy without having to resort to tight monetary and fiscal policies to combat inflation.

Whether a social accord will ever be signed, however, remains doubtful, to say the least. This part of the strategy has a strong Utopian flavour to it. The situation resembles the classical Prisoners' Dilemma. All the players could be better off by cooperating, but the incentives to break the accord, or never enter into it, are strong as far as both business and labour are concerned. Employers will face great difficulties when they come to constitute themselves as a single, concerted player. In a market economy decisions with respect to prices and investment are made by individual firms and not on a central or regional level. Hence, a moral hazard problem will arise. Without adequate policing arrangements firms cannot be forced to maintain prices and make investments that are conducive to employment, and such policing arrangements do not exist in post-apartheid South Africa. That labour knows this will, in turn, foster a negative attitude in the unions. As long as the workers do not trust the employers to make credible commitments, they will not be prepared to show wage restraint.

Perhaps too much attention has already been paid to the question of how to bring about a social accord. It may not even be necessary. After the fall of apartheid, South Africa has rejoined the international community which,

in turn, means that we should expect the factor price equalisation theorem to apply. With the gradual reduction of protection South African wages will increasingly resemble those prevailing elsewhere, i.e. they will tend to vary among sectors, and there may be little that domestic forces can do to change this tendency. There is, however, also considerable uncertainty with respect to what increased wage flexibility may actually achieve in terms of employment and income creation. Existing estimates of long-run employment elasticities are in the order of-0.7, i.e. a 10 per cent wage reduction should lead to a 7 per cent employment increase *(Restructuring the South African Labour Market* 1996:51–52). However, the methodology employed has been severely criticised in a recent ILO study (Standing *et al.* 1996) which also argues that growth in the recent past has been more employment-creating than conventional wisdom would lead us to believe. Actual wage flexibility could be higher than the available estimates indicate, not least in the informal labour market.

To what extent increased employment will succeed in alleviating poverty is also uncertain (Bhorat and Leibbrandt forthcoming). Income inequalities in South Africa are largely wage-driven. The overall contribution of wage inequality to overall income inequality in South Africa is 73.5 per cent, but almost half the wage inequality is accounted for by the 34 per cent of households with no wage income whatsoever, and 76 per cent of those unemployed who belong to a household with no wage earner are poor. The latter figure declines, but not too drastically, when the number of wage earners in the family increases to one and two (53 and 57 per cent, respectively; 56 and 66 for Africans, against 78; and 73 and 82, against 84, for rural households).[7] Thus, although there is no doubt that employment creation must be a central part of any development strategy in South Africa, mere access to employment does not automatically ensure poverty alleviation. Whether the latter can be achieved also depends on the size of the income generated. In addition, direct support measures to the poorest are necessary, especially in rural areas where employment is scarce *and* wage levels are particularly low.

Conclusions

Economic policy-making in contemporary South Africa is not an enviable task. The government is under pressure from many quarters to deliver. The political promises made during the 1994 election campaign must be made good at some, not too distant, point in time. Of course, everybody cannot drive a Mercedes or have a swimming pool in the backyard, even in the long run, but a reasonable amount of employment must be created; and housing, education, health care and social programmes must be provided to a reasonable extent. Otherwise, by definition, the transition to the 'after post-apartheid' stage will never be completed. The South African economy will remain a 'transitional' one for ever.

As we have demonstrated in the present chapter, there is no automatic mechanism that guarantees that the government will be able to honour its economic promises. Apartheid left a dismal heritage—one which it will be costly to get rid of. Even though, as we have pointed out, there are considerable efficiency gains to be had from moving away from the distorted situation that characterised the apartheid period, building the institutions, for example in the educational field, that make this possible will certainly require resources, but resources can only come out of economic growth. Now the ANC-led government has launched a macroeconomic strategy which is intended to make possible the realisation of the *Reconstruction and Development Programme*. This strategy points both to a commitment to action and to a willingness to seek new ways when the old ones prove insufficient. Whether the new ways are the best ones available in the sense that they will deliver the desired results is, however, a completely different matter. To generate growth in South Africa is difficult, given that the government lacks control over some of the most critical components in the process. In order to succeed, the policy-makers may need some luck too.

Notes

1 It should be noted that the causes behind these figures differ slightly over time. It remains clear, however, that at all times inequalities between the races played a major role.
2 'At the beginning of 1994 the poverty line for an urban household with two adults and three children was approximately R840 per month, and R740 for a rural household with two adults and three children' (Whiteford *et al.* 1995:2).
3 In addition, there were documents by Business South Africa (1996), the National African Federated Chamber of Commerce and Industry (1996) and the civic organisations (South African National Civic Organisation *et al.* 1996). Most interest has, however, been concentrated on the views of established business interests and the unions, respectively.
4 This section has benefited substantially from conversations with Anthony Black, Murray Leibbrandt and Nicoli Nattrass, University of Cape Town; Keith Lockwood, South African Chamber of Business and Lieb Loots, University of Western Cape in July 1996. Nattrass (1996) and (forthcoming: chapter 11) compares the government strategy with those proposed by the South African Foundation and the trade unions.
5 Interviews with Keith Lockwood, South African Chamber of Business, Johannesburg, 12 July 1996 and Anthony Black, University of Cape Town, Cape Town, 17 July 1996.
6 The output elasticity was 0.42, i.e. for every 1 per cent increase of output, employment increased by 0.42 per cent (Bhorat *et al.* 1995:3).
7 The higher figures for two-wage earner households are presumably due to the fact that no attempt was made to control for household size.

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3

CHANGING PATTERNS OF INEQUALITY IN THE SOUTH AFRICAN LABOUR MARKET

Nicoli Nattrass and Jeremy Seekings

Introduction

South Africa is infamous for its extreme inequality. Under apartheid, inequality was rooted in labour markets structured by a battery of repressive and discriminatory measures. Land dispossession forced black people into the labour market, but influx control restricted their access to urban employment, channelling many into low-wage jobs on the farms and mines. Better paid, skilled employment was reserved for white people. Black workers were excluded from industrial collective bargaining institutions.

Under this apartheid institutional framework, the market acted 'like a malevolent invisible hand, working to the advantage of white workers and capitalists, and widening the wage differentials between white and black workers' (McGrath 1990:92). The ratio of per capita incomes of white to black people rose from 10.6:1 in 1946–47 to 15:1 in 1970 (ibid.: 94). White people comprised just 20 per cent of the population but earned about 70 per cent of the national income until the 1970s (McGrath and Whiteford 1994:3).

By the mid-1970s, clear tensions had emerged between apartheid labour market regulations and the requirements for rapid, peaceful economic expansion. Job reservation was steadily abandoned, and the system of labour controls frayed at the edges (Nattrass 1990). The rise of the militant independent black trade union movement, social unrest and the economic slowdown forced a major restructuring of the institutional framework.

During the 1980s, black workers were incorporated into the system of industrial collective bargaining and influx control was lifted in 1986. The transition to democracy in 1994 marked the formal end of apartheid. The sectoral system of collective bargaining and minimum wage regulation has subsequently been strengthened by the 1995 Labour Relations Act (LRA) (which was finally implemented in November 1996). This has strengthened and extended to all workers the rights formerly restricted to white workers.

As the apartheid system unravelled, the black share of national income rose—from 20 per cent in 1970, to 25 per cent in 1980 and to almost 30 per cent in 1993 (McGrath and Whiteford 1994:33, Whiteford *et al.* 1995:15). Racial discrimination in wages likewise declined dramatically (as indicated below). Yet the overall inter-household distribution of income in South Africa has not changed. Extreme inequality is still rooted in the labour market, but it is now driven to a large extent by rising unemployment. The main faultlines running through the post-apartheid labour market are between:

1   a very small elite of internationally competitive skilled, professional and managerial employees (and a stratum of less competitive middle management);
2   an enclave of regulated and protected semi-skilled and unskilled employment;
3   a growing twilight zone of unregulated casual, informal, sub-contracted, and out-sourced employment;
4   and the unemployed.

The labour market policy reforms of the late apartheid and post-apartheid periods serve primarily to protect the second of these groups. By providing incentives for employers to develop more capital-intensive production or to shift to less regulated and secure forms of employment, policy reforms may serve to entrench this second group as a shrinking, if deracialised, labour aristocracy.

Moreover, South African labour markets are not isolated from changes in labour markets globally. As South Africa becomes more open to world markets, global forces exert pressures to widen the wage distribution. Policies that resist rather than accommodate these trends could result in even higher levels of unemployment and unregulated, insecure employment. Perversely, perhaps, the reduction of poverty and income inequality in an open labour surplus economy might require increased inequality in the distribution of wages—so long as this is brought about through the growth of new low-wage jobs rather than through a fall in existing wages.

The burden of the past: inequality and unemployment

Given the duration of apartheid, it is not surprising that race remains an important dimension of labour market disadvantage in South Africa. Average black wages are just over a third of average white wages.[1] Despite significant shifts in the racial composition of employment over the past forty years (Crankshaw 1995), there is still a close correlation between race and occupation. Black South Africans are disproportionately concentrated in unskilled and semi-skilled occupations, whereas white South Africans dominate the skilled and managerial occupations.[2]

Racial discrimination, however, accounts for a declining share of racial disadvantage. McGrath calculated that in 1976, black workers were paid 43 per cent less than white workers in the same jobs on account of their race alone; this had dropped to 22 per cent by 1985 (McGrath 1990:102). A recent study that takes job discrimination as well as wage discrimination into account indicates that total discrimination fell from 20 per cent of the black wage in 1980 to 12 per cent in 1993 (Moll 1995b).[3]

The decline in discrimination, together with upward mobility through the occupational structure, has resulted in rising wages for a significant number of black workers. But the incomes of black people continue to be constrained by severe systemic disadvantage. As the recent ILO review of the South African labour market puts it:

> labour market disadvantage for Africans and for other non-white groups has remained a cumulative process, beginning with schooling, being intensified through training and job-allocation systems, and further intensified by patterns and practices of job grading and occupational mobility within enterprises. It has been overlaid by their relative concentration in precarious work statuses and in small-scale, informal units. The disadvantage is so structural and systemic that it would be unrealistic to expect much progress unless all elements in the process were addressed in a coherent and sustained manner
> (Standing *et al.* 1996:382)

Systemic disadvantage has resulted in the burden of rising unemployment falling almost entirely on black South Africans. The combination of higher wages (for some black workers) and rising unemployment has resulted in growing inequality within the black population. Whiteford *et al.* (1995:21) suggest that the income distribution amongst black South Africans is more unequal than the overall distribution in most middle-income economies.

Race is not the only important dimension of labour market disadvantage. Gender remains a major, and often inadequately acknowledged, factor. One study found that white women earn between 98 and 100 per cent of white men's salaries (cited in Standing *et al.* 1996:395). Indian women earn 84 per cent of Indian men's salaries. The corresponding figures for coloured and African women are 73 and 70 per cent respectively. The experience of unemployment is also gendered (see below). By any definition, women have higher rates of unemployment than men (ibid.: 111).

Whereas until the 1970s inequality was determined primarily by the gap between white and black incomes, inequality in the 1990s appears to be driven to a large extent by the wage income gap between the employed and unemployed. Bhorat *et al.* (1995) using Southern African Labour and Development Research Unit (SALDRU) data have shown that wage income inequality contributes 73.5 per cent to total inequality. Of this wage

inequality, 46 per cent is because 34 per cent of South African households have no access to wage income whatsoever, while the remaining 54 per cent is due to inequality within wage-earning households (Bhorat and Leibbrandt 1996:154). The International Labour Organisation (ILO) review, however, believes that the SALDRU survey under-sampled poor households and farmworkers (Standing et al. 1996:226–40). If this is the case, then Bhorat *et al.*'s (1995) Gini decomposition analysis would overstate the effect of unemployment on poverty. Unfortunately the ILO review does not estimate how much under-sampling took place, so no meaningful adjustments can be made to existing work on the relationship between inequality and unemployment.

Analyses of the significance of unemployment are beset by problems of conceptualisation and measurement. Estimates of South Africa's unemployment rate have, for some time now, varied enormously depending on the definition and data used in the calculations (Archer *et al.* 1990). The unemployment rate is the number of unemployed people expressed as a percentage of the labour force.[4] The measured rate thus depends on how the labour force is estimated, what counts as work and on how unemployment is defined.

Most reported unemployment refers to the standard recommended by the ILO: persons above a specified age who during the reference period are without work, currently available for work and seeking work. This makes unemployment hard to define partly because: 'it combines a *condition* (being without employment), a *need* (for work or for income), an *attitude* (desire for paid work), a *capacity* (ability to accept and opportunity, or at least availability to do so), and an *activity* (searching for work)' (Standing *et al.* 1996:99).

The Central Statistical Services (CSS) uses the following definition of unemployment in South Africa: people over 15 who:

1 were not in paid or self-employment;
2 were available for paid employment or self-employment during the seven days preceding the interview;
3 took specific steps during the four weeks preceding the interview to find paid employment or self-employment;
4 had the desire to take up employment or self-employment.

To qualify as unemployed under the 'strict' definition, people would have to comply with statements 1, 2 and 3. In other words, if they had not taken specific steps during the preceding four weeks to find work, they would be classified as economically inactive, and hence defined as being out of the labour force. The 'expanded' definition of unemployment, by contrast, includes those people who satisfy statement 4, but not 3, i.e. the 'discouraged workseekers'.

Table 3.1 Strict and expanded unemployment rates

	Asian	Coloured	White	Black	Total
October Household Survey 1994					
Expanded definition	17.1	23.3	6.4	41.1	32.6
Strict definition	14.1	19.2	4.1	25.8	20.3
SALDRU Survey 1993					
Expanded definition	11.3	20.9	4.5	38.5	30.1
Strict definition	7.8	15.2	3.3	16.0	12.8

Sources: *CSS 1995; SALDRU 1994*

As can be seen from Table 3.1, the strict and expanded definitions of unemployment calculated by the CSS from the 1994 October Household Survey (OHS) differ substantially in South Africa, particularly for black people. Table 3.2 indicates that this is particularly the case for black women. In other words, most unemployed black people appear to have given up looking for work. The extent of this 'discouraged workseeker' problem is high by international standards (see World Bank 1995:28).

According to the ILO review, South Africa's unemployment rate is overestimated by both the strict and expanded measures. The review points out that the CSS's 'strict' definition is not as strict as in many other countries where the reference period is one week rather than four (Standing *et al.* 1996:104). This helps explain why the strict unemployment rate using ILO definitions and SALDRU data is so much lower than that of the OHS (see Table 3.1). In the SALDRU questionnaire, respondents were asked if they had looked for work during the past week.

Table 3.2 Unemployment amongst men and women

	Asian	Coloured	White	Black	Total
October Household Survey 1994					
Expanded definition					
Men	13.3	19.7	4.5	33.6	26.2
Women	24.2	27.8	9.2	50.2	40.6
SALDRU Survey 1993					
Expanded definition					
Men	8.1	17.7	3.6	33.6	25.7
Women	16.7	24.8	5.6	44.2	35.2
Strict definition					
Men	7.1	12.5	2.7	14.6	11.5
Women	9.1	18.4	3.9	17.9	14.7

Source: *Standing* et al. *1996:111*

The ILO review disputes the CSS's 'expanded' measures, on the grounds that OHS respondents were just asked if they would accept 'suitable' employment without specifying when it would have to be taken up—such as during the next week, which is commonly used as a restrictive condition in measuring broader notions of unemployment. In the SALDRU survey, discouraged workers include those who had not looked for more work or for a job in the last week because, they said, no jobs were available.

The ILO review believes that the labour force participation rate amongst black women is higher than estimated because women working in subsistence agriculture are counted as economically inactive by the official (CSS) statistics. This implies that if women 'working' in subsistence agriculture are included in the labour force as part of the employed, then the resulting unemployment rate for black women will be lower than indicated in Table 3.2.

However the review provides no estimate of the extent of such 'employment'—or how the inclusion of it in the statistics would affect the unemployment rate. Given that rural household surveys consistently show that income from agriculture (including crops and livestock which are consumed by the household) contribute only a small fraction of household income,[5] it seems unlikely that there are significant numbers of black women productively engaged in meaningful own-account agricultural employment.

A different way of measuring unemployment expresses formal employment as a percentage of the (expanded) labour force. Formal employment is obtained from official statistics drawn from industrial surveys rather than household surveys. This measure of labour absorption into formal wage employment shows a steady decline over the past two decades. According to the CSS, the formal employment absorption rate fell from 60.2 per cent in 1975 to 49.7 per cent in 1985 and to 39.3 per cent in 1994 (Standing *et al.* 1996:106). The IMF (1995), and Pereira da Silva (1996) used a related measure, namely the 'formal employment gap'. This measure expresses the (strict) labour force minus formal sector employment as a proportion of the labour force. Pereira da Silva estimated South Africa's 'unemployment rate' in 1994 to be 43.4 per cent (1996:8).

Such measures clearly over-estimate unemployment because the informal sector and self-employment is ignored. The ILO review argues further that these measures of unemployment in South Africa are artificially inflated by poor official employment statistics which fail to capture formal employment adequately (Standing *et al.* 1996: chapter 3). The review argues, *inter alia*, that employment growth during booms is underestimated by the South African sampling frame, which fails to incorporate new firms,[6] and that the questionnaire is ill-designed to pick up casual, sub-contracted and other irregular forms of employment.

It is these forms of employment which appear to be increasing everywhere. ILO Enterprise Labour Flexibility Surveys around the world show that:

> There has been a trend towards more insecure, irregular forms of employment, typically also involving lower social wages, less representation security and fewer social entitlements. More companies have been turning away from reliance wholly or largely on full-time workers to use of temporary workers, part-time workers, contract labour and out-workers, and have been sub-contracting or using other forms of 'outsourcing'.
>
> (Standing 1996:12)

According to the ILO's South African survey, 83 per cent of the firms had employed temporary or casual labour in the recent past, and 29 per cent stated that they were increasing their use of temporary labour as a share of total employment (Standing *et al.* 1996:326). In 35 per cent of the firms, temporary workers were paid lower wages and received fewer benefits. The survey also showed growing use of contract labour, part-time employment and the use of homeworkers or out-workers (ibid.: 327–29). The ILO review argues that South African industry is resorting fairly extensively to such 'external flexibility'—a trend which is not adequately reflected in official employment statistics.

However, even assuming that formal employment is under-estimated by 20 per cent, over a third of the labour force still remains outside of such employment. This figure can be whittled down further by defining 'discouraged' workseekers as being out of the labour force, and by making assumptions about the size of the informal sector, casual labour, out-sourced, sub-contracted work, etc. What is clear is that South Africa's formal sector has been manifestly incapable of generating stable, regulated, formal jobs for people of working age—particularly young, female, Africans in rural areas.[7]

The failure of the economy to create adequate jobs is the result of two broad dynamics: the slowdown in economic growth since the mid 1970s and the rising capital-intensity of South African production. According to Bowles (1995), the structure of the South African economy changed during the past two decades in ways which destroyed almost two million jobs.[8] Economic policies and trends in relative factor prices probably contributed to this development.[9]

There is clearly a need to reorient economic policies in support of a labour-intensive rather than a capital-intensive growth path. But are the emerging labour market institutions appropriate in this regard? The following section explores how the industrial wage-setting machinery—specifically, the extension of collective agreements to non-parties—could dampen the expansion of regulated, secure employment.

Labour market institutions in a global context

There are strongly opposing claims in South Africa about the relationship between labour market institutions and the growth path. At the neo-classical extreme it is argued that labour market institutions and regulations which restrict managerial prerogative in hiring and firing decisions, and which dictate minimum wages, raise the costs of employment, and hence contribute to higher unemployment and slower growth (see e.g. South African Foundation 1996, IMF 1995). Arguments in this vein stress the trade-off between wages and employment,[10] and the disincentive effects on hiring of regulations governing employment security.[11] The policy implications are less government regulation of the labour market.

The counter-claim to the neo-classical position is that market regulation of the labour market is exploitative and inefficient. According to the ILO review (Standing *et al.* 1996) and the Congress of South African Trade Union (COSATU 1996), stable relations between labour and capital which provide opportunities for peaceful negotiation will promote trust, create incentives to train, facilitate productivity growth and arrest the trend towards more insecure and irregular forms of employment. The ILO review thus supports 'voice regulation' rather than pure market regulation, where 'voice regulation implies that labour market practices and changes are managed through bargaining between representatives of potentially conflicting interests, which must be embracive of those on the margins as well as established vested interests' (Standing *et al.* 1996:10).

Let us take the following as working assumptions:

1   voice regulation through collective bargaining and social accords is preferable for social reasons, and for promoting productivity growth and dynamic efficiency;
2   raising the costs of employing labour can have negative effects on employment which are socially undesirable in a labour surplus economy.

An ideal set of labour market institutions would thus promote voice regulation, productivity growth and the expansion of relatively low wage, labour-intensive production. Labour market institutions should facilitate productivity growth (particularly in higher-value-added, export-oriented firms), but not at the cost of restricting the expansion of lower (labour) productivity employment. Those at the 'margins' (e.g. the unemployed, small enterprises, less-skilled, irregular workers, etc.) must not be harmed by voice regulation of powerful, established interests.

But South Africa's labour market policies and institutions are not being reformed in a vacuum. South Africa is increasingly part of a dynamic global economy which is exerting considerable influence on the labour market. There is growing evidence that international trade between developed and

developing countries is placing downward pressure on unskilled wages and upward pressure on skilled wages (Wood 1994, Sachs and Shatz 1994, OECD 1994). This acts to widen the wage distribution. Workers with skills (particularly those with internationally transferable skills) are experiencing strong demand for their services—and hence are able to bargain for higher wages. By contrast, workers who remain unskilled are likely to experience either falling wages, or job losses. According to Greenaway and Milner (1995), the recent Uruguay GATT round will exacerbate these trends.

This is the pattern in the developed economies, which have responded in one of two ways to global integration: by allowing greater wage and employment flexibility, as in the USA and Canada; or by protecting the wages of unskilled labour through labour market interventions, as in Europe (Wood 1994, Glyn 1995). In the USA and Canada workers have a greater chance of becoming unemployed, but an unemployed person has a much better chance of being rehired quickly, albeit at low wages (OECD 1994:13, 23).

Similar trends are discernable in developing countries, although the picture is complicated by the presence of a large informal sector and widespread avoidance of labour market regulations (Wood 1994, ILO 1994). Labour markets, particularly in Latin American countries, are increasingly fragmented as many firms avoid regulations and operate in the informal sector.

These international developments suggest that as South Africa proceeds with trade liberalisation, and hence experiences growing competition (particularly from lower-wage economies), downward pressure will be placed on unskilled wages. If this is not accommodated by the labour market, then either unemployment will rise or irregular, insecure, informal forms of employment will grow—or both. In short, South Africa cannot, in todays increasingly globalised economy, embark on a strategy designed to narrow the wage distribution and thereby increase productivity. The Swedish model is no longer available.

During the post-war boom, Sweden pursued centrally negotiated solid-aristic wage policies which, in the context of full employment, served the dual purpose of achieving greater socio-economic equality and facilitating structural adjustment (Standing 1988). Those workers in less efficient firms who lost their jobs as a result were quickly retrained with the help of Sweden's active labour market policies and redeployed in the rapidly growing economy. This economic strategy (until it was undermined by slower growth, especially in the 1980s) resulted in narrowing inequality, low unemployment and rising real incomes for all.

This vision has its proponents in South Africa.[12] Arguments in favour of artificially narrowing the wage distribution are consistent with it.[13] So too are arguments in support of extending wage agreements concluded in industrial (bargaining) councils to non-parties (see below).

There are two serious problems with such a strategy for South Africa. First, attempts to narrow the wage distribution by raising unskilled wages

will probably cause job shedding (particularly in the formal sector) and hence widen inequality. In a high unemployment, labour-surplus economy such as South Africa's, attempts to narrow the wage distribution and raise labour productivity in this manner could have profoundly inegalitarian outcomes.

Second, South Africa cannot afford the flip side of the Swedish model—namely the sophisticated welfare state to support those workers driven out of low-wage employment (Nattrass and Seekings 1996). Given the government's commitment to reducing the deficit, government spending on such welfare provisions is likely to be highly circumscribed. For the foreseeable future, the welfare of the poor and the unemployed is going to depend on economic growth and job creation. A high labour productivity strategy which rests on the destruction of low-wage jobs is thus unacceptable in the current context of high unemployment. Rather, the policy focus should be on improving the productivity of capital through labour-intensive growth.

The OECD calls for a balance to be found between high labour productivity jobs and the expansion of low-wage jobs in order to reduce unemployment: 'policies that inhibit the creation of (low-wage) jobs should be avoided, or steps taken to minimise their employment-hindering effects' (OECD 1994:33).[14] The OECD argues that as some jobs are only viable at a very low wage, a 'widening of the wage differential could be expected to support faster employment growth' (ibid.).

In a low-unemployment economy, widening the wage distribution will worsen inequality (Glyn 1995). However, in a labour-surplus economy such as South Africa's, creating low-wage jobs—and thereby widening the wage distribution—could well be consistent with narrowing inequality and alleviating poverty. This is simply because so many people are without jobs which, even at low wages, would significantly improve their standard of living. For example, simulations using the 1994 SALDRU/World Bank data show that a 10 per cent increase in real household income that accrues entirely to currently poor households via new formal but low-wage employment results in over one-third of poor households rising above the poverty line. The Gini coefficient falls from 0.65 to 0.54 (Hertz 1995).

Note, however, that the above simulation assumes nothing about how the expansion of low wage employment takes place. If such expansion was the result of a general lowering of unskilled wages, then the effects on inequality will be more ambiguous: some redistribution would take place at the bottom end of the income distribution from those whose wages fall to those who obtain new low-wage employment.

The following section argues that the extension of collective agreements to non-parties in South Africa may act as a barrier to the expansion of new low-wage jobs.

The extension issue in South Africa[15]

Collective bargaining at industrial level takes place in South Africa in Industrial Councils (ICs) (soon to be called Bargaining Councils). For an industrial council to be registered, the relevant employers' associations and trade unions must convince the industrial registrar that they are 'sufficiently representative' of the specified sectoral interest and geographical area for which the application is made. ICs usually bargain over minimum wages, hours of work, leave and bonus provisions, retrenchment procedures, etc.

On request by parties to the IC, the minister of labour may declare the terms of an agreement binding on all firms deemed to fall within the ICs jurisdiction, even though they are not party to the agreements. According to the most recent available data from the Department of Labour, South Africa has seventy-six ICs of which four concern local government. Of the seventy-one private sector ICs, only two do not extend their agreements to non-parties—and this is simply because they regulate single-firm industries. In other words, all the private-sector ICs in industries covering more than one firm extend their agreements to non-parties.

Extension thus lies at the heart of the South African industrial bargaining system. By extending collective agreements to non-parties, the ICs effectively set minimum wages for workers in the industry. The minimum wages of workers who fall outside the area and scope of ICs are set by the Wage Board. The labour legislation, however, gives encouragement to wage setting through ICs; even where parties are not representative, the minister may choose to extend agreements to non-parties if he is convinced that by not doing so, the practice of industry level bargaining would be threatened.

Non-party employers (and party employers who have difficulty complying with the agreement) can apply to the IC for an exemption. However, this process appears to be arbitrary and uneven. Of thirty-eight surveyed ICs,[16] only two were able to provide documentation indicating which criteria were taken into account when evaluating requests for exemption from a wage agreement. Most ICs simply indicated that they evaluated applications 'on merit', or in accordance with unspecified 'financial criteria'. Several pointed out that only audited, documented proof of inability to pay was taken seriously in an application for exemption. As it is in the interests of party firms and unions to eliminate low-wage paying firms, there is little incentive to grant exemptions.[17]

Industrial councils and the wage cliff

Some analysts have attributed South Africa's rising wages in the presence of substantial labour surplus in large part to the strength of South African trade unions and the nature of this industrial relations system. Peter Moll (1995a) points out that real wages rose in most of the covered (i.e. regulated) sectors

between 1980 and 1994, whilst real wages in the uncovered (i.e. unregulated) sectors stagnated or declined.[18] He argues that a 'combination of union activity[19] and the array of minimum wages set by the industrial councils helped to preserve and increase real wages even in the slackening labour market' (Moll 1995a:4).

Moll hypothesises that wage setting through ICs (which he, in 1993, estimated covered 64 per cent of manufacturing workers in 1985) is partly responsible for the failure of real wages to converge with those of workers with similar skill levels in the uncovered sectors.[20] He argues that without extensions the covered-uncovered differential would probably be substantially smaller (Moll 1995a).

The extent to which industrial councils are responsible for Moll's 'wage cliff' is a moot point. The ILO, for example, observes that as most of the industrial councils are regional or local in scope, firms could simply move to other areas if IC regulations were a problem for them (Standing *et al.* 1996:145–46). This argument, however, is suspect given the geographically concentrated nature of production in South Africa and the fact that ICs of one sort or another cover all the industrial areas.[21] If it pays firms to operate in the major centres, then there are clearly costs involved in moving away.

Not all ICs employ an adequate inspectorate. For this reason, it could be argued that ICs are less effective when it comes to enforcing agreement than it might appear. However, of the ICs which responded to a Department of Labour request for information (to answer a parliamentary question from MP Tony Leon), only 23 per cent had no agents or designated agents; the other ICs had an average of 3.6. It is difficult to know whether this is an adequate inspectorate. However it is certainly sufficient to question a judgement which suggests that ICs are ineffective—especially given the 5,288 IC prosecutions between September 1993 and August 1994.[22] Although fines tend to be low, convicted employers get criminal records[23] and are forced to pay back-pay, accumulated industrial council levies, etc.

Indtistrial councils and small firms

For employers to be deemed 'representative' in an industrial council, they must collectively employ 50 per cent or more of the workers in the industry. For unions to be representative, they must likewise organise 50 per cent of the workers. Where an industry is characterised by firms of differing sizes, the very real possibility exists that larger firms and unions will be able to club together to eliminate 'unfair competition' from smaller firms, which tend to use more labour-intensive techniques and pay lower wages (Moll 1995a).

The inherent bias against smaller firms is reflected in evidence showing that non-party firms tend to be smaller than party firms (Du Toit *et al.* 1995).[24] In the largest national IC (for iron, steel, engineering and metalurgical industries), party firms represent only 28 per cent of the total number of

firms employing 65 per cent of the workers (Standing *et al.* 1996:143). In other words, less than a third of the firms, employing two-thirds of the workforce, set minimum wages for the whole industry.

Furthermore, when it comes to the granting of exemptions, only eleven of the thirty-eight surveyed ICs said they made special dispensation for small businesses—and this was usually for a start-up period only, and for businesses with fewer than five employees. One IC justified not making special provision for small firms on the grounds that 'a small business on reduced wages could put a large business out of business'.

The larger, more profitable firms have a very strong incentive to participate in the industrial council system. First, a centrally negotiated wage is likely to be lower than that which profitable firms might have to pay under a system of decentralised bargaining. This boosts their profits relative to the smaller, less profitable firms who find themselves having to pay higher than optimal wages. Supplementary wage bargaining at plant level, however, tends to erode this benefit.

Second, by forcing up wages in such firms through the extension mechanism, larger firms can eliminate 'unfair competition'. This is a very powerful incentive. According to Bendix, 'If agreements were not extended to non-parties it would, in the opinion of many employers, be of little use to continue negotiating on industrial councils' (1995:492). Indeed, thirteen out of thirty-eight recently surveyed ICs claimed that the IC would collapse in the absence of the extension mechanism.

When faced with higher minimum wages, non-party firms could react in three ways: reduce employment, 'externalise the labour function' (through increased use of sub-contracting etc.) or raise labour productivity to justify the higher wage. Alternatively, they could go out of business, ignore the minimum wage or apply for exemption. There is very little evidence concerning the effect of extended minimum wages on non-party firms—and such as exists tends to be anecdotal. The ILO dismisses such evidence on the grounds that complaints about the industrial council system by small employers 'invite the retort, "Well, they would say that, wouldn't they?"' (Standing *et al.* 1996:142).

Much more research is required into the effects of industrial councils before their contribution to unemployment and labour-absorption can be determined more precisely. As is the case internationally, the theory and practice of labour law are often worlds apart. Nevertheless, that a system exists on the statute books which if enforced with any degree of vigour could, at least in principle, result in job destruction in small labour-intensive firms is disturbing. It would be extremely inappropriate for a high unemployment economy like South Africa's to operate within an industrial relations system predicated on eliminating low-wage competition through the extension of industrial council agreements to non-parties.

Conclusions

Inequality in South Africa appears to be driven to a large extent by the wage income gap between the employed and the unemployed. Creating jobs, even at relatively low wages, for unskilled, unemployed people must form part of an egalitarian strategy. In todays increasingly globalised economy, such a strategy is likely to be accompanied by a widening wage distribution. Labour market institutions must accommodate this, or unemployment will rise or irregular, insecure, informal forms of employment will grow—or both.

We have argued that institutions (such as the extension of IC agreements to non-parties) which raise unskilled wages across entire economic sectors with little regard for size of firm, choice of technique, regional labour market conditions, etc. are likely to slow down job creation and widen inequality.

We have not argued that lowering existing wages will either create jobs or narrow inequality. We have simply observed that raising unskilled wages is likely to have an adverse effect on the expansion of unskilled jobs. It is quite possible that the relationship between wages and employment is asymmetrical: raising wages might harm employment, whereas lowering wages might not bring about a significant expansion of employment.

We have also not argued that minimum wages should be abolished. If extensions were removed, workers in non-party firms would still be protected by the Wage Board, i.e. by an independent body which does not have an interest in eliminating rival lower-wage labour-intensive firms.

South Africa needs a consistent set of labour market and economic policies which will allow both higher value-added (higher-wage) and labour-intensive (lower-wage) sectors to expand. This entails both improving South Africa's skills base and ensuring an adequate supply of relatively low-wage jobs for unemployed unskilled workers. Only by simultaneously expanding the demand for unskilled labour will a narrowing of economy-wide inequality be possible. Wages appropriate to the higher-value-added sector must not be generalised across the lower-value-added sector.

There is a strong case for removing the extension measure—or at least ensuring that agreements are extended only after careful attention has been paid to the circumstances facing non-parties, especially the smaller businesses. In this respect, it is disturbing that the 1995 LRA obliges the minister of labour to extend agreements to non-parties if the party firms and unions are deemed representative (Nattrass and Seekings 1995). It is to be hoped that the recommendation by the South Africa Labour Market Commission (LMC 1996), that the minister be given greater discretion in the decision to extend, will be adopted by the government.

Will the removal of extensions bring about the end of industrial level bargaining? Although thirteen out of the thirty-eight surveyed ICs claimed that the removal of extensions would cause the IC to collapse, it is important to bear in mind that employer associations and trade unions have incentives

to bargain collectively other than the elimination of low-wage competition. This is why industrial-level bargaining exists in countries where extension to non-parties does not occur. If those thirteen ICs do indeed collapse, then it is probably for the best. An IC which exists solely to eliminate low-wage competition is an unsuitable institution in a labour-surplus economy.

It is worth quoting the following response by an official of one of South Africa's larger national ICs when asked what would happen if extensions were removed:

> The councils would lose the bulk of its monitoring functions and would exist simply as a means for providing a forum for party negotiations and the administration of party agreements. Employers would probably join the council as parties only as a result of trade union pressure on such targeted employers to participate in industry-level collective bargaining. A councils influence and power would therefore be a reflection of the trade unions ability to organise at plant level in the first instance and to exert pressure on employers, through the threat (or implementation) of industrial action, to join the council. This may be a desirable process as the strength of a council would be a direct function of the industry's propensity to organise collectively, and not, as is currently the case, a function of pressure group influence at government level.
>
> (confidential questionnaire: Nattrass)

We have argued that an IC system without extensions is more appropriate for a labour-surplus middle-income economy for South Africa. Where new jobs are created, even at low wages, unemployment and inequality will decline. However, it may well be the case that as a result of removing the extensions, some existing unskilled wages will fall (as non-party employers lower the wage). This will clearly reduce the beneficial impact of increased employment on inequality—at least in the short term. However, in a labour-surplus economy such as South Africa's, the beneficial impact on inequality of removing barriers to the expansion of labour-intensive employment is likely to exceed any negative impact resulting from downward wage drift.

Notes

1 According to data from the Central Statistical Services (CSS), the ratio of black to white wages rose from 0.32 in 1989 to 0.37 in 1993 (CSS 1995).
2 According to CSS data, of the employed African workers, 42.1 per cent are in unskilled occupations. The largest category after this is services and sales. While Asians and whites are rarely labourers, African and coloured workers are concentrated in this category. Of all employed white workers, 40.3 per cent are found in the top three occupations, namely managers, professionals and technicians. The corresponding figure for Africans is 14.4 per cent, which is

also lower than the national mean of 20.6 per cent (Bhorat and Hertz 1995). Similar results were obtained by the ILO's South African manufacturing labour flexibility survey (reported in Standing *et al.* 1996).

3 Measurements of racial discrimination, however, should be treated with caution. First, the measured race effect is an amalgam of the effects of differences in educational quality, job experience, access to capital and other factors which affect prior labour market discrimination. Second, estimates of racial discrimination in wages vary depending on the data sources and methodology used. For example, Tom Hertz, using the same SALDRU data set as Peter Moll—but applying a different multiple regression technique—came up with significantly higher estimates of the effect of discrimination in wages (see Bhorat and Hertz 1995).

4 The broadest notion of labour supply consists of the working-age population (15–64). The 'economically active population' is usually measured as the working-age population minus students, women occupied solely in domestic duties, the retired and persons living entirely on their own means or wholly dependent on others. Although some researchers regard this as identical with the 'labour force', a narrower measure is usually obtained by subtracting own-account workers, unpaid family workers and members of producer's cooperatives from the economically active population (Archer *et al.* 1990:165).

5 See May (1990) for a brief review of this evidence.

6 This could account for the fact that household surveys (such as the OHS) estimate employment to be in the region of eight million, whereas employment as measured by industrial surveys is roughly two million lower.

7 According to Bhorat and Hertz (1995), unemployment amongst black people is higher in rural than urban areas with the result that an economically active black woman between the age of 16 and 24 who lives in a rural area has the highest probability of being unemployed.

8 Using a decomposition analysis, Bowles has shown that the change in the number of jobs reflects a strong positive accumulation effect (i.e. jobs have grown with investment), a strong negative technology effect (i.e. job destroying) as choice of technique became more capital intensive, and a less strong negative sectoral distribution effect as capital-intensive sectors grew in relation to labour-intensive sectors.

9 Capital-intensive strategic investments by the state, accelerated depreciation allowances and subsidies which lowered the cost of capital, industrial policies which militated against downstream (and small-scale) production and the absence of any significant measures aimed explicitly at fostering the development of small firms have all been implicated in the explanation of South Africa's capital-intensive growth path (see e.g. Joffe *et al.* 1995, Kaplinsky 1995). The fact that wages rose faster than productivity for most of the post-war period (Nattrass 1990), no doubt also contributed to South Africa's capital-intensive growth path.

10 Independent recent research by Fallon (reported in Pereira da Silva 1996) and Bowles (1995) suggests a wage employment elasticity of about -0.7 for South Africa. This means that after accounting for other factors (e.g. sectoral economic shifts), a 10 per cent increase in the real wage has been associated with a 7 per cent decline in employment. This is slightly higher than that of around 0.5 for the OECD and the USA (Glyn 1995, Freeman 1995, Periera da Silva 1996). The ILO Review however, warns that such elasticity calculations are suspect theoretically, and based on such doubtful employment statistics that their validity is highly questionable.

11 Regulations governing employment security can act as a disincentive to hire workers—especially for those firms who wish to expand employment during booms and cut back later during recessions. However, there is no systematic evidence that South Africa's regulations governing employment security have a negative impact on employment, although they may act as an incentive for firms to externalise the employment function and make greater use of contract labour (Standing *et al.* 1996).

12 This is particularly true for the trade union movement. For example, the Labour Research Paper by Young (1991) was used by the National Union of Mineworkers (NUM), COSATU and South Africa National Council of Trade Unions (NACTU) representatives in their verbal submissions to the Labour Market Commission.

13 An example is the demand of the National Union of Metal Workers of South Africa (NUMSA) for unskilled wages to be pegged to 60 per cent of the artisan wage.

14 In order to promote job creation, the OECD suggests, *inter alia,* support for entrepreneurship and enterprise development (in ways which do not unduly favour established large firms at the expense of new small firms) and reducing policy-induced disincentives to hiring (such as payroll taxes) which drive a wedge between the wage received by the worker and the cost of that worker to the firm (1994:35). The ILO *World Employment Report* likewise suggests reforming social security systems financed out of payroll taxes (1995:152). Both the ILO report and the OECD favour greater flexibility of working hours.

15 See Nattrass and Seekings (1995) for a more detailed discussion of the extension provisions in the LRA.

16 This survey was conducted by N.Nattrass in 1995–96. All ICs were sent a postal questionnaire. Thirty-eight responded.

17 Under the new LRA, applications for exemption will be considered by an independent body. Nevertheless, it is still the parties to the agreement that will determine the terms under which exemptions may be granted.

18 These observations are true both of the average real wage of all occupations combined and of the real wage of unskilled workers (Moll 1995a:48). N.B.: the uncovered sectors include agricultural labour, self-employment and employment in the informal sector, domestic service, casual labour, and employment in very small firms in the formal sector.

19 Moll estimates that the union-non-union wage differential has risen considerably from 1985 to 1994. He concludes that the 'South African union differentials of 26 to 43 per cent are among the highest in the world' (1995a: 42).

20 Moll estimates that the remuneration of most unskilled workers in the urban uncovered sector is R705 a month. By contrast, the 'general worker in Motor Transport (Goods) earns R1,245 which is 77 per cent above the uncovered mean, and the Steel and Engineering general worker's Rl,628 is 131 per cent above the uncovered mean' (Moll 1995a:37). This wage cliff is high by international standards.

21 The 1C for steel, engineering and the metallurgical industry is national in scope, as is that for the motor industry and the textile industry. ICs for furniture, building and clothing cover all of the major industrial producing areas.

22 Information from the Department of Labour.

23 This, however, will be changed once the new LRA is promulgated. Rather than relying on criminal courts, the new system will be based primarily on mediation, conciliation and arbitration.

24 Du Toit *et al.* (1995) found that the average party firm had fifty-three employees, whereas the average non-party firm had thirteen employees.

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4

SOUTH AFRICAN TRADE AND INDUSTRIAL POLICY IN A REGIONAL CONTEXT

Colin McCarthy

Introduction

The political transition introduced by the election of 27 April 1994 launched the South African economy into a new situation of acceptance in world markets. In April 1994 South Africa also signed the Marrakech Agreement, thereby committing the country to the discipline of the World Trade Organisation (WTO) and a phased process of trade liberalisation. The change in the trade regime which this brought about represented a significant acceleration in the transition from an inward-looking economy to an outward-looking policy stance.

The demise of apartheid and with it international isolation also meant that the role of the largest and most developed African economy could be reconsidered within a regional context. South Africa's accession to the Southern African Development Community (SADC) in August 1994, the decision not to join the Common Market for Eastern and Southern Africa (COMESA) and the renegotiation of the Southern African Customs Union (SACU) Agreement all point to the re-appraisal of regional relationships.

This chapter reviews the change in trade and industrial policy in South Africa. However, considering the dominant and pivotal position of the South African economy in the region, policy changes on South Africa's part will have repercussions in the region. The intention, therefore, is to include the regional context of South African policy in the overview.

While the emphasis is on trade policy the underlying approach is that trade and industrial policies cannot be considered separately. Trade policy is a branch of microeconomic policy that seeks directly to influence at the 'border' the quantity and prices of tradable goods. The aim is to re-allocate resources among sectors and industries from less productive to more productive use. Other measures which try to achieve a similar end form part of industrial policy. However, since trade policy has an influence on domestic production and consumption patterns while industrial policy has an impact

on patterns of trade, an absolute separation between the two policies is not appropriate in policy analysis.

Both aim, often in tandem, to influence the size and the composition of the tradeable goods sector, defined as consisting of exportables and importables. In the three-sector economy, consisting of non-tradables and exportables and importables as the tradable sector, the aim of development policy in developing countries usually is to increase the size of the tradable sector through a process of industrialisation. Two approaches can be taken in this regard: import-substituting industrialisation would seek to protect and encourage the growth of the import-competing sector by raising the relative domestic price of importables, whereas an export-oriented growth strategy encourages production for export by increasing the relative domestic price of exportables. It can also be argued (see Bhagwati 1988:258) that a proper outward-looking approach would represent a neutral position between the production of importables and exportables, that is producers will face a position of neutrality between the two. The latter implies that the effective exchange rate for a country's exports will approximately equal the effective exchange rate for its importables. South Africa, it will be noted in the paper, has gone through successive stages of import-substituting development and the provision of export incentives to neutralise the anti-export bias created by protectionism.

The South African economy is in need of a re-orientation in trade and industrial policy. This is reflected, in its most direct manner, in the inability to keep pace with the growth in international trade over the last decade. South Africa's share in world exports declined consistently from 0.88 per cent in 1984 to 0.60 per cent in 1994 (WTO 1995). The fact that Africa as a whole did even worse and, consequently, that South Africa's share in African exports increased from 21.2 per cent in 1984 to 27.8 per cent in 1994 provides little comfort. The economy has also been doing rather poorly since the mid-1970s. Economic growth fell from an annual average rate of 6.3 per cent during the first half of the 1960s to 0.8 per cent during the first half of the 1990s. The decline in growth has been associated with a sharp fall in job creation. During the period 1960–65 no less than 95.4 per cent of the growth in the labour force was accommodated in formal sector employment. This fell sharply and consistently to 14.6 per cent for the period 1985–90; during the period 1990–95 formal sector employed actually declined.

A picture of distortion also appears if factor utilisation is considered. Figure 4.1 illustrates a number of disquieting features of development in the manufacturing sector, which is supposed to be the leading sector of development. Since 1960 the ratio of manufacturing employment to value added (net output) has fallen quite strongly while the ratio of the capital stock to employment has risen. These tendencies reflect the growing capital intensity of the manufacturing sector which is also illustrated by the increase in the capital stock/value added (capital/output ratio) ratio. Considering the
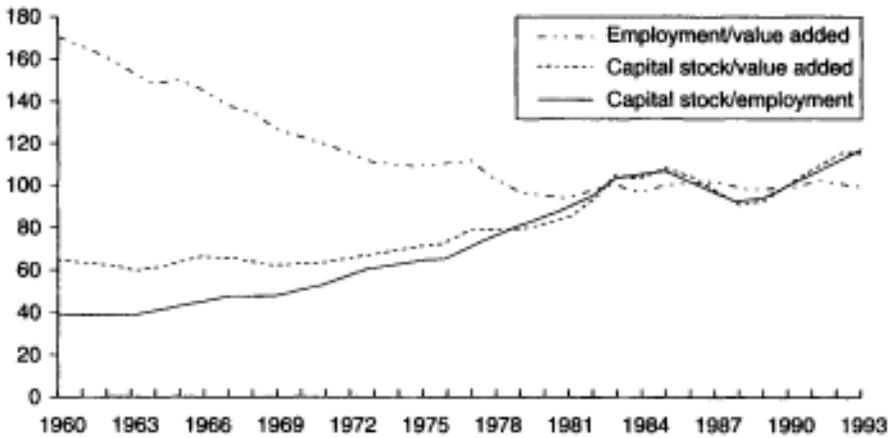
Figure 4.1 Employment and capital stock ratios in South African manufacturing, 1960–1993 (Indices: 1990=100)
Source: South African Reserve Bank, *Quarterly Bulletin,* various issues, Pretoria

fact that the South African economy has an abundance of labour and a scarcity of capital, a re-orientation in industrial and trade policy to encourage greater labour intensity is appropriate (Labour Market Commission 1996:38). The change in direction during the 1980s, shown in Figure 4.1, does not reflect an improvement in the situation but rather the outcome of the 'lost decade' of manufacturing, characterised by falling employment, investment and output growth. In the sections that follow, the history of protectionism is briefly reviewed before the efforts to create an outward-looking economy are examined. This is followed by an overview of the regional dimensions of South African trade and industrial policy.

Protectionism

South Africa was launched on the road of modern economic development and integration into the world economy by the mining revolution of the late-nineteenth century and the rapid growth of the gold mining industry. The mining industry provided a stimulus for industrial development through backward linkages and the production of consumer goods to meet the demand generated by wage-earning mine workers. In 1925 industrialisation became explicit policy with the introduction of industrial protection. South Africa thus became one of the first developing countries to introduce the inward-looking industrial policy that became popular during the 1950s and 1960s when the structuralist school of development, associated with economists such as Raul Prebisch and Hans Singer, dominated development thinking.

This school of thought was based, as Rostow succinctly summarised it, on 'asymmetrical assumptions about the relative elasticities of the demand for exports and imports of developing countries and its believed long-run degenerative relative price trend for basic commodities' (1990:404).

The aim of import-substitution policies is to create room for competition for domestic industries in the home market by raising the domestic price of importables. The infant industry argument justifies protection for an industry with potential comparative advantage. It follows inevitably that the size of the market and the economies of scale it allows will determine the ability of the protected industry to grow to maturity and competitiveness. It is therefore not surprising that regional economic integration became a popular means to enlarge the market for import-substituting growth, enabling developing countries to exploit the dynamic benefits of scale and competition. The larger integrated market would provide the opportunity for industrial growth which is neither autarkic nor free trade but decidedly protectionist, thus producing a particular brand of export-oriented growth within the larger, protected regional market. In Latin America, the UN Commission for Latin America and the Caribbean (ECLAC) encouraged regional integration as the way out of the dead-end which arose when the first (easy) stage of import-substituting industrialisation came to an end towards the end of the 1950s (Tussie 1982). During the post-colonial period in Africa, regional economic integration as a means of encouraging import-substituting industrialisation also became popular. The Lagos Plan of Action (LPA) adopted in 1980 as an initiative of the UN Economic Commission for Africa, the Organisation of African Unity and the African Development Bank, and re-affirmed by the Abuja Treaty of 1991, embodied the ideological goal of self-reliance within an Africa-wide common market. It was envisaged that this goal would be achieved through import-substituting growth within regional arrangements that would cover the whole of Africa.

Elements of the structuralist thinking of the 1950s have since 1925 been part of South Africa's protectionist policies. During the 1920s the terms of trade turned against economies such as South Africa, with low and falling agricultural prices, which was especially sharp in the case of wool, South Africa's main agricultural export commodity at the time. The prices of manufactured goods did not fall nearly as much. Consequently, a need was perceived for greater economic diversification. This was supported 'by a more critical view of the theory of free trade, which had up to then been adopted almost without question as part of the heritage of British ideas' (Houghton 1971:25). There was also a fear that the gold reserves would be exhausted and that this would leave the South African economy without a growth engine. But most importantly, the manufacturing sector would serve as a new field of employment for white workers, thereby contributing to the alleviation of the 'poor white problem'. The discontent of the white poor and the growing confrontation in the labour field, where white workers were

facing the threat of being replaced by cheaper black workers in a cost savings exercise by the gold mine industry, culminated in the South African Party of Jan Smuts losing the 1924 general election to an election pact of the National Party and the Labour Party.

The industrial policy of the Pact Government had a dual objective of economic diversification through import-substituting industrial growth and the protection of white workers. The two objectives were even linked with the Tariff Act of 1925 incorporating the principle that the minimum tariff, and not the usual maximum rate, would apply if it was found that an industry maintained 'unsatisfactory labour conditions', a qualification that included insufficient employment of white workers. Industrial policy was therefore also aimed at the redistribution of opportunity and income (McCarthy 1992).

The abandonment of the gold standard in December 1932 and the devaluation of the South African pound launched the South African economy on a road of sustained growth that lasted until the early 1970s. Initially, gold mining, benefiting from the 46.6 per cent increase in the gold price (the devaluation) led the way, but manufacturing also grew rapidly and with the outbreak of World War II received a strong stimulus through enforced import substitution. In 1944 manufacturing surpassed mining in its contribution to GDP. Diversifying manufacturing growth continued during the post-war period, with import substitution often the fortuitous outcome of quantitative restrictions on imports that were implemented to protect the balance of payments. The capital outflows of the 1980s, the foreign debt crisis and the resulting balance of payments disequilibria prompted the use of import surcharges to contain the balance of payments problems. On a more sector-specific level the motor vehicle industry was encouraged through successive local content programmes to move beyond assembly activities and to increase domestic value added. These programmes may not have succeeded in establishing a competitive motor vehicle industry in South Africa, but they did contribute to the development of a large industrial sector which at its highest point in 1982 provided jobs for 99,860 workers, that is 6.2 per cent of manufacturing employment compared to 4.7 per cent in 1960 (Industrial Development Corporation 1995, Department of Statistics 1976).

From the 1960s onwards growing international isolation shifted attention to the strategic industry argument as justification for protection. The development of an armaments industry, with strong spin-off effects in capital-intensive chemicals (including petro-chemicals in particular), metals and engineering industries, came to be regarded as important in an economy facing international isolation. Public investment became an important source of creating industrial capacity through projects such as the oil-from-coal Sasol II (1974) and Sasol III (1979) projects, Atlantis Diesel Engines, the extension of Iscor's steel-producing capacity and, as *grand finale,* the 11 billion rand Mossgas off-shore gas and refinery project (1987). The impact on factor

utilisation which these capital-intensive developments has had is revealed in Figure 4.1.

The structure of protection and the protected economy that came about were strongly influenced by the style of protection management practised by the Board of Tariffs and Trade. In its review of South African trade policies the World Bank emphasised the fluidity of the system with tariffs 'set on a day to day basis in response to requests from the business community' (Belli *et al.* 1993:3). It is significant, however, that in its tariff management government did not adopt a proactive stance of identifying selected growth industries for protection. It was largely left to industry to apply for protection, which then was not provided indiscriminately, but selectively. The intention was to avoid excessive effective protection. Protected industries were expected to supply at least 60 per cent of the domestic market while criteria on, for example, contributions to employment creation, economic growth and technological development were also taken into account, apparently in an effort to detect potential comparative advantage in the true spirit of the infant industry protection. A notable feature of the system of protection has been the menu of protection measures. In addition to a multitude of tariff rates, levies on imports include, or until recently had included (a) ordinary customs duties, which in turn can be *ad valorem,* specific or a formula duty that is based on a reference price and aims to provide protection against 'disruptive' competition (dumping) (b) the import surcharges mentioned earlier and (c) numerous exemptions from tariff and surcharge payments on a firm by firm basis. The latter has led the World Bank to describe the tariff as importer-specific rather than product-specific (Belli *et al.* 1993:3).

The result of the approach to protection has been the creation of an extremely complicated system, noted for the great variation in tariff rates, but not one characterised by a high average level of protection. In a research report published in 1990, the Industrial Development Corporation referred to the fact that import duties collected amounted to only 5 per cent of total imports but that qualitative analyses of the tariff structure showed that, because of the variation in tariffs, 'the tariff wall behind which production took place is closer to 20 per cent' (Industrial Development Corporation 1990:6).

Export promotion and trade liberalisation

While the hostile international trading environment forced the government to intensify protection, the 1970s and 1980s also saw the introduction of export incentives to neutralise the anti-export bias created by protection. The Export Commission (Republic of South Africa 1972) emphasised the importance of export promotion while keeping a policy of import replacement in place. This view was later echoed by the Study Group on Industrial Development Strategy (Department of Industries and Commerce 1983) who

saw the process as the coordination of import replacement and export promotion to prevent distorted development. The study group argued that this coordination could be effected 'by keeping the level of protection against imported products as low as possible or by compensating for it with export assistance' (ibid.: 194).

Since the early 1970s a number of export incentives were introduced and frequently changed. A prominent scheme was the tax concessions, linked to value added in export production, introduced in 1980. Also on offer were tax concessions on export marketing costs, discretionary cash payments linked to finance costs, rail rebates and assistance in respect of electricity and air freight costs. While the export incentives served to neutralise the bias against export production in the protected economy, the accelerated elimination of quantitative import restrictions after 1983, and the replacement of these restrictions with tariff levels that were lower than those implicit in the quantitative restrictions, introduced an element of trade liberalisation. The drawback and rebate of duties on inputs used in export production could also be seen as falling in the category of trade liberalisation.

In April 1990 the General Export Incentive Scheme (GEIS) replaced the earlier system of export incentives. GEIS is a selective system of liberal tax free grants that increases through four phases of higher value added and domestic content. Industries characterised by high value added and a high local content qualify for a nominal subsidy of 19.5 per cent of export turnover, while a firm with low value added and low local content qualified for only 2 per cent.

On the protectionist side of policy the South African government had previously played a significant role in selecting industries for fast-track development; this was particularly pronounced in the industries given special assistance on the basis of the strategic industry argument and in the case of the establishment of a domestic motor vehicle industry. Something similar was done on the export production side. For a relatively brief period, significant tax concessions were provided under Section 37 E of the Income Tax Act to firms that established capacity for export production in mineral beneficiation. This incentive was terminated in September 1993. Sectoral selectivity was also contained in the structural adjustment programmes introduced in 1989. A scheme of reciprocity was introduced in the motor vehicle industry and in clothing and textiles which allowed the duty-free import of inputs or finished goods in return for the exportation of a part of their production.

South Africa's signing of the Marrakech Agreement in April 1994 introduced a major shift in trade and industrial policy. A commitment exists to a drastic simplification of the tariff structure, a phased reduction of tariff protection (by one-third on average) and the phasing out of GEIS by the end of 1997. Significant progress has already been made with these commitments. Also, the tariffication of the remaining quantitative controls has taken place, while import surcharges had progressively been lowered

and then totally removed in October 1995. However, a comparison of the Uruguay Round offer on tariff reductions with the elimination of GEIS has produced the conclusion that the economy still has a strong anti-export bias (Holden 1996). This, of course, is to be expected since tariff protection, albeit much lower, remains in place.

While the relative domestic prices of exportables and importables determine the trade bias, access to markets and suppliers is a necessary condition if an economy is to be successful in export-oriented growth. Under sanctions and in the face of boycotts, South African producers faced non-price constraints which would have prevented a large-scale entry into world markets. Now, in the post-apartheid era, markets have opened up for South African goods, and export producers have reacted in a significant way. Furthermore, South Africa's membership of the WTO has ensured the continuation of most-favoured nation access to the markets of all member countries. South Africa has also been granted Generalised System of Preferences (GSP) status by various developed countries, notably the USA and the European Union, which secured preferential access to these markets. Efforts to join the Lomé Convention did not succeed, but a free trade agreement with the European Union is under negotiation.

It is difficult to link export growth to changes in the trade regime without a rigorous export function. However, it is suggestive that manufactured exports have significantly grown in importance since 1980, especially since approximately 1985. The real depreciation of the rand during most of the 1980s and slack domestic demand, with its vent-for-surplus effect, re-inforced export incentives in stimulating manufactured exports. If the convention is followed of defining categories 5–8 of the Standard International Trade Classification (SITC) as manufactured exports, it appears that the volume of manufactured exports grew much faster than total merchandise trade between 1988 and 1994. The growth in the export volumes of SITC 7 (machinery and transport equipment) and SITC 8 (miscellaneous manufactured articles) by 158 per cent and 168 per cent from 1988 to 1994, although from a low base, remains a significant development since these trade categories in general represent a more substantive form of manufacturing value added than SITC 5 (chemicals) and SITC 6 (material intensive manufactured goods), which were 135 per cent and 3 per cent higher in 1994 than in 1988. The share of manufactured exports (SITC 5 to 8) in total non-gold exports increased from 43 per cent in 1985 to 56 per cent in 1994.

The macroeconomic strategy on Growth, Employment and Redistribution adopted by the government in June 1996 is an important further instalment in the evolving trade and industrial policy (Department of Finance 1996). The strategy aims to change manufacturing from an inward-looking to an outward-looking sector that will earn its spurs through competitive and labour-absorbing growth. The substitute for GEIS is a package of supply-side measures (ibid., appendices: 4) of which the most important are two

fiscal incentives aimed at the encouragement of new investment. The first is a scheme for accelerated depreciation allowances for which existing firms will qualify on the basis of new investment in manufacturing plant (10 per cent per annum over ten years compared to the standard 5 per cent over twenty years) and equipment (33.3 per cent per annum over three years compared to the standard 20 per cent over five years). This incentive, which clearly aims to encourage investment in manufacturing, is available during the three-year period, 1 July 1996 to 31 September 1999, and must be seen as an effort to boost economic growth to the annual average of 6 per cent envisaged by 2000.

The second incentive, a tax holiday, aims to encourage investment by new firms in 'completely new pre-approved' projects that meet basic qualifying conditions such as a sufficient level of domestic value added and evidence of a commitment to important economic goals, including human resource development, foreign exchange conservation and environmental responsibility. The incentive came into effect on 1 October 1996 and also has a window for entry of three years. The tax holiday can last for a maximum of six years and will only come into effect once the project is profitable and thus liable for tax. It is not to be used after the tenth year following the initial investment which means that the firm has four years in which to become profitable and benefit from the maximum six-year tax holiday. The duration of the tax holiday will be determined by three factors: regional location, job creation and the priority accorded the industry, each contributing a maximum of two years to the maximum of six years. Regional priorities, decided by need and the potential for industrial development, will determine the location criterion within a framework of designated qualifying locations defined as manufacturing development corridors or manufacturing development zones. Job creation (labour absorption) will be evaluated on the basis of the proportion of value added consisting of wages and salaries. The priority of industries will be defined by the minister of trade and industry. The following categories have been specified in this regard: labour intensive industries, critical industries with strong economic linkages, sensitive industries affected by tariff reform and industries described as 'future industries defined in terms of their potential to secure a larger share of global consumer expenditure' (Department of Finance 1996, appendices: 26).

In addition to these tax incentives a number of other supply-side measures also apply or are envisaged. These include measures to improve productivity and others to encourage industrial innovation, competition and the institutional reform of regional development corporations and other development agencies. The idea of industrial clusters apparently has also established itself in South African policy circles; studies are underway to identify the mechanisms that can be used to make selected clusters more competitive.

The new framework for industrial and trade policy calls for a few broad comments. The first concerns the essential nature of the supply-side measures.

These measures target relative prices and incentives of a non-border nature; export subsidies will be removed from the policy agenda to meet the requirement of WTO legality. The removal of GEIS, the incentive which raises the relative domestic price of exportables, is at least partly being compensated for by the lowering of tariffs, but since full-blown trade liberalisation is not on the cards, elements of anti-export bias will remain in the South African economy. The fall in the real effective exchange rate to a level which in mid-1996 was estimated to be 12 per cent below the January level (Department of Finance 1996:12) does not in general remove the bias against exports since it impacts on the domestic prices of both importables and exportables, raising these *vis-à-vis* those of non-tradables. Even if the potential which this fall in the value of the rand creates for an acceleration of tariff reductions is taken into account, the maintenance in the end of some tariff protection keeps an anti-export bias in place. It is difficult to understand how a set of transparent supply-side measures, in the place of GEIS, can meet both the requirements of raising the relative domestic price of exportables and also be legal in WTO terms. The current system of duty drawbacks and customs rebates appears not to be regarded by the export community as an efficient way of removing the trade bias.

The second observation concerns the selectivity of the new industrial policy. In the first place, a set of fiscal incentives that differentiates between the investment of new and existing enterprises in favour of the latter creates a strategic advantage for these firms in the market. A permanent lower corporate tax burden for all could be more beneficial for long-term investment growth than a distorting incentive which selectively benefits new enterprises and their investment. But the issue of selectivity becomes more pertinent if note is taken of the conditions that will apply in the selection of projects that will qualify for the incentives. In the macroeconomic strategy document a number of qualifying adjectives appear, for example the accelerated depreciation allowances that will apply to qualifying plant and equipment, the pre-approved projects that will qualify for the tax holiday, with the duration of the tax holiday determined by three factors of which priority industries is one, and the efforts to enhance the competitiveness of selected industrial subsectors.

These qualifications would seem to indicate that the government has adopted a policy of industrial targeting, albeit a soft version, and that the policy measures to create an outward-looking economy are not to be applied uniformly but selectively in a way that goes beyond special assistance for sensitive industries which have to adjust to international competition. Consideration of industrial policy and the efforts on the part of governments to select winning industries go beyond the confines of this paper. Suffice it to note the observation by Chris Milner that 'comparative advantage changes through time, and governments are unlikely to be better pickers of new export "winners" than they have been of "infant industries" to substitute for

imports'. According to Milner: 'Given the complexities of economic structures and processes in an industrialising country and given the inherent administrative inefficiencies in LDCs, it is unlikely that selective state intervention will approximately achieve either an optimal resource allocation (at any one moment or over time) or induce the efficient use of resources once allocated' (1988:76). Targeting could work, but there is no reason to believe that governments have sufficient knowledge and information to select winning industries on a systematic basis.

The regional dimension

The economies of Southern Africa have always been closely integrated, to an extent and in a way which have led many commentators to see it as a relationship of dependency of the smaller neighbouring states on South Africa, and with significant benefits for the latter (see, for example, Lewis 1990:80–96, Weimer 1990:20–22). South Africa has been a net importer of labour from the region and an exporter of capital and management. South African firms, the Anglo-American De Beers group in particular, has been a prominent player in the region's mining sector, while South African manufacturing and trading firms have also been active in the neighbouring states. Trade flows have also been substantial, with a large balance in South Africa's favour. The close integration of transport and communications infrastructure in the region is also well known. To deal with these relationships, South Africa has always maintained an extensive network of economic links with the region, including trade arrangements and functional cooperation of a sector and project-specific nature (Maasdorp 1991). Because of these links and the dominant position of its economy, South Africa's trade and industrial policy is bound to have a significant impact on the region as a whole.

The close links within the region are a legacy of colonial times. With the exception of the two ex-Portuguese colonies, Angola and Mozambique, Great Britain was the colonial power in the region; and prior to independence and the growing grip of apartheid policies in South Africa after 1948, a common sense of identity existed between the Union of South Africa and the anglophone colonies and protectorates of the region. Mozambique was also drawn into the South African influence sphere through its dependence on labour exports to South Africa. Maputo is the port closest to the industrial heartland of South Africa and also used to be an important destination for South African tourists.

Independence and the strong opposition to apartheid South Africa created a difficult situation within the integrated economy of the region, especially when the neighbouring states became the targets, first of South African efforts to extend its influence in the region (mainly through the concept of a Constellation of Southern African States), and subsequently of destabilising intervention in the neighbouring countries. The Southern African

Development Coordination Conference (SADCC) was established in 1980 as an effort to decrease the dependence of the southern African states on South Africa. Even the Southern African Customs Union (SACU, consisting of South Africa and the BLNS countries—Botswana, Lesotho, Namibia and Swaziland), the oldest operating customs union and most intensive form of integration in Africa, represents an effort to deal with the economic inter-dependence of politically independent countries. Botswana, Lesotho, Swaziland and Namibia (the latter joined SACU in 1990) were during their pre-independence years largely governed as sub-regions of the South African economy. A common market with a common external tariff determined by South Africa, an integrated infrastructure, a common currency and close administrative structures existed. The SACU Agreement of 1910 was a rather cursory document that provided for the free interchange of manufactured goods, to facilitate the unrestricted flow of goods to the landlocked High Commission Territories, and the distribution of customs union revenue through a formula that determined a fixed share for each of the territories.

The post-independence SACU Agreement (1969) acknowledged the economic asymmetries between South Africa and the BLS countries (Botswana, Lesotho and Swaziland) by providing for a development objective. The structure of the agreement was changed from a neutral revenue distribution mechanism to a development-oriented arrangement that provides for variations in trade flows and for the impact of South Africa's protectionism and the influence which this has on the common external tariff (McCarthy 1994). The smaller member states are compensated for trade diversion and thus higher prices in their markets by the inclusion of imports from South Africa in the revenue-sharing formula of the custom union; the residual of the revenue accrues to South Africa. The revenue-sharing formula also incorporates a multiplier which compensates the BLNS through fiscal transfers for polarised development, trade diversion again and for the loss of fiscal sovereignty. Exceptions to the duty-free flow of trade within the common customs area are provided for to enable the BLNS countries to protect infant industries or industries which are of special interest to their economies. South Africa's protectionist use of quantitative restrictions, in turn, was accommodated by the recognition of the right of contracting parties to restrict the importation (or exportation) of goods for Economic, social, cultural or other reasons' (article 11(1) of the Agreement) and by cooperation in the application of import restrictions to ensure the economic objectives of import control legislation (article 11(5)).

In spite of the elements of developmentalism, the SACU agreement essentially remained an arrangement which had to deal with the situation of small but politically independent African states being locked into an integrated economy with apartheid South Africa, that is a marriage of convenience. How does one, in view of these considerations, explain the longevity of SACU compared to, for example, the promising East African Community that failed?

The answer to this question might perhaps be found in two prominent reasons for the failure of integration arrangements. The first is the existence of economic asymmetries and the phenomenon of polarised growth, that is the concentrated location of economic activity in the larger and more developed participant. The second is the unwillingness to sacrifice control over economic policy; countries find it difficult to cede sovereignty to a supra-national regional authority or some form of inter-governmental organisation.

In the case of SACU, the South African tariff, determined by the industrial development needs of South Africa, and excise duties determined by the South African Department of Finance, apply in an arrangement administered by South Africa. Delegating the affairs of SACU to South Africa effectively serves as a substitute for the supra-national body which would have been required to act in the common interests of the customs union (McCarthy 1995:225). This means that the BLNS in practice cede sovereignty on important elements of economic policy; for South Africa the issue of policy independence has never arisen. The economic asymmetry between the larger and more developed South Africa and the BLNS countries has always been an important issue. However, even considering the dissatisfaction among the smaller SACU members with the level and procedure of compensatory payments, the fact is that enhanced fiscal transfers took place as a form of compensation which, on balance, is more fundamental than the industrial policy and transfer taxes of the East African Community had been in countering the polarised development that focused on Kenya.

The democratisation of South Africa introduced a new dimension to the Republic's involvement in regional integration arrangements. For SACU the demise of apartheid meant that the 'at arms length' approach of the BLNS countries to relations with apartheid South Africa could be replaced by a new interactive approach. In South Africa the need for a revision of the SACU agreement has also been widely appreciated. An official SACU investigation into the operation of, and changes to, the agreement started towards the end of 1994. Despite optimism that the investigation could be completed in a matter of months, a report has still not been completed (at the time of writing in October 1996) which seems to indicate that the problems encountered are more difficult and sensitive than previously imagined.

An important issue is the perceived need to democratise SACU which apparently means the elimination of South Africa's dominating role in the operation of the customs union. It is difficult to argue against a cause as worthy as democratisation, but it is possible that the longevity of SACU can in part be explained by its undemocratic nature. Considering the discrepancy in economic size and development between South Africa and the smaller customs union members, and the different approaches to development which this allows, it is unlikely that South Africa would have remained a member of SACU if it had to cede its sovereignty in the field of industrial and trade policy to a supra-national agency of the customs union. For the BLNS

countries the loss of policy independence had been compensated for by access to a large protected market and, more importantly, fiscal compensation. South Africa faces particular development problems in its domestic economy, specifically the change from an inward-looking to an outward-looking economy in a fragile democracy that has to bridge a large welfare gap in society. The challenge may become one of addressing these problems with less than complete sovereignty in industrial, trade and fiscal policy. For SACU as a whole, South Africa's WTO commitments and the lowering of tariff levels have important implications. The price-raising effect of protection, a negative outcome of SACU membership which the BLNS countries has consistently highlighted, will become less severe, while customs union revenue, depending on the price elasticity of the demand for imports, is likely to decrease.

For SADCC the pending democratisation of South Africa also meant a dramatic change of scene. Since SADCC derived its existence from the perceived need to be less dependent on apartheid South Africa, the move towards democracy in South Africa necessitated a re-orientation of the organisation. The result has been the Treaty of Windhoek in August 1992, which transformed SADCC into the Southern African Development Community (SADC) and introduced trade integration as a goal. South Africa joined SADC as the eleventh member in August 1994 (Namibia having joined in 1990 and Mauritius as the twelfth member in 1995) and was allocated the portfolio of finance and investment in terms of the SADC mission of functional cooperation and the division of the selected areas of cooperation among the member states. The SADC member states, with the exception of Angola, have signed a trade protocol which still has to be ratified and the exclusions specified. The aim is to achieve a free trade area eight years after the ratification of the agreement.

The intra-regional trade flows, shown in Table 4.1, reveal a trade balance heavily in favour of South Africa. South Africa's democratisation has provided an additional impetus to the country's exports into the region, of which the dollar value grew by 24 per cent from 1990 to 1994. Imports from the region increased by 29 per cent, which was not sufficient to reduce the size of the trade balance. The latter actually increased from an estimated US$ 3,271 million in 1990 to US$4,004 million in 1994.

Theoretically there is no reason why trade between countries and within regions should be balanced. However, in a regional framework characterised by the aspirations of integration and a need for the lesser developed countries to benefit from the more developed country, trade flows are interpreted within the context of the intra-regional distribution of the benefits of integration. For some of the countries in the region, trade barriers are important obstacles in the development of two-way trade. A case in point is Zimbabwe, an economy with substantial industrial capacity and South Africa's largest non-SACU trading partner in the region. Zimbabwean officials and business

Table 4.1 South African trade with countries in the region (US$ millions)

	South African exports to		South African imports from	
	1990	*1994*	*1990*	*1994*
Botswana	1,318	1,146	160	157
Lesotho	579	830	27	69
Namibia	1,013	1,014	347	425
Swaziland	552	793	262	323
Total: SACU	3,462	3,783	796	974
Malawi	145	175	47	52
Mozambique	200	396	10	26
Zambia	227	326	11	29
Zimbabwe	301	693	200	288
Total	4,335	5,373	1,064	1,369

Source: *Trade estimates by the Nedcor Economic Unit, June 1995, Johannesburg: Nedbank*

people felt particularly miffed by the opposition of South African interest groups to the renewal of a bilateral trade agreement, which in the end was concluded and became effective on 1 September 1996. Zambian interest groups are equally disturbed by the inflow of South African goods, at the cost of domestic production, after Zambia's uniteral trade liberalisation as part of the country's structural adjustment programme. In both cases a widely held view is that the South African economy is benefiting from non-reciprocal trade relations with weaker neighbouring states. However, while trade barriers may be important in some cases, it is more likely that the predominant problem is a lack of capacity to produce tradable goods which can be sold competitively in the South African market. A poor infrastructure and the absence of a dynamic private sector, brought about by the earlier emphasis on parastatals in import-substituting industrial development, are the principal causes of the paucity of production capacity.

These issues are a manifestation of the wider problems that arise when countries at different levels of development and with different approaches to development enter into agreements to integrate their economies. This problem became apparent when South Africa's regional industrial development policy became a stumbling block in the distribution of industrial activity within SACU. Since 1960 South Africa has gradually provided more generous incentives to encourage decentralised industrial growth. Manufacturing is a footloose form of economic activity, and from the start the government endeavoured to provide the homelands with some economic substance through a programme of regional industrial development. In official South African circles the economic rationale of the industrial decentralisation policy was argued to be the need to counter the geographic over-concentration

of economic activity in South Africa's metropolitan areas and the social costs associated with congestion. A regional industrial development programme (RIDP) was introduced in April 1982 that provided manufacturing firms with wide-ranging and generous incentives which towards the end of the 1980s cost the South African tax payer approximately 800 million rand a year in recurrent expenditure.

The programme was largely unsuccessful. The decentralised industries, it was found, could not survive without subsidy and the programme was replaced in 1991 by a new RIDP. The measures introduced in 1991 were less generous and adopted a largely uniform approach to economic space, that is the homeland focus was abandoned, with only the Pretoria/ Witwatersrand/ Vereeniging metropolitan area and the central Durban core area excluded from benefiting from the programme. The tax holiday introduced on 1 October 1996 replaced the RIDP.

The BLS countries found the RIDP of the 1980s to be a major constraint on their ability to attract and in some cases to hold industry. Since SACU forms a single space economy behind a common external tariff, the ability nationally to implement regional investment incentives can distort competition for investment in the common customs area. The decentralisation incentives, which could not be matched by the BLS countries, not only strengthened the polarisation effect but also introduced a new element in the polarisation process. The polarisation impact of regional integration derives from Myrdal-type backwash effects; because of agglomeration economies, economic activities concentrate geographically in the metropolitan centres of the common market. In SACU the industrial growth encouraged by the larger market concentrated in the metropolitan areas of South Africa, and what the RIDP did was to redirect some industrial activity not to the lesser developed regions of the common customs area but to particular regions of South Africa, specifically the homelands.

The impact of South Africa's regional industrial policies highlights the difficult issue of industrial and trade policy and different dimensions of polarisation in an integrating region. Trade patterns in Africa typically have a 'hub and spoke' character. The 'hub', which is the dominant centre of economic activity located in the developed world, mostly Europe, acts as the source of manufactured exports to Africa and of the demand for primary good imports from Africa. Low levels of intra-regional trade exist among the African 'spokes' (Baldwin 1995). A major exception to this pattern is the core-peripheral relationship in Southern Africa with South Africa acting as the 'hub' with its regional spokes. The infrastructure of the region is integrated and centred on South Africa with regional trade flows heavily in favour of South Africa. The latter exports manufactured goods to countries in the region but with few imports of primary products.

Two dimensions of polarisation can be identified in this core-peripheral relationship: the first is between South Africa and the neighbouring countries;

and the second, within South Africa itself, exists in the large disparities between the major metropolitan areas and the poor, traditionally black rural areas. The latter is reflected in the wide variations in per capita income levels among the provinces of South Africa: the per capita incomes of the Northern Province and the Eastern Cape, the poorest provinces, are only 14.5 per cent and 27.2 per cent of the per capita income of Gauteng, the richest province (Development Bank of Southern Africa 1994). A rural/urban divide is reflected in the estimate that about 75 per cent of the poor live in the rural areas where 53 per cent of the population lives. Looked at from a different angle, about 74 per cent of the rural population is poor, compared to about 41 per cent of the urban and 20 per cent of the metropolitan populations (Ministry in the Office of the State President 1995). South Africa may be the most developed country in the region, but large rural areas of the country are very poor.

But why does the flow of factors of production not produce greater equality in the spatial distribution of economic activity? One would expect that people would migrate from the poor to the more affluent regions in search of jobs and higher incomes and that capital, in search of the higher returns that derive from its greater scarcity, would flow in the opposite direction. In the first place, it should be noted that people are socially constrained in their mobility. Nevertheless, people are relocating, as the growth of informal settlements in South African cities and the increase in urban unemployment and informal employment show. This is not merely a national phenomenon; estimates of illegal immigrants (also referred to as undocumented people) from African countries seeking a livelihood in South Africa vary, but even the most conservative among these point to numbers of around three to four million. Labour flows run up against low job-creating growth and labour market inflexibilities which restrict the absorption of large numbers of workers in formal employment. An important issue is that comparatively high wage levels, which combines with low productivity to yield high unit-labour costs, exist in a labour market characterised by large un- and underemployment, powerful trade unions and a large gap between the average incomes of skilled, mainly white workers, and unskilled and semi-skilled black workers. Entry-level wages in formal employment are about three times higher than in the neighbouring countries. Under these circumstances it is unlikely that South Africa, in the face of strong trade union opposition in particular, will embrace a free flow of labour in the region.[1] The experience of the Economic Community for West African States (ECOWAS) with the free movement of people, in particular the reaction during the early 1980s of the more developed Nigeria and Ghana to the large inflow of foreign workseekers (Ghana closed its border in September 1982 and Nigeria expelled illegal aliens in 1983 and 1985) would seem to support the view that panAfricanism, African solidarity or regional cohesion does not always stretch so far as to include labour mobility. Furthermore, it

is also worth noting that the flow of migrants to South Africa contain elements of a brain drain of skilled workers to South Africa which could only worsen the problem of regional economic imbalance.

Capital flows and their role in addressing regional inequalities must also be considered. Bell has argued persuasively that during the thirty years since 1960 a regional restructuring of industry has taken place in South Africa with labour-intensive industries such as textiles, clothing and footwear shirting, in search of relatively cheap labour, first to Durban-Pinetown and then to the Cape Peninsula. In these centres the Indian and Coloured workers were relatively cheap compared to the predominantly white work force in the Transvaal and Port Elizabeth. This was followed in the 1970s by a shift to the homelands as centres of cheap black labour (Bell 1990). The governments efforts at industrial decentralisation therefore meant that the decentralisation incentives encouraged a movement which has already developed on the basis of market considerations. As noted earlier, this was negatively received by the smaller SACU members who could not afford similar incentives. Recently, a number of reports have indicated that South African business is on the move again but this time investing and trading in the neighbouring states to take advantage of trade liberalisation and lower labour costs. During the sanctions era SACU countries attracted significant South African investment that sought to avoid the stranglehold of international isolation. Sanctions evasion is no longer required; the new force underlying cross-border investment could be the effort to escape the inflexibility and relatively high wage levels that apply in the South African labour market compared to those in the countries of the region.

However, these investment flows do not necessarily imply a preference for investment outside South Africa to a metropolitan complex in South Africa; it is also an issue of countries in the region being preferred to the lesser developed rural areas of South Africa. A striking example in this respect has been the decision by Pepkor, a major integrated clothing concern which produces and retails in the lower-price mass market, to close its factory in Butterworth in the poverty-stricken Eastern Cape Province and subsequently to establish a factory in Malawi. While lower wage costs were a consideration in this decision, it is significant to note that the crucial factor which decided the location in Malawi was the duty-free entry into the South African market that a bilateral trade agreement permits Malawi-produced products. Location outside SACU allows the clothing manufacturer to escape the protection afforded South African textile producers and to access the cheapest sources of cotton material in world markets, complemented by production at much lower unit labour costs for duty-free import into South Africa. Lower corporate tax rates with added tax discounts complete a package which allows profitable production for the South African market.

South African direct investment can be a powerful instrument in bringing about a more equal distribution of economic activity in the region. The South

African business sector has the knowledge of African circumstances and the ability to contribute through cross-border investment to the creation of a capacity to produce goods in the neighbouring countries for export to South Africa and further afield. Facilitating such a flow of capital and a commensurate flow of trade will fit in with an arrangement such as the Cross Border Initiative (co-sponsored by the World Bank, the IMF, the European Union and the African Development Bank) that aims to encourage regional integration and development through the removal of obstacles to the flow of goods, labour and capital (World Bank 1995).

However, large-scale South African investment in the regional market will not be without its political sensitivities, especially if this is perceived by labour to be at the cost of job opportunities in South Africa. Since lower wage costs in the more flexible labour markets of the region could be the main driving force of such investment in manufacturing, three options seem to exist for organised labour in South Africa. The first is to remove the cost advantage of countries in the region through intra-regional labour organisation and the raising of wages and labour standards in the neighbouring countries. The second is to seek ways of restricting the mobility of capital to prevent it from utilising cheaper labour in neighbouring states and the third is to adopt strategies that will allow labour to compete in the world economy on a high-wage/high-value-added basis, that is, on a basis that justifies comparatively high wage costs. The Congress of South African Trade Unions (COSATU) is known to favour the third approach as a general industrial development strategy of 'moving up the value scale' (Joffe *et al.* 1995:27–31). However, this strategy has not been proposed against the background of regional development but only within the national context. It is doubtful whether the second option is politically feasible since, in essence, it will amount to a morally indefensible 'beggar thy neighbour' policy which will present itself as politically incorrect. The first option is the most likely one to be chosen with trade unions concentrating their efforts on exporting South African formal sector labour market practices to the region.

The official South African position favours an active role for South Africa in the region. In a recent discussion document prepared by the Department of Foreign Affairs a strong emphasis is placed on the country's regional and development roles and the view is expressed that 'investment in the neighbouring countries by the private sector should be encouraged' (Department of Foreign Affairs, undated: 27). In view of South Africa's dominant economic position within the context of regional integration it could be expected that consistent and serious consideration would be given to the impact of South African policies on the economies of the region. In the words of the Department of Foreign Affairs: 'When policies are formulated in South Africa, role players should consider the manner in which a particular issue presents an opportunity for South Africa to promote the interests of the SADC region or the African continent' (Department of Foreign Affairs, undated: 11).

However, it is not clear how the changes in industrial and trade policy in South Africa will affect the growth and development of the other countries in southern Africa, in particular the customs union partners with whom South Africa shares a single space economy. Even more important is the fact that the most recent changes in South African trade and industrial policy have been adopted, apparently without explicit consideration of the regional dimensions of these policy changes. Even the commission on labour market policy, in a whole chapter on industrial strategy, does not once refer to or even implicitly consider the regional dimension of South African industrial development policies (Labour Market Commission 1996:29–48).

Concluding summary

The principal aim of recent changes in South Africa's trade and industrial policy has been to make the economy, manufacturing in particular, more competitive in international markets. At first import-substituting growth was maintained and even intensified as a reaction to increasing international isolation; simultaneously, efforts were made to neutralise the cost-raising impact of protection on export producers through direct and indirect export subsidies. The demise of apartheid and WTO membership have brought about a change in approach. Sanctions-driven constraints on market access were removed and incentives that target export production became illegal in terms of WTO commitments. Tariffs are to be lowered over an extended period, the WTO-illegal export subsidy scheme (GEIS) is to be phased out and its place taken by supply-side measures which are meant to place manufacturing on a competitive footing in the world economy. Quantitative import restrictions have been removed and the real exchange rate has declined sharply since February 1996, as if in excessive reaction to the wishes of many economists who have propagated a lower value of the rand to encourage trade-based development.

Much will depend on the efficacy of the supply-side measures in encouraging investment in export capacity. The point has been made in the paper, however, that WTO-legal supply-side measures would in all likelihood not remove the anti-export bias in the economy, since, like the depreciation in the currency, they will be neutral in their impact on the domestic prices of importables and exportables. Also of concern is the element of targeting built into the tax holiday. Criteria are to be used in the awarding of the tax holiday which clearly intend to encourage investment in selected manufacturing subsectors. South Africa has a poor track record of inward-looking intervention to promote selected industries. Circumstances have changed significantly with a new government in place and with enhanced access to the regional and global market, but there is still no reason to believe that these changes have introduced a wisdom in economic governance that can do better than the market in selecting winning industries.

The large differences in the economic development of South Africa's nine provinces, and in particular the extent of mass poverty in some of them, will mean that the targeted use of the tax holiday to encourage investment at selected places will bring about a return to the selectivity of the earlier efforts to promote decentralised industrial development in South Africa, but this time without the overtones of Grand Apartheid and homeland development. However, this will be cold comfort for the smaller members of SACU who find themselves in a single economic space with South Africa. The tax incentives, through its selective impact in the region, could constrain the cross border investment by South African firms required to build capacity for the production of tradable goods in the region. Without this capacity, intra-regional trade cannot contribute to the sustainable growth of the region. For non-SACU countries access to the South African market will also be important. In this respect, the lack of synchronisation between South Africa's phased reduction of trade restrictions and the neighbouring states' SAP-based trade liberalisation is bound to be a problem. However, where bilateral trade agreements with South Africa exist, as is the case for Zimbabwe and Zambia, the protection of the South African (SACU) market opens a window of opportunity for these countries to attract South African direct investment. An example was given in the paper of a South African clothing manufacturer and retailer that has shifted part of its production to Malawi to benefit from cheaper imported inputs in production for the South African market. Should SADC advance towards a free trade area, the current country-selectivity that results from bilateral agreements will be removed which means that within SACU special attention will have to be given to the BLNS countries if they are not to lose out as locations for South African investment.

The success of regional cooperation and integration in Southern Africa will largely be determined by the ability to deal with the problem of polarised development and the imbalance in regional trade. This paper has not concerned itself with the options that exist to address these issues. The emphasis has been on the evolution of South African trade and industrial policy and the impact these changes in the dominant economy have on the region. However, there is not yet any concrete evidence in South African policy-making that consideration of the regional consideration matches the rhetoric that characterises public pronouncements.

Note

1 This problem is not unique to South Africa and its position within Southern Africa. In an analysis of the negotiation stances typically adopted by more and lesser developed developing countries on integration arrangements, Axline considered greater freedom in the mobility of labour and capital and then concluded that the more developed developing countries 'themselves with unemployment often surpassing 25 per cent, will be extremely reluctant to implement this basically distributive policy' (1977:94).

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Part II

REGIONAL STUDIES

5

TRADE INTEGRATION AND ECONOMIC DEVELOPMENT: SOME SOUTHERN AFRICAN ISSUES

Gavin Maasdorp

International economic relations today are characterised by two trends, namely globalism and regionalism. The signing of the Marrakech Agreement in 1994 signalled the conclusion of the Uruguay Round of the General Agreement on Tariffs and Trade (GATT) and led to the establishment of the World Trade Organisation (WTO) in 1995. All Southern African countries are members of the WTO and hence are committed to the process of multilateral trade liberalisation. However, the Uruguay Round was paralleled by greater regionalism in the form of trade integration schemes, notably in Europe, North America, South America and South-East Asia, with a looser association in the Asia-Pacific area.

Another noteworthy trend is the continuing globalisation of national economies. The activities of multinational corporations (MNCs) have been encouraged by greater economic liberalisation globally as well as by the electronics-based technological revolution. This has led to the undercutting of national boundaries by the 'information superhighway' and the electronic media, and to MNCs becoming increasingly 'footloose' with respect to the location of their overseas plants. All these changes have raised questions as to the relative economic power of national governments as opposed to MNCs and to the future importance of traditional trade integration schemes.

There is now a fair measure of agreement among economists that, theoretically, the optimal trade area is the world and that multilateral free trade for all is the first-best case (Cooper 1994, Bhagwati 1994). Regionalism, in the form of trade integration schemes such as free trade areas, customs unions, common markets and economic unions, is a second-best solution. The argument is that regional blocs should be building blocks, not stumbling blocks, towards global trade liberalisation. In fact, since tariffs on intra-regional trade are virtually dismantled in economic integration schemes, regionalism extends the geographic area

of free trade and is, therefore, complementary to the WTO's global measures.

The analysis of the costs and benefits of trade integration has moved away from the traditional Vinerian approach for examining trade creation and trade diversion (Viner 1950). In a study of the economic consequences of European integration, Ohly (1992) identified a number of trade effects. These include changes in trade flows and the resultant adjustments in the structure of production; changes in employment and income; changes in the terms of trade; changes in the rate of growth; economies of scale; improvements in technical efficiency; learning effects in production; cost savings and price reductions arising from the elimination of non-tariff barriers; and price reductions arising from increased competition. Some of these effects are static, i.e. they are once and for all, for example as a result of a more effective allocation of resources; others are dynamic, i.e. they create additional resources in the long run. The effects will differ among sectors, industries or enterprises.

The analysis of the costs and benefits accruing to any country from trade integration is imperfect because of the complexities arising from static and dynamic effects as well as from micro- and macroeconomic processes. Nevertheless, a number of attempts have been made at assessing the effects of integration in the Southern African Customs Union (SACU). Leith's (1992) stricture, that these studies, by virtue of their partial nature and confinement to static welfare effects of trade creation versus trade diversion, have excluded the dynamic, non-conventional and competitive effects of integration, still holds. This paper is essentially a 'thinkpiece'. The writer has participated in several studies attempting to quantify the effects of trade integration in the Southern African region, but the use of sophisticated models has been hampered by the paucity of trade data at both the institutional and country level. The production of detailed statistics on a comparable basis for all countries is a major need as far as the analysis of regional trade is concerned. However, despite the problems inherent in providing conclusive evidence, and also the lack of serious studies for individual countries outside of the SACU, there seems to be a strong view among Southern African governments that regional trade integration is a 'good thing'.

The state of trade relations in Southern Africa

Variable geometry

The establishment of a regional trade bloc does not preclude a sub-group of countries from moving more rapidly than the rest through the hierarchy of integration arrangements. This process is variously known as variable geometry, concentric circles, or a multi-speed or fast-track approach and does

not compromise subsequent region-wide trade liberalisation. There are three distinct groups of countries within the Southern African Development Community (SADC) in terms of intra-regional trade relations.

First, the five SACU countries are members of an orthodox customs union involving duty-free trade in goods and services among the members and a common external tariff (GET) on imports from the rest of the world.

Second, of the remaining SADC countries, five (Malawi, Mauritius, Tanzania, Zambia and Zimbabwe) are participating in the Cross-Border Initiative (CBI), a fast-track group of fourteen countries in the Common Market for Eastern and Southern Africa (COMESA)/SADC region which are moving towards the elimination of tariffs on intra-regional trade and the harmonisation of external tariffs by October 1998. If this ambitious timetable is adhered to, the CBI countries will have reached the stage of a free trade area and be very close to a customs union: the harmonised external tariff is not quite the same as a GET—it allows scope for flexibility—but is seen as part of a process of achieving a CET.

Third, Angola and Mozambique are committed to trade liberalisation under the WTO and COMESA. However, they are not involved in any short-term moves towards free trade.

The SADC countries, therefore, present a picture of variable geometry, with some countries already being at advanced levels of trade integration and some moving more quickly towards free trade than others. All countries, however, are members of either the SACU or COMESA (an organisation which has trade integration as its specific goal) with some overlapping of membership in the case of Lesotho, Namibia and Swaziland. In addition, a number of bilateral trade agreements exist in the region, e.g. South Africa with Malawi and Mozambique; Zimbabwe with Namibia and Botswana.

When it was reconstituted in 1992, the SADC moved away from its original stance as a sectoral-cooperation organisation to one which also included free trade in its ambit. A Trade Protocol was signed by all countries except Angola in August 1996. The timetable stipulated that agreement should be reached on a detailed list specifying the schedule for tariff reductions within six months, i.e. by February 1997, after which the countries should sign the treaty and thereafter free trade was to be achieved within eight years, i.e. by 2005. The SADC's insistence on establishing its own free trade area has puzzled many observers, given the existence both of the SACU and COMESA (which are legally binding multilateral trade treaties) and of the fast-track CBI group.

At the same time as the SADC was drafting its trade protocol, individual countries such as Zambia and Zimbabwe pressed for the conclusion of bilateral trade agreements with South Africa. This suggests that the implications of the Marrakech Agreement had not been fully appreciated.

The WTO and its implications

Any changes to intra-regional trade arrangements have to be consistent with the Marrakech Agreement. Two sections are particularly relevant to Southern Africa, namely Article XXIV and Part IV (WTO 1995, Kumar 1995, Blumberg 1994). For the purposes of this paper, the main implications for the region are as follows:

1   Article XXIV enshrines the principle of multilateral non-discrimination, i.e. each contracting country has to offer unconditional most-favoured nation (MFN) treatment in regard to trade to all other contracting countries. The MFN principle is the cornerstone of the WTO.

2   The only exception to MFN treatment is in the case of free trade areas and customs unions, which are provided for as long as they go virtually all the way towards the elimination of intra-regional trade barriers. In terms of Article XXIV, regional integration arrangements must eliminate duties and non-tariff barriers on 'substantially all trade' between member countries. Ten years is deemed to be a reasonable length of time for the formation of a free trade area or customs union.

3   There is an important difference between a free trade area and a customs union. In the former, each member country is entitled to enter into free trade agreements with third countries. By contrast, in a customs union the CET provision precludes the independent exercise of trade policy by a member country towards outsiders, i.e. members have to maintain common trade policies towards non-members.

4   A customs union as a whole is entitled to enter into a trade agreement with an outside country or group of countries. An example of this is the establishment of the European Economic Area (essentially a free trade area, entered into between the EU and the EFTA).

5   Part IV of the GATT establishes the principle of non-reciprocity in trade negotiations between developed and less developed countries (LDCs). This allows developed countries to adopt special measures to promote the expansion of imports from LDCs. An example of non-reciprocity in terms of Part IV is the Lomé Convention between the EU and the Africa, Caribbean and the Pacific States (ACP) countries in which the EU did not demand reciprocity from the latter. However, the Lomé Convention was challenged, the argument being that non-reciprocity violated MFN treatment since Part IV endorses special treatment in favour of *all* LDCs, not just a sub-group. The Lomé Convention is therefore operating under a waiver until 2000.

Article XXIV, Part IV and the waiver granted to Lomé IV have a number of implications for Southern Africa.

1   Bilateral agreements are not consistent with customs union membership,

and MFN treatment has to be accorded to third parties. The 1969 SACU Agreement is weak in this respect. It contains an article allowing a member country to enter into bilateral trade agreements with third parties providing the remaining members agree. This article should be eliminated in the new agreement: not only would it be inconsistent with Article XXIV but it would open the remaining members to problems of trade deflection, i.e. the leakage of goods imported by one member country from the rest of the world into the territory of other member countries without paying the customs duties imposed by those countries on imports originating outside the customs union. South Africa's bilateral trade agreements with Malawi, Mozambique and (until recently) Zimbabwe, as well as Namibia's and Botswana's bilateral agreements with Zimbabwe, are at odds with SACU membership. Zambia's requests for bilateral trade agreements with South Africa and Namibia, and indeed the SADC resolution of January 1996 encouraging bilateral agreements with SACU countries, also contravene Article XXIV.

2   Article XXIV requires that agreements to establish customs unions be notified to the WTO for study by a working group and subsequent registration. The 1969 SACU Agreement was not notified to the GATT at the time. South Africa was the only party which belonged to the GATT, for political reasons it did not wish to draw unnecessary attention to the SACU and it argued that the Customs Union had in any case been in existence since 1910 and therefore pre-dated the existence of the GATT. However, the SACU countries have agreed that the renegotiated Agreement be notified to the WTO.

3   Individual member countries of the SACU may not unilaterally join other free trade areas. As Kumar (1995) states: 'the SACU countries would need to act in concert, and be treated as one, in the SADC negotiations for the reduction of tariffs'. The SADC free trade agreement, therefore, will essentially be between the SACU as a bloc and the non-SACU countries.

4   The existing membership of Lesotho, Namibia and Swaziland in COMESA is inconsistent with customs union practice. As a corollary, the decision by Botswana and South Africa not to join the COMESA is in line with customs union convention.

5   The bilateral negotiations between South Africa and the EU regarding the conclusion of a free trade agreement are inconsistent with the former's membership of the SACU. It is now agreed both by South Africa and the EU that the other SACU members should be brought into the negotiations, although to date exchanges continue to be on a bilateral basis.

6   The WTO regards the SACU countries as consisting of one developed economy (South Africa) and four developing economies (BLNS). The BLNS countries are members of the Lomé Convention, and consequently

do not have to reciprocate trade preferences with the EU, but South Africa, with its developed country categorisation, cannot receive non-reciprocal trade preferences from the EU. A free trade area, however, must involve reciprocity, and this is the basis for the negotiations.

7 Not only is South Africa unable to negotiate bilateral trade agreements with third countries by virtue of its SACU membership, but as a categorised developed country it cannot anyway give non-reciprocal trade preferences to developing countries without violating MFN rules. Thus, even supposing that bilaterals were consistent with the Marrakech Agreement, any non-reciprocal bilateral trade agreements which African countries seek to enter into with South Africa would have to be applied by South Africa to all other developing countries in the world. No African country can gain unique trade preferences with South Africa unless it were to enter into a free trade agreement with the SACU.

The free trade area debate

Against this background, let us now consider the current arguments surrounding free trade in the SADC region. The most strident proponents of 'free trade now' appear to be Zimbabwe and Zambia, both of which have had serious differences of opinion with South Africa regarding access to its market. Malawi and Mozambique have trade agreements with South Africa which pre-date the Marrakech Agreement and, for this reason, are held to be unaffected under the WTO. These agreements are asymmetrical, favouring exports from these countries. The Preferential Trade Agreement with Zimbabwe dates from 1964; it benefited in particular Zimbabwean clothing and textile exporters. In 1992, faced by a growing flood of cheap imports from the Far East, South Africa raised its tariffs on clothing and textiles from 15 per cent to 75 per cent. Zimbabwe's five percentage point preference now meant a tariff of 70 per cent instead of 10 per cent, its relative preference falling from one-third to only 6 per cent. Zimbabwe regarded this as unreasonable and requested South Africa to reinstate its relative preference on clothing and textiles (the Agreement continued to operate unchanged in respect of other commodities). There followed protracted haggling with South Africa offering Zimbabwe revised access based on the requirement of 75 per cent local content, later reducing this to 25 per cent. Not only was this again rejected by Zimbabwean producers, who stated that the figure was still too high since they imported all their raw materials, but it was opposed by the South African industry, which complained that it had not been consulted and that cheap products from the rest of the world could be routed through Zimbabwe with only a limited amount of value added in the form of labelling. Already, they added, clothing and textiles from the Far East were entering South Africa having taken advantage of the trade agreements with Malawi and Mozambique. Eventually, South Africa agreed to reduce

tariffs on Zimbabwean clothing and textiles to 30 per cent from September 1996 and 20 per cent by 2000.

Despite being labelled protectionist in the region, South Africa has been engaged in trade liberalisation for several years. The base year for tariffs in the Uruguay Round was 1989 for industry and the 1986–88 average for agriculture. Belli *et al.* (1993) found an effective protection rate for 1992 of 28 per cent compared with the Industrial Development Corporations 17 per cent for 1994. This suggests that unilateral liberalisation occurred between 1989 and the beginning of the implementation period, i.e. 1 January 1995. Moreover, the South African government has moved significantly faster than required by the WTO in key industries such as clothing and textiles, and motor vehicle assembly and components. These industries had very high protective tariffs, and South Africa was offered a twelve-year phase-in period by the GATT but in fact accepted eight years. South Africa sees trade liberalisation as an important element in restructuring the economy, increasing competitiveness and creating long-term employment. For other industries the offer was relatively simple, that is an average one-third cut in equal stages over five years.

The implementation of the GATT offer commenced at the beginning of 1995. The tariff cuts occurred at the same time as South Africa's customs controls at ports and border posts began to crumble for various reasons, mainly relating to manpower. The result has been that cheap imports of clothing, textiles and footwear have flooded the country, and employment in these industries has declined rapidly. Yet these industries are politically sensitive because they have traditionally been major employment subsectors and have had strong trade unions. Another politically sensitive industry, motor vehicles, has faced increased competition because of a loophole (relating to the definition of 'semi-knocked down') in the South African legislation on local content in the industry. A Korean assembler was able to take advantage of this loophole and, by locating in Botswana, gain access through the SACU to the South African market. Now, this example has been followed by other foreign manufacturers, and the effect has been that the reduced protection levels the industry had expected to face in 2002 are in fact being experienced today.

Zambia has felt that its rapid trade liberalisation under structural adjustment has gone unrewarded: it has opened its markets to South African goods but its industrial reconstruction is being hampered by tariff barriers to the South African market. Its request for a bilateral agreement was referred by Pretoria to the SACU level, and consideration is being given to an interim arrangement with Zambia which would be consistent with the move to free trade in the broader region. Details were scheduled to be finalised by the end of 1996.

In the face of opposition from key manufacturing pressure groups and unions regarding its trade liberalisation policy, the South African government

did not appear anxious to commit itself to any further liberalisation over and above its contractual obligations to the WTO. However, the rapid depreciation of the rand led the government to announce in June 1996 that it would indeed reduce tariffs at a faster pace than the GATT offer made provision for.

South Africa enjoys a favourable balance of trade with its neighbours. The BLNS countries together represent South Africa's largest export market and trading partner. In 1994, for example, exports to BLNS were worth 13,788 million rand (more than double that to any other country) while total trade with BLNS was 17,131 million rand as against 16,678 million rand with Germany, South Africa's largest single-country trading partner.[1]

However, South Africa's foreign trade statistics are usually subsumed under the SACU. The non-SACU SADC countries argue that the SACU's favourable trade balance with them is the reason for an overall favourable trade balance. Table 5.1 compares the SACU's trade balance with the other SADC countries and the rest of the world since 1992.

According to these figures, the SACU's favourable balance of trade in 1992–94 was accounted for largely by trade with the rest of the world, not the rest of the SADC. In 1995 the reverse was the case, and there was an unfavourable balance of trade with the rest of the world. SACU foreign trade, of course, is mainly that of South Africa, which enjoys a highly favourable balance of trade with the non-SACU SADC countries. The exportrimport ratio, after falling from 4.96 in 1992 to 4.44 in 1993 and 4.34 in 1994, rose to 6.56 in 1995. This widening of the trade gap in 1995 may be because South Africa has a transactions cost advantage in Southern African markets and/or that in some of these countries output has declined and tariffs have been lowered rapidly under the influence of structural adjustment programmes, Zambia being a good example. It could not have been due to South Africa's much maligned General Export Incentive Scheme (GEIS), since this subsidy has been substantially reduced and will be phased out in 1997 ahead of the time schedule agreed in the GATT tariflfication offer.

Table 5.1 SACU foreign trade, 1992–1995 (rand millions)

	Rest of SADC			Rest of world			Total		
	X	*M*	*X–M*	*X*	*M*	*X–M*	*X*	*M*	*X–M*
1992	5,036	1,016	4,020	63,199	51,553	11,646	68,235	52,569	15,666
1993	5,407	1,219	4,188	74,074	57,768	16,306	79,481	58,987	20,494
1994	6,684	1,541	5,143	82,938	73,980	8,958	89,622	75,521	14,101
1995	9,694	1,477	8,217	91,811	97,036	−5,225	101,505	98,513	2,992

Source: *Department of Trade and Industry, Pretoria*

The SADC 'free trade now' proponents argue that this would be in South Africa's interests: the favourable balance of trade is crucial to South Africa and, if it did not agree to free trade, it could lose its valuable markets in the rest of the SADC countries. In South Africa, by contrast, there is a view that these markets would be retained irrespective of whether there were trade integration or not and that the disparities between South Africa and the other SADC countries are so large that integration would enable South African companies to overrun SADC markets even more than they are already doing with devastating consequences for deindustrialisation in, for example, Zimbabwe and Zambia. The South African government continues to reiterate that it is conscious of the need for economic growth throughout Southern Africa. Indeed, the consequence of deindustrialisation and failed economic growth in neighbouring countries would be greatly increased levels of illegal immigration to South Africa, something which is already viewed as a serious problem. But South Africa does not see free trade as the panacea, and its caution appears to find some support in Holdens (1995) argument that if South Africa were to be part of a free trade area in the COMESA region, trade diversion would be likely to occur with large costs to the other countries. She concluded that regional trade integration is not a substitute for multilateral trade liberalisation if it means that preferences have to be given to a more dominant economy (as South Africa is in Southern Africa).

Intra-SADC trade and convergence

How important is intra-SADC trade to member countries? In 1994 only 8.9 per cent of the SACU's total foreign trade (15.6 per cent of exports and 3.3 per cent of imports) was with Africa, and most of this was with the Southern African region. Zimbabwe is by far the most important trading partner for SACU in the region: in 1994 it was the eleventh largest trading partner overall, with Mozambique in 20th position.[2]

For the seven non-SACU countries in SADC, trade among themselves is also only a small proportion of their total foreign trade. From intra-COMESA trade data, it has been calculated that intra-trade among the seven ranged from 0.1 per cent of Angola's to 7.1 per cent of Zambia's total foreign trade in 1994, the figure for all seven together being 3.2 per cent. By contrast, their trade with the SACU—and South Africa—was far more important. Recent data from the Economist Intelligence Unit[3] show that South Africa is the main supplier of imports to Malawi (48 per cent), Mozambique (27 per cent), Zambia (27 per cent) and Zimbabwe (33 per cent). It is also the main customer for the exports of Zimbabwe (15 per cent) and the second largest customer for Mozambique (17 per cent). In addition, it is one of the major suppliers of imports to Mauritius and one of the main contributors to that country's tourist industry.

Five of the seven, therefore, can be regarded as closely tied to South Africa, but Angola and Tanzania are weakly locked into Southern African trade, a historical tendency and one which has not changed materially over the years (Maasdorp 1993:14–15). However, important prices (namely, the inflation and interest rates) in the economies of some of these countries differ substantially from those prevailing in the SACU region, e.g. inflation rates of 25–45 per cent per annum prevail in Zimbabwe and Mozambique, three-digit levels have persisted in Zambia and both Zimbabwe and Mozambique currently have high interest rates. These differentials do not facilitate trade integration since manufacturers would prefer to locate in countries with lower and more stable rates. Moreover, Jenkins and Thomas (1996) find clear evidence of per capita income convergence in the SACU countries from 1971 onwards while the remaining SADC economies fail to converge; there was also evidence of policy convergence (fiscal and monetary policy, interest rates, inflation, etc.) among the SACU countries. Of course, four of the SACU countries also belong to the Common Monetary Area (CMA) and, since Botswana's currency is heavily weighted towards the rand, the entire SACU area is subject to a high degree of convergence in monetary policy.

The findings of Jenkins and Thomas appear to confirm Easterly's (1996:27) 'contagion effect', i.e. that a particular country's economy is affected by its neighbours' condition. Easterly argues that spillovers can be good or bad, and that a critical mass of successful economies with stable political conditions is required in order to change a negative contagion effect into a positive one. Holden (1995) refers to a view in the BLNS countries that polarisation has occurred within the SACU region in favour of South Africa but feels that further research is required into the determinants of industrialisation in those countries before any conclusion can be drawn.

Now, it is possible that South Africa, which on the whole has followed cautious macroeconomic policies with a reasonable degree of political stability, has provided the critical mass for its four smaller partners to benefit from a positive contagion effect. The role of the CMA as an adjunct to the SACU should not be underestimated, but the effect of sanctions against South Africa, as well as BLNS access to EU markets under the Lomé Convention and to US markets under the generalised system of preferences, were also important factors in the growth of manufacturing industry in Botswana, Lesotho and Swaziland in the late 1980s. Whether or not there would be a positive contagion effect in a broader Southern African trade area is unclear, but the prospects would probably be greater if a fast-track group of countries could move forward together on the basis of variable geometry.

A possible way forward

As pointed out earlier in this article, variable geometry is something which already exists in the form of a three-tier categorisation of countries. The

five SACU countries have been renegotiating the existing Agreement since late 1994. The negotiations have been conducted behind closed doors with very little information being made available to the public, but it is well known that the major issues which are taking time to resolve are the revenue-sharing formula and the institutional structure of the proposed Secretariat. The latter issue, in fact, appears now to be the more difficult of the two. The new Agreement is expected to be concluded in 1997, but it then has to be ratified by the various parliaments, so that it is unlikely to be in operation until the 1998–99 fiscal year at the earliest.

The second group of five countries belong to the Cross-Border Initiative. Namibia and Swaziland are also participating in the CBI but, because of SACU's common external tariff, are unable to reciprocate tariff reductions. The CBI, at meetings held in 1995 and 1996, has stipulated that tariffs on intra-trade as well as non-tariff barriers should be eliminated by 31 October 1998 and that a harmonised external tariff should be established by that date. Thus, it plans to reach the stage of a free trade area by then. As at March 1996, the participating countries (excluding Namibia and Swaziland) had reduced tariffs on intra-trade by 60–70 per cent; this figure was scheduled to reach 80 per cent by October 1996 and 90 per cent by October 1997 before elimination a year later.

The intra-regional trade policy of Angola and Mozambique is subject to the COMESA Treaty. When the CBI commenced in 1992, they were invited to participate but, because of their internal security problems, considered that a fast-track move towards regional trade integration was not appropriate. Neither country has been implementing COMESA tariff reductions at the agreed rate.

Details regarding the tariffs of the SADC countries are shown in Table 5.2. Most SADC countries have relatively similar overall tariff structures, although individual product tariff rates may vary from country to country. All either have or are initiating tariff reforms which would see them having tariffs between 0 and 30 per cent. Non-tariff barriers (NTBs) have been reduced considerably. The non-SACU countries now have very few quantitative restrictions on imports and have generally removed all export subsidies in conformity with GATT requirements and structural adjustment programmes. In most of these countries import licences have been abolished, while exchange control regulations have been removed or relaxed in all adjusting countries. Some countries such as Mauritius have abolished exchange controls on both the current and capital accounts, while most of the other adjusting countries have fully liberalised their current account transactions. All, however, maintain import licence restrictions on some goods for reasons of national security, health, safety and sometimes the environment. Some maintain NTBs on specific commodities, most notably agricultural produce, while some also use them selectively for protection purposes.

Table 5.2 SADC tariff rates, mid-1996 (per cent)

Country	Range	Main range	CBI reductions
Angola	0–80	10–30	
Malawi	0–40	20–35	70
Mauritius	0–160	0–20	70
Mozambique	0–35	10–25	
SACU	0–100	0–30	
Tanzania	5–40	20–40	60
Zambia	0–25	0–15	60
Zimbabwe	0–100	10–30	60

Source: *Imani Development, Harare*

From the Table 5.2 it may be calculated that tariffs on intra-CBI trade are low, in the main not exceeding 10–15 per cent. Intra-SACU trade, of course, is duty free. The high tariffs on intra-SADC trade are found between SACU and the rest, Angola and the rest, and Mozambique and the rest.

The tariff reduction schedule has received very careful attention within the CBI. Although some observers are sceptical about the ability of the CBI to meet the October 1998 deadline for the removal of tariffs on intra-trade, the Table 5.2 suggests that this should not be beyond the reach of the five CBI countries in the SADC. In fact, Tanzania (which has far greater trade ties with Kenya, Burundi and Rwanda than with the SADC) has agreed to form a free trade area with Kenya and Uganda under the umbrella of the new East African Cooperation by October 1997, i.e. fast-tracking the CBI integration process.

If the CBI realises its target, there would be two free trade areas within the SADC by October 1998, namely the SACU and the CBI. The logical next step then would be to attain a single SADC-wide free trade area. This could be approached in stages, for example first aligning the SACU s common external tariff with the harmonised external tariff of the CBI.

The CBI harmonised external tariff involves three tariff rates, namely a low rate on raw materials and consumer goods, a middle rate on intermediate goods and a high rate on finished capital goods. Countries may choose rate structures of 0–10–20 per cent or 5–15–25 per cent: that is, the maximum difference allowed between the lowest and highest rates for a particular country is 20 percentage points. The path which any particular country takes to reach the harmonised external tariffs by 1998 would depend heavily on (a) its current tariff structure and (b) the likely effects on its trade, industry and government revenue.

Once the external tariffs of the two free trade area components of the SADC have been brought into line, the final stage would be to reduce them rapidly on trade between the two component areas so as to meet the SADC's

eight-year deadline. However, trade negotiations invariably take longer than anticipated by governments, the SACU renegotiations being a case in point. The SADC case will involve exclusions, tariff schedules and special protocols for sensitive products such as motor vehicles, textiles, sugar, and wheat and flour. Given that none of the countries has undertaken an in-depth study of the effects of SADC free trade on its economy, it is highly likely that the negotiations will take considerably longer than the six months allowed in the timetable, so that a more realistic date for the achievement of free trade would be about 2006 or 2007 rather than 2005. Of course, there could be some fast-tracking of the process between the SACU countries and some individual countries such as Zimbabwe.

Yet, if the treaty establishing a SADC free trade area is not identical to that of the COMESA, there would be confusion in intra-regional trade. Take trade between Zimbabwe and Zambia as an example: at present it is governed by the COMESA Treaty. If a SADC free trade protocol were to differ from the COMESA Treaty, which one would govern the conditions under which this trade takes place? This is a serious issue which will require clarification.

Regionalism beyond the SADC?

Easterly's contagion effect, referred to earlier, is related to an argument that customs unions and free trade areas should consist of geographically proximate countries only since the inclusion of geographically distant countries would lead to trade diversion. This argument is based on the assumption that geographically proximate countries have higher proportions of trade with one another than with distant countries and that integration, therefore, would probably be trade and welfare creating. The validity of this border premise has been queried since it stresses the static impact effect and ignores the more important dynamic time-path issue: it would make economic integration arrangements 'more exclusive and less open to new members, undercutting the objective of moving speedily towards…[non-discriminatory] multilateral free trade for all' (Bhagwati 1994).

The case for Eastern Africa

Whilst it might be argued that the SADC area is a more coherent one for sectoral cooperation, the very existence of the CBI suggests that, for trade integration purposes, the region ought to extend beyond the present SADC limits. One might be hard put to argue that a free trade area including Angola and Mozambique would be preferable to one containing Kenya and Uganda, for example, and the business sector (on which the success of trade blocs depends) has, through the Eastern and Southern Africa Business Organisation, expressed its preference for the wider area. The northern

part of the COMESA region does not appear to have a good image in South Africa, notwithstanding the African Development Bank (ADB 1993) having singled out Kenya and Ethiopia as important potential trading partners for South Africa. Kenyan firms do substantial trade with Ethiopia, Somalia and Sudan, and find them prompt payers. Babu (1996) sees hopeful signs in East Africa and the Horn, and cites the recent transformation of the Intergovernmental Authority on Drought and Development (IGADD) into the Intergovernmental Agency for Development (IGAD)—a grouping of nine countries which, despite wars in Burundi, Somalia and Sudan, has a core of countries with the common purpose of promoting regional stability and prosperity. If Babu is correct, it would lend weight to the CBI fast-track concept. The more expansive outlook of the business sector might well have advantages over the 'geographically proximate' policy, and it is particularly unfortunate that governments have not yet been able to rationalise the functions of the SADC and the COMESA.

Infra-African or intercontinental integration?

A variation on the 'geographic proximity' theme is presented by another growing tendency, that towards inter-continental integration. It has been argued that, rather than less developed countries (LDCs) integrating among themselves in a trade bloc of poor countries, they should integrate with developed countries (Robson 1996). Since it lacks credibility, regional integration among LDCs has seldom attracted direct foreign investment; to be successful such integration demands enhanced credibility, and one way of attaining this is to forge external links either with an industrialised country or with a regional bloc involving industrialised countries. Such links are inherent in the Asia Pacific Economic Cooperation (APEC), while the North American Free Trade Agreement (NAFTA) integrates Mexico with the USA and Canada. Robson (ibid.: 44) writes that: 'The gain in credibility so afforded, and the advantage of locking in reforms in developing countries, may turn out to be the most important determinants of the ability of these arrangements to stimulate investment, trade and development significantly.' He argues that African policy-makers ought seriously to reconsider their approach, which has resisted north-south trade reciprocity, e.g. in Lomé. Certainly, attempts at trade integration in Africa are conspicuous by their lack of success (Aryeetey and Oduro 1996, Lyakurwa 1996).

However, there are now a number of initiatives aimed at intercontinental integration involving African countries, e.g. the proposed Mediterranean Basin Free Trade Area and the South Africa (or SACU)–EU Free Trade Area. Although it is only in its early stages and talk of a free trade area has been eschewed, the Indian Ocean Rim Association for Regional Cooperation also brings together countries at different stages of development (including Australia and four of the rapidly growing ASEAN economies) in an initiative

to increase trade and investment flows. For South Africa in particular, the benefits (in the form of increased direct foreign investment, transfer of technology and human resource development) from participating in intercontinental integration might well prove to be as considerable as the market benefits from regional integration in Southern and Eastern Africa. Of course, there is nothing in the Marrakech Agreement to prevent the SACU countries from participating in more than one free trade area, but the costs and benefits would require careful study in order to determine the pace at which free trade ought to be introduced so as to give sensitive industries an opportunity to prepare for the increased competition which would result and governments an opportunity to investigate new sources of revenue to replace customs revenue which would be lost, i.e. to convert the beneficial price effects enjoyed by consumers into revenue for governments.

The writer has been involved in one such study,[4] namely on the impact of the proposed South Africa-EU free trade area on the BLNS economy. This study employed a partial equilibrium approach to assess the static costs and benefits but was unable to quantify the dynamic effects. On the basis of the partial equilibrium approach, the desirability of the BLNS countries joining such a free trade area was unclear. Customs revenue would fall if they joined, but they would incur costs of policing their borders with South Africa for trade deflection if they did not. The existence of EU agricultural subsidies would pose a major threat for key producers in the BLNS countries, and much would depend also on the future of the Lomé Convention under which they enjoy trade preferences with Europe and which give them an advantage over South African competitors.

Cooperation as an alternative to integration

A final issue is whether regionalism in Southern Africa ought to stress sectoral cooperation rather than trade integration. All WTO member countries are obliged to reduce tariffs and eliminate non-tariff barriers. Beyond these WTO commitments, are any additional advantages to be derived from regionalism in the sense of trade integration? The Marrakech Agreement implies that, as universal multilateral trade liberalisation proceeds over the next decade or so, members of conventional trade blocs will derive fewer benefits from intra-regional free trade *per se* (the levels of protection against outsiders will fall) and more from other forms of institutionalised regional cooperation. Thus, an alternative model to trade integration, or at least a complementary endeavour, is that of functional cooperation on sectoral lines.

If a region has efficient infrastructural links (in transport and communications, electricity and water), cooperation in services (financial, commercial and tourism) and convergence in macroeconomic policies, then trade liberalisation will be facilitated. Sectoral cooperation is less controversial

and consequently easier to achieve than free trade; indeed, the original SADCC was designed with this in mind. Now that South Africa is a member, there is an opportunity for the SADC at last to make a real contribution to improving both the international investor image and the competitiveness of Southern African countries by encouraging convergence in macroeconomic policies and improving infrastructural links and sectoral cooperation. This opportunity would be strengthened were the business sector, as well as operating agencies such as the railways, airways, road hauliers and telecommunications, electricity and water corporations to be accorded a pivotal role in the process. This is now being realised and the entire modus operandi of SADC, felt by many observers to have been a major stumbling block in the way of efficient operations, is being reviewed.

South Africa's view that free trade is not a panacea for the SADC has been mentioned earlier; rather, it is arguing for a regional approach to manufacturing industry, harmonisation in the financial sector and regional infrastructure projects. Holdens (1995) findings, mentioned earlier, are pertinent here: the evidence does not suggest that non-SACU countries will gain from a free trade area, but unless trade integration is a positive-sum game, it might fail as has happened elsewhere in Africa. A regional industrial location study is being undertaken in Southern Africa with a view to identifying the comparative advantages of the various countries. This is all very well, but, of course, governments cannot plan the allocation of industry among countries: it is industrialists who decide on the location of their plants. Harmonisation in the financial sector is intended to facilitate the rapidly growing flow of cross-border investment, and South Africa has relaxed exchange control for companies wishing to invest in Southern Africa. The Maputo Corridor, a joint South Africa-Mozambique project involving infrastructure upgrading as well as agricultural and mining projects, financed primarily by the private sector, is now being touted as the model for practical cooperation between countries.

Conclusion

Despite their commitment to global multilateral trade liberalisation, the countries of Southern Africa will not find regional trade integration easy to achieve. This should not be surprising since that is also a worldwide experience. For countries which have been protectionist, it is a question of pace. There are ways of bringing the SACU and non-SACU areas of the SADC together in a free trade area, but the path would be easier were there to be greater convergence in terms of macroeconomic policies and more effective cooperation in key sectors. Progress on these points is as important as progress on tariff reduction; it is the business sector which conducts intra-regional trade, but it cannot do this effectively if telephones do not work, business travel is obstructed by visa and residence permit problems and so on.

Moreover, the problems within the region should not blind countries to the possibility of participating with more distant regions, even intercontinentally, in initiatives aimed at greater economic interaction. In its attempt at widening trade integration, Southern Africa should not become inward-looking.

Notes

1 Statistics supplied by South African Reserve Bank.
2 From figures supplied by the South African Reserve Bank and the Department of Trade and Industry, Pretoria.
3 Published in the EIU's *Country Report* series for the different countries (various issues, 1996).
4 An unpublished consultant's report for the Commission of the European Communities.

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6

REGIONAL INTEGRATION
AND CEREAL TRADE

John Weeks and Turan Subasat

Introduction*

This paper investigates the prospects for agricultural trade among the countries of the Common Market for Eastern and Southern Africa, COMESA.[1] The regional grouping began in 1981, with the purpose of achieving 'a Common Market by the year 2000 in order to allow the free movement of goods, capital and labour within the region' (PTA 1992: xii). By 1995 it included virtually every Eastern and Southern African country, plus several Indian Ocean states.[2] As Lipton has argued persuasively, the goals of food security and regional integration should not be confused (Lipton 1988); nor should trade integration be considered the principal component of a development strategy, either for the sub-region or individual countries. But increased agricultural trade in itself would bring important benefits to the sub-region, as is increasingly recognised by bilateral and multilateral donors. Sub-regional trade need not be defended on the basis of increasing food security or redesigning development strategy, though it may facilitate these goals.

Data do not permit direct measures of comparative costs across countries nor are there bilateral trade data except in the aggregate. In light of the data limitations, other measures implied by trade theory are employed, especially indicators of complementarity in consumption and production. The analysis is restricted to 'official' trade; that is imports and exports as recorded in national and United Nations databases. It is quite likely that unrecorded trade, especially cross-border trade in agricultural products, is substantial between some of the countries. While it is a limitation to treat only formal trade, such statistics cover the vast majority of imports and exports. In any case, the purpose of the analysis is to identify policies to foster official trade. To the extent that this is achieved by cross-country specialisation (potentially trade creating), or drawing more trade into formal channels ('trade revealing'), is a secondary, though important, consideration.

Regional trade in cereals

Considerable scepticism has been expressed about expanding Eastern and Southern African agricultural trade. It is asserted that were there substantial potential for trade among the countries, it would occur through the operation of market forces. It implies that the observed pattern of trade corresponds, more or less, to the potential for trade. This is a surprising argument to encounter, because it dismisses the concept of 'market distortions' which has come to play such a large role in policy analysis of the Sub-Saharan region. Utilising this concept, multilateral reports on Africa repeatedly maintain that the economic outcomes one observes should not be taken as the only possible outcomes. On the contrary, with different national policies governments could produce quite different outcomes. This general argument is equally applicable to regional trade, which is characterised by myriad private and public distortions. Some of these, tariffs and non-tariff barriers to trade, could be eliminated quickly. If liberalisation between the COMESA countries and the rest of the world is expected to produce greater trade, the same should hold for liberalisation and intra-regional trade. Other distortions, such as woefully deteriorated transportation systems (frequently constructed with an eye to trade with colonial powers), would require longer time to eliminate, as well as substantial investment.

Scepticism about the gains from integration and, indeed, its likelihood, arise in part from the extremely disappointing experience of several sub-regional groupings.[3] Perhaps least successful of the major initiatives has been the Economic Commission of West African States, an association of sixteen countries that embraces two smaller regional organisations, the West African Economic Community (CEAO, seven members) and the Mano River Union (three countries). After over a decade of formal steps towards sub-regional integration, trade among the countries of the Economic Community of West African States (ECOWAS) and CEAO was less relative to total trade in the early 1990s than it had been before these steps were initiated (Badiane no date; FAO 1991).[4] Further, due to fiscal pressures in the various countries, or lack of commitment, member states were in arrears to the ECOWAS Secretariat by over US$10 million in 1990 (FAO 1991:10). On the basis of trends in intra-group trade, COMESA would seem no more of a success than the much maligned ECOWAS. Trade among COMESA countries averaged about 8 per cent of the groupings' total exports and 5 per cent of imports for 1980–81, before the treaty, and 1 percentage point less by the end of the decade (see COMESA Data Base and Gulhati 1990). A substantial increase in intra-group trade over 1989–92 failed to bring the share back to the level of 1980–81.

The potential for increasing trade, especially in basic staples, depends upon the structural characteristics of the economies of the countries and national policies. As is well known, orthodox trade theory predicts that the potential

for trade is greater, the greater the differences between countries in terms of economic characteristics. Before turning to a detailed specification and analysis of characteristics specifically relevant to trade, it is useful to describe the countries at a more general level. As we shall see, one finds in the literature a tendency for some authors to suggest that the countries of Eastern and Southern Africa are quite similar.

While many of the countries are extremely underdeveloped, this is not true for all (ADB 1994b, World Bank 1996). The countries account for slightly over half of the Sub-Saharan population and gross domestic product (excluding South Africa). For all twenty-four actual and prospective members of COMESA, per capita income varied from a low of US$ 111 (Mozambique) to a high of over US$4,000 (Seychelles). One might wish to exclude the island states, Madagascar, Mauritius, Comoros and Seychelles, on the grounds that these are essentially different from the continental countries. Similarly, South Africa might be excluded as a special case. Even with these countries omitted, per capita income varies by a factor of fourteen between Mozambique and Botswana. If one divides the countries into two groups, those with relatively large populations and those with relatively small ones, the differences within each group remain great. The consequence for trade of the large differences in per capita income is not obvious. On the one hand, differences in levels of development may be associated with trade-creating differences in relative prices; on the other, large variations in level of development within trade groupings can stimulate political conflicts over the distribution of the gains from integration (Takirambudde 1993).

The countries are also quite different in degree of urbanization—from the highly urban South Africa, Namibia and Zambia to the virtually rural Ethiopia, Burundi and Rwanda. Urbanization has at least two important implications for trade. First, it tends to be positively correlated with the degree of monetisation of food production. Second, numerous studies have shown that it affects the composition of the demand for food (Jamal 1988, Jaeger 1992), shifting it toward wheat and rice. One indication of possible gains from trade is factor endowments, especially the ratio of the rural labour force to arable land measured in hectares. For this, the variation is enormous, from less than 0.2 persons per hectare (five hectares per person) for South Africa and Botswana to approximately three people per hectare for Kenya and Madagascar (FAO 1994). These person-land ratios should not be taken as measures of the potential for expanding cultivated area, at least under existing methods of production. Rather, they tend to reflect differences in ecological conditions, though potential exists for expansion of land use in several countries (ADB 1994a: vol. 3, 85).[5]

These differences among the countries, measured by level of development, urbanization and rural population density provide initial support for gains from trade. Growth performances have also been substantially different over the last two decades. For gross domestic product, nine of the nineteen

countries for which there are data enjoyed growth rates in excess of population for 1970–94. While growth during 1980–94 averaged lower than for the 1970s, the difference in means across countries is not statistically significant. For agricultural value added, the performances were considerably worse. During the 1970s only in four countries did agriculture grow faster than population, and only in two in the second period. The decrease, from four to two, resulted from higher population growth rates, for average GDP growth across countries rose slightly. While keeping in mind measurement errors, it appears that agricultural output per capita declined for every country except Mauritius for the period as a whole. Mauritius is, indeed, the exception that proves the rule, for the increase in output per head was slight and resulted more from slow population growth than a robust agricultural performance.[6] Low as the agricultural growth was, food production performed worse: for the period as a whole, not a single country was measured to have an annual rate increase as much as three per cent. Especially in the early 1990s, this poor performance of food production reflected the severe droughts that afflicted the central and southern countries of COMESA. When this adjustment is made for drought years, seven countries were measured to have growth rates in excess of population increase.[7] Still, the performance of cereals cannot be considered impressive and implied a gap between domestic supply and demand to be filled by imports.

The imports of food must play a central role in an analysis of regional integration, since its *raison d'être* is that supply from within the region could replace rest of the world imports. Such a shift in food trade raises the questions of whether commercial imports of regional origin would be justified by comparative costs.[8] Prior to this question is another: does the 'normal' pattern of food trade suggest that a substantial shift from extra-regional to intra-regional trade would be possible?[9] Table 6.1 attempts a first, crude answer to this question. Net imports for 1961–92 are first reported in thousands of metric tons, then as a proportion of domestic production. On the naive assumption that all cereals are perfect substitutes, one can sum across countries to obtain the 'total' column, net cereal imports for COMESA as a whole. The last column omits South Africa from this sum. To reduce annual fluctuations, net imports are averaged over five-year periods (fewer years for the first and last period). If South Africa is included, the region was a net exporter in the 1960s and 1970s, and subsequently a net importer. If one takes the 1980s as 'normal', rather than the more drought-afflicted 1990–92, annual net imports were about 1.4 million metric tons for the decade. Omission of severe drought years during the 1980s, especially 1984 and 1985, results in near zero net imports. If one excludes South Africa, the 'normal' net import level might be estimated as between two and two and a half million metric tons for the other countries. The relatively low level of net cereal imports is also demonstrated in the table when imports are expressed as a proportion of national production. For all countries, including

South Africa, net cereal imports represented only 5 per cent of national production in the 1980s. However, the pattern of net imports and exports is extremely unbalanced. Inspection shows that South Africa and Zimbabwe generated virtually all of the net exports. Thus, one can conclude that were the COMESA group suddenly cut off from the rest of the world and all cereals were perfect substitutes, the region could achieve near self-sufficiency in cereals in normal years, with two of the countries as exporters and nineteen as importers. While an interesting statistical result that dispels the image of the region as a chronic cereal importer, its practical importance is limited.

The calculations prove substantially different if one excludes wheat (Table 6.2). Separating other grains from wheat in the analysis of trade has three justifications. First, few COMESA countries produce wheat in substantial quantities,[10] and only Kenya, South Africa and Zimbabwe export wheat. Thus, cereal imports in the aggregate might conceal the possibility of intraregional trade in other grains. Second, a substantial amount of wheat imports enters the region as food aid, perhaps more on the basis of donor country production patterns and surpluses than consumer preference within Eastern and Southern Africa. Should food aid be reduced, or donor supply replaced in part by local purchases or 'triangular' arrangements,[11] potential would arise for wheat to be replaced by other grains. Third, and related to food aid, in several countries white maize is the grain preferred by consumers.[12] Because there is no world market for white maize, shortages within the countries of COMESA must be met by suppliers within the region if at all.

Once wheat is subtracted from net cereal imports, the pattern of trade among the countries changes notably. With South Africa included, the region generated an export surplus in all periods but the drought-plagued early 1990s (last two columns). Taking the 1980s as 'normal' and excluding the drought-affected years in the middle of the decade, actual or potential exporters of grains include Kenya, Malawi, South Africa, Sudan, and Zimbabwe. If Zambia and Mozambique emerged as net exporters (ADB 1994a, Koester 1993), the COMESA countries in normal years would be divided into seven net exporters, thirteen net importers[13] and one case of near-self-sufficiency (Burundi). This division exaggerates the imbalance between net exporters and importers, since three of the latter have populations of less than one million (Comoros, Djibouti and Swaziland). While the potential for trade in cereals should not be exaggerated on the basis of Tables 6.1 and 6.2, they do show that for the fourteen countries with populations over five million in 1989, five generated export surpluses in the 1980s and half might do so in the future. Thus, cereal trade could potentially be much more evenly distributed among the COMESA countries than manufacturing trade.[14]

This section has provided several insights into the potential for cereal trade among the COMESA countries, some of which go against conventional

Table 6.1 Net imports of cereals, 1961–1992 (metric tons, thousands)

Years	Angola	Botswana	Burundi	Comoros	Djibouti	Ethiopia	Kenya	Lesotho	Malawi	Mauritius	Mozambique	Namibia
1961–64	−83.2	38.8	4.0	8.7	12.7	5.2	−28.3	4.5	−5.4	110.1	65.2	32.5
1965–69	−68.2	53.6	7.1	12.0	12.7	34.6	−107.7	25.2	−40.9	119.1	39.4	31.8
1970–74	−2.9	41.3	9.8	17.3	22.9	47.1	−61.5	46.6	12.0	134.6	62.1	39.0
1975–79	220.4	35.7	12.1	15.7	20.4	162.9	−29.7	82.9	19.4	147.2	225.0	47.6
1980–84	316.0	94.1	18.1	26.2	29.4	295.8	267.4	110.7	−19.2	177.7	337.5	62.2
1985–89	247.6	118.0	12.5	27.7	47.2	711.6	26.1	94.5	53.5	179.4	470.7	90.3
1990–92	328.1	96.6	22.5	35.7	73.5	844.4	369.7	132.0	226.6	198.4	721.5	123.0
As % of domestic production												
1961–64	−15.3	248.3	3.0	72.2	n.a.	0.1	−1.4	2.0	−0.6	n.a.	10.2	55.0
1965–69	−12.1	226.1	4.6	79.5	n.a.	0.8	−4.2	11.8	−3.3	n.a.	5.5	45.3
1970–74	−0.2	159.6	6.2	129.4	n.a.	1.1	−2.6	25.7	1.5	n.a.	8.4	58.7
1975–79	50.0	220.4	6.5	90.7	n.a.	3.3	−1.1	43.1	1.5	n.a.	34.5	54.1
1980–84	89.6	710.1	8.1	147.8	n.a.	5.4	12.7	77.3	−1.2	n.a.	51.8	66.1
1985–89	73.6	383.7	4.5	160.4	n.a.	11.9	1.0	54.6	3.5	n.a.	74.3	74.8
1990–92	95.2	318.9	7.5	255.2	n.a.	12.8	12.7	101.0	25.8	n.a.	216.6	244.6

Table 6.1 continued

Years	Rwanda	Somalia	S. Africa	Sudan	Swaziland	Tanzania	Uganda	Zambia	Zimbabwe	Total	without S. Africa
1961–64	−0.5	40.8	−1620.6	31.5	4.9	81.5	18.9	34.3	−102.9	−1347.5	273.1
1965–69	3.4	43.7	−941.7	114.2	8.0	45.9	35.3	−9.2	−100.0	−681.7	260.1
1970–74	7.3	68.6	−1997.0	134.1	9.5	136.2	37.7	138.1	−258.5	−1355.9	641.1
1975–79	12.0	141.2	2610.7	48.7	15.0	141.0	6.6	117.4	−447.6	−1616.8	993.9
1980–84	18.8	312.3	−1637.6	149.3	48.9	297.5	24.8	280.8	−107.6	1103.0	2740.6
1985–89	18.1	227.8	−1443.3	639.5	56.7	172.7	18.5	151.1	−255.0	1665.1	3108.5
1990–92	16.8	234.6	1214.6	815.4	81.0	134.9	−9.2	280.6	133.8	6074.3	4859.7
As % of domestic production											
1961–64	−0.3	14.9	−23.6	1.9	10.7	7.4	2.1	4.2	−8.0	−6.3	1.9
1965–69	1.9	17.0	−11.4	6.8	14.7	4.0	2.8	−0.8	−5.4	−2.5	1.8
1970–74	3.5	30.3	−19.4	6.5	9.4	10.4	2.5	13.3	−13.6	−4.6	3.5
1975–79	5.0	55.2	−22.7	1.8	16.9	6.3	0.4	9.2	−21.6	−4.8	4.6
1980–84	6.4	83.0	−8.4	9.0	68.1	10.0	2.2	29.5	−5.5	5.1	13.3
1985–89	6.0	39.7	−11.1	18.5	43.6	4.6	1.4	10.5	−11.1	4.5	11.9
1990–92	5.4	87.8	28.0	23.1	93.9	3.7	−0.6	41.4	82.9	19.4	19.5

Source: *FAO 1994 AGROSTAT*

Table 6.2 Net imports of cereals, excluding wheat, 1961–1992 (metric tons, thousands)

Years	Angola	Botswana	Burundi	Comoros	Djibouti	Ethiopia	Kenya	Lesotho	Malawi	Mauritius	Mozambique	Namibia
1961–64	-120.2	33.8	1.7	7.8	n.a.	-1.3	-23.9	2.9	-13.1	n.a.	25.7	24.0
1965–69	-123.4	47.0	1.7	10.5	n.a.	3.8	-73.8	5.2	-54.7	n.a.	-24.5	18.8
1970–74	-104.6	29.4	1.0	15.1	n.a.	-1.4	-65.8	5.1	-11.9	n.a.	-24.7	21.4
1975–79	100.8	14.3	1.4	13.9	n.a.	12.9	-74.7	19.9	2.1	n.a.	125.9	27.0
1980–84	159.6	64.7	0.9	23.6	n.a.	22.0	168.4	36.0	-40.2	n.a.	191.0	36.6
1985–89	130.4	72.8	-0.1	24.0	n.a.	61.5	-110.4	45.3	31.8	n.a.	355.1	63.8
1990–92	185.5	51.1	0.7	31.1	n.a.	38.9	120.2	52.1	220.5	n.a.	583.6	95.1
As % of domestic production												
1961–64	-22.2	214.7	1.3	65.0	n.a.	0.0	-1.1	1.3	-1.5	n.a.	4.1	40.7
1965–69	-22.1	196.6	1.1	69.3	n.a.	0.1	-2.6	2.4	-4.6	n.a.	-3.3	26.9
1970–74	-19.3	128.1	0.6	112.3	n.a.	0.0	-2.7	2.9	-0.3	n.a.	-3.0	32.2
1975–79	23.1	129.9	0.7	80.5	n.a.	0.2	-2.8	10.5	0.2	n.a.	19.1	30.7
1980–84	44.9	533.8	0.4	133.2	n.a.	0.4	8.3	24.4	-2.7	n.a.	29.3	38.9
1985–89	38.4	254.9	0.0	138.9	n.a.	1.0	-3.5	24.9	2.0	n.a.	55.6	52.8
1990–92	53.8	161.6	0.2	221.9	n.a.	0.6	3.9	42.1	25.1	n.a.	181.7	180.2

Table 6.2 continued

Years	Rwanda	Somalia	S. Africa	Sudan	Swaziland	Tanzania	Uganda	Zambia	Zimbabwe	Total	without S. Africa
1961–64	-0.5	27.9	-1779.2-	-77.6	4.9	43.3	-5.0	13.7	-178.8	-1932.9	-153.7
1965–69	0.3	24.3	-1169.9	-46.0	8.0	8.9	6.1	-55.3	-181.2	-1518.2	-348.3
1970–74	0.9	37.5	-1892.7	-52.8	9.5	93.3	7.8	42.7	-310.5	-2116.7	-224.0
1975–79	3.7	65.1	-2525.2	-104.4	15.0	72.5	3.4	8.3	-456.2	-2585.7	-60.5
1980–84	5.6	174.5	-1729.2	-218.9	23.2	240.0	12.8	158.5	-138.3	-696.5	1033.1
1985–89	8.1	105.5	-1258.7	-64.1	18.2	114.0	6.4	98.6	-321.1	-493.3	765.4
1990–92	6.7	104.3	611.0	177.7	23.8	56.1	-25.3	254.6	55.9	2765.9	2154.9
As % of domestic production											
1961–64	-0.3	10.3	-26.0	-4.7	10.7	4.0	-0.5	1.7	-14.7	-9.0	-1.1
1965–69	0.2	9.5	-14.4	-3.6	14.7	0.6	0.2	-5.7	-11.3	-6.1	-2.1
1970–74	0.5	17.0	-18.2	-2.5	9.4	7.0	0.5	4.2	-16.3	-7.3	-1.2
1975–79	1.5	25.6	-21.9	-4.2	16.9	3.5	0.2	1.6	-21.9	-7.7	-0.3
1980–84	1.9	46.9	-9.1	-8.1	33.2	8.1	1.2	16.5	-7.6	-0.7	5.1
1985–89	2.7	18.4	-9.9	-5.7	13.5	3.1	0.5	6.7	-13.5	-1.3	2.9
1990–92	2.2	39.8	20.2	2.9	28.5	1.6	-1.6	38.4	73.7	9.5	8.7

Source. *FAO 1994 AGROSTAT*

wisdom. First, the countries of the region are quite diverse in levels of development, urbanization and intensity of land use. Second, while agricultural growth has generally lagged behind population increase, this can to an extent be explained by drought. Third, the distribution of net imports of cereals across countries suggests considerable scope for grain trade within the region.

Potential for cereal trade

That the net imports of grains of the COMESA countries were relatively low and that the region had a division between net importers and exporters is not in itself evidence for increased trade in grains among the countries. Trade results from gains between partners. The purpose of this section is to investigate the possibility of such gains. In Heckscher-Ohlin trade theory, specialisation results from differences in relative factor endowments among countries. The ratios of agricultural labour to arable land provided a prima facie case for differences in factor endowments among the countries. Specialisation can also result from other relative differences among countries which are usually ignored by orthodox trade theory. The first of these that we investigate is differences in consumption patterns.[15]

Two countries with the same relative factor endowments would gain from trade if the structure of consumption in each country were different. Beginning from a position of autarky, the two countries would have different relative prices of outputs as the result of the different preferences of consumers. Welfare gains would be achieved if, in each country, factor inputs were not perfectly substitutable between outputs. One of the arguments against the likelihood of increased agricultural trade among the COMESA countries is the allegation that the consumption patterns across countries are much the same. If this allegation is sustained, the case for expending effort to foster such trade is weak.

Using FAO food balance sheets, for each of twenty-one COMESA countries a percentage distribution of consumption was calculated, measured in calories, for forty-three items of consumption.[16] A Chi-square test was carried out to test the null hypothesis that the consumption distributions for pairs of countries are not significantly different. For the twenty-one countries there are 210 pairs, and for 184 of these the null hypothesis is rejected at the 5 per cent level of probability. The implication of the test can be summarised in a counter-factual scenario. Assume that countries can be treated as individual consumers and that the distribution of consumption in the food balance sheets represents the autarky pattern for each country. Further, assume that at the start of a market period each country is endowed with the same set of commodities in the same proportion (with the absolute amount determined by population and per capita income) and that there are no transport costs. On these assumptions, the outcome of the test implies that the opening of trade would result in exchange between virtually all of the countries.

A similar exercise was carried out on production of the twenty-one countries except Botswana and Djibouti, testing the null hypothesis that the distribution of food outputs does not vary significantly across countries. In this case there are 171 country-pairs, and for only fifteen is the null hypothesis sustained. Again, a counter-factual illustrates the implications of the result. From a position of autarky in which each country has the same pattern of consumption, let trade open. As a result of differences in production structures, the countries investigated would become enmeshed in a matrix of food trade.[17] Therefore, both with regard to the basis of differences in production patterns and differences in consumption patterns, there would appear to be considerable potential for intra-COMESA trade in food. This conclusion supports the findings of Koester, who tested similar hypotheses in his seminal work on Eastern and Southern African trade (Koester 1986).

Statistical evidence suggests that in consumption and production the COMESA countries are significantly different. This is a necessary but not a sufficient condition for trade. In addition to the presented cross-country differences, gains from trade require that countries respond to changes in demand by trading partners. Just as it has been argued that COMESA trade would be restricted by similarity of consumption and production structures, it is also argued that variations in agricultural output are positively correlated across countries.[18] To put the position in extreme form, it is alleged that the COMESA countries consume the same things, produce the same things and all have surpluses or shortages at the same time.[19] Having rejected consumption and production similarity, we now investigate changes in output across countries. Before presenting the empirical evidence, it should be noted that the potential for trade is supported by confirming the null hypothesis that output variations are not significantly and positively correlated; i.e. randomness is sufficient to demonstrate the potential for trade.

Part A of Table 6.3 summarises the statistical tests of the null hypothesis that there were no significant correlations in crop production across countries. This part of the table is the result of tests carried out separately for each listed crop. In each case, the first annual central difference in production level was regressed pair-wise for all available countries. The correlation for any pair was judged significant if the F-statistic was significant at the 5 per cent level or lower. Table 6.3 part A reports the total number of pairs, the pairs for which the F-statistic was significant at .05 and significant at .01.[20] Overall, the table shows limited evidence that changes in crop production are correlated across countries. For all cereals, there were thirteen pairs with significant correlations, slightly less than 10 per cent of all pairs. For maize and sorghum, the percentage was almost the same but was substantially lower for cassava, millet and rice. Overall, the table prompts a rejection of the hypothesis that changes in the output of basic staples are positively correlated across countries over time; to no substantial extent do the COMESA countries generate agricultural surpluses and shortages in concert.[21]

Table 6.3 Annual variations by crop: significant correlations between countries of changes in production and imports (number of pairs)

A. Production

Crop	All Cereals	Cassava	Maize	Millet	Rice	Sorghum	Total
Positive * .01	7	2	7	1	2	3	15
Positive * .05 >.01	6	3	6	1	1	5	16
Total positive	13	5	13	2	3	8	31
Negative *	3	3	0	2	0	3	8
Total pairs	136	78	136	66	91	78	449
Positive (%)	9.6	6.4	9.6	3.0	3.3	10.3	6.9
Negative (%)	2.2	3.9	0	3.0	0	3.9	1.8

B. Imports

Crop	Cereals	Cereals (not wheat)
Positive *.05	41	47
Negative *.05	15	9
Total pairs	210	210
Positive (%)	19.5	22.4
Negative (%)	7.1	4.3

Source: *Data from FAO 1994 AGROSTAT*
Note: *Correlation coefficients significantly different from zero at the 1% or 5% level*

A sceptic might question the results of Table 6.3 part A on grounds that national production data are too unreliable to support the reported tests. While the reliability of production data does vary across countries, their method of estimation would suggest a bias toward positive correlations. For most countries of the region and most crops, output is estimated on the basis of sample surveys, with total production calculated by using estimates of land applied to that product and the rural labour force. Because labour force growth rates are much the same across countries, one would expect a spurious tendency towards positive correlations. Since relatively few such correlations appear, the conclusion that changes in output across countries is not positively correlated is strengthened. This conclusion could be challenged by arguing that the data, both for agriculture as a whole and particular crops, are so unreliable that the absence of correlations merely reflects the randomness of estimation errors.

As a check on the possibility that the calculations are spurious, we tested for the correlation across countries of imports of cereals (Table 6.3 part B).

If one assumes that cereal imports compensate for shortfalls in national production, then positive correlations between countries for changes in imports can be interpreted as indirect evidence that the two countries tend to suffer shortages and enjoy surpluses in concert. Thus, the sceptical view of COMESA agricultural trade predicts that the net import matrices should display a large number of positively and significantly correlated cells. For all cereal imports, the first relative differences are positively and significantly correlated in forty-one of 210 pairs, one less than 20 per cent. For the other 169 cells, fifteen (7 per cent) show significant and negative correlations. While the number and proportion of significantly and positively correlated pairs is much greater for net imports than national production, for the vast majority of the countries the relationship is negative or random. If, as before, wheat is excluded, the significant and positive cells increase to forty-seven (and the negative pairs fall to nine). The net import correlations could be interpreted as suggesting that the national production data understate the extent to which changes in output are positively correlated across countries. However, the import correlations sustain the view that for the vast majority of the countries, there exists the potential for compensating trade in cereals.

Conclusion

This study set itself a narrow task: to determine the potential for expanding trade in grains among the COMESA countries. In the absence of measures of comparative costs, the method has been to determine whether the consumption and production characteristics of the COMESA countries imply that trade is below its potential. Throughout the analysis, the concept of 'normal production conditions' was used, referring to periods free of drought. Many of the COMESA countries have suffered drought simultaneously, but this does not imply that changes in grain production are positively correlated over time. Further, fostering more regional trade in grains need not reduce access to extra-regional sources of grains in drought years, either as commercial purchases or food aid.

The potential for trade in grains among the COMESA countries has been under-estimated. On the basis of relevant measures, the countries demonstrate characteristics consistent with far greater trade in grains than occurs. Taken as a whole, the region is not a chronic importer of grains, except in years of severe drought. While the major grain exporters in the foreseeable future would be Kenya, South Africa and Zimbabwe, under a more liberalised regional policy framework that facilitated cross-border trade several other countries could emerge as net exporters. The bases for intra-regional trade in grains are the significantly different structures of consumption and production across countries. These differences imply that while greater grain self-sufficiency for each country taken separately is probably not efficient in most cases, it could be for the region as a whole. Along with the evidence

for differences in consumption and production patterns goes statistical support for the ability of the countries of COMESA to absorb each other s surpluses and fill each others shortages over time.[22] Complementing this might be a regionally organised stockpiling system which would reduce the level of inventories implied by a nationally based system (Koester 1986).

There remains much that the COMESA countries can do to facilitate regional grain trade without external assistance. Tariffs on grains among the countries are frequently high and extremely complicated. A quick movement toward a common external tariff on grains and a near-zero internal tariff could have substantial trade-inducing effects. However, the shortage of storage facilities represents an important obstacle to increased regional trade in grains (Pinckney 1993). Until investments are made in storage, much of the increased trade between countries will be short-haul cross-border. Transport facilities, especially roads, limit regional grain trade. Lowering transport costs by improving roads and other infrastructure will be a long-term task, to which aid donors can contribute.

In the shorter term, donor governments can contribute to increased regional trade in grains in several ways. First, they can support and encourage the shift in position of the multilateral donors on regional integration in Eastern and Southern Africa.[23] This would involve not only encouraging integration moves as such but also coordinating structural adjustment programmes rather than treating each as an isolated national policy exercise (Muir-Leresche 1993a, 1993b).[24]

Notes

1 The sub-regional grouping was initially established under the name, Preferential Trade Area for Eastern and Southern African States (PTA). The name change occurred in December 1994. The original name represented the trade integration strategy of the initial stage of integration, preferential reductions across existing national tariff structures for the members of the PTA, rather than a common external tariff.

2 The PTA was created by treaty on 21 December 1981, with ten countries (EGA 1982). The official list of members is Angola, Burundi, Comoros, Djibouti, Eritrea, Ethiopia, Kenya, Lesotho, Madagascar, Malawi, Mauritius, Mozambique, Namibia, Rwanda, Seychelles, Somalia, Sudan, Swaziland, Tanzania, Uganda, Zambia, and Zimbabwe. In addition to these twenty-two, it is anticipated that Congo (Democratic Republic) and South Africa will join. In December 1994 an unsuccessful attempt was made to unify COMESA and the Southern African Development Community (SADC). Lack of success left in doubt the organisational basis upon which integration will be based for the region. Treating this issue is beyond the scope of this paper.

3 For discussions of the political economy of trade integration in Africa, see Gore (1992) and Hall (1987).

4 There is some difference of opinion over the performance of the CEAO. In contrast to the scepticism of the FAO (Food and Agriculture Organisation), the World Bank judged it as the 'most successful' of Sub-Saharan trade groupings (World Bank 1989:149).

5 Referring to Central Africa, Koester writes: 'Malawi, Zambia and Zimbabwe differ significantly in their factor endowments and in their ecological environments… In general, rainfall in Malawi and Zambia is higher and more reliable than it is in Zimbabwe. Zambia has considerably more unexploited land than Zimbabwe, whilst Malawi, with the highest population density, is expected to have virtually all its cultivable land in production by 2010' (Koester 1993:355). More generally, the African Development Bank foresees the possibility of an expansion of production in the wetter zones of the region: 'It follows that a substantial augmentation of existing regional production should come from the higher rainfall zone…which stretches from Angola to southern Tanzania…. The basic constraint on an expansion of production in this area is the uneven and generally poor quality of the soil… [T]he adoption of more intensive production systems by small farmers will be necessary (ADB 1994a vol. 3:83).

6 The growth rates are derived from the World Bank's African Development Indicators 1996, and the FAO data base, AGROSTAT. A long version of the paper provides these growth rates in a table, available from the authors.

7 Referring to the southern countries of COMESA, the ADB commented: '[T]he major foodcrops of maize, rice and sorghum have failed to maintain a comparable rate of growth [to population], but only by 1 per cent' (ADB 1994a:85).

8 The issue of food aid is treated in Weeks and Subasat (1995).

9 'Normal' refers to trade and production in the absence of drought.

10 These are Ethiopia, Kenya, Lesotho, South Africa, Sudan, Tanzania, Zambia and Zimbabwe.

11 In 1993 local purchases accounted for about 10 per cent of cereal food aid in Sub-Saharan Africa as a whole (World Food Programme, food aid data sheets).

12 A persistent problem in the delivery of food aid in the region has been resistance by local consumers to yellow maize.

13 These are Angola, Botswana, Comoros, Djibouti, Ethiopia, Lesotho, Mauritius, Namibia, Rwanda, Somalia, Swaziland and Tanzania.

14 Excluding South Africa, over two-thirds of manufacturing trade within COMESA comes from Zimbabwe and Kenya.

15 Heckscher-Ohlin theory assumes that all trading partners are characterised by the same set of consumer preferences. The theory does not assert this as fact, but makes the assumption in order to focus upon the theoretical relationship between trade and factor endowments.

16 'Consumption' includes final and intermediate demand but not inventory accumulation.

17 It can be noted that there are seven pairs for which both consumption and production patterns are not significantly different. Three of the seven involve the members of the former federation of central Africa, Malawi, Zambia and Zimbabwe.

18 Hay and Rukuni write: Climate similarity 'reduces the opportunities for countries which hold surpluses in any one year to supply food deficit neighbouring countries. The extent to which regional cooperation would aid supply stability in individual countries is therefore limited by the synchronous nature of year on year fluctuations in most SADCC [later, SADC] countries' (1988:1015).

19 Referring to the SADC countries, Lipton asserts: 'the region-wide droughts of 1983–84, which turned Zimbabwe and even [South Africa] into net grain importers, point up the high covariance among regional sources of grain supply' (Lipton 1988:97).

20 Tables reporting the correlations in detail appear in an earlier version of this paper, available from the authors.

21 These empirical results are in contrast to those presented by Hay and Rukuni (1988:1015) in their definitive work on food security policies of the SADCC (subsequently SADC) countries: '[P]ossibly [the] most important point…is the high degree of correlation between national [cereal] output variability; Lesotho and Tanzania are the only two countries in the region where annual changes in output are inversely correlated with those of their neighbours.' The difference in empirical results may arise from the shorter time period covered by the Hay and Rukuni study. Our conclusion is similar to that of Koester. 'Trade could bridge the gap between national demand and national supply in years of normal harvest through the redirection of present trade flows' (Koester 1993:356).

22 This same conclusion was reached for West African countries:

>   The traditional explanation of the low level of trade among neighboring developing countries is that the potential to expand intratrade is restricted by the high degree of similarity in resource endowment… The indicators [for the West African countries] of revealed comparative advantage and domestic resource costs…confirm the divergence in country production structures. Moreover, the strongly unequally distributed and weakly or negatively correlated fluctuations of production across individual countries represent a source of and real incentives for intratrade.
>
>   (Badiane no date: 7)

23 A shift in the position of the World Bank occurred in the mid-1990s, from strong scepticism to conditional support for integration moves in Eastern Africa (Foroutan 1992, Rajaram and Marcelo 1994). Japanese aid policy supports moves toward regional integration (JICA 1994).

24 The African Development Bank comments: '[S]ub-regional groupings should play a role in implementing SAPs; but this has not occurred in any systematic way. Indeed, there has been little discussion as to what aspects of structural adjustment should interact with which components of economic integration' (ADB 1993:154).

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THE DYNAMIC ROLE OF MICRO AND SMALL ENTERPRISES IN SOUTHERN AFRICA

Carl Liedholm and Donald Mead

Introduction

The contribution of micro and small enterprises (MSEs) in generating employment and income has become increasingly recognised not only in Southern Africa but also around the world. In most developing countries these contributions appear to have been increasing over time. To some observers this is an encouraging sign; markets are working, people are finding opportunities to participate in ways that empower and nourish many others, particularly including those that are otherwise most disadvantaged. To other observers, however, this increase in the numbers of people engaged in micro and small enterprises is a sign of failure of the economy to provide productive jobs; people are forced to take refuge in activities that provide only minimal, subsistence support. Sorting out these differences is of great importance to those who wish to address the problems of poverty and growth.

Until recently, however, relatively little has been known about the dynamic contributions of MSEs. Such enterprises typically are hidden from view and easily elude the standard statistical nets. Although baseline surveys of MSEs conducted in several countries have enabled static portraits of these enterprises to be drawn, these have shed little light on MSEs' dynamic properties.

Studies have, however, been conducted in Southern Africa, using new survey techniques that can now provide some illumination of the patterns of enterprise births, survival, growth and closure. Among the data collection innovations have been the introduction of 'closed' MSE surveys, continuous panel surveys, 'tracer' surveys of MSEs that existed in the past and modified baseline surveys that provide information concerning the growth of enterprises since their start-up. These new surveys, which were undertaken as part of the GEMINI project supported by United States Agency for International Development (USAID) and under the overall supervision of

staff from Michigan State University, were conducted in seven countries in Southern Africa—Botswana, Kenya, Lesotho, Malawi, South Africa (two townships only), Swaziland and Zimbabwe. In all these countries except South Africa, these surveys were national in coverage and were based on a random selection of enumeration areas, stratified by degree of urbanization and other key characteristics.[1]

The universe of enterprises covered in these surveys includes all enterprises engaged in non-primary activities (i.e. excluding agriculture, forestry, hunting and fishing, mining and quarrying, but including the processing and refining, transportation and marketing of primary products), where at least 50 per cent of the output is sold (i.e. excluding products made primarily for home consumption) and engaging up to fifty workers (including unpaid family members, working proprietors, apprentices and part-time workers). This means that this definition of micro and small enterprises (MSEs) encompasses both establishments consisting of one person weaving baskets for sale in the market and also factories with forty or fifty workers, using complex machinery. Microenterprises cover the smaller end of the MSE range—enterprises with ten or fewer workers.

The outline of this paper is as follows. A brief static picture of MSEs in Southern Africa will be presented first. A dynamic overview of MSEs follows next, highlighting the new evidence from the GEMINI surveys on the turbulent process of MSE creation and closure as well as MSE expansion. The interrelationships between MSEs and the macroeconomy will then be examined. An examination of the general policy and assistance implications will conclude the paper.

Static descriptive profile

Magnitude

A key finding from the house-to-house baseline surveys in Southern Africa is that the micro and small enterprise sector is far larger than is reported in most official statistics, which often cover only registered firms. In nationwide surveys, the share of households reporting that some member of the household operated a micro or small enterprise ranged from about 20 per cent in Botswana to over 40 per cent in Malawi and Kenya. Over 20 per cent of the labour force is employed in MSEs in the six countries of the region with national survey coverage (see Table 7.1). Employment densities—the number of people engaged in MSE activities per 1,000 persons in the population—ranged from seventy to ninety in Botswana, Kenya, Lesotho, Malawi, and South Africa to 110 or more in Zimbabwe and Swaziland. For six countries in Southern Africa, estimated employment

Table 7.1 Characteristics of micro enterprises in Southern Africa

	Botswana	Kenya	Lesotho	Malawi	Swaziland	Zimbabwe	South Africa
MSE employment/ population age 15–64 (%)	17	18	17	23	26	27	n.a.
MSE employment per '000 persons in the population	71	83	84	92	118	127	81
Share of all MSEs that are one-person enterprises (%)	65	47	79	61	69	69	47
Share of all MSEs with 10–50 workers (%)	3	2	1	1	2	2	1
Share of hired workers (%)	39	24	10	18	15	16	19
Locational breakdown of MSE employment (%)							
Urban areas	24	15	18	12	25	30	n.a.
Rural towns	28	7	10	4	10	6	n.a.
Rural areas	48	78	72	84	65	64	n.a.
Sectoral breakdown of enterprises: urban areas only (%)							
Manufacturing	15	18	35	29	33	64	17
Commerce	71	74	41	62	56	30	70
Sectoral breakdown of enterprises: rural areas only (%)							
Manufacturing	34	27	62	36	70	75	n.a.
Commerce	64	66	27	60	24	16	n.a.
Share of enterprises owned by females	75	46	73	46	84	66	62
Share of all workers that are females	67	40	76	40	78	57	78

Sources: Survey data (see references) except for the population data in the first line which are taken from United Nations and World Bank statistics

in micro and small enterprises is nearly twice the level of total employment in registered, large-scale enterprises and the public sector.[2] Clearly, micro and small enterprises are a major source of livelihood for a significant proportion of the population in the region.

Size distribution of MSEs

Most activities categorised as MSEs are very small. In most countries in Southern Africa, the majority of MSEs consist of one person working alone (see Table 7.1). Self-employment is thus a central element in these economies. If one defines the MSE universe as those firms with one to fifty workers, the upper end of the tail—those with ten to fifty workers—constitutes less than 2 per cent of the businesses in virtually all the Southern African countries.

Labour force characteristics

Most of the labor force in MSEs in the region is made up of working proprietors and unpaid family members. With most enterprises operating as one-person undertakings, it is not surprising that the largest employment category is working proprietors, a group that comprises more than half the MSE workforce in most countries. When unpaid family members are added, the numbers reach three-fourths of the workers in most places. Only in a few countries do hired workers comprise as much as 20 per cent of the MSE labor force. Trainees and apprentices add a significant share of workers in some locations, particularly in West Africa; in Southern Africa, as in other parts of the third world, apprentices constitute under 10 per cent of the MSE labor force.

Location

Most MSEs in the region operate in rural areas. The share of all enterprises in urban locations—cities and towns with at least 20,000 inhabitants— reaches as high as 30 per cent in Zimbabwe but was 25 per cent or less in most other countries (see Table 7.1). Even adding enterprises in rural towns— generally, concentrations with 2,000–20,000 persons—still generally leaves well over half the enterprises in strictly rural areas in most countries. It is important to keep these facts in mind since many programmes focus on enterprises in urban areas, where they are often more obvious and easier to reach.

Composition of activities

While many MSEs in Southern Africa are engaged in trading, a significant number are involved in manufacturing activities. It is a common perception

that micro and small enterprises are overwhelmingly made up of vendors and other small traders. There is some truth to this perception, since in several Southern African countries the majority of enterprises are engaged in commerce. It is important to recognise, however, that in all countries small manufacturing activities are also an important component of the MSE sector. These manufacturing activities are particularly significant in rural areas, where they constitute a higher share of enterprises than in urban areas in each of the African countries with the relevant data.

Three activities have consistently been identified as the most important categories among micro and small manufacturing enterprises: textiles and wearing apparel, food and beverages, and wood and forest products. Survey results suggest that these three categories comprise about 75 per cent of manufacturing enterprises in urban areas in many developing countries, and nearly 90 per cent of the enterprises in rural areas. Yet these apparent regularities hide wide variations, from country to country and between urban and rural areas, as to which activity is most important, as well as to the nature of the most prevalent activities within each of these three broadly defined sectoral groupings.

Gender

The majority of MSEs in the region are owned and operated by women. Indeed, it is a striking fact that, in five of the seven countries, women outnumber men as owners and operators of micro and small enterprises (see Table 7.1). Furthermore, since working proprietors are the single largest category of the labour force, the great majority of workers in such enterprises are also women. MSEs headed by women tend to be concentrated in a relatively narrow band of sectors or activities, such as beer brewing, knitting, dressmaking, crocheting, cane work and retail trading. Finally, MSEs headed by women are more likely than their male counterparts to operate from the home (Liedholm and Mead 1995). Since it is the home-based MSEs that tend to be hidden and overlooked, women owners of MSEs are more likely to be 'invisible entrepreneurs'.

Efficiency

Earlier studies based on detailed analyses of data concerning sales and production costs in four developing countries suggest substantial differences in economic efficiency, depending on enterprise size (Liedholm and Mead 1987). In particular, the data indicate that returns per hour of family labour are significantly higher for enterprises with two to five workers compared to enterprises with only one person working alone. This increase in economic returns continues for the next larger size group, those with six to nine workers; thereafter, the number of observations is small and the results more

ambiguous. Similar results were found in a recent survey of MSEs in Kenya (Daniels *et al.* 1995). In all of these studies, the data suggest that one-person enterprises generate the lowest returns to the enterprise; even a small increase in size is associated with a substantial increase in economic efficiency, which for these very small enterprises is closely associated with the level of income generated for those who work in the enterprise. There is also evidence that the economic returns in the sectors in which female entrepreneurs predominate tend to be relatively low (see Daniels 1994).

The dynamics of MSEs: churning and growth

Micro and small enterprises are in a constant state of flux. Most of these changes are missed, however, if one focuses just on the aggregate changes in the level of MSE activity over time. It is only when the individual components of these changes are scrutinised that the magnitude of this churning becomes apparent. Not only are new firms being created (new starts or births) while others are closing, but existing (surviving) firms are expanding and contracting in size. These components of change are sometimes summarised in two concepts: net firm creation, which is new starts minus closures; and net firm expansion, which is firm expansion minus firm contraction. Since the individual components move in opposite directions, however, these aggregate or net measures of change mask the magnitude of the churning that is taking place among MSEs.

New MSE Starts

Empirical evidence on new business starts (firm creation) in developing countries has been virtually non-existent until recently. New findings, which are summarized in Table 7.2, for the surveys in the five Southern Africa countries with the requisite data reveal, however, that the rate of new MSE starts is substantial. The annual rate of MSE new starts in these survey countries averages over 20 per cent, ranging in a narrow band from 19.3 per cent in Zimbabwe to 25.2 per cent in Botswana. Although the figures are still somewhat crude in most cases, they are broadly indicative and, given the techniques used, provide lower-bound estimates of the orders of magnitude involved.[3] These surprisingly high figures are substantially above the 10 per cent rate typically reported for small enterprises in industrialised countries.

The vast majority of the new firms being created are one-person establishments. In the Southern African countries, in fact, these firms run by one self-employed person comprise almost 80 per cent of the new starts. Not only is the new start rate higher for one-person firms than larger ones as revealed in Table 7.2, but there were also typically more such firms in existence. It should also be noted that the new start rates for female-headed

Table 7.2 Annual MSE new starts rate (per cent)—by initial size

Country	Year	Enterprise size (number of workers)			
		1	*2–9*	*10 +*	*Overall*
Botswana	91	32.9	11.5	4.2	25.2
Kenya	92	33.7	10.3	1.6	21.2
Malawi	91	26.9	14.1	13.1	21.7
Swaziland	90	26.3	10.8	2.4	21.7
Zimbabwe	90	22.8	10.6	18.7	19.3
Average		28.5	11.5	8.0	21.6

Source: *Computed from individual country survey data. Averages are unweighted across the five countries*

MSEs are substantially higher than those of male-headed firms. In the region, the female rate was over five percentage points higher than the male rate, a pattern that held in each country as well.[4]

Relatively little is known about the central forces driving the MSE new start rate. A recent study by Daniels (1994) for MSEs in Zimbabwe indicates that the determinants of new starts differ between high and low return (profit) activities. For high-return activities, initial capital requirements, experience of the entrepreneur and level of regulation are all inversely related to the new start rate. For low-return activities, the rate of new starts is related (inversely) only to the aggregate level of economic activity; for these firms, the lower the level of aggregate economic activity, the higher the rate of new starts, reflecting the importance of the push-factor in firm creation.

A key implication of these findings is that there is no overall scarcity of entrepreneurs in the Schumpeterian sense of individuals willing to incur the risk of establishing a new venture. Most of these new starts are one-person firms, which are typically the least efficient and remunerative of the MSEs; they tend to enter in greater numbers when the overall economy is languishing.

MSE closures

Unfortunately, overall closure rates are not available for countries within the region. Recent findings from our survey countries outside the Southern Africa region indicate, however, that MSE closure rates are also quite high. The annual rate of closures of MSEs in the Dominican Republic, the only country for which accurate annual figures exist, exceeded 20 per cent in the early 1990s.[5] The Dominican Republic findings, which are probably not atypical, highlight the extreme volatility of MSE activity, where simultaneously one large segment is starting just as another large segment is closing.

Why do MSEs close down? A somewhat surprising survey finding is that only a portion, frequently a minority, of the closures can be attributed to the traditional business failure, where the firm is not financially or economically viable. Somewhat less than one-half of the MSE closures in the region were due to 'bad business conditions'; lack of demand and shortage of working capital were the two most frequently mentioned underlying causes of these failures.[6] For the others, approximately one-quarter of the MSEs closed down for personal reasons, such as illness or retirement, while the remainder closed down because of even better options or because the government forced them to close down.

When are MSEs most likely to close down? Most closures occur in the early years of a firms existence. In Botswana, Kenya, Swaziland and Zimbabwe, over 50 per cent of the MSE closures had occurred within three years of start-up.[7] MSE closures peaked before the end of the first year in Botswana and Swaziland, and between years one and two in Kenya and Zimbabwe. Clearly, MSEs are particularly vulnerable during the fragile initial years when they are learning how to operate the business.

Given the high MSE closure rates, particularly in the crucial initial years, it is important to know the characteristics of the MSEs that close down, and how, if at all, these differ from the characteristics of the survivors. The results of systematic analyses of closure patterns of MSEs in Swaziland and Zimbabwe have now made it possible for an initial portrait to be painted of the type of enterprise that is most likely to survive.[8] The findings of these studies are summarized in Table 7.3.

What are the salient characteristics of MSEs that are most likely to survive? In addition to age, the past growth, initial size, sector, location and owner-gender might be expected to play a role.

An important finding is the discovery that MSEs adding workers were more likely to survive than those that remained the same size. More specifically, the results from Zimbabwe and Swaziland indicated that for

Table 7.3 Key determinants of MSE survival and growth

	Survival likelihood (higher if MSE)	*Growth likelihood (higher if MSE)*
Age	Older	Younger
Past growth	Grown in past	—
Initial size	Smaller	Smaller
Sector	Not in trading	In particular sectors that vary by country
Location	Urban, not in home	Urban, not in home
Gender	Male-owned	Male-owned

Source: *Derived from McPherson 1992*

every 1 per cent increase in employment, the MSE reduced its likelihood of closing down during the year by approximately 5 per cent (McPherson 1992). Such findings are consistent with the notion that the expanding MSEs have become more efficient and thus more able to survive. One of the surprising results is the direct relationship that was found to exist between the MSE's initial size and its survival chances. Firms that started the smallest, other factors being held constant, were more likely to survive than their counterparts that started larger. This finding is directly opposite to what one would have expected and indicates that smallness, by itself, is no impediment to survival.

Another key result is that MSE survival rates varied significantly by sector. Retail trading MSEs in all three countries faced the highest closure risks; such firms were almost 30 per cent more likely to close down during the year, than their counterparts in woodworking, for example. Real estate, wood processing, wholesale traders and non-metallic metal enterprises were the least likely to close, while trading, transport and chemical MSEs were the most likely to do.[9]

Another striking finding is that location plays a central role in determining MSE survival. Urban MSEs, for example, had an almost 25 per cent greater chance of surviving the year, holding all other factors constant, than their counterparts in rural areas.[10] Moreover, MSEs located in commercial districts were more likely to survive than those operated from the home. Proximity to growing markets would thus seem to be an important factor in enterprise survival.

The gender of the entrepreneur also is a significant determinant of MSE survival. More specifically, female-headed MSEs were less likely to survive the year, all other factors constant, than their male-headed counterparts. These analyses examined the survival and close-downs of MSEs due to all factors. Relatively high percentages of the close-downs of female-headed MSEs in these countries, however, were due to personal and other non-business failure reasons. When only closings due to pure business failures were analysed separately, the gender of the entrepreneur was no longer found to be a significant determinant. Thus, in terms of closings due to business failures only, female- and male-headed MSEs were equally likely to survive.

Finally, at the more macro level, there is evidence from Zimbabwe of an inverse relationship between the overall level of economic activity and the closure rate, particularly in low-return activities.[11] Thus, as the overall level of activity increases, the likelihood that MSEs would survive the year would be expected to increase as well.

MSE expansion

To this rapid churning resulting from the entry of some new firms and the closure of others must be added the growth from the net expansion of existing

enterprises over time. The net expansion depicts the expansion minus the contraction of those MSEs that survive and summarizes two opposing dynamic forces at work.

The indicator typically used to measure the magnitude of the net expansion of MSEs and the one used in the surveys reported in this study is the change in the number of workers since start-up. This measure tends to be favoured because it is most easily and accurately remembered by the entrepreneur and does not need to be deflated.

What biases might arise from the use of employment as a measure of expansion rather than alternative indicators such as changes in sales, output or assets? Although data on these other indicators are sparse, some recent surveys have begun to shed light on this issue. Parker's (1995) analysis of the growth in Kenyan MSEs, for example, found that net increases in real sales were almost double the growth in employment. A similar pattern was revealed in the Jamaican Quarterly Panel Survey of MSEs (Gustafson and Liedholm 1995), where the change in real sales was twice the change in employment. Such findings highlight the 'lumpy' nature of employment which appears to increase with a lag after a sizeable growth in real sales and indicate that the employment growth measures provide a lower-bound, more conservative estimate of net firm expansion.

One of the most striking findings to emerge from the various surveys is the high overall growth rates exhibited by the existing (surviving) MSEs. Table 7.4 reveals that the average annual compound employment growth rate since start-up was 8.6 per cent in six countries of Southern Africa.[12] The country variation around this average is large, however, ranging from 2.4 per cent in Lesotho to 24.0 per cent in Kenya. These high growth rates are all the more impressive when it is recognized that, except for Botswana and Lesotho, they are at least double the overall growth in GDP in these countries during the 1980s. Moreover, even in absolute terms, the annual number of jobs created per firm is impressive (see Table 7.4, column 3). These generally rapid growth rates are even more impressive, when it is realized that the majority of the MSEs in the survey countries had not grown at all since start-up. Less than one-quarter of the MSEs added workers, while over three-quarters remained the same size (Liedholm and 1995).[13] MSE employment expansion was the exception rather than the rule, and this expansion was thus being propelled by a minority of the MSEs.

Of those MSEs that grew, over 90 per cent added fewer than four workers. Overall, only 1 per cent of the MSEs 'graduated' from the microenterprise seedbed and ended up with more than ten workers. Thus, most of the expansion was due to most of the growing MSEs expanding just a little.

When an existing MSE expands by adding even one or two workers, it is quite likely that this will be associated with a sharp increase in its economic efficiency as well as in its net income. The reasoning is as follows. Most new

Table 7.4 Annual employment growth of existing small enterprises alternative measures Annual change since start-up

Annual change since start-up

Country	Annual growth rate – average growth measure (%)[a]	Annual growth rate – compound growth measure (%)[b]	Annual change in number of jobs per firm (number)[c]
Botswana	8.4	6.3	0.119
Kenya	29.0	24.0	0.297
Lesotho	5.9	2.4	0.094
Malawi	10.5	9.0	0.112
Swaziland	6.6	4.1	0.061
Zimbabwe	7.4	5.6	0.084
Southern Africa (average)	11.3	8.6	0.128
Niger	8.5	5.7	0.101
Dominican Republic	15.1	12.6	0.157
World (average)	11.4	8.7	0.128

Sources: *Swaziland—Fisseha and McPherson 1991; Lesotho—Fisseha 1991; Zimbabwe—McPherson 1991; Kenya—Parker 1994; Dominican Republic—Cabal 1995; Botswana—calculated from data generated by Daniels and Fisseha 1992; Niger—calculated from data generated by Joumard, Liedholm, and Mead 1992; Malawi—calculated from data generated by Daniels and Ngwira 1992*

Notes: [a] *Average annual growth rate in terms of employment and is calculated as: {(Current Employment—Initial Employment)/Initial Employment)}/Firm Age.*

[b] Annual compound growth in employment is calculated as: {(Current Employment/ Initial Employment) $^{(1/Firm\ Age)}$ −1 .

[c] Average annual growth in jobs since start up is calculated as: (Current Employment— Initial Employment)/Firm Age.

MSE start-tips are one-person enterprises, which is also the least efficient size category (see above). If some of these MSEs subsequently expand, adding even one more worker, they will be moving into a size category where their economic efficiency, as well as their net income, is likely to be significantly higher.[14] Moreover, the jobs created should be more permanent and possibly generate a higher wage.

Given the economic significance of MSE expansion, it is important to know the characteristics of those enterprises that expand and how, if at all, they differ from the characteristics of those that do not grow. The results of a systematic analysis of the determinants of growth in the six Southern African countries make it possible to provide a profile of the type of MSE most likely to expand.[15] The overall findings, which are summarized in Table 7.3 above, on the role of age, initial size, sector, location country, gender of entrepreneur as well as human capital will now be examined.

An important finding from the analysis was the discovery of an inverse relationship between the age of the MSE and expansion. Thus, it was the younger MSEs that were most likely to generate more expansion jobs. Similar results were reported in the Dominican Republic (Cabal 1995) and Kenya (Parker 1995). Examining the growth and age performance of individual MSEs over time, however, Parker (1995) found that the inverse age and growth relationship held only for MSEs that started with one worker or with more educated entrepreneurs; much of the expansion occurred in years one and two. After the eighth year a common pattern of downsizing took place among MSEs of all types and sizes.

An inverse relationship was also found to exist between initial size and growth of the MSE. The smaller MSEs at start-up thus added more expansion jobs per firm than did their larger-scale counterparts, a powerful finding for those concerned with employment creation. Parallel findings have been reported elsewhere in Africa (Parker 1995, McPherson 1996), although a direct relationship between initial size and growth was found in the Dominican Republic (Cabal 1995).

The sector in which an MSE operated also appeared in the analysis to be an important determinant of growth. At the most aggregate sectoral level, MSEs in manufacturing and services were more likely to expand than those in trading. At a more disaggregate level, the specific sectors that were likely to generate more MSE expansion varied from country to country. In Swaziland, for example, MSEs in non-metallic minerals expanded substantially less than those in retail trading, while in Kenya all sectors, including non-metallic minerals, expanded more rapidly than retail trading. What these findings suggest is that sectoral differences are significant at the country level in explaining MSE expansion, reflecting perhaps each country's comparative advantage—its unique fingerprint. At the same time, no universal sectoral growth patterns seemed to emerge.

Another important set of factors identified by the analysis as a determinant of MSE expansion was location. MSEs located in rural towns and villages, for example, were less likely to grow than their urban-based counterparts. Moreover, MSEs operating in commercial districts or even alongside the road showed a markedly stronger tendency to expand than did those operating from the home. Other studies have yielded generally the same results but with a few exceptions. McPherson (1992), for example, found that in Southern Africa MSEs operating even in traditional markets were more likely to expand than home-based firms.

A particularly significant finding from the analysis was the revelation that male-headed MSEs were more likely to expand than female-headed ones, even when controlling for such variables as sector and location. The regional survey results had indicated that female-headed MSEs generally grew less rapidly (approximately 7 per cent per year) than those headed by males (approximately 11 per cent per year) and tended to be concentrated in the

more slowly growing sectors of the Southern African economies (Liedholm and Mead 1995). What are the possible explanations for these gender effects on growth? Mentioned in the literature are such factors as the dual domestic and productive responsibilities of women or possible differences in the business objectives of females and males. Females may also be more risk-averse than their male counterparts and thus may be more likely to use any available funds for diversification into new activities rather than for an expansion of existing ones (Downing and Daniels 1992).

Although data limitations precluded the inclusion of the 'human capital' in the formal analysis, related studies provide evidence that it does significantly affect MSE expansion. McPherson (1992) found that in Southern Africa entrepreneurs with vocational training expanded their MSEs 9 per cent faster than those without such training. For Kenya, Parker (1995) reported that entrepreneurs who had at least seven years' experience were more likely to expand their business more rapidly than those without such experience. Entrepreneurs who had completed secondary school were also found to be more likely to expand in Kenya (Parker 1995) and Zimbabwe (McPherson 1996).[16] Completion of primary school by the entrepreneur, however, was found to have no significant effect on MSE expansion in any of these countries

Finally, at the more macro level, there is evidence of a direct relationship between the level of economic activity and MSE expansion. The higher the level of overall economic activity, the greater the amount of MSE expansion.

MSE jobs and the macroeconomy

Micro and small enterprises make a major contribution to the total economy in the nations in which they operate. Conversely, the state of the overall economy has a significant impact on patterns of growth of MSEs, particularly jobs. In this section, we set out the major dimensions of these interrelationships.

Survey data suggest that, during the 1980s, the expansion in employment in micro and small enterprises absorbed close to 30 per cent of the increase in population of working age.[17] Since not everybody of working age is working or even seeking work, the contribution of MSEs to the absorption of new workers joining the labour force is substantially higher than this.[18] In terms of secular patterns of growth, then, MSEs are the single most frequently chosen path for people entering the labour force and seeking to find a way of earning a living in developing countries.

New MSE jobs come into being in two ways: through new business creation and through the expansion of existing enterprises. The distinction between the two is important since in many cases the forces leading to the growth of employment are different. While this is not always true, it appears that a higher percentage of the new jobs arising from new start-ups reflects

survival efforts by people with few options. In many cases, these new enterprise starts are driven by a necessity for finding any source of income, even those providing only minimal returns, in situations where few alternatives are available. As indicated previously, a substantial share of MSE new start-ups are one-person enterprises concentrated in activities that are the easiest to get started, i.e. those with the lowest barriers to entry, with a consequent danger of overcrowding and resulting low returns. It has also been pointed out earlier that closure rates are particularly high in the early years of a new enterprise.

New MSE jobs arising from an expansion of existing enterprises are more likely to reflect a response to an identified business opportunity. Entrepreneurs take on additional workers primarily because they have tried a particular pattern of doing business, have found a market and would like to expand their participation in that market. Such a dynamic is particularly likely to hold in cases where the added worker is a hired worker: the entrepreneur would only take him or her on if there is a reasonable prospect of covering the added costs from additional sales revenues. This reasoning is less clear if the additional worker is an unpaid family member or a trainee.

Returns to labour in jobs resulting from an expansion of existing enterprises appear to be substantially higher than those arising from new business start-ups. A recently completed survey in Kenya provided estimates of net returns to labour in various types of micro and small enterprises. Looking at new jobs that had come into being during the eighteen months previous to the survey, returns to labour in enterprises that had expanded their labour force during that period were more than twice the levels for enterprises established during those eighteen months (Daniels *et al.* 1995). This is consistent with our expectation that expansion jobs are not only more likely to endure but also likely to provide higher incomes than those that result from new business start-ups. It is also consistent with the earlier mentioned findings of the higher efficiency of MSEs with more than one worker.

Most MSE jobs come into being through people starting new businesses. Of the 4.8 million people working in MSEs in the Southern African survey countries at the time of the recent surveys, about 3.7 million of those jobs—just over 75 per cent of the total—came into being when the enterprise itself was started. The remaining quarter were taken on as a result of an expansion of these businesses, subsequent to their start-up.

While the figures in the previous paragraph reflect long-term patterns of job-creation, the patterns can be quite different over shorter periods of time. In particular, there is evidence that when the overall economy is growing well, many micro and small enterprises are also thriving and expanding by adding to their workforce. Under such circumstances, the majority of new jobs in MSEs result from an expansion of existing enterprises. By contrast, when the overall economy is contracting, the opposite forces are at work: relatively more survival-type new businesses appear, and fewer enterprises

of any size are expanding. In such times, then, the majority of new jobs in MSEs come from new start-ups. Daniels' (1994) analysis of the relationship between MSE growth patterns and the performance of the overall economy in Zimbabwe provides support for this view, as do similar analyses undertaken for Jamaica (Gustafson and Liedholm 1995) and the Dominican Republic (Liedholm and Mead 1995).

Policy and assistance implications

An array of policy and project implications emerges from these survey findings of MSE dynamics in Southern Africa. At the general policy level, broad-based macro policy reform aimed at creating a more dynamic economy can be an effective vehicle for fostering the productive expansion of existing MSEs. Conversely, when the overall economy is distorted or stagnant, relatively little of this kind of expansion takes place. Moreover, although MSEs in the region rarely mention direct governmental controls or regulations as problems of central concern, the indirect effects of such regulations can be more subtle and more pervasive. Governmental policies frequently discriminate against MSEs in favour of their larger scale counterparts when it comes to access to inputs and the prices the two types of enterprises must pay for them; eliminating such distortions 'with simply a stroke of the pen' can do much to foster the growth of MSEs.[19]

At the project assistance level, one of the most important implications from the survey findings is the recognition that the clients for this assistance, the MSEs, are heterogeneous. Among the MSEs, there are different target groups, each with different opportunities and different needs. Those designing MSE assistance programmes must recognise these differences and craft interventions that are appropriate to the needs of that particular group.

Enterprises that are starting up, for example, face different problems and constraints than those of existing firms seeking to expand. In view of the already large number of new starts in the region each year, along with the high attrition rates in early years of an enterprises life and the multiple needs of new enterprises, one might seriously question whether many scarce resources should be allocated to facilitating new starts. If there are strong pressures to support this group, it would be important to build on any existing experience of these new entrepreneurs.

Existing firms that have survived the first three years or that have grown even slightly would appear to be more likely candidates for assistance. Even in this instance, however, a distinction might usefully be made between three categories of existing MSEs: (1) those that are not growing; (2) those that seek to grow just a little; and (3) those that seek greater growth or even to 'graduate' to the upper end of the small enterprise scale.

These different types of existing MSEs have different contributions to make to the dual objectives of poverty alleviation and growth. Non-growing MSEs,

for example, are primarily survival activities and thus are a particularly appropriate target group for those concerned with poverty alleviation. Programmes aimed at this group can increase the likelihood that such enterprises can survive or earn somewhat higher levels of income. Assistance focused on enterprises that seek to add to their labour force, by contrast, makes its major contribution in the area of growth.

For the first two categories of existing enterprises, small amounts of a single missing ingredient, working capital, are often all that is required to sustain the enterprise or to enable it to expand slightly. Until recently, there were few proven cost-effective mechanisms for making such funding available to MSEs. Fortunately, the innovative microenterprise credit schemes that originated in Asia have now been adapted and applied with some success in Southern Africa. The Get Ahead Foundation in South Africa and the Kenya Rural Enterprise Programme, for example, have demonstrated that it is possible to reach relatively large numbers of MSEs with credit schemes that are at least operationally self-sufficient and that can generate borrower repayment rates exceeding 95 per cent (Otero and Rhyne 1994).

For MSEs that are seeking somewhat more sizeable expansions or changes, however, the simple provision of working capital alone will generally not suffice. Many other constraints, such as fixed capital along with an array of non-financial constraints, loom large for these enterprises. Business support and service institutions typically have played a central role in providing much of this assistance. One of the key and difficult challenges facing such institutions is finding ways to ensure that the needed services are provided to this extensive and widely dispersed client group in a reasonably cost-effective manner. Recent experience has shown that a subsector approach, which focuses on the interrelationships between enterprises in a particular subsector (such as furniture), may be one way of meeting this challenge.[20]

Several gender implications of the findings deserve special mention. Since females are more likely than their male counterparts to be 'invisible entrepreneurs', MSE programmes must be aggressive in identifying and approaching female clients by actively seeking them out and penetrating the household, where the vast majority of MSEs operate. Moreover, since large numbers of women-owned enterprises are concentrated in household-based, low-return activities where growth prospects are bleak, particular attention needs to be focused on the working capital intervention that has been found to be particularly appropriate for such non-growing MSEs. For those female entrepreneurs desiring to expand, attention must be focused on providing the multiple inputs that are typically required to shift them into more lucrative and growing product lines.

In summary, MSEs are a major feature of the economic landscape of Southern Africa. There is much churning and diversity within this MSE universe. Policies and projects grounded on a solid understanding of this

changing universe can help ensure that the important contributions of MSEs to the development process in Southern Africa can be fully realised.

Notes

1 For details of these surveys, see the survey sources listed in the references. The surveys, which were conducted between 1990 and 1995, covered over 35,000 enterprises. Dynamic data were typically not generated for South Africa and Lesotho.

2 The six countries are Botswana, Kenya, Lesotho, Malawi, Swaziland and Zimbabwe. For details, see Liedholm and Mead (1993).

3 New start (birth) rates are typically calculated by dividing all new firms appearing in a given time period (usually one year) by the number of firms already in existence at the beginning of the year. The number of firms at the end of the year served as the base; given the net increase in the number of firms, this creates one source of downward bias. A second source of downward bias, present in all countries, is the omission of the short-lived firms that appear and then disappear within the year. A study of short-lived firms in the Dominican Republic indicates that if these are included in the analysis the birth rate in the Dominican Republic would have increased by 6.5 percentage points. For more details of these methodological issues, see Liedholm and Mead (1993).

4 See Liedholm and Mead (1995), for more details of these gender findings.

5 Specifically, on the basis of area-based panel surveys, the annual closure rate was 29 per cent in 1992 and 22 per cent in 1993 (Cabal 1995). In Zimbabwe, a closure rate of 11.5 per cent per year (from 1991–93) was reported from a similar area-based panel survey of MSEs (Daniels 1994); but since 42 per cent of the firms could not be located in the resurvey, this closure rate must be considered a lower-bound estimate. The area-based panel surveys, where all enterprises in the same areas are surveyed over time, generate much more accurate closure rates than those generated from either tracer or closed enterprise surveys, both of which are subject to severe selectivity biases that understate the closure rates. Annual closure rates derived from tracer surveys range from 1.3 in Nigeria (Kilby 1994) to 4.1 per cent in Jamaica (Fisseha 1994), while those from closed enterprise surveys hover around 6 per cent per year

6 In Kenya (Parker 1994), those who closed for demand reasons were much more likely to start a new enterprise than those who closed because of a lack of working capital. Indeed, overall, of those who closed, 60 per cent subsequently opened a new business, 15 per cent worked in agriculture, 8 per cent accepted paid employment and 17 per cent were no longer economically active.

7 More incomplete data from Malawi indicate that approximately one-third of the MSEs had closed three years after start-up.

8 For details, see McPherson (1992). These studies make use of recent developments in 'hazard analysis' to provide an explanation of enterprise closure and survival. The dependent variable in the analysis is the enterprise 'hazard rate', which is the probability that a firm will close during the year. The independent variables used to explain the hazard rate are such items as the age, sector and location of the enterprise. Econometric techniques are used to estimate the relationships (see Liedholm and Mead 1993, for more details).

9   The complete sector-ranking of MSEs by survival probabilities from highest to lowest in Swaziland and Zimbabwe combined was (McPherson 1992) as follows: real estate, wood processing, wholesale trade, non-metallic minerals, textiles, other services, food and beverage processing, construction, miscellaneous manufacturing, metal fabrication, hotels and restaurants, chemicals, retail trade, transport. The rank differences were, however, not always statistically significant.

10 The rural-urban distinction was not statistically significant in the Dominican Republic analysis (Cabal 1995).

11 Using regression analysis, Daniels (1994) found an inverse relationship between the GDP growth rate over the 1988–93 period and the annual closure rate in Zimbabwe. Similar findings have been reported for the Dominican Republic (Cabal 1995).

12 The compound growth measure provides a lower-bound estimate of the growth rate compared with the average growth rate measure, which uses initial employment in the base. An absolute measure, the annual change in jobs per firm, is also presented in Table 7.4; it can be particularly useful in assessing the overall contribution of the smallest firms to job creation. The data for all the growth measures were generated by asking entrepreneurs for retrospective information (event histories) about their firms.

13 About 5 per cent of the enterprises had declined in size since start-up (see Liedholm and Mead 1995).

14 See sub-section on *Efficiency* above as well as Liedholm and Mead (1987), for cross section evidence. See Parker (1995), and Parker *et al.* (1995) for time-series evidence.

15 Following McPherson (1996), statistical techniques (linear ordinary least squares regression equations) were used to test whether or not the various independent variables, such as age and initial size, were significantly related to the dependent variable, which was enterprise growth since start-up measured in absolute terms. See Liedholm and Mead (1993) for details.

16 No significant relationship between secondary school education and MSE expansion could, however, be found in Botswana or Swaziland (McPherson 1996).

17 Based on data from five countries: Botswana, Kenya, Malawi, Swaziland and Zimbabwe. For more details about estimate approach, see Liedholm and Mead (1995). The aggregate estimate for these six countries is 28.7 per cent. Working age is 15–64.

18 Labor force estimates are notoriously unreliable. For five countries in Africa covered by our surveys, the United Nations Development Programme (UNDP) has estimated the growth of the labor force at 72 per cent of the growth in population of working age (see Liedholm and Mead 1995, for details). It implies that the growth of employment in MSEs absorbed about 40 per cent of the labor force growth in these countries.

19 See Liedholm and Mead (1987) and Joumard *et al* (1992) for details of policy distortions that are not neutral by enterprise size. The differential effects of the import duty structure is one example. Large enterprises can typically import their capital equipment at low or zero import duty rates via investment promotion schemes; small enterprises, however, do not qualify for such schemes and often find, as well, that their capital equipment, such as sewing machines and outboard motors, are classified as luxury consumer goods for tariff purposes.

20 Subsector analyses examine the vertical marketing and production channels within each sector, identify the links between large and small firms, analyse the competitive forces between and within channels and identify those points that

provide the greatest leverage for growth. Many times these leverage points act indirectly on the targeted MSEs. In Botswana, for example, the leverage point was the establishment of a commercial malting firm, which lowered the cost of malt to the small sorghum beer producers and enabled them to compete effectively with the large-scale beer producers. See Boomgard *et al.* (1992).

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IS SOUTHERN AFRICA READY FOR REGIONAL MONETARY INTEGRATION?

Carolyn Jenkins and Lynne Thomas

Introduction[1]

International interest in economic integration is spawning new regional initiatives in every continent. Africa does not lag the world in setting up these arrangements; in fact the world's oldest customs union exists in Southern Africa, and the list of both past and present multilateral economic agreements is probably longer than that of any other continent. Africa's problem lies in setting up regional initiatives where both benefits for members and penalties for non-compliance are sufficiently substantial to ensure continuing cooperation. There are successful examples, notably the Southern African Customs Union (SACU) and the (Rand) Common Monetary Area (CMA), and some partially successful arrangements in francophone Africa, but Africa's record of creating workable regional frameworks is poor.[2] African policy-makers are nevertheless still searching for broader economic cooperation as a solution to small markets and generally weak economies. South Africa's participation in an economic community centred on the Southern African Development Community (SADC), which it dominated even while it was excluded, is seen as the opportunity with greatest potential for success.

It should not be assumed that because regional economic integration is fashionable, it is necessarily an appropriate strategy to pursue. Economic research is building some consensus on the conditions under which policy coordination and/or trade blocs may be optimal. Many of the most recent developments in the theoretical (and empirical) literature on macroeconomic policy coordination applies to developed economies. However, there are important applications to be made to developing regions.

This paper begins by reviewing the theoretical and empirical literature on macroeconomic policy coordination. The conclusion drawn is that some degree of macroeconomic convergence is necessary for effective policy coordination. The paper goes on to consider macroeconomic policy and convergence in the SADC.

Lessons from theory and experience

This review of the literature is long, but there are several issues that are critical when discussing the readiness of a group of countries for macroeconomic policy coordination. In essence, the argument is as follows. The desire to coordinate policy arises from three sources. First, changes in macroeconomic policy in one country have spillover effects on others, possibly generating a need for adjustment which would not otherwise have arisen. Second, there is a desire to avoid beggar-thy-neighbour devaluations in the pursuit of high employment. Third, the theoretical prediction that poorer countries should catch up with richer ones (because, for example, they can take advantage of existing technological developments without having to develop their own) is weakly supported in groups of countries where cooperation is occurring; there is a growing consensus that 'convergence clubs' exist, where countries with a lower GNP per capita grow more rapidly because they are members of a trade group, or because domestic policy gains credibility by being tied to the domestic policy of a country with a better economic reputation. However, there are also costs attached to economic policy coordination: primarily a loss of the use of policy instruments for domestic stabilisation (in political terms, a 'loss of sovereignty'). For policy coordination to create a net gain, it is necessary that there be some degree of 'convergence' (explained below) between the participating countries, and that either they fulfil certain criteria in terms of both the domestic policy stance and the structure of domestic institutions or there is a supranational body which has sufficient authority to enforce compliance. The international experience is mixed, both in terms of feasibility of cooperation, and in terms of effectiveness of regional arrangements.

Macroeconomic policy coordination and the problems of spillover effects

This section reviews the desirability and form of multilateral macroeconomic policy coordination.

World economies are linked in such a way that monetary and budget policies adopted in one country affect the economic performance of other countries. Much of the current literature on international macroeconomics deals with the international transmission of national macroeconomic policies (see Persson and Tabellini, 1995, for references). Clearly inefficiencies (and worse) are possible: governments choose policies to maximise domestic objectives and ignore the externalities imposed on other countries, possibly generating sub-optimal equilibria. The current concern with international policy coordination (or cooperation) stems from a felt need to take into account both domestic policy incentives and international strategic considerations. This at least is one motivation for the concern within the

SADC over macroeconomic policy coordination. South Africa's economic dominance means that changes in its domestic economic policy may have large spillover effects on its neighbours. Moreover, some countries have been adversely affected by cross-border effects of uncoordinated structural adjustment programmes in the region.

Even within a single country, there are often difficulties with policy coordination, not least because different agents have responsibility for oversight. In developed countries, fiscal policy is the collective decision of politically motivated representatives, while monetary policy is implemented by a single-minded institution, with a greater or lesser degree of distance from the direct political process. In African countries, fiscal policy may be determined by collective decision-making in parliament, although sometimes it is the preserve of a centralised decision-making body consisting of the president and ministers of economic departments. Monetary policy is frequently subservient to the dictates of financing the budget deficit. Furthermore, some autonomy in domestic economic policy-making may be lost to the international financial institutions (IFIs). In the latter case, the IFIs usually also have objectives limited to the domestic economy and ignore the externalities which structural adjustment programmes impose on other countries.

Changes in *domestic fiscal policy* are transferred to other countries: (1) through changes in the terms of trade; (2) where capital is internationally mobile, through changes in the after-tax return to international capital in different localities and (3) through changes in the demand for imports. Internationally there are no examples of tight fiscal policy coordination outside of federal structures (Persson and Tabellini, 1995:3). Cooperation in fiscal policy would imply some harmonisation of tax rates and of expenditures on subsidies. However, governments with private agendas, like re-election or a particular ideology, would find it in their interests not to cooperate, since this reduces their room for manoeuvre. Only when there are long-term relationships between countries, which create reputational and institutional incentives to maintain the relationship, can some policy coordination be sustained. If self-enforcement is insufficient, then international structures (agencies of restraint) which have authority to enforce cooperation are necessary. Alternatively, in situations where one country is dominant, lump sum compensating payments by the dominant country may be necessary to hold the participating countries together.

Changes in domestic *monetary policy* are transmitted to other countries through changes in interest rates and changes in the real exchange rate. Cooperation will reduce the inefficiencies which arise when there are conflicts over stabilisation policies or growth targets. A cooperative regime also produces better responses to supply shocks or relative shocks in aggregate demand. However, monetary policy coordination may be counterproductive if governments lack credibility with the private sector, i.e. gains from

cooperation are only ensured when the appropriate domestic institutions are in place (Rogoff 1985:200, 210). If domestic solutions to credibility problems cannot be found, countries have to resort to international arrangements. Examples include supranational authorities like the Bretton Woods institutions, in the case of developing countries, or the European Monetary System.

Monetary cooperation usually takes the form of a fixed exchange-rate regime, where the smaller country makes a one-sided commitment to a specific monetary policy 'reaction function', while the dominant country chooses its monetary policy freely Where shocks affect the two countries symmetrically, there is no need for any cooperative agreement—the one-sided peg is sufficient for a cooperative outcome (e.g. the Austrian schilling pegged to the D-mark). If shocks affect countries asymmetrically, then they strain the whole mechanism, especially when they affect the central country (e.g. the US and the Vietnam War under the Bretton Woods system, or German unification under the European Monetary System). The stronger country must not only take the smaller country into account but must give it extra weight, and a contract is necessary whereby the central-currency country commits itself to pursuing restrictive monetary policy when it suffers a negative external shock and the periphery country commits itself to a fixed exchange rate (Persson and Tabellini 1995:42). However, usually only the smaller country is prepared to commit to such a contract. A fixed exchange-rate contract is therefore only feasible in the case of extreme symmetry (and, possibly, extreme asymmetry, although the literature rarely deals with this case). Incentives to deviate from an exchange-rate peg are only small if (1) the central country has a lot of credibility; (2) shocks are not asymmetric and (3) macroeconomic development in the participating countries is relatively parallel. These issues are dealt with in greater detail below.

Before examining more closely the economic issues of policy coordination, note that there are important *political issues* to be considered. To a very great extent, a nation has the ability to achieve its economic goals by itself. Although the levels of demand, inflation and interest rates in one country affect economies elsewhere, a country can manage its own monetary and fiscal policies to offset many of the potential influences from abroad. There is a serious risk that economic summits and ministerial meetings can slow down the taking of painful decisions to make appropriate changes to domestic policies. This occurs either because politicians feel that they can escape their responsibilities by blaming poor domestic performance on policies pursued abroad, or because they hope that coordinated foreign action will make domestic changes unnecessary or because their actions are, in fact, bound by international agreements. Moreover, the attempt to pursue coordination in a wide range of macroeconomic policies is likely, even among developed countries, to result in disagreements that reduce the prospects for cooperation in those more limited areas of trade, defence and foreign assistance where

international cooperation is actually necessary (Feldstein 1988:3). The collapse of, or non-compliance with, international agreements can lead to recriminations, souring foreign relations. It is better not to set up a policy union which is destined to fail.

In summary, policy unions are difficult to maintain, particularly if member countries respond asymmetrically to external shocks. Where there are long-term relationships that are mutually desirable then some policy coordination may be sustained, but the wider the range of policy variables tied by international treaties, the smaller the likelihood of compliance.

Exchange-rate coordination

There is consensus in economic theory that fixed exchange rates are less appropriate for countries dependent on the inflation tax; without factor mobility; subject to rigidities, so that shocks take years to work their way through the economy; and where shocks for core and peripheral countries are asymmetric. The most extreme form of exchange-rate coordination is the formation of a currency union. Adopting a common currency means that a country cannot (1) devalue/revalue on its own or (2) control the quantity of money (De Grauwe 1992).

The reasons for pegging are: (1) to reduce the costs associated with unpredictable volatility, both short term and long term; (2) to restrain domestic inflationary pressures; (3) to import credibility from the low-inflation country and (4) to anchor price inflation for internationally traded goods, providing a guide for private-sector inflation expectations.

The costs of pegging include: (1) the loss of the exchange rate as a stabilisation instrument; (2) the loss of control of the domestic money supply and, consequently, loss of monetary instruments for stabilisation; (3) an increase in fiscal burden for higher inflation countries by reducing seigniorage revenue if disinflation is necessary (Gros and Vandille 1995); (4) the threat (and reality) of speculative attacks; and (5) if a common currency is adopted, the potential for conflict over, for example, the distribution of seigniorage, common versus domestic stabilisation requirements, etc..

Since the breakdown of the Bretton Woods system, very few fixed-rate regimes have actually remained intact, not only because of the costs of pegging, but because reserves are dwarfed by the size of short-term capital flows, and giant capital markets magnify any weakness in a country's commitment to a fixed rate, leaving little room for manoeuvre (Obstfeld and Rogoff 1995:94).

European efforts to peg exchange rates within narrow bands have ended in spectacular débâcles. As European and Mexican experiences have shown, a fixed exchange rate is very costly for a government to maintain when its promises not to devalue lack credibility. At the same time, developing and

maintaining credibility has become increasingly difficult, as the 1994–95 Mexican and 1996 South African experiences showed.

Certain conditions must be fulfilled if there is to be a net gain from fixing exchange rates. One relevant area of theory is that of optimal currency areas (OCAs), although this is criticised by some as 'murky and unsatisfactory' (Buiter 1995:1). Nevertheless, the key insight of this body of theory is that countries or regions which experience a high diversity in output and employment growth need considerable labour market flexibility if they want to form a monetary union and avoid major adjustment problems.

Consider the following example. If there are two countries in a monetary union and an external shock shifts demand from one country's goods to the other's, the first country will run a current-account deficit and the second a surplus. In order to adjust, it is necessary for labour to move from the deficit country to the surplus country, or for real wages to fall in the deficit country and to rise in the surplus country. If neither, then the surplus country must allow inflation to occur. Resisting this means that the current-account surplus will persist, and that inflationary pressures will therefore persist. By contrast, the deficit country will have unemployment. If it cannot devalue, it must deflate to eliminate the deficit, but this will worsen the unemployment problem.

An alternative solution would be for the surplus country to increase taxation and transfer the revenue to the deficit country. The deficit will then persist but will be financed by the surplus country. These transfers between countries are known as 'regional policy'. This is in effect what happens within one national unit (country), where transfers occur from more prosperous regions to ailing regions via the Department of Finance.

Countries with a low degree of flexibility in the labour market, given the level of real divergence, do not form an OCA and are better advised to maintain some degree of exchange-rate flexibility, even if this carries economic costs.

Nevertheless, credibility gains are possible for a small country, if it pegs to the currency of a large neighbour with a credible anti-inflationary policy as has occurred in the (Rand) Common Monetary Area. This may suggest adopting the (stable) currency of a larger country under a currency board arrangement, as in, for example, Estonia (Burdekin and Langdana 1995:24–25) or creating a supranational authority with currency boards.

In summary, monetary union is optimal if one—or a combination—of several conditions is fulfilled: there is wage flexibility; labour is mobile between countries; politically easy transfers are possible; and countries react similarly to shocks. A degree of real economic convergence (explained immediately below) is necessary for exchange-rate coordination. The consensus seems to be that for groups of countries which are not OCAs, maintaining exchange-rate flexibility is best, while at the same time introducing/ preserving institutional constraints on expansionary policy (like

guaranteeing the independence of the central bank, and/or reforming monetary institutions to focus on restraining domestic inflation; see the recommendations for Southern Africa by Harvey and Hudson, 1993). In other words, the exchange rate becomes an indicator and not the central target for monetary policy (Irwin and Vines 1995:18, Obstfeld and Rogoff 1995:74).

Convergence

The convergence literature is confused and confusing. There appear to be different issues involved, and no consensus on any particular issue! For example, the literature refers to, but does not self-consciously distinguish between, convergence in two different contexts: convergence in GDP per capita (i.e. a tendency for equalisation of income); and convergence in macroeconomic stability indicators.

Convergence in GDP per capita arises out of the prediction of neo-classical growth theory that poor economies might 'catch up' with richer ones. If countries are converging, there would be a negative relationship between income per head at the beginning of some time period and subsequent rates of growth (in income per head).

Most empirical studies testing the convergence hypothesis find no convergence occurring among all countries in the world, or even among a very large sub-sample of the worlds economies (Romer 1986). In fact, many poorer countries have been experiencing negative per capita growth, so that the gap between rich and poor countries has been increasing.

However, within smaller groups of countries (regions), like the OECD countries, the US states or Japanese prefectures, there is evidence of convergence (Barro and Sala-i-Martin 1991, Dowrick and Nguyen 1989). The contrasting evidence has given rise to two related hypotheses:

> *convergence clubs*, which are a subset of countries for which convergence applies (Baumol *et al.* (eds) 1994), suggested for countries with similar initial human capital endowments. Members of the 'club' which are only moderately backward are able to take advantage of technological improvements in front-runners and catch up. An alternative version of this is that all countries which are open and integrated in the world economy are members of the 'convergence club' (Sachs and Warner 1995:41). Ben-David (1995) also argues that trade-based groups show higher convergence than randomly created groups.
> *conditional convergence,* where each country has its own long-run per capita income, and grows more rapidly the greater the gap between initial income per head and its own long-run income per head (which is proxied by certain structural variables, like initial

human capital endowments) (Barro and Sala-i-Martin 1991, 1992, 1995). Other structural variables causing substantially different steady states include disparities in savings rates, fertility, and the available technology (Barro *et al.* 1995:103). Sachs and Warner argue that their hypothesis (that trade liberalisation creates the right conditions for convergence) can also be cast as a conditional convergence hypothesis: apparent differences in long-run income levels are due to differences in policies regarding economic integration (1995:41).

There is a debate as to whether convergence in macroeconomic stability indicators is a precondition for or a result of a fixed exchange-rate regime. The literature deals almost exclusively with the EU and the conditions that make up the Maastricht criteria for joining the proposed European Monetary Union (EMU). As such, these convergence criteria provide a natural starting point for examining the international experience.

Clearly the criteria were envisaged by those who drew up the Maastricht Treaty as a precondition for monetary union in Europe (see Artis 1992, Healey and Levine 1993). Article 109F of the treaty sets out the following requirements for eligibility: (1) inflation rates must converge close to the average rates achieved by the three countries with lowest inflation; (2) long-term nominal interest rates on government debt must converge to a level close to the average of those achieved by the three countries with lowest inflation; (3) exchange rates must be stable (within the ERM bands) for two years prior to EMU without any measures to stop the free flow of foreign exchange; (4) the deficit-to-GDP ratio must not exceed 3 per cent; (5) the public debt-to-GDP ratio must not exceed 60 per cent. However, it is argued that at least some of these criteria will be automatically satisfied on monetary unification, particularly interest-rate equalisation and common equilibrium inflation in traded goods (Buiter 1995:39, 16).

The point of the criteria is to minimise the costs to other members of any particular country's entry into the EMU. The inflation condition effectively rules out sharp differences in indirect tax policies (Artis 1992:303). The point of the exchange-rate criterion is to rule out an 'endgame devaluation' (a last devaluation push immediately prior to full integration in order to gain a competitive advantage or to amortise excessive public debt). The inclusion of the interest-rate criterion is a way of taking advantage of the forward-looking character of financial markets, because expectations about future inflation, exchange rates and fiscal policy are embodied in the interest-rate premium. The fiscal criterion is probably the most contentious of all, and a compromise was struck by allowing the 3 per cent figure to be interpreted as a guideline. The basic argument for fiscal discipline turns on the analysis of Sargent and Wallace (1981), who argue that fiscal and monetary policy must be consistent: a country with an expansive fiscal policy, and which has

a growing government debt-to-GDP ratio, must, at some stage, monetise that debt, making a restrictive monetary policy impossible. The point of the deficit-to-GDP and debt-to-GDP ratios is, therefore, at least in part, to protect other members from having to service part of a country's debt directly or indirectly through European Central Bank monetisation (Buiter 1995:42). Although fiscal criteria create an inherent contractionary bias in fiscal policy (Bean 1996:25), countries with a high preference for low inflation are likely to insist on such criteria because they will not want a union with fiscally more expansive economies. On this point alone, a policy union in Southern Africa is demonstrably premature.

There is a lack of consensus as to whether or not exchange rate coordination has helped to foster convergence in macroeconomic stability indicators among EU members (reviewed in Bank of England 1991). There is also a lack of consensus as to whether monetary integration in Europe is good or bad. Some argue for immediate monetary union (for example, Buiter 1995). Others argue that the prospects for a single European currency that delivers price stability are not good (Fry 1991:502), while still others prefer to remain agnostic (Allsopp *et al.* 1995, Begg *et al.* 1995).

Finally, there is no agreement on the issue of whether convergence in Maastricht criteria (or monetary union) can foster 'catch-up' convergence. The evidence for Europe seems to be mixed, with greater convergence occurring in some periods and not others (Neven and Goyette 1995). Also it is argued that the costs of achieving forced convergence between West and East Germany have been high and has required large transfers, and that the Mezzogiorno (southern Italy) remains relatively poor, despite having complete economic unification, including a common currency, with northern Italy. In fact, any reduction in income disparities between north and south in Italy appears also to have required large transfers (Begg *et al.* 1995:10).

In summary, there is a lack of agreement as to the precise nature of the relationship between economic policy coordination and economic convergence. However, in practice, any group of countries contemplating a policy union will require convergence in macroeconomic stability indicators as a prerequisite for admission in order to protect other members from adverse policy spillover effects.

Macroeconomic policy and convergence in SADC

There is no a priori expectation of convergence among SADC countries. There is no reason to believe that they form an OCA. Their economies generally, and labour markets specifically, exhibit rigidities. All are primary commodity exporters, but some are mineral exporters, others rely on tree crops and others are dependent on other agricultural output to generate foreign exchange. Consequently, they respond asymmetrically to external price shocks. SADC(C) was formed in 1980 (with nine of its current twelve members) with the goal of reducing dependence on the dominant regional economy,

South Africa, which was excluded. As yet there has been no substantive moves towards facilitating intra-regional trade or factor movements. Moreover, there is substantial variation in their current macroeconomic and trade policy frameworks. This point is dealt with in the next sub-section. The extent of general economic convergence follows.

Summary information of current policy frameworks

Table 8.1 contains summary information of macroeconomic policies currently pursued in SADC member states. The qualitative information in the table was collected primarily by interview method. When suitable interviewees were not available, information was derived from Economist Intelligence Unit (EIU) quarterly reports. Quantitative data are calculated from published statistics. There are several points to be noted from Table 8.1:

- Performance indicators at the top of the table diverge considerably, with very large ranges for the variables in 1993–94, even when Angola, which was still experiencing civil war, is excluded.
- Nearly two-thirds of SADC countries are undergoing structural adjustment with funding from the World Bank and/or IMF, and many of these programmes have been in place for about a decade.
- Aid dependence is high in around half of SADC countries, as evidenced by the large disparities between the savings and investment ratios coupled with persistent government deficits and, the external counterpart to this, the large proportion of imports financed by aid.
- The range of policy variables shows considerable variation in domestic policies: for example, the relative sizes of the budget deficits, the range of real lending rates and the number of countries which regularly permit overvaluation of their currencies.
- In spite of the fiscal stance in two-thirds of SADC countries being described as 'cautious', only half of SADC members have sustained deficits of less than 6 per cent of GDP for more than two years.
- In very few SADC countries does the central bank have operational independence, even in those countries where this is a constitutional provision.
- In most countries the exchange-control regime has been liberalised considerably—completely in two (non-CMA) countries.
- In less than half of the SADC countries can the degree of financial liberalisation be termed 'moderate to high'.
- In all but Angola and Mozambique the trade regime can, on average, be called liberal, although this does not imply that there are still no substantial barriers to entry in some markets.
- Although political liberalisation is occurring, there is little public debate on economic policy issues, and business confidence is undermined by

political uncertainty and by corruption. All but one country report evidence of corruption, in some cases of 'macroeconomic proportions'; the record of prosecuting for corruption is poor.
- Roughly half of SADC members have potential for increased political or economic (or both) instability in the medium term.

Table 8.1 SADC performance and policy stance summary (numbers in words refer to the number of countries where 'yes' applies)

	SADC average (1990–94)	SADC range (1994)
Average GDP growth rates (%)	+2.5	–10.7 to +17.5
Average inflation rates (%)	28.8[a]	7.3 to 52.5
Average debt-to-GDP (1993, %)	121.8	13.4 to 450.3
Average investment-to-GDP (%)	32.0	9.2 to 85.8
Average savings-to-GDP (%)	8.8	–13.7 to +44.4
Number with SAPs	seven[b]	—
Average length of SAP	9.4 years	5 to 15 years
SAP broadly on target	four	—
Aid greater than 20 per cent of imports	five	1.2 to 113.4%
Aid withheld for non-compliance	three	—
Aid withheld for political pressure	three	—
Fiscal policy		
Cautious fiscal stance[c]	eight	—
Under pressure from IMF/World Bank	seven	—
Average deficit-to-GDP ratio (1990–93, %)[d]	–6.1	–22.2 to –0.2
Monetary policy		
Monetary stance: tight	six	—
loose/inactive	six	—
Average lending rates positive (1993)	eight	–26.2 to +8.7%
Central bank operational independence	three	—
Dominant external influence IMF/ World Bank	six	—
Exchange rate policy		
Official rate market determined	eleven	—
Regular over-valuation occurs	four[e]	—
Average premium on parallel rate (1989, %)	87.9[a]	10.0 to 100.2
Dominant external influence IMF/ World Bank	six	—
Exchange control regime free	two	—
Exchange control regime liberal	nine	—

Table 8.1 continued

	SADC average (1990–94)	SADC range (1994)
Financial policy		
Foreign banks allowed	ten[f]	—
Degree of financial liberalisation modest–high	five	—
Government ownership of commercial banks	seven	—
Trade policy		
Openness: exports+imports/GDP (%)	96.1	45.5 to 155.3
Trade regime liberal	ten	—
Dominant external influence IMF/ World Bank	five	—
Dominant external influence WTO	two	—
Political regime		
Broadly democratic[g]	four	—
Reports of corruption	eleven	—
against which action taken	two	—
Potential for political instability	six	—
Potential for economic instability in medium term	four	—

Sources: *Qualitative data collected primarily by interview method and represent the subjective opinions of government employees or economic advisors to national governments. Other information is taken from published sources:* World Data, *World Bank;* International Financial Statistics, *IMF;* Country Reports, *Economist Intelligence Unit; and national sources*

Notes: [a] *Angola is excluded because its high inflation/parallel premia would distort the averages;* [b] *Angola negotiating, although negotiations currently in abeyance;* [c] *'Cautious fiscal stance' implies no slippages;* [d] *Budget deficit-to-GDP, excluding grants;* [e] *No information available on three countries;* [f] *No information on two countries;* [g] *'Broadly democratic' is wider than multi-party democracy, which is too thin a definition as it excludes those countries where there are reports of harassment of political opposition (including journalists), where regimes are considered authoritarian and where the political situation is unresolved.*

From the above, the following weaknesses in policy can be deduced. Most obviously and importantly, on average, the fiscal stance is weak: very few countries manage to keep their deficit-to-GDP ratios below 5 per cent. This has important implications for the operation of macroeconomic policy generally. The burden of stabilisation falls on the monetary authorities, the external debt-to-GDP ratios are high and, in many cases, rising. A country with an expansive fiscal policy, and which has a growing government debt-to-GDP ratio, must, at some stage, monetise that debt, making a restrictive monetary policy impossible. For countries engaged in structural adjustment

programmes, a weak fiscal stance undermines the goals of monetary and financial liberalisation, and, ultimately, the effectiveness of the whole programme. This may explain, at least in part, why those countries with, on average, a tighter fiscal stance, also have, on average, higher GDP growth rates, lower consumer price inflation, lower debt-to-GDP ratios and higher investment-to-GDP ratios (see Table 8.4 below). Despite a greater degree of market determination of official exchange rates, four countries regularly allow overvaluation to occur. The large discrete adjustments cause problems for traders.

Although the adoption of structural adjustment programmes by many of the countries suggests that, in principle, policy variables should converge, there is no evidence that this is the case. This is at least in part because not all countries comply fully with the conditions.

The extent of divergence in policy stance and in indicators of macroeconomic stability would suggest that it is premature to consider policy coordination among SADC members. What is not clear is whether there is an underlying trend towards convergence or divergence in the SADC: because the majority of SADC members have adopted donor-sponsored structural adjustment programmes in the past decade, is a greater degree of macroeconomic convergence occurring in the region?

Extent of macroeconomic convergence

Because of the problems attached to measures of convergence, there is no consensus as to which measure is best. Three measures have been calculated below. The most simple measure is s-convergence, when the dispersion of cross-sectional income levels diminishes over time, with dispersion typically measured by the standard deviation of per capita income. In this case it is irrelevant whether a single economy shows convergence; what is important is how the entire cross section behaves. If countries which are initially very different are converging, it is expected that the standard deviation will be growing smaller.

A comparison is made below with the European Union (EU)—not because the EU is considered a suitable model, or because the EU is necessarily ready for policy union but so that readers unfamiliar with the methodology have a point of reference for comparison. Since the formation of the Common Market in the 1950s, the standard deviation of per capita income of all EU members has been falling as shown in Figure 8.1 (using data from the Penn World Tables, Mark 5,[3] revision 6). There was some interruption to this trend in 1982–83, when a degree of divergence occurred, but this was subsequently reversed.

The calculations for SADC members are plotted in Figure 8.2. In contrast to the downward sloping pattern of convergence that is evident in the data for EU countries, the pattern for SADC countries is essentially flat—indicating

that no convergence in per capita incomes has occurred over the thirty-year period. Indeed, the degree of dispersion was marginally higher at the end of the period than at the beginning which suggests that the countries have, if anything, diverged slightly. The absence of convergence among the SADC countries may be due to several factors, including different responses to the oil and exchange-rate shocks of the 1970s and different problems with indebtedness, but there are also uniquely domestic policy issues which have promoted or slowed growth.

If, however, the sub-sample of SACU member countries is examined separately, as shown in Figure 8.3, a strikingly different pattern emerges. Although the intra-SACU dispersion of per capita incomes held roughly constant through the 1960s, it dropped steadily in the 1970s and 1980s. The result of this downward trend was that the dispersion at the end of the period was little more than half what it had been at the beginning—a degree of convergence that slightly exceeds that evident in the EU countries over the same period. It is particularly interesting that neither the oil price shocks of the 1970s nor the gold price shock of 1980—both of which would have had asymmetric effects on the SACU countries—caused any significant interruption to this pattern of convergence. (The same calculations were also made for the sub-sample of CMA countries and are almost identical to those of the SACU members, which is not surprising, given that Botswana used the rand until 1976 and did not allow the real pula-rand exchange rate to diverge significantly thereafter.)

The most common measure of convergence is ß-convergence. This occurs when, in a cross-section regression of (time-averaged) growth rates on initial levels of GDP per capita, the (ß)-coefficient on initial levels is negative. The underlying assumption is that each region has a steady-state growth path. A downward-sloping plot of average growth rates on initial GDP will indicate possible ß-convergence; if the hypothesis of convergence is supported by the data, then those countries whose per capita income was below the average for all countries at the beginning of the period should have higher average growth rates subsequently.

Using the data in the Penn World Tables, with 1960 as the initial year, average growth rates for the next thirty years were calculated for each country. This information is plotted in Figure 8.4 for the EU and in Figure 8.5 for the SADC countries. The EU plot is included simply as an illustration of a region where the data suggests that ß-convergence has occurred.

In 1960, the poorest country in Europe in per capita income terms was Portugal, whose income per head was 64 per cent below the European average. Portugal grew by an average of 4.8 per cent in real terms annually over the next thirty years. On the other hand, Sweden and Britain, with per capita incomes of 45 and 30 per cent above the average respectively in 1960, grew most slowly over the decade.
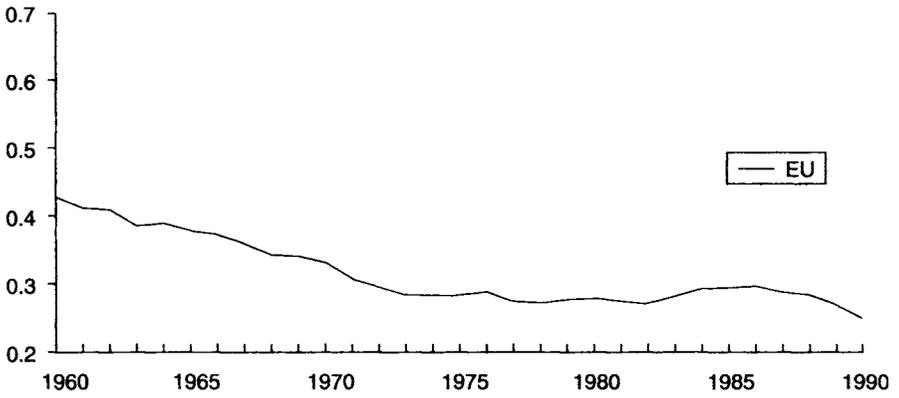
Figure 8.1 Standard deviation of log of per capita income: EU
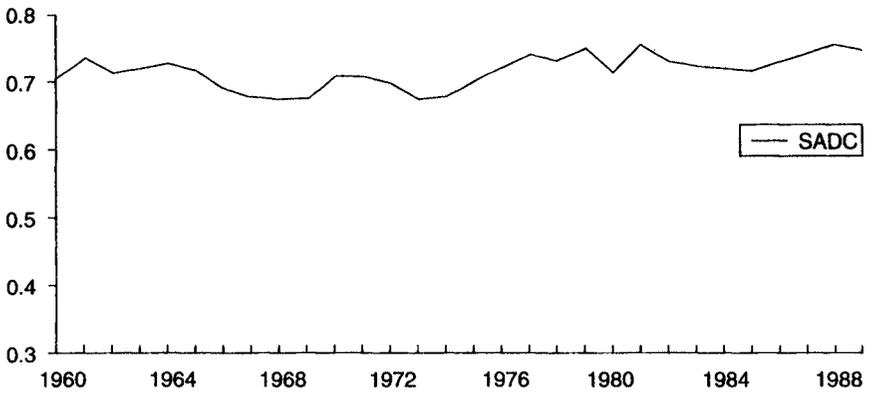
Figure 8.2 Standard deviation of log of per capita income: SADC
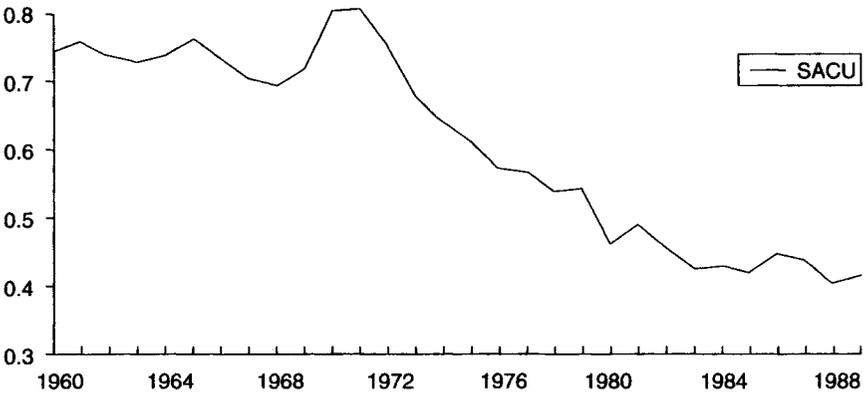
Figure 8.3 Standard deviation of log of per capita income: SACU

Figure 8.5 shows that, using this second measure, there is no pattern of convergence among Southern African economies over the period. Almost all of the below-average economies in income per capita terms had below-average growth rates over the period, while Mauritius began as best off in 1960 and grew on average 3 per cent each year (in terms of real income per head) over the thirty years which followed. However, if one looks at the sub-set of SACU countries, there is again a very clear trend of convergence, with initially low income Botswana and Lesotho converging on Swaziland, Namibia and South Africa but diverging from Malawi and Tanzania which began with similar levels of income per head.

ß-and s-convergence are interesting for illustration, but do not, even in theory, explain whether poorer countries are catching up with richer ones (Quah 1995:15). ß-convergence collapses dynamic processes into a single summary statistic, and the assumption that each country has a steady-state growth path is simply not supported by data. There are alternative measures. Time-series measures, for example, usually use cointegration techniques to show that convergence occurs when the economy returns to its own steady-state equilibrium after a shock (see, for example, Hall *et al.* 1992). However, these are applied to time-series data for single countries, and omit the cross-sectional issues which are important for understanding 'catch-up'. Panel data techniques on the other hand raise concerns over how to deal with individual (fixed or random) effects—and controlling for these means that persistent differences across countries are left unexplained.
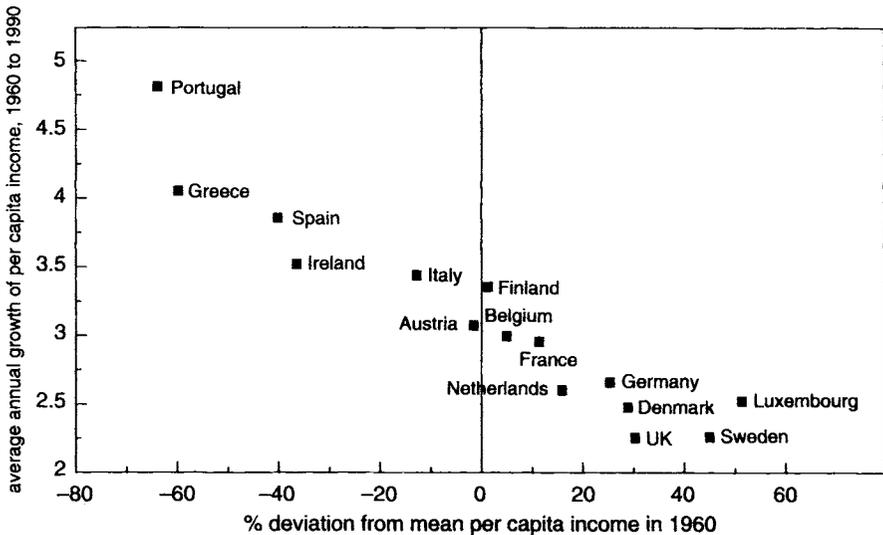
Figure 8.4 The relationship between per capita income in 1960 and subsequent growth: EU
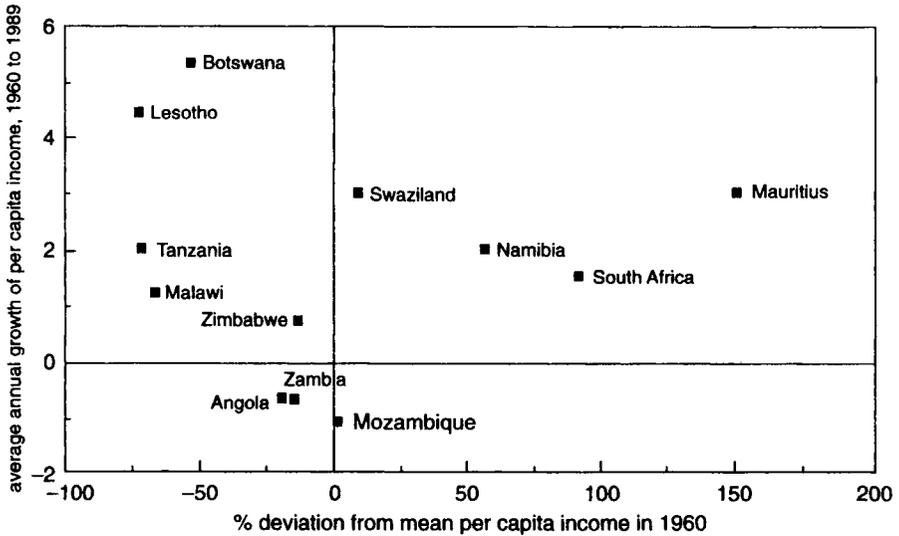
Figure 8.5 The relationship between per capita income in 1960 and subsequent growth: SADC

An approach suggested by Quah uses a Markov chain-type methodology to estimate the probability that relatively poorer (richer) countries will raise (lower) their per capita income in the next period and thereby converge. The methodology is described simply in Quah (1993) and more technically in Quah (1995). The analysis is descriptive. It does not explain convergence/ divergence, but it sheds light on how poorer countries behave relative to richer ones and can show not only whether convergence is occurring but also whether countries are diverging.

Quah's methodology views the process of convergence as a transition process across a number of possible states. Each country/year GDP per capita relative to the sample average constitutes an observation (y_{it}). Observations are grouped in five states of relative prosperity, State 1 being the poorest (y_{it} < 0.33); State 2:0.33 = y_{it} < 0.67; State 3:0.67 = y_{it} < 1; State 4:1 = y_{it} < 2; and State 5 being the richest (y_{it} = 2). The choice of interval is somewhat arbitrary; the criterion is that the initial number of observations belonging to each state must be roughly similar—or at least the differences not too large. The annual progression from one distribution into another can be described by a 5×5 Markov chain transition matrix, the *(j, k)* entry of which is the probability that an economy in State *j* moves to State *k* in one year.

The analysis for SADC is recorded in Table 8.2a. (Data are from Penn World Tables, Mark 5, revision 6). The first column in the table is the total number of observations with starting points in each state. For example, of the 360 observations (12 countries×30 years) 73 began in State 3 (the middle), and of these, 90.4 per cent remained in that state the following year; 5.5 per

cent moved down into State 2; and 4.1 per cent moved into the State 4. It appears from State 3 that a representative economy is almost certain to remain in that state, but, if it moves, it has a marginally greater chance of falling behind than of moving ahead.

The following can be observed from Table 8.2a. The dominance of the diagonal elements suggests a high degree of persistence, especially among poorer economies. Persistence is least in the middle group. As would be expected, changes are not spectacular: strictly positive elements are observed only around the diagonal. In the neighbourhood of the main diagonal, the tendency at lower incomes is to become or to remain poorer, while at higher relative incomes per head (State 4), there is a marginally higher chance of upward mobility. This suggests cross-country incomes tending to extremes at both high and low endpoints. This finding is consistent with Quah (1993:431, 1995:22). In other words, it appears that the poor get (or remain) poorer, the rich remain rich and the middle class 'vanishes'. Table 8.2b, which records the distribution of countries appearing in each of the five states in 1960 and 1989, corroborates this conclusion. There appears to be a limited poverty trap, although upward mobility is possible. Moreover, this illustration of the dynamic process suggests that SADC countries have actually diverged over the thirty years from 1960.

The procedure was repeated for SACU countries, and the results are reported in Table 8.3. By contrast with the SADC matrix, and consistent with the findings for the SACU using alternative measures, persistence increases as one moves down the diagonal, and then decreases from the middle state towards relatively richer economies. This implies a convergence as observations tend towards a mass point, rather than the divergence that is implied in Table 8.2a.

Table 8.2a Real GDP per capita relative to the SADC average, 1960–1989 (states: 5; number of observations: 12 countries×30 years=360)

	Final state				
(No. of observations initial state)	*0–0.33*	*0.33–0.67*	*0.67–1*	*1–2*	*2+*
(67)	0.97	0.03	0	0	0
(84)	0.024	0.952	0.024	0	0
(73)	0	0.055	0.904	0.041	0
(90)	0	0	0.033	0.922	0.044
(46)	0	0	0	0.087	0.913

Methodology: *from Quah 1995*
Notes: *Indicated levels, relative to the SADC average. Cells are arranged in increasing order, with lowest right-hand corner displaying transitions from rich to rich. The numbers in parentheses are the number of country/year pairs beginning in a particular cell*

Table 8.2b Distribution of countries across 'states', 1960 and 1989

	0–0.33	0.33–0.67	0.67–1	1–2	2+	
1960	2	2	3	4	1	= 12
1989	2	5	0	4	1	= 12

Table 8.3 Real GDP per capita relative to the SACU average, 1960–1989 (states: 5; number of observations: 5 countries x 30 years=150)

(No. of observations initial state)	Final state				
	0–0.4	*0.4–0.8*	*0.8–1.2*	*1.2–1.6*	*1.6+*
(24)	0.833	0.167	0	0	0
(29)	0.069	0.897	0.034	0	0
(37)	0	0	0.838	0.162	0
(44)	0	0	0.159	0.795	0.045
(16)	0	0	0	0.25	0.75

Notes: *Indicated levels, relative to the SACU average. The numbers in parentheses are the number of country/year pairs beginning in a particular cell*

Extent of convergence of indicators of macroeconomic policy and macro-stability

Having ascertained that SADC countries have, if anything, diverged in the last twenty years, while the sub-set of countries which are part of a monetary and customs union have converged, it is now necessary to consider whether divergence in policy variables may have contributed to this result. Table 8.4 is a reproduction of Table 8.1 above, this time with policy indicators divided into SACU and non-SACU members. There are several points which should be noted:

- Both fiscal and monetary policy stances appear to be more cautious on average among SACU members than non-SACU members, despite all non-SACU members (apart from Angola) currently engaging in structural adjustment under IMF/World Bank sponsorship—and, on average, having done so for nearly a decade.
- There is a greater degree of fiscal convergence among SACU countries, with the range of deficit-to-GDP ratios being much closer to the average in 1993 (and, in fact, throughout the period for which data are recorded).
- There is a greater degree of interest-rate convergence among SACU countries, with all five averaging positive real (lending) interest rates

Table 8.4 SADC policy stance summary (numbers in words refer to the number of countries where 'yes' applies)

	SADC (twelve)	non-SACU (seven)	SACU (five)
Average GDP growth rates (1990–94, %)	2.5	1.8	3.3
Average inflation rates (1990–94, %)	28.8[a]	42.3[a]	12.7
Average debt-to-GDP (1994, %)	121.8	192.3	23.1
Average investment-to-GDP (1990–93, %)	31.8	27.2	35.0
Number with SAPs	seven[b]	six[b]	one
Average length of SAP	9.4 years	9.7 years	8 years
SAP broadly on target	four	three	one
Aid greater than 20 per cent of imports	five	five	—
Aid withheld for non-compliance	three	three	—
Aid withheld for political pressure	three	three	—
Fiscal policy			
Cautious fiscal stance[c]	eight	three	five
Under pressure from IMF/World Bank	seven	six	one
Average deficit-to-GDP ratio (1990–94, %)[d]	-6.1	-7.8	-2.5
Range of deficit-to-GDP ratios (1993, %)[d]	-22.2 to -0.5	-22.2 to -0.5	-7.8 to -0.5
Monetary policy			
Monetary stance: tight	six	two	four
loose/inactive	six	five	one
Average lending rates positive (1990–95)	eight	three	five
Central bank operational independence	three	two	one
Dominant external influence IMF/World Bank	six	six	—

Exchange rate policy			
Official rate market determined	eleven	six	five
Regular over-valuation occurs	four[c]	four[c]	—
Average premium on parallel rate (1989, %)	87.9[a]	133.7[a]	19.3
Dominant external influence IMF/World Bank	six	six	—
Exchange control regime free	two	two	—
Exchange control regime liberal	nine	four	five
Financial policy			
Degree of financial liberalisation modest–high	five	three	two
Government ownership of commercial banks	seven	six	one
Trade policy			
Openness: exports+imports/GDP (%)	90.1	75.4	110.8
Trade regime liberal	ten	five	five
Dominant external influence IMF/World Bank	five	five	—
Dominant external influence WTO	two	—	two

Sources: *Qualitative data collected primarily by interview method and represent the subjective opinions of government employees or economic advisors to national governments. Other information is taken from published sources:* World Data, World Bank; International Financial Statistics, IMF; Country Reports, *Economist Intelligence Unit; and national sources*

Notes: [a] *Angola is excluded because its high inflation/parallel premia would distort the averages;* [b] *Angola negotiating, although negotiations currently in abeyance;* [c] *'Cautious fiscal stance' implies no slippages;* [d] *Budget deficit to GDP, excluding grants;* [e] *No information available on three countries.*

during the 1990s. This is inevitably the result of all but Botswana being members of a currency union, and Botswana having a deliberate policy for the pula to edge up marginally against the rand.

- In almost all non-SACU members the government owns or part-owns at least one of the commercial banks; some, but by no means all, state-owned commercial banks have severe bad-debt problems; and in some countries, but by no means all, banks experience interventions for non-commercial purposes.
- The degree of openness to international trade is, on average, much higher among SACU countries.

In order to examine the policy issue more fully, some of these variables are considered in more detail. The natural starting point is the variables listed in the Maastricht Treaty as criteria for entry into the European Monetary Union: inflation rates (CPI); long-term interest rates (as indicators of inflationary expectations); real exchange rates; the debt ratio; and the ratio of the budget deficit to GDP. This permits international comparison. Furthermore, there is some international consensus as to the appropriate goals for these variables. Because of the different circumstances confronting Southern African countries, it would be useful to examine additional variables, such as the premium on the black-market exchange rate and the extent of aid dependence. The problem with many of these variables is the lack of data: there is virtually no information on long-term bond yields; data on interest rates and black-market exchange-rate premia are patchy; and many of the published series do not go back much before 1980.

Table 8.5 records 1990–94 average convergence indicators for those variables where data are available. There is a marked lack of convergence in key policy and stability indicators among SADC countries. Average inflation rates for 1990–94 vary from 8.6 per cent to 870.3 per cent, while deficit-to-GDP ratios range from 26.2 per cent to Botswana's surpluses (the latest figure available for Angola is 23.7 per cent in 1990). This masks a greater degree of convergence among a sub-sample of: CMA members, Botswana and Mauritius. Inflation rates for CMA countries-plus-Botswana range tightly within 1.5 percentage points and public debt-to-GDP ratios are below 60 per cent (with the exception of Lesotho).

One possible reason for the similar inflation rates is the fixing of exchange rates within the CMA, and Botswana's policy of edging the pula up against the rand. South Africa's dominance in regional trade makes it difficult for other countries' currencies to diverge for too long. During the 1980s the real rand bilateral rates of all SADC countries, except Tanzania (which traded much less with South Africa) and Mozambique, appear to have been almost constant (Harvey and Jenkins 1992). Thereafter, the rates for Botswana, Malawi, Mauritius and Zambia remained relatively constant with the rand, while those of other countries depreciated very rapidly.

Table 8.5 Convergence indicators—SADC countries (per cent)

		Inflation 1990–94	*Deficit(surplus)/ GDP 1990–94*	*Public debt/GDP most recent* [a]
non-SACU	Angola	870.3	n.a.	n.a.
	Malawi	20.3	−8.2	117.3
	Mauritius	8.6	−0.5	31.7
	Mozambique	44.0	−26.2	n.a.
	Tanzania	24.3	−3.8	n.a.
	Zambia	129.8	−3.6	127.6
	Zimbabwe	26.5	−7.5	70.3
SACU	Botswana	12.8	+6.6	14.0
	Lesotho	13.6	−6.4	67.7
	Namibia	12.2	−5.0	12.3
	South Africa	12.5	−4.9	54.9
	Swaziland	12.3	−3.5	19.8
Average of three best		11.0		

Notes: [a] *Botswana 1992; Lesotho 1991; Malawi 1987; Namibia, 1989; South Africa 1994; Swaziland 1993; Zambia 1987; Zimbabwe 1994.*

Sources: World Data, African Development Indicators, *World Bank;* Country Reports, *Economist Intelligence Unit;* Quarterly Bulletin, *South African Reserve Bank;* Quarterly Economic and Statistical Review, *Reserve Bank of Zimbabwe*

Past macroeconomic policy, particularly fiscal policy, pursued in each country may, however, be more important than the fixing of exchange rates. Table 8.5 suggests that the rate of inflation is more highly correlated with the public debt-to-GDP ratio than recent deficit-to-GDP ratios, possibly implying that the financing of past budget deficits is having an inflationary effect. The discipline imposed on CMA members by the fixed exchange-rate regime may have assisted in maintaining a cautious fiscal policy stance, but Mauritius, which is not a member, was cautious without the discipline, and maintained high growth.

Another candidate for explaining the better growth performance of smaller members of SACU and Mauritius is trade openness which is considerably higher in these countries than, on average, in most non-SACU countries (Table 8.4). Trade openness is emerging as an explanatory factor in faster economic growth in worldwide empirical studies (Ben-David 1995, Dollar 1992, Sachs and Warner 1995).

Finally, there are factors specific to each country that have nothing to do with regional integration which may have enhanced growth in the smaller SACU countries and retarded it in the others. The explanation of the convergence observed in SACU is the subject of further research.

Conclusion

This chapter considers the question of whether Southern Africa is ready for economic integration. The question is prompted by international interest in macroeconomic policy coordination which, in turn, stems from the potential for coordination to address the problem of spillover effects from national macroeconomic policies and also from the evidence of the existence of 'convergence clubs', in which countries with a relatively lower per capita income can catch up with other members of the club over time. Economic theory and international experience suggests that for policy coordination to be beneficial, there must be some degree of convergence between countries, and domestic policy and institutions should be effective agencies of restraint on the discretionary powers of government (or else there needs to be some supranational institution with powers to enforce compliance).

There is no evidence of convergence of per capita income in SADC members for the period from 1960 to 1990; two measures indicates that there may even have been a slight divergence. However, there has been a marked pattern of convergence amongst the SACU countries, with Botswana and Lesotho 'catching up' with Namibia, South Africa and Swaziland. Moreover, there is significant divergence of key policy and stability indicators across SADC as a whole, but a degree of convergence in the sub-set consisting of the CMA countries, Botswana and Mauritius. Two possible underlying factors explaining the 'catch up' effect exhibited by the SACU countries are (1) the similar domestic economic policies, driven in part by the currency union between four of the five members of SACU; and (2) the relative openness to international trade in the SACU economies, which may form a convergence club. Further research is required to assess the contribution of these two factors, and others, in explaining why convergence appears to have occurred in SACU but not in SADC as a whole.

In conclusion, the apparent lack of convergence of the Southern African economies over time and the current significant divergence of policy and stability indicators suggests that Southern Africa is not yet ready for regional monetary integration. Premature attempts at monetary integration could have political costs, since a failed attempt at monetary integration can generate political disagreements and recriminations that weaken the prospects for coordination in trade, infrastructural development, defence and law enforcement.

Notes

1 This chapter is based on background work carried out as part of a larger macroeconomic policy project for the SADC Finance and Investment Sector Coordinating Unit in the South African Department of Finance.
2 The SACU consists of South Africa and the BLNS countries—Botswana, Lesotho,

Namibia and Swaziland—and the CMA of all the SACU countries except Botswana.
3   See Summers and Heston (1991).

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STRUCTURAL ADJUSTMENT AND TRADABLES: A COMPARATIVE STUDY OF ZAMBIA AND ZIMBABWE

John Weeks and Paul Mosley

Background to 'structural adjustment'

Basis of comparison

To be useful for producing lessons that can be generalised beyond specific cases, comparative studies should have a clear analytical basis for the inclusion of the countries. In the early years of structural adjustment in the Sub-Saharan region, participation in multilateral-funded programmes alone was frequently taken as sufficient for comparative analysis. By the end of the 1980s virtually every country in the region had formally taken such programmes, implying that further criteria were necessary to establish the relevance of comparisons. This study focuses upon Zambia and Zimbabwe.

Both countries were British colonies with their political economies dominated by a white minority prior to independence, and both had been members of the short-lived Federation of Central Africa (along with Malawi, then Nyasaland). Mineral exports were and continue to be important in the two countries, for Zambia overwhelmingly so. As a result of the importance of mining and the role of the white settler population, Zambia and Zimbabwe had labour force characteristics somewhat uncommon in the Sub-Saharan region. In both countries large-scale agriculture provided the bulk of commercial production of food crops as well as exports, accompanied by a substantial amount of rural wage employment. One consequence of the importance of white agriculture, which continued after the end of British rule,[1] was a distribution of land considerably more unequal than in virtually all other Sub-Saharan countries (as in a third white-settler colony, Kenya). Zambia is the more urban of the two countries.[2] For both, formal wage employment was a relatively high percentage of the labour force and of considerable political importance. In terms of economic structure,

agriculture's contribution to gross domestic product was quite low in both countries compared to the regional average, and industry's share much higher.[3] Partly in consequence of the importance of industry, per capita incomes were relatively high, Zambia's 20 per cent above the regional average in 1990 and Zimbabwe's 80 per cent higher (World Bank 1992:10).[4] Finally, and of importance for tradable commodities, both countries are landlocked, with relatively high transport costs.

Differences between the two countries are also relevant to adjustment. In Zambia copper dominated the economy; indeed, the country had one of the worlds most concentrated and least diversified export sectors, comparable to many petroleum exporters. As a consequence, the decline in copper prices during the 1970s had a devastating effect on the Zambian economy, while Zimbabwe weathered this shock with relative success. The Zambian economy suffered almost continual decline from the 1970s onwards, while Zimbabwe's growth performance was respectable in the Sub-Saharan context. During the period we review, the Zambian economy suffered negative per capita income growth, severe current account instability, gathering inflation and unmanageable fiscal deficits. Over the same time frame, Zimbabwe maintained moderate growth and macroeconomic balance and, by regional comparison, a diversified if not robust export performance. Why economic performance differed in the two cases and the lessons implied for adjustment policy are the central themes of this study. These issues are all the more interesting because of an apparent correlation in GDP growth rates for the two countries, suggested by inspection of Figure 9.1. An obvious interpretation of the correlation in growth rates is that it reflects the cross-country effect of so-called external factors,[5] with the residual representing
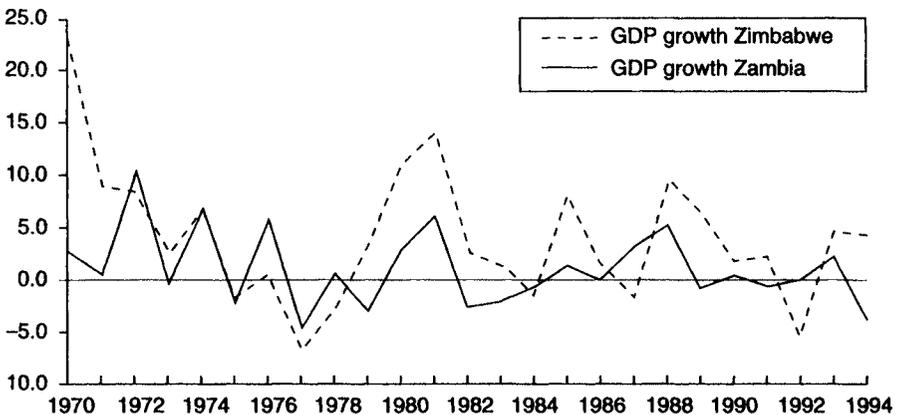
Figure 9.1 Zambia and Zimbabwe: growth rates of GDP, 1970–1994
Source: World Bank data base 1996

'internal' factors, one of which (but not all) would be differences in government policy.

Rural-urban differentials in Zambia and Zimbabwe

Historically one of the worst-educated countries in Africa, with only seventy university graduates at independence in 1964, Zambia continued to experience severe skill shortages in spite of a rapid expansion of schooling since that time. The shortages were typically filled on a short-term basis by expatriates.[6] These skill shortages not only acted as a deterrent to investment and growth but also combined, unusually for Africa, with trade union power on the copper belt to secure relatively high wages for those few with access to a modern-sector job. Although a low-income country, Zambia has had a high-wage formal sector, a combination that might be the 'Zambian disease'.[7] Attempts to reduce real modern-sector labour costs through devaluation have been met with violent political resistance, as in the case of the copper belt riots of late 1986 which caused the reversal of the government's structural adjustment policies. In consequence, the ability of the economy to diversify its export base from capital-intensive copper to cheap labour manufactures or plantation agriculture has been severely impaired. Worse, the traditional agricultural sector, hampered by pricing policies that lowered incentives for farmers, for many years remained poor, with low technology and unable to provide an effective 'backward linkage' stimulus to local industry. The combination of low traditional sector incomes, high modern-sector wages and astronomical expatriate incomes not only tended to abort structural adjustment efforts but also created one of the most unequal distributions of income in the world, as illustrated in Table 9.1. The Gini Coefficient for

Table 9.1 Estimated structure of earnings, Zambia and Zimbabwe, 1993 (average values in US$ per month)

Category	Zambia	Zimbabwe
Professional/technical	95.8	90.2
Sales	2.6	62.5
Production/transport	43.9	53.1
Urban average	54.9	38.9
Rural average	6.4	12.5
Poverty line (per capita per month)	9.2	12.4
Core poverty line (per capita per month)	6.4	7.1
Percentage of poor	67	25

Sources: *World Bank 1994:143; Zimbabwe 1992*

Table 9.2 Zambia: labour force and formal-sector employment

Year	Labour force ('000s)	Formal employment ('000s)	Formal employment, % of labour force	Annual average real earnings, all sectors (1975=100)
1980	1586	379	23.9	72
1982	1710	366	21.4	n.a.
1984	1845	365	19.8	44
1986	2700	361	13.4	n.a.
1988	3780	369	9.8	n.a.
1990	3860	377	9.8	30

Source: *World Bank 1994, tables 2.1 and 2.2*

Zambia was estimated at 0.59 in 1985, quite high by international standards (World Bank 1985:17). As the economy declined during the period of adjustment, formal employment stagnated and real wages dropped dramatically (Table 9.2).

As indicated in Table 9.1, Zambia, while its modern-sector wage levels stood higher than Zimbabwe's, had lower rural income levels and suffers from a much higher level of poverty, most of which is in rural areas. This reflects the continuing failure of Zambia to achieve significant productivity increases in smallholder agriculture. As noted, both Zambia and Zimbabwe inherited from the colonial period an agriculture divided between high-productivity (formerly European) commercial farms and low-productivity communal farms. Upon independence, the government of Zimbabwe launched a major effort to supply modern inputs, new seeds, credit, fertiliser and minor irrigation to 'communal-area' farmers. This led to an increase in smallholders' yields and their share in aggregate food production in the first six years of independence (Table 9.3). Due to financial constraints, the government-led intensification of smallholder agriculture hit a plateau in 1986 and was further damaged by the 1992 drought. None the less, smallholder utilisation of hybrid seed reached over 90 per cent, very high by Sub-Saharan standards. Total maize production, which was about the same in the two countries at the beginning of the 1980s, was higher in Zimbabwe in the mid-1990s by a factor of between 50 and 100 per cent (Weeks and Subasat 1995).

By contrast, Zambia has experienced no such intensification of communal agriculture. Government expenditure on agriculture has remained lower than in Zimbabwe (Table 9.3), and the use of modern inputs and yields by small farmers has remained low, around the African average. This has kept down rural incomes and the supply price of labour to the urban areas. It also reduced the level of labour demand coming from within small-farm

Table 9.3 Agricultural expenditure and food crop production, 1980–1993 (averages for periods)

Item	1983–84	1985–86	1988–91	1992–94
(a) Agricultural expenditure as % of national income				
Zambia	n.a.	1.4	1.6	n.a.
Zimbabwe	3.3	4.3	4.6	n.a.
(b) Maize production ('000 metric tons)				
Zambia	878	1,142	1,494	1,036
Zimbabwe	1,020	2,025	1,940	1,491

Sources: *FAO,* Production Yearbooks, *consecutively from 1980–94;* IMF Government Finance Statistics Yearbook *1995*

agriculture, since hybrid seeds, with their associated demands for labour for weeding, minor irrigation, etc. are much more labour-intensive than traditional varieties.

The meaning of adjustment in Zambia and Zimbabwe

In the absence of a convincing theory to move from static welfare gains to dynamic growth,[8] it would seem that multilateral adjustment programmes are more an *ad hoc* collection of policies than a development strategy (Mosley *et al.* 1995). Especially in the case of Zambia, but also Zimbabwe, the desired outcome of adjustment was clear: to shift resources toward tradable commodities in order to diversify exports. This goal was of paramount importance for the former country. In the 1970s (when adjustment efforts began), copper accounted for over 90 per cent of export earnings and the world price had declined dramatically. Thus, the central policy issue was what set of policies would best achieve the outcome of export diversification.

Throughout the Sub-Saharan region standard adjustment programmes have tended not to make a direct link between policy instruments and between policy outcomes (except for growth itself). As Yanagihara (1995) has argued, orthodox structural adjustment posits no specific outcome which the economy is to achieve. There is no yardstick of success other than increased output and export growth themselves. Because outcomes are to be achieved within an increasingly 'policy neutral' framework of fiscal and monetary austerity and deregulation, all outcomes, since they are produced by the 'free' market, would be judged as equal.[9] If growth does not accelerate nor exports expand, these negative outcomes are characteristically interpreted as a failure of implementation. This approach

rejects development strategy as a concept. A strategy involves specifying an outcome *ex ante,* identifying the instruments to achieve the components of that outcome, then, after an appropriate time period, comparing the *ex post* performance with the *ex ante* goals or targets.[10]

The central policy objective in both Zambia and Zimbabwe during the 1990s was the diversification of exports. To an extent, the latter country achieved this, while the former did not. The relative success of the policy regimes in Zimbabwe and failure in Zambia are demonstrated in Table 9.4. In Zambia, exports in constant prices declined from the 1970s through the 1980s, and the shrinking export package became more concentrated, as measured by UNCTAD indices. One hardly needs these indices, for the conclusion is self-evident. In 1970 ores and minerals (i.e. copper) accounted for 99.1 per cent of export earnings. In 1990 this category had apparently fallen to 83.4 per cent, but since the 11.2 percentage points listed as manufacturing were virtually all copper in various degrees of processing, the export contribution of the sector broadly defined declined only to 96.7 per cent. In contrast, the policy regimes in Zimbabwe, interventionist during both the 1970s and 1980s, were associated with substantial diversification, especially in manufacturing where import substitution would provide the basis in some sectors for the development of new export products.

Why the experiences of these two countries were so different, and the associated implications for employment generation and labour market policy, is the subject of the following sections. In anticipation, we provide a periodisation of policy regimes, shown in Tables 9.5a and 9.5b. In the case of Zambia (Table 9.5a), one can divide the twenty-five years into four periods, two of relative policy autonomy during which stabilisation and/or adjustment programmes of the IMF and World Bank had relatively light conditionality (1970–77) or there was no funding agreement with these multilaterals (1987–90).[11] During the latter period, the government was in conflict with the multilaterals, both over policy focus and its refusal to service its foreign debt. Several years of strongly conditional multilateral lending separated these two periods, and policy again reflected multilateral conditionality in the 1990s. By chance, the periods of policy autonomy and multilateral conditionality were of almost the same duration. The strongest GDP growth performance occurred during the periods of policy autonomy, though other indicators were more mixed. For all indicators except inflation during 1987–90 and 1991–94, the variation within periods is so great as to render differences in the mean values non-significant.

The purpose of the table is not to assess the effectiveness of different policy regimes, but rather to suggest that policies as such may have a limited impact upon an economy so dependent upon a single export. The importance of copper mining for the economy is indicated by the growth of both agriculture and manufacturing being above the rate of growth of GDP for all policy periods with the single exception of agriculture for 1987–90. As a harbinger

Table 9.4 Exports and export diversification, 1970–1990

Part A: Zambia

Item/Year	*1970*	*1975*	*1980*	*1985*	*1990*
Total exports (US$ millions)	994.5	805.1	1,300.0	539.0	899.0
Percentages					
Food	0.6	1.4	n.a.	2.2	1.8
Agricultural inputs	0.1	0.1	n.a.	2.3	1.4
Ores and minerals	99.1	97.5	n.a.	93.4	83.4
Manufactures	0.2	0.7	n.a.	1.5	11.2
Indices of:					
Diversification	n.a.	n.a.	.960	n.a.	.961
Concentration	n.a.	n.a.	.717	n.a.	.931
Number of products exported	n.a.	n.a.	49	n.a.	33

Part B. Zimbabwe

Item/Year	*1970*	*1976*	*1980*	*1985*	*1990*
Total exports (US$ millions)	367.0	844.8	1,423.0	1,109.0	1,723.0
Percentages					
Food	n.a.	36.2	29.3	36.3	44.1
Agricultural inputs	n.a.	9.1	9.3	13.2	7.3
Ores and minerals	n.a.	26.0	21.8	13.0	15.9
Manufactures	n.a.	27.4	37.3	30.9	30.9
(textiles)	n.a.	(11.5)	(11.2)	(12.2)	(11.5)
Indices of:					
Diversification	n.a.	n.a.	.854	n.a.	.775
Concentration	n.a.	n.a.	.257	n.a.	.245
Number of products exported	n.a.	n.a.	87	n.a.	170

Source: *UNCTAD 1993:6, 241, 243*
Note: *For explanation of indices see UNCTAD 1993:244*

of the discussion to come, it should be noted that the relative price of tradables and non-tradables behaved in a more complex way than orthodox theory would predict. During the first period, then, under the subsequent IMF programmes, tradable prices rose relatively but most rapidly under the strongly protectionist policies of the 1987–90 period. This reflects, of course, the dramatic fall in copper prices during the 1970s, in the context of which no relative improvement in aggregate tradable prices could have been achieved.

Table 9.5a Periodisation of policy regimes, Zambia, 1970–1994

Average annual growth Variable:	Policy autonomy 1970–77	IMF programme 1978–86	Policy autonomy 1987–90	IMF programme 1991–94
GDP growth	2.3	0.3	2.0	–0.3
standard deviation	5.0	3.0	2.8	2.2
coefficient variation[a]	2.17	9.98	1.38	–7.31
Export growth	2.1	–2.4	–5.5	5.0
standard deviation	30.4	13.8	16.5	35.8
coefficient variation	14.5	–5.75	–3.03	7.15
Import growth	–4.9	–6.0	14.2	5.7
standard deviation	15.7	14.8	22.5	28.3
coefficient variation	–3.20	–2.47	1.58	4.96
Inflation	4.9	24.6	70.6	117.5
standard deviation	12.2	24.3	29.3	53.0
coefficient variation	2.49	0.99	0.42	0.45
PPP exchange rate	4.5	13.1	–7.4	1.5
standard deviation	13.3	18.4	23.6	6.7
coefficient variation	2.93	1.40	–3.21	4.62
Relative price, tradable/non-tradable	–8.7	3.8	7.5	4.7
standard deviation	21.9	6.8	26.4	12.8
coefficient variation	–3.85	1.79	3.52	2.73

Source: *World Bank data base*
Note: [a] *Standard deviation/mean*

Another aspect of the complex relationship between tradables and nontradables is shown by the comparison 'real exchange rates' measured in terms of tradables and non-tradables, and with a Purchasing Power Parity (PPP) measure. If markets operate efficiently, the two should move together, but during two periods the mean changes take different signs.

In Table 9.5b, Zimbabwean performance is divided into three policy periods: 1970–79 (white rule), 1980–90 (majority government and policy autonomy) and 1991–94 (World Bank liberalisation). The first two periods, for different reasons, involved relatively little policy-based lending, though there was a small sectoral adjustment loan of the World Bank in the 1980s. In the 1990s policy was strongly influenced by World Bank lending tied to market liberalisation. Inspection of columns one and three suggests that the rate of GDP growth was the same for the years of white rule and majority government. However, this results from an extreme value for 1970, when the economy expanded by 22 per cent. If this year is omitted, the growth rate of the first period falls to 2.1 per cent, barely more than half the rate for the 1980s (see column two).[12] During the final period, heavily affected

Table 9.5b Periodisation of policy regimes, Zimbabwe, 1970–1994

Average annual growth *Variable:*	*UDI*[a] *1970–79*	*(UDI)* *(1971–79)*	*Policy autonomy majority rule* *1980–90*	*World Bank liberalisation* *1991–94*
GDP growth	4.1	(2.1)	3.9	1.5
standard deviation	8.2	(5.4)	4.4	4.7
coefficient variation[b]	2.03	(2.56)	1.12	3.05
Export growth	3.9	(2.7)	2.0	–6.9
standard deviation	7.1	(7.2)	7.8	6.0
coefficient variation	1.82	(2.63)	4.06	0.88
Import growth	–2.7	(–4.8)	3.2	–3.8
standard deviation	11.9	(11.8)	15.2	25.6
coefficient variation	4.34	(2.43)	4.76	6.59
Inflation	9.2	c	12.2	29.7
standard deviation	3.3		5.0	5.7
coefficient variation	0.36		0.47	0.19
PPP exchange rate	2.5	c	–4.9	– 9.0
standard deviation	6.3		9.7	11.6
coefficient variation	2.47		1.97	1.30
Relative price, tradable/non-tradable	1.0	c	–4.0	–3.9
standard deviation	7.1		7.0	9.5
coefficient variation	7.14		1.75	2.44

Source: *Zimbabwe data disc 1996*
Notes: [a] *Unilateral Declaration of Independence;* [b] *Standard deviation/mean;* [c] *Not significantly affected by omitting 1970*

by drought, the growth rate fell to below the rate of population increase. For export growth, the rate was slightly higher in the 1970s than in the 1980s, then negative in the 1990s (again, reflecting the effect of drought). Superficially consistent with these changes, the relative price of tradables rose in the first period (albeit only slightly) and declined in the next two periods. As for Zambia, the difference among means for performance indicators across periods is non-significant, except for inflation.

This overview of economic performance indicates the complexity of the adjustment process in both countries. No obvious conclusion in either case can be drawn with regard to the impact of different policy regimes. Rather, the analysis will seek to identify the extent to which relative price adjustment occurred and the response of the real economy to these changes.

Failed adjustment in Zambia

Adjustment disaster

Over the last twenty years Zambia represents a case of catastrophic decline, even by African standards. In 1975 it was classified by the World Bank as 'middle income' with a per capita income of US$900; by 1994 it had collapsed into the middle of the low-income group with a per capita income of US$280. So drastic a decline for a country not affected by civil conflict was paralleled only by Nigeria. That it is not solely due to adjustment or to the collapse in the copper price is demonstrated by the case of Chile, another 'adjusting' copper exporter, whose per capita income moved from US$800 to US$3,170 over the same period.

It is generally recognised that the implementation of stabilisation and adjustment policies was itself unstable, thereby depriving the latter of whatever credibility in the eyes of external investors they might otherwise have had (Loxley 1990, Meijer 1990, Hawkins 1991). Following an initial period of hesitation in the early 1980s, stand-by agreements were concluded with the IMF under which foreign-exchange auctions were introduced, many import licensing restrictions and price controls removed and maize subsidies reduced. In early 1987, in response to rioters in the copper belt protesting against the increased price of food, the foreign exchange auction was suspended and the so-called New Economic Reform Programme introduced, involving the reimposition of price controls, the pegging of the exchange rate and the limitation of debt repayments to 10 per cent of export earnings. This package found little favour with the Washington institutions, but a fortuitous rise in the copper price sustained it until 1989, at which point lack of external finance forced the government to devalue and decontrol prices with the notable exceptions of maize and maize flour. The Paris Club concluded an agreement for the rescheduling of Zambia's unpaid overseas debts in 1991. Substantial transfer of Zambian government assets to the private sector began with the advent of the Chiluba administration in 1992, but in a manner that was seen by potential external investors as neither transparent nor equitable. As a consequence, the potential dividend expected from the government's embrace of the Washington Consensus did not materialise, and investment from overseas, except for official development assistance (ODA) flows, remained minimal.

It is partly as a consequence of these continuing policy uncertainties that the rate of investment in Zambia, which structural adjustment was meant to enhance, dropped from an average of 20 per cent of GDP in 1975 to an average of 8 per cent in 1990–94. The sequence was a familiar one: IMF-conditional reductions in government expenditure and central bank credit fell almost entirely on the capital component of the government budget, and

the drop in government development spending transmitted itself both (through a collapse of backward linkages) to local private investment and (through a collapse in investor confidence, as earlier described) to inward private investment from overseas.

Relative prices and output

In as far as the goal of adjustment in Zambia was to reduce the dependence of the country on copper, it failed. The central question we address is whether this failure reflected a failure of relative prices to adjust. In an insightful analysis of the Zambian economy during the 1970s and 1980s, Meijer has argued convincingly that the various multilateral adjustment programmes did little to achieve diversification of the economy, that 'the… adjustment efforts, reinforced through IMF involvement, did not sufficiently change the bias against tradables production' and attributes this to a faith in the relative price effects of devaluation and market liberalisation, with little attention to 'balanced implementation of expenditure switching policies' (Meijer 1990:657).[13] Loxley has made a similar argument, maintaining that the standard stabilisation and structural adjustment packages fail to address the unique characteristics of a mineral-dependent economy (Loxley 1990:139–40).

Our analysis of relative price changes will be by use of charts.[14] Figure 9.2 presents trade in current US dollars which shows a strong cyclical pattern with exports tending to lead imports. Figure 9.3, in constant prices, suggests that the cyclical pattern was largely due to price effects. While cycles can be discerned in Figure 9.3, their amplitude is narrower than for current prices, and the correlation of the import level with real exports considerably lower. The latter is not surprising, since the capacity to import reflects nominal export earnings, especially as foreign reserves decline. Perhaps the most striking aspect of Figure 9.3 is its demonstration of the virtual stagnation of export (i.e. copper) volume from 1972 onwards.[15] As others have pointed out, the severe balance of payments pressures suffered by Zambia resulted both from the dramatic decline in copper prices and from the apparent inability of supply to respond to increase.

In a competitive and efficient market, theory predicts that export volume should positively respond to devaluation, with the elasticity determined by supply constraints. This analysis would not apply to Zambia for several reasons. First, the world market prices for the major minerals are quoted in dollars (or other reserve currencies), so a country makes its output cheaper by price-cutting rather than by devaluation as such. Second, state ownership of the sector implies that production decisions would not be made only on grounds of profitability. Third, for other actual and potential export products, their production is stimulated if depreciation of the real exchange rate translates into a rise in the price of tradables relative to non-tradables.
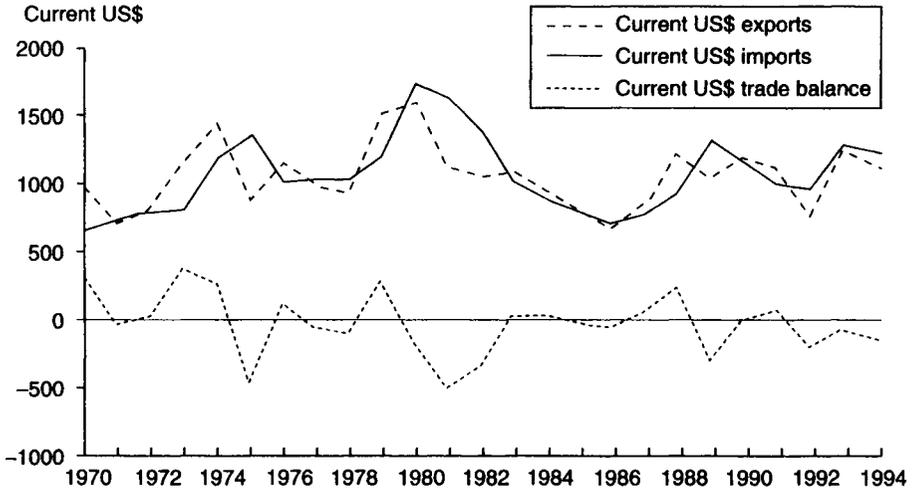
Figure 9.2 Zambia: exports, imports and trade balance of goods and services, 1970–1994 (current US$)
Source: World Bank database 1996
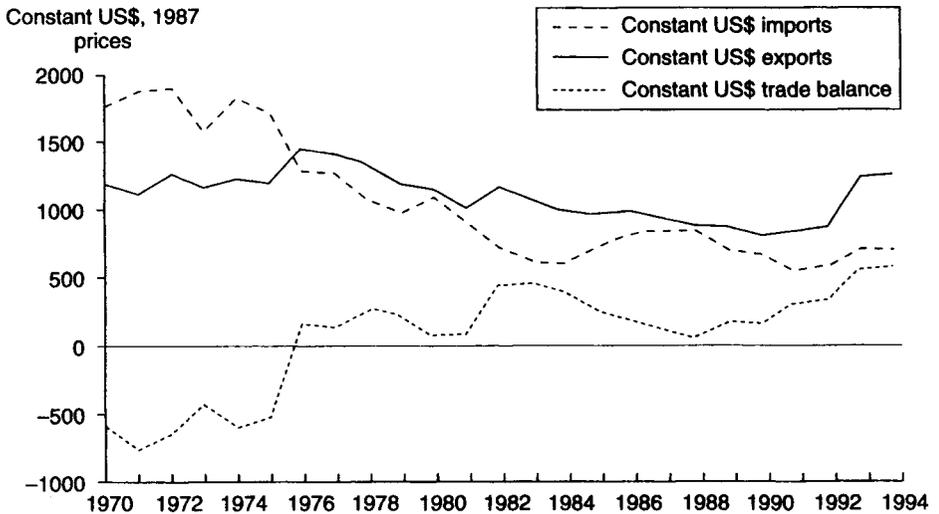
Figure 9.3 Zambia: exports, imports and trade balance of goods and services, 1970–1994 (constant US$, 1987 prices)
Source: World Bank database 1996

In Figure 9.4 we pursue the analysis of relative prices further by disaggregating tradables into agriculture and manufacturing. None would doubt that the mining sector produced exportables, but there would be less agreement about agriculture and manufacturing. While Zambia has been historically a net importer of agricultural products, many have argued that with an appropriate exchange rate and active interventions to lower production costs, the country could be a net *exporter*.[16] Less credible, at least for the 1990s, is that the manufacturing sector could emerge as a net exporter, except for copper derivatives (Andersson and Kayizzi-Mugerwa 1989, World Bank 1984). In the longer term, it is likely that both sectors are capable of net exports in some product lines.

In any case, efficient import substitution or export expansion in the context of liberalisation requires that relative prices move in favour of the two tradable sectors. For the twenty-five years as a whole, relative manufacturing prices are considerably more stable than agricultural relative prices. The pattern for relative agricultural prices appears cyclical. The extreme values for agriculture during 1991–94 can be explained by the impact of drought.[17] If one excludes the drought years, the trend rate of growth for relative agricultural prices is slightly negative (-0.8 per cent per annum) and non-significant. It appears that repeated attempts at liberalisation and substantial nominal devaluations were not successful in shifting relative prices in favour of agriculture. Further, it is surprising to discover that the most dramatic increase in relative agricultural prices (excluding drought years) occurred when the Zambian government broke with the multilateral agencies and shifted to a more protectionist trade regime (1987–90).
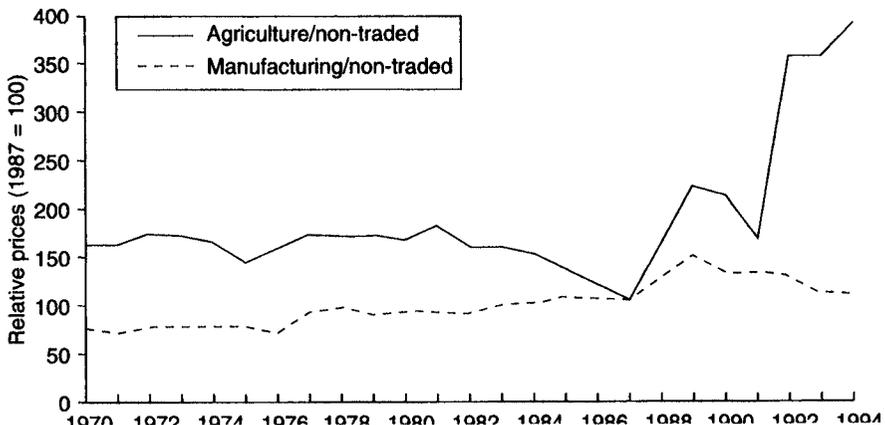
Figure 9.4 Zambia: agricultural and manufacturing prices relative to nontradables, 1970–1994 (1987=100)
Source: World Bank database 1996

For manufacturing, the relationship was quite different. The trend value in relative manufacturing prices over 1970–90 was a positive 2.8 per cent per annum and highly significant.[18] As in agriculture, relative manufacturing prices rose in the late 1980s but declined in the 1990s. The decline may have been the result of the rapid tariff reduction under the adjustment programme of the 1990s which had a severely negative impact upon manufacturing output.[19]

A series of multilateral-fostered adjustment programmes sought to shift relative prices in favour of tradables, with repeated optimistic assessments that the goal was being realised.[20] However, Figure 9.4 shows that for agriculture no sustained shift in relative prices occurred, except that associated with drought (1990 onwards). For manufacturing, an increase in prices relatively to non-tradables did occur, but this was a long-run tendency, apparently not associated with any particular policy regime. If one divides the twenty-five years by policy regimes (see Table 9.5b), the improvement in manufacturings terms of trade is positive during the IMF programmes of 1978–86, at 1.8 per cent per annum. However, much more significant is the 4.8 per cent per annum increase during 1979–89 which spans both a period of multilateral adjustment and policy autonomy. It would appear that differences in policy regimes are inadequate in themselves to account for shifts in the internal terms of trade. Of central importance to the adjustment effort, and over-riding the effects of exchange-rate adjustment, was the severe fiscal constraint resulting from the decline in copper prices during the 1970s and into the 1980s. As the economy contracted in response to this in the 1980s, 'prospects for economic recovery were actually diminishing', due to falling investment expenditure and export revenues (Meijer 1990:671). Further, the relative price shift which occurred in favour of manufacturing had limited impact on supply. This limited supply response resulted from the mining-specific character of several subsectors, the high import content of production for consumer goods and the dependence of most subsectors on tariff production for viability. As a result of these characteristics, the liberalisation of the 1990s provoked a recession in manufacturing rather than recovery. Absent in the adjustment strategy was a programme of investment which would have facilitated a positive output response to the improvement in relative prices, with state investment severely restricted by the pressure to reduce expenditure to accommodate external debt payments (see concluding section).[21]

In the case of agriculture, Zambia, like many mineral exporting countries, was a heavy food importer, in part because of a pattern of trade consciously fostered during the colonial period. During the 1970s considerable progress was made towards reducing food imports (with 1976 the last year of net maize imports).[22] However, none of the policy regimes pursued by the government proved successful in generating the relative price changes to provide incentives for agriculture.

Immediately after independence, it was clear to the government of Zambia that the only viable development strategy would involve a diversification of the economy, with this based on a diversification of exports. During the late 1960s and early 1970s, before copper prices collapsed, the 'most significant gains in diversification' occurred (Meijer 1990, Loxely 1990, Gulhati and Sekhar 1982). Subsequent adjustment efforts, in the context of an increasing fiscal constraint and debt burden, achieved little towards that goal. The shift of resources from non-tradables can in the abstract be separated into two phases: the contraction of non-tradable production and the associated release of resources, on the one hand, and the relative price adjustment to induce the tradable use of the idle resources, on the other. In Zambia the first occurred, in as far as the non-tradable public sector contracted,[23] but the latter did not. While employment data are limited and of questionable reliability, it is clear that formal-sector jobs declined drastically. In Loxley's words, the orthodox adjustment programmes in Zambia proved 'too blunt to deal with the subtle peculiarities of the economy' and carried with them 'too little foreign capital to permit supply-side recovery and economic diversification' (Loxley 1990:172). We have reinforced this conclusion by demonstrating that the required relative price adjustments also did not occur.

Incomplete adjustment in Zimbabwe

Relative prices and output

A 1991 World Bank report on Zimbabwe refers to the country's macroeconomic performance after independence as 'disappointing', goes on to describe GDP growth as 'sluggish and uneven', bemoans that 'export performance has not fulfilled its potential', and concludes that 'the economic policies pursued since Independence (1980) have contributed to the lackluster performance' (World Bank 1991:3). As shown above, Zimbabwe's GDP growth rate in the 1980s was almost 4 per cent per annum, well above the rate for the 1970s. Whether this can be considered as 'lackluster' is a subjective judgement. Of greater interest is a comparative assessment of policies since independence (1980), and the implications for adjustment.

The statistics for Zimbabwe are much more comprehensive than for Zambia, especially for employment,[24] allowing for a more comprehensive analysis of adjustment. We begin, as for Zambia, with an inspection of trade performance in current dollars (Figure 9.5). In the case of Zimbabwe, the trade balance is considerably less volatile, showing substantial deficits only in two years between 1970 and 1990 (for 1981 and 1982). The largest deficits came at the end of the period, associated with the drought of the 1990s. Thus, unlike Zambia, Zimbabwe did not face a serious problem of balance of payments stabilisation. In real terms, performance was less impressive, for exports in constant dollars grew at a statistically significant but sluggish rate of 0.8 per cent per annum
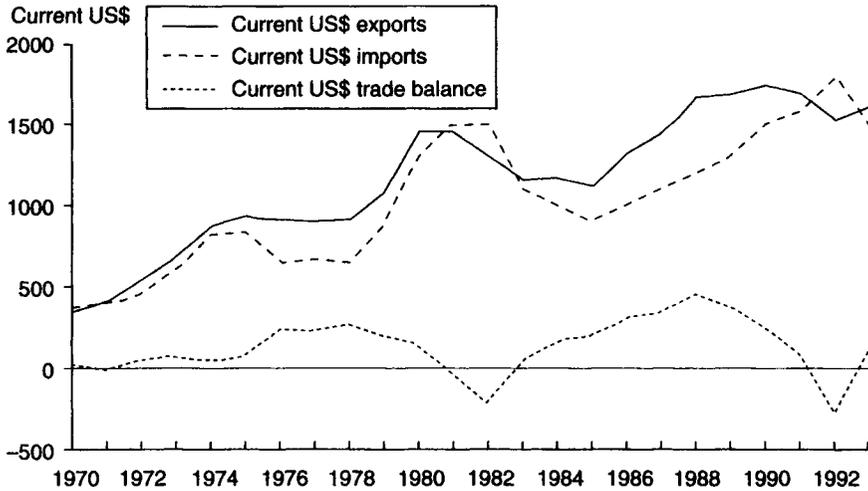
Figure 9.5 Zimbabwe: exports, imports and trade balance of goods and services, 1970–1993 (current US$)
Source: Zimbabwe data disk 1996

for the entire twenty-five years. If the drought years are excluded (1991–93), the trend rate is greater, 1.2 per cent per annum, but still modest. Thus, Zimbabwe's respectable rate of output growth in the 1970s and 1980s was associated with a declining trade share in GDR

In the orthodoxy of neo-classical theory, the relative production of tradables and non-tradables should be determined primarily by relative prices. If we disaggregate,[25] we find that for the 1970s there is a rise through the first half of the decade for agriculture and mining, followed by a down-turn, with manufacturing prices relatively stable (Figure 9.6). During the 1980s agricultural and manufacturing relative prices rose substantially, with a more subdued increase for mining. The first year of the liberalisation programme brought another large increase in the relative price of agriculture and manufacturing (as the orthodoxy would predict), but this was then followed by decline. Overall, there is no sustained increase in tradable prices during liberalisation.

Figure 9.7 shows the growth rates of output of tradable and non-tradable sectors. Tradable production was considerably more volatile than non-tradable, which may reflect the greater instability of world market demand as compared to domestic demand. Inspection of Figure 9.7 does not suggest that tradable production performed better in the 1980s relative to nontradables, despite the tendency for the relative price of the former to increase. Figure 9.8 gives the distribution of tradable and non-tradable employment, and there is a clear pattern: a continuous decline in the employment share for agriculture (especially during 1978–82) and a slow
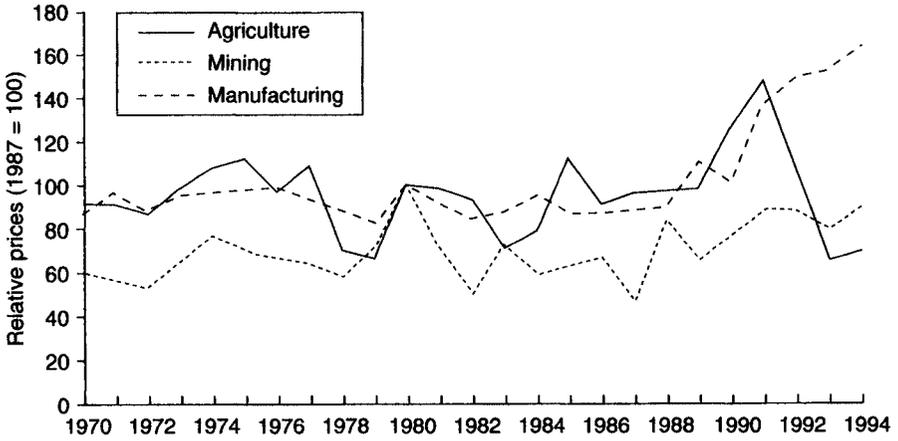
Figure 9.6 Zimbabwe: relative prices of tradables to non-tradables, 1970–1994 (1980=100)
Source: Zimbabwe data disk 1996
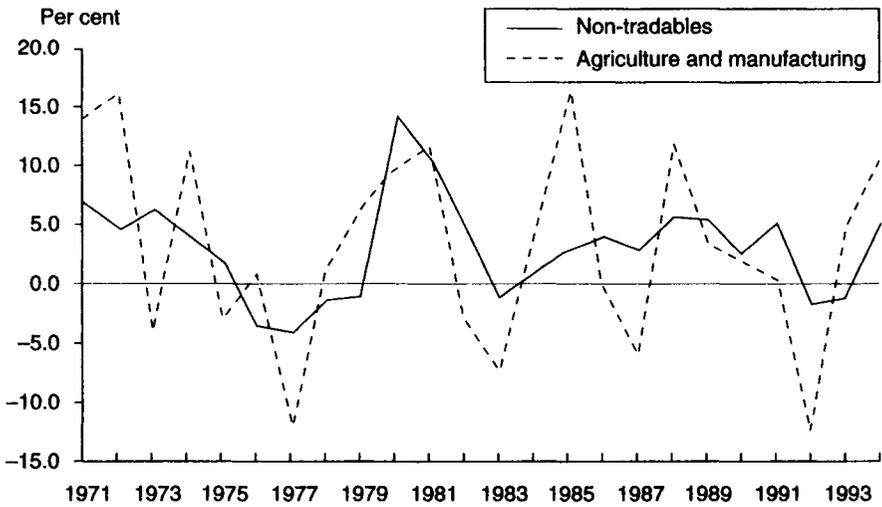
Figure 9.7 Zimbabwe: growth rates of output of tradable and non-tradable sectors, 1971–1994
Source: Zimbabwe data disk 1996

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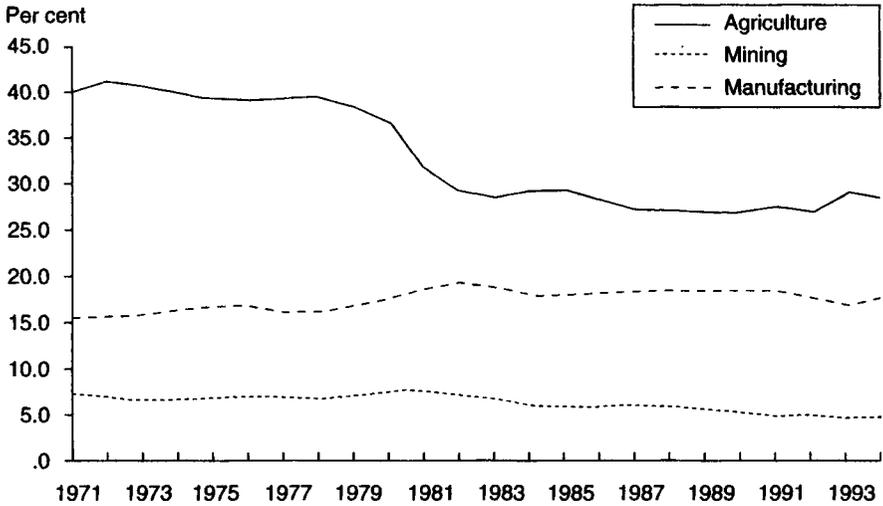
Figure 9.8 Zimbabwe: shares of employment in tractable sectors, 1971–1994
Source: Zimbabwe data disk 1996

decline in the mining share after 1980. Associated with these was a relative increase in manufacturing employment, of about two percentage points from 1975–80 to 1981–89, after which there was a decline. The employment data have two important implications. First, those sectors most open to trade, agriculture and mining, responded less to the favourable changes in relative prices. This could be explained by the output in those sectors being constrained by demand, rather than prices. A demand interpretation is consistent with the relative increase in manufacturing output and employment, whose output was largely for the less volatile domestic market, while exports responded to an excess demand to be seized upon as it presented itself. In addition, it is likely that the supply flexibility in manufacturing would be considerably greater than for either mining or agriculture. For mining, the extent to which producers can shift the composition of output in response to relative price changes is severely limited by natural resource endowment and the specialised nature of mining equipment. Supply flexibility in agriculture is also affected by the endowment of nature and, more importantly, by complementary infrastructure and market access.[26] Central to improving the performance of agriculture in terms of both growth and tradability would be the reduction in the dualism between the large-scale commercial sector and the so-called communal areas (Loxley 1990).

Orthodox theory argues that tradable sectors in underdeveloped countries tend to be more labour-intensive than non-tradables, or that freer trade will shift production within tradable sectors towards more labour-intensive products. This assumes that trade is not determined by natural resource

endowments or other country-specific production ingredients and that all countries employ (or, are knowledgeable of) the same production techniques. With this analysis in mind, Table 9.6 subjects relative productivity to trend analysis, omitting the drought years after 1990. We find that when tradables are disaggregated into their three broad sectors, only for agriculture is there a statistically significant positive trend, at 1.7 per cent per annum. For mining and manufacturing there is no significant trend, and in the latter the coefficient is negative. While the relative price of tradables rose in the 1980s, this was not associated with an increase in tradable production relative to non-tradable or with a relative increase in productivity in tradables, except for agriculture.

Table 9.6 Zimbabwe, relative productivity trends, 1970–1994

Sector	*Constant*	*Coefficient*	R^2	*F*
Non-tradables	4.793	–0.016	.920	218.48
standard error	(.007)	(.001)		
t-statistic	689.76	–14.78		
Tradables	4.441	.011	.901	172.21
standard error	(.005)	(.001)		
t-statistic	851.28	13.12		
Agriculture	3.799	.017	.564	24.54
standard error	(.022)	(.003)		
t-statistic	176.57	4.954		
Mining	4.907	.003	.046	0.93
standard error	(.002)	(.003)		
t-statistic	226.87	.961		
Manufacturing	4.908	–.002	.089	1.856
standard error	(.008)	.001		
t-statistic	581.24	–1.362		

Source: *Zimbabwe data disc 1996*

Employment and relative prices

The neo-classical literature on employment generation places special importance on the role of relative factor prices. Is there evidence to suggest that wage increases in Zimbabwe had a negative impact on employment growth and, therefore, the shift of output from non-traded to traded sectors (see Knight, Chapter 10 in this volume)? We have seen that there is little evidence of a relative increase in labour productivity in tradable sectors, except for agriculture, but might higher producer real wages have prompted a shift to more capital-intensive techniques in general? The evidence suggests that this was not the case. First, the statistics in Table 9.6 show that of the three tradables sectors, only in agriculture did output per worker increase,

at about 2 per cent, in either the 1970s or the 1980s. Thus, there is relatively little productivity increase to explain, whatever its cause. The productivity increase in agriculture was associated with a substantial increase in the product wage[27] in the 1980s, but this appears to have been the continuation of an earlier trend. Figure 9.9 shows the three-year moving average of the marginal output-labour ratios in agriculture and manufacturing.[28] For six years from 1979, this ratio rose in agriculture, then declined for the next five, with the fluctuations in the 1990s perhaps due to drought. Since the year-to-year movement of the agricultural product wage was considerably different (not shown in Figure 9.9), influences other than relative factor prices were probably dominant.

For manufacturing, the marginal output-labour ratio was relatively constant from 1970 through 1983, then shifted upwards, to be relatively constant again at a higher level during 1987–91. It could be argued that this shift resulted from the rather large nominal wage increases in 1981, when the majority rule government delivered on its promise to partially redress previous wage repression of black workers. The evidence is ambiguous, however. The overwhelming portion of the product wage increase for the decade occurred in 1980 and 1981: the average rate for the ten years was 3.6 per cent, and only 1.3 when these two years are excluded. The same pattern holds for the consumer real wage (standard of living), with the increases minuscule or negative across all sectors when 1980 and 1981 are excluded. Even if one assumes that the increase in the marginal output-labour ratio in manufacturing from the 1970s to the 1980s was the result of the
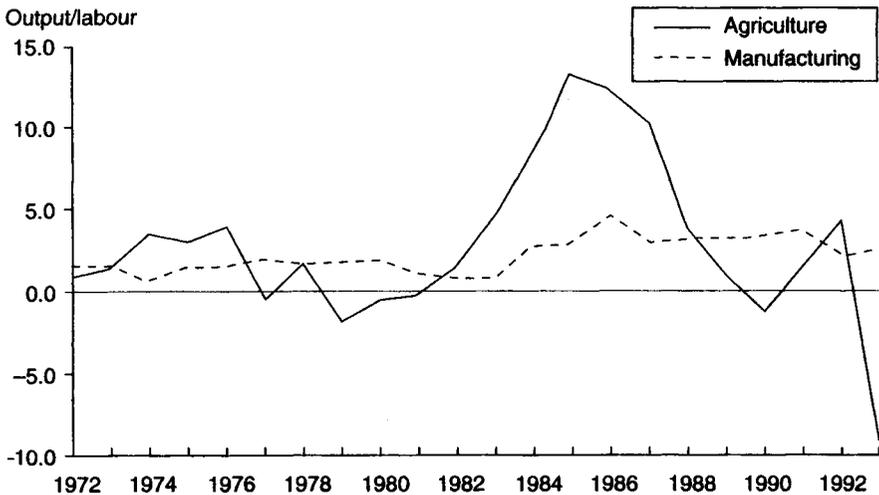
Figure 9.9 Zimbabwe: marginal output/labour ratios, 1972–1993 (three-year moving average)
Source: Zimbabwe data disk 1996

product wage increase in 1980–81, the implied reduction in employment growth can be viewed as a necessary part of the changes in the political economy of the labour market after majority rule and a one-off increase that could be compensated by faster output growth.

However, the data show that changes in the product wage in tradables, except for large increases in 1980 and 1981, were little different from their changes in the 1970s, and were followed by decline after 1990.[29] The pattern of the twenty-five years suggests that employers taking a long-term perspective on technique choice would have been unlikely to have shifted to substantially more capital-intensive techniques. Especially for manufacturing, there seems to be little relationship between productivity growth and the product wage, as Figure 9.10 illustrates. Only during 1983–85 do they seem to move together. Subsequently, the rate of change of the product wage declined, while productivity growth continued to be positive, in the 2–4 per cent per annum range. If one subtracts the changes in productivity and the product wage after 1986, the result implies a continuous decline in unit labour costs.

The cost of labour to employers should not be confused with the standard of living of workers. Figure 9.11 demonstrates this for the manufacturing sector. From the mid-1970s to the early 1980s, the two real wage measures moved together. However, during 1982 through 1989 there was a clear divergence. This indicates that the interaction between product and labour markets was complex in Zimbabwe such that improvements in the standard
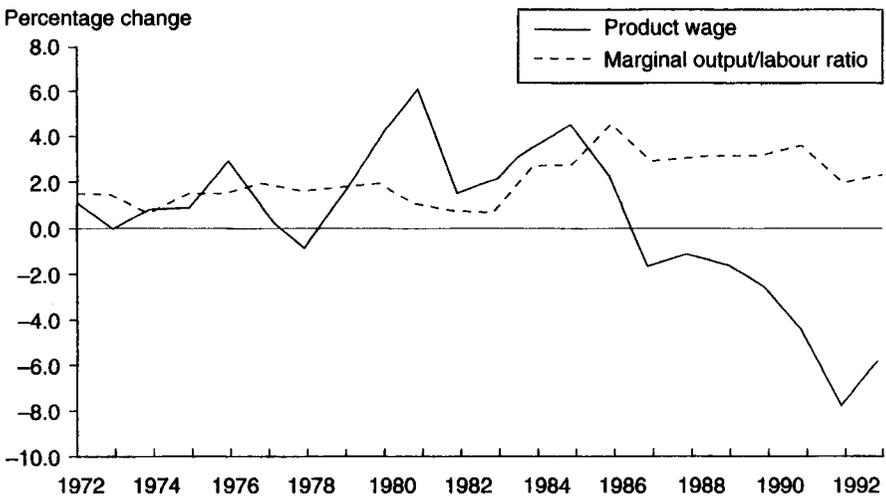
Figure 9.10 Zimbabwe: percentage changes in the manufacturing marginal output/labour ratio and the product wage, 1972–1993
Source: Zimbabwe data disk 1996
Note: 'Product wage' is a measure of the unit cost of hiring labour (see Note 27)
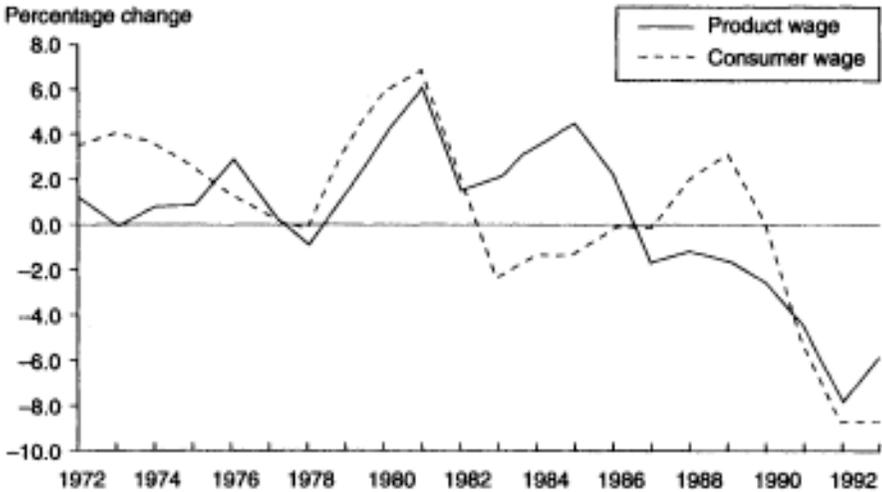
Figure 9.11 Zimbabwe: percentage changes in the manufacturing product- and consumer wage, 1972–1993
Source: Zimbabwe data disk 1996
Note: 'Product wage' is a measure of the unit cost of hiring labour; 'consumer wage' is a measure of the standard of living (see Note 27)

of living of workers did not necessarily imply increase in the unit cost of hiring labour.

Finally, Figure 9.12 presents real producer wages in tradable and non-tradable sectors. If relative prices had moved in favour of tradables, one would expect that real wages in tradable sectors would have risen relatively to those in non-tradables. Except for 1981, when the government granted large nominal wage increases in the public sector, the movement of wages in tradables and non-tradables is virtually identical. This further demonstrates the failure of relative prices to adjust in favour of tradables. The chart shows that this failure was not the result of the inflexibility of real wages, which after 1981 declined during ten years, while increasing in only seven (with virtually no change in 1994). Thus, we conclude that whether one judges adjustment in Zimbabwe to have been successful or unsuccessful in promoting the production of tradables, labour market inflexibility cannot be considered a limiting influence.

Achieving success in adjustment: lessons from Zambia and Zimbabwe

In the wake of our discussion of the adjustment process in Zambia and Zimbabwe, we summarise the main lessons to be derived. Notwithstanding their common colonial past, as Northern and Southern Rhodesia, the seeds
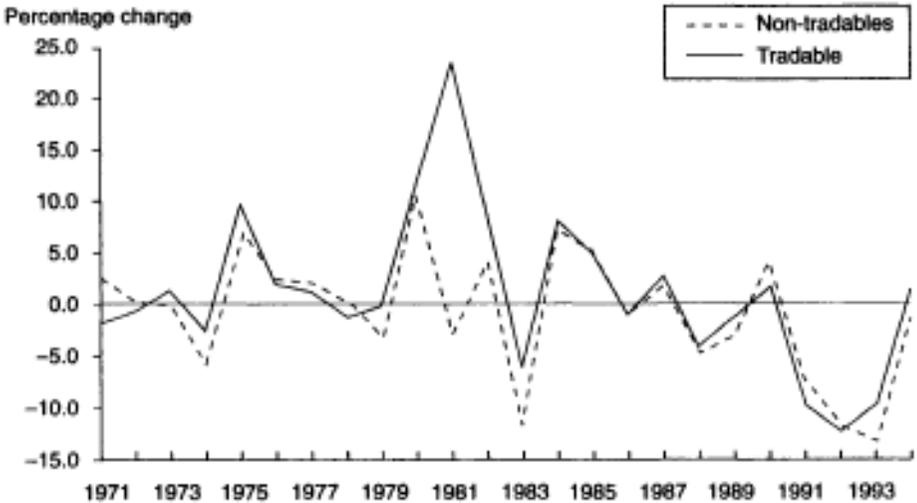
Figure 9.12 Zimbabwe: percentage changes in product wages in tradable (agriculture and manufacturing) and non-tradable sectors, 1971–1994
Source: Zimbabwe data disk 1996

of their divergent adjustment experience were sown in the 1930s. During this period the much more numerous and politically powerful expatriate community of Southern Rhodesia provided the pressure for the provision of a transport infrastructure better than that in most of Africa. This was part of the creation of import-substituting industries, some of which (such as clothing and fruit juices) became competitive in export markets. Under white rule the state also fostered an agricultural research system for food crops, which as early as the 1930s transmitted new technologies (in particular improved seeds) from European to African areas. These three developments constitute some of the 'initial conditions' established in pre-independence Zimbabwe which have no analogue in Zambia.

Initial conditions relating to the labour market, listed in Table 9.7, represent a more complex issue which has already been extensively analysed. It appears to have been in the early 1950s (in the wake of the Korean War minerals boom) that a systematic attempt was made in Zambia to narrow the wages differential between African and European markets in the copper mines, in order to create a stabilised, peaceful labour force on the copper belt.[30] Given the political power of the white labour force, this narrowing could only be achieved by raising black wages.

This method of dealing with a temporary shortage of labour, not copied in Zimbabwe, had permanent effects on competitiveness and the cost of labour in Zambia, both on and off the copper belt. The Zambian political economy was one in which the unionised modern-sector labour force was

Table 9.7 Factors explaining relative performance in adjustment in Zambia and Zimbabwe

Initial conditions:

Zambia	*Zimbabwe*
export concentration	export diversification
low-yield, non-exportable agriculture	medium-yield, partly export-based agriculture
sticky real wages	flexible real wages
poor human capital and physical infrastructure	better human capital and physical infrastructure

Adjustment actions bearing mainly on growth rate:

compression of government investment	maintenance of government investment, especially in agricultural sector
policy unstable	delayed adjustment, but policy broadly stable
liberalisation	maintenance of protection of 'strategic' industries

Adjustment actions bearing explicitly on employment or on poverty reduction:

mix of macro-policy instruments: minor real devaluation, increases in indirect tax ratio	substantial real devaluation, little use of indirect tax increases
major subsidies to capital	minor subsidies to capital

able to insulate its wage from the income level prevailing in the rural economy. Real wages, although declining through the period of adjustment, remained at a level much higher than Zimbabwe's, and at a level which precluded the price signals given by adjustment being converted into a substantial expansion of non-traditional exports. Much of Zambia's adjustment failure, therefore, consisted of a failure to deal effectively with initial conditions that would have crippled adjustment in any country.

However, government actions during the adjustment affected the experience of the two countries. We divide these into two categories: those which bore purely on the growth rate of the economy and those which bore on the distribution of the gains from growth, in particular its impact on employment. As highlighted in Table 9.8, government investment in Zambia was more severely compressed than in Zimbabwe during the adjustment period (particularly in relation to the food-crop agriculture sector), the thrust of macroeconomic policy was much less stable and the process of liberalisation less focused on the provision of cost advantages to potential

Table 9.8 Key catalysts of adjustment success

Investment rate

	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994
Zambia	13.5	19.8	11.7	11.5	10.9	14.7	14.7	14.1	10.3	9.2
Zimbabwe	19.8	n.a.	17.2	21.8	19.8	20.4	25.0	24.3	22.5	n.a.

Stance of macroeconomic policy

Zambia	*1970–77*	*1978–86*	*1987–90*	*1991–94*
	policy autonomy: direct controls on imports, price and investment	attempted stabilisation: foreign exchange auction, credit and expenditure restrictions	policy autonomy: cap on external debt repayment, price controls reimposed, pegged exchange rate	liberalisation: privatisation of SOE[a], exchange rate refloated

Stance of macroeconomic policy

Zimbabwe	*1970–79*	*1980–90*	*1991–94*
	UDI:[b] import substitution under sanctions	policy autonomy: managed exchange rate, planned state investment, protection for export-based industries' outputs	World Bank-inspired liberalisation: decontrolled exchange rate, subsidy removal, reductions in budget deficit

Notes: [a] *State-owned enterprises;* [b] *Unilateral Declaration of Independence*

exporters. These problems tended to constrain the recovery of growth in Zambia after the initial period of macroeconomic stabilisation and also to constrain the possibilities for an expansion of the employment.

Labour market effects, however, do not only depend on growth, but also on the choice of adjustment instruments and on the incentives which the economic system provides for hiring different categories of labour. Research by the OECD (Bourguignon *et al.* 1991) suggests that, of the available range of adjustment instruments, devaluation and recurrent expenditure cuts have the most 'human' face. They appear to generate the lowest increase in the poverty gap per unit reduction in aggregate absorption, whereas increases in indirect taxes, and to a lesser extent import duties, are more poverty-increasing. For example, the poor who produce export crops gain from devaluation, and indirect taxes fall heavily on the consumption of the poor. In Zambia and Zimbabwe taxed commodities consumed by the poor include

sugar, tobacco and kerosene. The Zambian adjustment programme was relatively intensive in anti-poor measures (in particular indirect tax increases), whereas the Zimbabwean programme, in particular after 1990, emphasised adjustment measures more favourable to the poor, real devaluation and cuts in the average level of indirect taxation. Finally, the high level of wage rates in Zambia enters the analysis a second time to explain why such growth as did occur in Zambia was not converted into increases in formal-sector employment. The labour market simply did not have, nor did it in the course of adjustment acquire, the flexibility required to make adjustment equitable.

As revealing as the contrast between Zambia and Zimbabwe may be for development policy, it should not be taken too far: Zimbabwe is not a model for imitation nor is Zambia a case to be avoided at all costs. What is clearly revealed is, first, the importance of initial conditions and 'Catalysts' in determining the success of adjustment; and second, the crucial role of the labour market in determining both the ability of the economy to adjust and spread the putative rewards from adjustment.

Notes

1 The terms 'before' independence and 'after independence' are unproblematical for Zambia, but require clarification for Zimbabwe. The white settler regime declared *de facto* a state independent of colonial rule in 1965, though it did not receive diplomatic recognition, not even by the South African apartheid government. For fifteen years this pariah state persisted, before yielding to majority rule in 1980. Following convention, the years up to 1965 will be called 'colonial rule', 1965–79 will be designated the Unilateral Declaration of Independence (UDI) period and 1980 onwards as 'majority rule'.

2 According to national definitions, in 1990 56 per cent of Zambians lived in urban areas compared to only 28 per cent of Zimbabweans. The latter per cent was slightly below the average for the entire Sub-Saharan region (29 per cent) and slightly above if Nigeria is excluded (World Bank 1992:317). It can be added that the total populations of the two countries were similar: Zambia with slightly over ten million in 1990 and Zimbabwe with eight million.

3 According to the *World Development Report,* in the early 1990s agriculture accounted for 13 per cent of GDP in both countries, compared to the Sub-Saharan average of 32 per cent. Industry, including mining, was 47 per cent in Zambia and 39 per cent in Zimbabwe (with the regional average being 27 per cent (World Bank 1995)). In the Meier and Steele volume, sponsored by the World Bank, the percentages for industry in 1986 are given as 48 for Zambia and 46 for Zimbabwe (Meier and Steele 1989:276–77).

4 Ten years before (and even twenty years before), Zambia's per capita income stood much more above the regional average.

5 The correlation for unadjusted annual real growth rates was .22 (F-statistic of 6.6). If one takes three-year moving averages, the correlation coefficient rises to .41, with a 3 per cent growth rate for Zimbabwe associated with a 1 per cent rate for Zambia.

6   In 1983, 12.3 per cent of posts in the 'professional technical and related' category were filled by non-Zambians, and 22.5 per cent of posts in the 'administrative and managerial' group (Colclough 1989, table 8).

7   The ratio of wage rates to per capita GNP in 1986 was 0.3 in Zambia, by comparison with 0.19 in South Korea, 0.13 in the Philippines and 0.18 in Nigeria. Zambia has also manifested symptoms of the better-known 'Dutch disease' due to its dependence on copper.

8   For a discussion of the theoretical underpinnings of structural adjustment, see Mosley (1991), Mosley *et al.* (1995), and Condos (1986).

9   Yanagihara argues as follows: 'In the [World Bank approach to adjustment] setting the framework right is considered to be a necessary, if not always a sufficient condition for successful development defined in terms of economic indicators…by the very essence of this approach, there is little mention of the picture of the economy which is supposed to result from setting the framework right.' (Yanagihara 1995:22)

10   Again, Yanagihara goes to the heart of development strategy: 'There is little conscious attention [by the World Bank] to long-term determinants of sustainable development, since dynamic efficiency is postulated to be achieved *ex post as* an economy continuously adjusts to changing domestic and external conditions in pursuit of static efficiency. In reality there might frequently arise tradeoffs between static efficiency and dynamic efficiency' (Yanagihara 1995:21–22).

11   The Zambian government entered into several IMF agreements during the 1970s and 1980s: a small low-conditionality stand-by arrangement in 1973 and another in 1976–77, both for SDR (Special Drawing Rights) 19 million and disbursed to completion; and a much larger stand-by agreement of SDR 250 million during 1978–80, also completed. However, the extended Fund facility of 1980–83 (800 million) was cancelled in July 1982 for non-compliance. Three more agreements, totalling SDR 665 million were suspended or cancelled in 1983, 1985 and 1987 (Loxley 1990:142).

12   The statistics in Table 9.5b, are from the national source. If the World Bank data disc growth rates are used, the average for 1971–79 is also 2.1, but for 1980–90 it is 4.9 per annum.

13   While the argument is cogently made, he provides no statistics to demonstrate its validity, which we seek to do below.

14   These figures are derived from the World Bank database, African Development Indicators 1996. Due to limits of space, the table with the statistics is omitted. This table is available from the authors in an earlier version of this paper.

15   For 1972–91 the trend rate of growth is a non-significant –0.3 per cent per annum.

16   See, for example, the report by the African Development Bank on economic integration in Southern Africa (ADB 1993, vol. 1, chapter 3). The ADB and others (Koester 1993) have argued that Zambia has the potential to export maize to other countries in the region.

17   The World Bank, in its compilation of drought-affected years by African country (World Bank 1992:242) identifies 1982–84 as drought-affected years for Zambia. Yet, unlike the drought of the early 1990s, the 1982–84 drought was not associated with a relative rise in agricultural prices. This may be explained by

the greater severity of the later drought. Policy measures, beyond the scope of this study, may also have affected relative prices.

18 The R-square is .79 and the T-statistic significant at greater than 0.1 per cent probability.

19 Both the World Bank (1996) and the WTO (1996) judged Zambia to have the most liberalised trade regime in the Sub-Saharan region in the mid-1990s.

20 In 1986, the World Bank wrote: 'The improvement in the terms of trade for tradables *vis-à-vis* tradables is essential for diversification of the Zambian economy, and there are already clear indications that this effect is at work' (World Bank 1986: vii).

21 The World Bank was aware of the central role that investment would play in a successful adjustment programme: 'Attaining [the projected] growth targets would require substantial changes in the investment and consumption/savings …of both the public and private sector…[Investment] is envisaged to rise from 12 per cent of GDP in 1985 to 16 per cent in 1990 and nearly 18 per cent by 1995…But ['foreign savings' in the current account] will have to be limited because Zambia must also finance large debt service payments' (World Bank 1986: xi). In the event, the ominous qualification about debt servicing proved to be operative. The investment targets were not reached and, as a result, the growth targets proved much too optimistic, 3 per cent per annum during 1986–90 and 3.5–4.5 during 1990–95.

22 See Meijer (1990:675), Weeks and Subasat (1995:15ff), and Weeks (1996).

23 During 1992–93 over 50,000 public-sector jobs were eliminated (Loxley 1990:146).

24 As for Zambia, the data on which the Zimbabwe figures are based is not included, due to limitations of space. The data table is available from the authors in a previous version of this paper. The data are those from the Central Statistical Office (CSO), available on disk. In some cases, most notably measures of 'real' exchange rates, the CSO time series give different results for some years than IMF and World Bank publications. After discussions with economists working on Zimbabwe, we judged the national source to be the more reliable. Most, but not all, of the basic statistical series used in this paper are published in the *Quarterly Digest of Statistics*. The authors wish to thank Rob Davies of the University of Zimbabwe for providing a copy of the data disk.

25 More detailed graphs are found in an earlier version of this paper, available from the authors.

26 The World Bank comments that Zimbabwe's agricultural sector was 'widely regarded as sophisticated', then goes on to caution that 'the slow growth in input use…is partly due to the unreliable pattern of rainfall in many communal areas' (World Bank 1991:2).

27 'Product wage' is nominal average earnings divided by the price index relevant for the sector which is a measure of the unit cost of hiring labour. The 'consumer wage' is nominal average earnings divided by the consumer price index which is a measure of the standard of living.

28 A moving average is used to 'smooth out' extreme values due to demand shocks and weather.

29 For a more detailed presentation of the statistics, see the earlier version of this paper, available from the authors.

30 For example, in 1953 African mineworkers were awarded a 77 per cent average pay increase (the 'Guillebaud awards') by a government-appointed arbitrator.

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10

LABOUR MARKET POLICIES AND OUTCOMES IN POST-INDEPENDENCE ZIMBABWE: LESSONS FOR SOUTH AFRICA

John Knight

Introduction

This conference paper is a summary of a longer, quantitative study on the Zimbabwe labour market (Knight 1996).[1] That, in turn, is part of a broader project entitled Economic Policies and Outcomes in Zimbabwe: Lessons for South Africa which Carolyn Jenkins and I have been conducting.[2] The motivation for the research was the realisation that the new South African government faced high expectations and political forces similar to those faced by the new Zimbabwe government when it came to power in 1980. The question that we wished to answer was: can South Africa draw helpful lessons from Zimbabwe's experience?

This analysis of labour market policies and outcomes in Zimbabwe therefore has two distinct purposes. The first is to understand the labour market in order to inform policy-making in Zimbabwe. The second is to compare the labour market issues and policy choices that faced the Zimbabwe government after the achievement of majority rule with those that now face the South African government, and to consider whether lessons from Zimbabwe's experience can be drawn for South Africa, or indeed for other countries with highly regulated and inflexible labour markets.

In 1980 the incoming Zimbabwe government adopted an interventionist approach to the labour market. Its main interventions took the form of wage policies (intended to raise the incomes of poor workers and to reduce income inequality), employment policies (intended to protect and expand employment, particularly the employment of relatively unskilled workers) and educational policies (which in the long term would promote the same objectives). How successful were government policies in pursuing these objectives of inter-personal and inter-temporal income redistribution—of

201

redistributing income to the African majority while encouraging rapid growth of the economy? That is our central question.

In 1990, as part of its general economic reforms, the government began to deregulate the labour market. There was to be less government intervention in labour relations, in wages and in employment, and the public sector was to be reduced. This new chapter represents a counterfactual to the post-independence interventionism. Although it is too early to judge the reforms, they can help us to assess the sensitivity of labour market outcomes to policies.

It is helpful at the start to clarify issues of nomenclature and evaluation. First, regulation and deregulation: all labour markets are regulated, whether by government or collective bargaining or market forces. The term "regulation is used here to mean government regulation. There can be no presumption that this form of regulation is better or worse than the others. Second, although much of the paper involves positive economic analysis, the evaluation of policy necessarily brings normative judgements. These concern the welfare of workers, both waged and self-employed, and its distribution among them; welfare in turn depends not only on income but also on other conditions of employment such as income variability and employment security.

The political economy of labour relations

The new government had to cope with the extremely high expectations of rapid improvement in the lives of black people that had been aroused by liberation, but it also had to take a long-term view. The leadership, which had been radicalised in the liberation struggle, envisaged a gradual transition towards socialism. It decided to maintain the interventionist economic policies of the previous government, reorienting them towards socialist transformation, and to extend government intervention to the labour market. It was concerned to end racial discrimination in the labour market, to increase low incomes and to decrease income differentials. Although the liberation struggle had been peasant-based, the new government expressed a commitment to workers and sought their support.

Its handling of the widespread strikes in the period 1980–82 was symptomatic of the competing pressures on government. The strikes occurred in response to a 'crisis of expectations': workers felt that improvements were now possible. At first, the government sympathised with worker demands. It called for the establishment of workers' committees in enterprises, pledged to examine the wage structure and set up a commission of enquiry into wages. The government introduced extensive statutory minimum wages in 1980, in recognition of workers' needs and demands. When the strikes continued, however, the strikers were ordered to desist. Eventually, strikes were broken

by police using force to make arrests. Government justified these measures in terms of the harm that strikes could do to economic development and political stability.

In many less developed countries not long after the attainment of political independence, governments took steps to control trade unions. A common method was to confer monopoly representation on a single trade union organisation and to 'incorporate' this body so that it would accept and implement government labour market policies. This strategy has both economic and political explanations—pursuit of the broader national economic interest and stifling of potential political opposition. The path taken by the Zimbabwe government had therefore been trodden before.

The government adopted a corporatist labour policy. It sought to monopolize political representation, especially for black people, not only among political parties but also among trade unions. The government played a positive role in the creation of the Zimbabwe Congress of Trade Unions (ZCTU) in 1981. Trade unions aligned with the ruling party, Zimbabwe African National Union, Patriotic Front (ZANU, PF) won the ZCTU elections, and their leaders took command. The ZCTU was granted a monopoly of worker representation in dealings with government. With strikes effectively prevented and the government in control of the ZCTU, the trade union movement was now subordinate to government. The trade union movement was further undermined by the government's assumption of trade union functions. Its use of tripartite organisations (involving representatives of ZCTU, the Employers' Confederation of Zimbabwe (EMCOZ) and government) to discuss minimum wages and its legislation against the retrenchment of workers diminished the unions' bargaining functions. Government attempted also to compress the inegalitarian wage structure by specifying maximum percentage wage increases which tapered as the wage level rose. Thus the interventionist wage policies reduced the scope for bargaining over both unskilled and skilled wages.

Despite the great powers over the labour market acquired by the state in the first five years of independence, these powers waned slightly over the next five years. The clique ruling the ZCTU came into disrepute owing to corruption and were ousted in elections in 1985. Thereafter the leadership showed greater, albeit muted, assertiveness of its members' interests: the relationship with government evolved from subservience to conflict.

In the late 1980s the Zimbabwe government increasingly recognised the deficiencies of its interventionist development strategy and in 1989 began to introduce less interventionist and more market-oriented policies, formalised in 1991 as the 'Economic Structural Adjustment Programme' (ESAP). Although the government claimed 'ownership' of the new strategy, the policy reversal reflected the lobbying of local interest groups and the influence of the International Monetary Fund and the World Bank (Skalnes 1995; chapter 7). As part of the policy reversal, government decided on some liberalisation

of the labour market. Zimbabwe was shifting from 'state corporatism' in labour matters—if not to free market solutions, then to 'bargained corporatism' (Shadur 1994:113).

Although the government s reversal on labour relations was part of the broader change in policy, it had some specific causes. First, there was pressure both from inside (ZCTU and EMCOZ) and outside Zimbabwe (the ILO and the World Bank) to restore collective bargaining. Second, the private interests of the leadership—becoming more involved in business—were changing. Third, the state increasingly recognised that it could not deliver rising living standards nor protect jobs. It saw an advantage in withdrawing and leaving the responsibility, and the blame, to others. Fourth, the government became concerned about the slow growth of employment in relation to the fast growth of the labour force and the consequent rise in unemployment: a new labour market strategy was required.

In the late 1980s the government allowed the employment councils to play a larger role in setting wages and conditions. In 1990 statutory minimum and maximum wages were abolished, except for agricultural and domestic workers. The labour laws were softened by a series of statutory instruments and acts of parliament. One eased the rules on retrenchment of workers. Another established regulations for 'codes of conduct', whereby labour relations were decentralised. Codes can be drawn up at the industry or at the firm level. Once registered, they are binding for the settlement of disputes. Particularly as some codes of conduct are not negotiated but are imposed on employees, the codes permit employers greater flexibility with regard to wages, retrenchment, dismissal and (relatively unprotected) contract employment. The ministry of labour is now involved only as a last resort.

The withdrawal of government labour regulations did not strengthen the bargaining power of the unions. On the contrary, the balance of power swung from employees to employers (Sachikonye 1995:64). First, the prohibition on strikes remained. Second, the threat of redundancy made workers insecure and afraid to voice discontent. Third, perhaps two-thirds of urban employees have ties with rural relations and access to land in the rural areas. The cushion that this provides reduces the capacity of unions to mobilise and negotiate on their behalf.

Human capital formation

The Zimbabwe government inherited a human capital stock ill-equipped to cope with renewed economic growth and expanded social services. The skills shortage was exacerbated by the emigration of whites, and the exodus affected the quality of the labour force. In the 1980s a remarkable expansion occurred in primary, secondary and tertiary education enrolments. Primary enrolment was doubled in 1980 and soon became universal. Secondary enrolment grew even more rapidly: the enrolment rate rising from 8 per

cent before independence to 50 per cent a decade later; it was distinctly higher for the four years of junior secondary education (72 per cent in 1989).

The rapid expansion of primary and secondary education had serious implications for the labour market. While the scarcity of highly qualified labour continued, the market for primary and secondary school-leavers changed abruptly. The number of form four leavers was under 10,000 in 1980 but exceeded 100,000 by 1987, when they represented half the 17-year olds. These young people expected to obtain formal sector non-agricultural jobs in the way that their predecessors had done. Yet the increase in non-agricultural wage employment over the period averaged less than 20,000 per annum.

We can examine how well or badly the economy absorbs school-leavers by tracing their subsequent experience in the labour market. In 1991 a tracer survey of secondary school-leavers—those who had completed form four in 1985 and in 1988—was conducted (Bennell and Ncube 1992). Unemployment was extremely high among the cohort who in 1991 had been three years in the labour market—accounting for well over a third of respondents. The proportion of those entering skilled occupations declined over time, suggesting that a process of 'filtering down' into lesser occupations was at work for labour market entrants. The proportion entering the public sector dropped sharply, reflecting the deceleration in its growth. The public sector accounted for only a quarter of the employment of the 1988 cohort. In the new, even harsher circumstances of the 1990s the potential of the informal sector productively to absorb educated young people has become a question much in need of an answer.

In the short term, at least, the educational policies presented a problem of educated unemployment and of potential social discontent. In the long term, however, it could be expected that the labour market would adjust as employers raised their recruitment criteria and entrants lowered their expectations. There is good evidence that educational expansion can increase human capital and thus the productivity of labour, and that, operating through the forces of supply and demand, it can erode the scarcity rents accruing to the educated (for example, Knight and Sabot 1990, chapters 3, 5, 7–9, with regard to Kenya and Tanzania). The evidence for Zimbabwe is incomplete: in particular we need to know the value of secondary education in the informal sector. Nevertheless, the educational expansion that has taken place since 1980 may, after adjustment lags, have raised output in the economy and the incomes of those who received the education. It may also have reduced the extreme inequality of wages that characterised Zimbabwe at the time of independence.

Whereas the expansion of education was extremely rapid after independence, the same cannot be said for formal training. Nevertheless, the case for more training was strong. Before 1980 the apprenticeship system

was racially biased and produced only few skilled manual workers. The number of apprentices was controlled by the white trade unions, which wished to maintain scarcity rents on skills. To correct the inherited distortions, the government centralised the recruitment of apprentices: prospective apprentices had to apply to the ministry of labour, and those selected were offered to employers, whose choices were limited. The number of indentured apprentices has fallen over time, not for lack of demand for places but for lack of supply. The explanation lay partly in an internationally observed decline in the need for apprenticeship training and partly in the hostility of employers to the role played by the ministry of labour.

In 1984 the Zimbabwe Manpower Development Fund was created by means of a 1 per cent levy on the payroll of formal sector employees. It was to compensate employers for the costs of training. For instance, rebates from the levy fund are automatically available to cover the first two of the four years of apprenticeship training (King 1990:22). However, employers complained of excessive bureaucracy giving rise to reimbursement difficulties and of the narrow range of eligible training. Moreover, a large proportion of the fund was used to finance government training institutions (Kanyenze 1995:8).

With the payroll levy, the formal apprenticeship scheme and the technical schools and colleges, the array of training institutions in Zimbabwe is impressive. Nevertheless, it appears that neither market forces nor government interventions have provided an adequate quantity and quality of training in Zimbabwe. These deficiencies are not unique to Zimbabwe: training is a perennial problem everywhere. Market solutions tend to fail because firms are reluctant to invest in workers who might leave and because workers cannot afford to pay. Government interventions are often bureaucratic and uninformed and underfunded in relation to their objectives. The government technical schools and colleges in Zimbabwe suffer from all these problems. Probably there is a case for increasing the government resources for training, even if they come from general education. However, there is also a case for improving the use of existing training resources.

At independence political power was transferred to Africans, but economic power remained largely in the hands of non-Africans. The expansion of education and training after independence would permit the indigenisation of the economy but the new government was determined to hasten the process through a policy of affirmative action. The Constitution of Zimbabwe empowered the president to direct the Public Service Commission to aim for a representative public service, and a directive was issued in 1980. The policy was vigorously implemented.

It has been suggested that the efficiency of the public service fell over the 1980s on account of the affirmative action policy (Strachan 1993:145). However, public service efficiency is not amendable to measurement, and anyway the contribution made by affirmative action is difficult to isolate. It

was after all replacing a system of negative discrimination which restricted the pool of talent, public service numbers were expanding rapidly and there was *ad hoc* political interference in appointments. Moreover, with 5,000 experienced white officials leaving under an incentive scheme shortly after independence, it was inevitable that normal procedures for recruitment and promotion be lifted.

The same process of indigenisation occurred in the parastatals and the private sector. However, these employers were not bound by the presidential directive, and the pace of black advancement was slower. The politics of reconciliation and the potential harm to a fragile economy limited affirmative action in the private sector. The Zimbabwe government attempted to redress the racial imbalance in the private sector through exhortation and non-preferential legislation. The Labour Relations Act of 1985 made labour market discrimination unlawful. The ministry of labour had investigative powers but was insufficiently resourced to monitor firms effectively (Bennell and Strachan 1992:30).

The policy of affirmative action was understandable and predictable in the circumstances of Zimbabwe's independence. Nevertheless, the lesson to be drawn is that the policy can be pushed too hard and that it may have done harm as well as good to society. This experience highlights the need for education and training to level the playing field and, after the initial inevitable replacement of resigning staff, for normal adherence to the principle of promotion on the basis of merit (Strachan 1993:149, Gatherer and Erickson 1993:152). There is a need not only for legislation against labour market discrimination but also for a well-resourced enforcement body.

Wages and their determinants

As one of its first decisions, the newly elected government introduced a comprehensive national minimum wage in July 1980, at a time when many unorganised and spontaneous strikes and expressions of worker discontent were taking place. This minimum wage legislation was a potentially powerful policy tool as no fewer than 1,010,000 workers were then in wage employment, representing some 36 per cent of the labour force. The greatest impact occurred in 1980, when the minimum wage was initiated, and in 1982, when it reached its peak in real terms.

The period of rapid increase in the real minimum wage, 1980–82, was one of post-independence economic boom. It was followed by a period of drought and economic contraction, 1982–84. The real minimum wage was permitted to fall below its initial 1980 level in 1984. The establishment, in 1986, of the tripartite Wages and Salaries Advisory Board provided a formal consultative machinery on minimum wage policy. This institutional development had the effect of strengthening the hands of technocrats relative to politicians, and it gave the employers greater influence over wage policy

(Herbst 1990:218–20). This helps to explain why real minimum wages fell again after 1985. General statutory minimum wage setting effectively ended after 1988 and was replaced by a policy of encouraging collective bargaining through industrial councils in all sectors.

Basically the stagnation of real earnings for most of the 1980s reflects two things: the slackness of the labour market and rising unemployment; and restraint in minimum wage setting, as the technocrats in government gained influence. Bursts of inflation had a short-term depressing effect on the real wage, but we cannot be sure, from the econometric evidence, that inflation had any long-term effect on real earnings.

For much of the 1980s Zimbabwe had been 'living beyond its means'— the current account deficit (including factor payments) averaged 3.7 per cent of GNP between 1980 and 1989, and the budget deficit (net of grants) 8.0 per cent of GNP. With public debt increasing, neither was sustainable in the 1990s. The introduction of the ESAP in 1990 was intended to correct the imbalance. Part of the adjustment was directed at the labour market. It took the form of a reduction in the public-sector real wage bill, government withdrawal from direct wage setting in the private sector, a cut in the budget deficit and a fall in the exchange rate; all four mechanisms would tend to squeeze real incomes. Kanyenze (1995:21) cites a World Bank document: a fall in real wages is 'a brutal but necessary adjustment to reflect labour unemployment caused by a growing labour force that has outstripped job creation and the need to become internationally competitive'. The real depreciation of the Zimbabwe dollar after 1990 required that real wages be flexible downwards in order to secure and maintain a competitive advantage.

The benefits of this strategy were expected to accrue over time, in the form of increased employment in the tradable sector—an issue addressed below. The costs—in the form of reduced economic welfare—were immediate and severe. Between 1990 and 1993 average real earnings in the formal economy as a whole fell by 36 per cent. The collapse occurred in all sectors—both private and public—although the tradable sector mining was the least affected (24 per cent). There was only a slight reversal of real earnings in 1994 (a 2 per cent recovery overall). Although the drought in 1992 and consequent inflation were contributory, their effects were not noticeably reversed.

The majority rule government wished to reduce the extreme dispersion of wages that it inherited. Therefore, not only did the government have a minimum wage policy but also a maximum wage policy. Increases in statutory minimum wage were usually accompanied by regulations setting out the maximum increases in rates of pay. These were tapered according to the wage level. The policy succeeded in compressing the wage structure but not to the extent implied by the regulations. Owing to skill shortages and the high labour turnover among skilled workers, employers had incentives to circumvent the controls. They did so by means of promotions, allowances and secrecy (Shadur 1994:125).

The government pursued an egalitarian incomes policy throughout this period. It was successful in compressing the wage structure in the public sector. However, it achieved limited success in the private sector. The fall in real earnings in the lowly non-manual occupations (such as clerk and typist), both absolutely and relative to the unskilled wage, may well have reflected the labour market response to the increased supply of secondary-educated labour. By contrast, the occupations requiring higher education or professional training (such as engineer and company secretary) continued to be in short supply. Employers responded to the increased scarcity by raising pay in relative as well as absolute terms.

The policy of compressing the wage structure, so widening the ratio between private-and public-sector pay, created severe difficulties for the public services, especially at the technical, professional and managerial levels. The policy generated a brain drain from the public to the private sector; staff shortages and turnover became acute in accounting, programming, engineering, architecture, etc. (Kanyenze 1993:165–70). Falling morale and effort and rising absenteeism and moonlighting were predictable consequences.

The threat of a brain drain to other countries of the region emerged with the fall in real incomes of professional staff in the public sector. In particular, the large occupational income differences between South Africa and Zimbabwe became more compelling as South Africa moved towards majority rule. The prospect of renewed economic growth and expanded social services in South Africa produced a need for more professionals, including doctors, nurses and teachers at all levels. It was reported in 1992 that some 200 Zimbabwe doctors had moved to South Africa over the previous 18 months, whereas the Zimbabwe government employed only 567 doctors in 1989–90. The median salaries of chartered accountants, programmers, employed medical doctors, engineers and university lecturers in Zimbabwe were about half of South African median salaries (Knight 1993:290–91, tables 9.14, 9.15).

This is another example of a problem that often faces interventionist governments. The urge to intervene with some desirable objective in mind can backfire because the government does not adequately foresee the indirect effects of the intervention. An alternative was to harness market forces and to allow educational and training policies to increase the supply of skills sufficiently to compress the wage structure. This policy might nevertheless fail in the presence of a regional market for highly qualified personnel.

The liberalisation of the labour market in the 1990s could be expected to widen the wage structure. In the private sector pay in skilled jobs, both manual and non-manual, did indeed rise sharply in relation to pay in unskilled and lower clerical jobs. Although generally subject to collective bargaining in employment councils, the private sector responded to market forces. In the public sector, also, there was some widening, with technical jobs gaining

in relation to unskilled and administrative jobs. The widening of differentials within the public sector was the result of a policy decision. In the 1990s the Public Service Commission—recognising that valuable staff had to be attracted, retained and motivated—decompressed the civil service pay distribution. In 1995 civil service grades were restructured to allow for greater pay flexibility according to skill scarcity and individual performance. The reform was hampered, however, by political resistance to increased pay for top civil servants.

A survey of 200 industrial enterprises was conducted in Zimbabwe in mid-1993 (Gunning 1994). An earnings function analysis of the sampled employees yielded a number of interesting findings (Velenchik 1994). First, by international standards, wages in Zimbabwe remain very unequally distributed. The coefficient of variation of hourly earnings is no less than 1.40. A major reason for this great dispersion is the remarkably high returns to human capital, a reflection of scarcity. In a human capital earnings function with *ln (hourly earnings)* as the dependent variable, earnings are found to rise with employment experience to a peak after thirty-eight years, when the premium on experience is 400 per cent. The return to a year of education is no less than 16 per cent.

Another important result of the survey is the powerful effect of firm-size on earnings. Distinguishing four size groups (small: 1–10 employees; medium: 11–100 employees; large 101–250 employees; and very large: 250+ employees), the mean earnings are 2.38, 5.35, 7.15 and 10.72 Zimbabwe dollars respectively. It seems likely that some small firms ignore the legally binding minimum wage laid down in the relevant employment council agreement and that some large firms pay well above it. There is considerable evidence from the survey that the larger firms pay efficiency wages. The firm-size effect was weaker for less skilled workers and also when controls for labour quality were introduced, and large firms had lower labour turnover. Large industrial firms in Zimbabwe are characterised by internal labour markets. The small-firm sector, by contrast, not only paid lower wages but also employed less human capital and rewarded it less well.

Because some firms in manufacturing (and no doubt some other sectors) choose to pay efficiency wages that are above the market-determined level, we might expect real wages to be maintained in the face of economic recession and inflation. However, the evidence indicates that private-sector real wages generally fell over the period 1990–95. One explanation is that efficiency wages may be set relative to market-determined wages, i.e. the benefits to employers derive from the differential in wages and not from their level. These considerations are important to the issue of whether real wages will recover from their collapse since 1990.

Employment

The government was concerned not only to increase output but also to increase employment. Formal sector wage employment, especially outside agriculture and domestic service, generally offered higher wages than other economic activities, especially household farming. This generated political pressures to create more employment, particularly as the numbers of school-leavers burgeoned and urban unemployment rose. Over the 1980s formal sector employment increased by 180,000, or by 18 per cent. Slightly more than half of this (100,000) was in the public sector, mainly education and administration. To some extent, as in many other developing countries, the public sector was serving as a provider of employment and as a means of advancement for indigenous people. By comparison, the private sector was left alone in the politics of reconciliation.

One of the objects of the ESAP was to reduce the size of the public sector. In 1990 government embarked on a reform and retrenchment of the public service. The number of civil servants (excluding health and education) was to be reduced by 22,000 posts, i.e. by 25 per cent (including vacancies). By February 1995, 18,000 public service posts had gone, including 7,000 actual retrenchments (World Bank 1995b: 20). Public-sector employment overall declined slightly (by 1 per cent) over the five years, although a somewhat variable picture emerges according to the precise definition being used. However, real earnings fell dramatically in the public sector (by 39 per cent, compared with 25 per cent in the private sector), and this was the factor primarily responsible for the squeeze on the public-sector wage bill.

The events and policies of the 1990s had various effects on employment, making it difficult to isolate any particular contribution. In the short run, at least, the effect of the ESAP was to harm private-sector output, which dipped in 1992 and 1993. Similarly, the drought of 1992 contributed to economic recession. The change in relative prices associated with trade liberalisation and exchange-rate depreciation caused redundancies in some sectors, with the prospect of employment creation in the sectors which became more profitable. The budgetary component of the ESAP caused some retrenchments in the public sector, although the net effect on public-sector employment was tiny. According to our elasticity estimates, the substantial fall in real wages should have increased employment: by almost 5 per cent in the formal sector as a whole. Total formal-sector employment rose by 8 per cent between the second quarters of 1990 and of 1994, there being a rise of 14 per cent in the private sector. This growth is roughly half of what the authors of the ESAP had expected (Zimbabwe 1991:18). The jury is still out on the effects of the ESAP on employment in Zimbabwe, but the results so far are disappointing.

Prior to majority rule the policy of the state on matters of worker dismissal and retrenchment was one of non-intervention. By contrast, the new

government was predisposed to intervene. Between 1980 and 1982 the government acquired considerable powers over the retrenchment and dismissal of workers. These job security regulations were, on one view, 'among the most onerous prescribed anywhere' (Fallon and Lucas 1993:242). The government intervention on retrenchment could be expected to make employers reluctant to dismiss workers but also reluctant to recruit workers who might need to be dismissed in the future. Fallon and Lucas (1993) argued that job security regulations reduce employment, partly because they increase adjustment costs and partly because they reduce efficiency. Greater job security reduces employees' incentives to be productive and employers' ability to choose and keep productive workers.

Fallon and Lucas (1993) used econometric methods to estimate the employment effects of the employment protection legislation. It is possible to quibble with their estimates and interpretation, but they found a powerful long-run effect: on average the legislation had reduced employment by 25 per cent in the industrial sector. Moreover, there was attitudinal evidence, based on a survey of employers, that the regulations served as a deterrent to employment (Hawkins *et al.* 1988: table 3.17). This appears to be another example of government intervening in a well-meaning way but having a harmful rather than a beneficial impact because of unforeseen general equilibrium effects. The employment regulations were effectively withdrawn in 1990. The immediate effect was to permit retrenchments associated with the ESAP, but the evidence suggests that in the long run their withdrawal will be a spur to employment.

The labour force and its absorption

The labour force grew from 2.59 million in 1980 to 3.80 million in 1990 (Zimbabwe CSO 1989a, table 2.16, Zimbabwe CSO 1989b: appendix A, table A,). By contrast, formal-sector employment grew from 1.01 million to 1.19 million. The annual percentage growth rates were 3.9 and 1.7 per cent respectively. The labour force grew on average by 122,000 per annum, whereas formal-sector employment grew by 18,000. How were the residual 104,000 additional workers absorbed into the economy each year? In the 1990s the equation has become worse. How can productive employment be found for the labour market entrants?

The national household surveys of 1984–85 and 1990–91 show a very considerable difference in average household per capita income between urban and rural areas. The income per capita of urban households was 3.5 times that of households in the rural areas (mainly the communal lands) in 1984–85, and 3.6 times in 1990–91 (Zimbabwe CSO 1988, 1994b). The Zimbabwe labour market is best seen as one in which the preferred non-agricultural formal-sector jobs are rationed by employers and the residual labour force is absorbed into open unemployment or the free-entry informal

sector. The glittering urban prizes can be expected to attract migrants from the rural areas and so generate unemployment and an urban informal sector.

Unemployment is largely an urban phenomenon. According to the 1986 labour force survey, it was 18 per cent of the labour force in urban areas. Urban unemployment (on similar definitions) rose from 18 per cent to 26 per cent between 1986 and 1990–91, and from 7 to 11 per cent for the country as a whole (Zimbabwe CSO 1989b: appendix A, tables A, D, E, 1994b: table 2.8). The unemployment rate was extremely high for those aged under 25 and for secondary school-leavers. If the data were available, they would probably show unemployment to be well over 50 per cent for educated young people in the urban areas. Even if this unemployment is transitory, one cohort of school-leavers is replaced with another, larger cohort. It is always difficult to measure unemployment, partly because there are many dimensions, which a single statistic cannot capture. However, the evidence is consistent with the claim that there is a trend rise in unemployment in Zimbabwe.

The policy of national reconciliation after the civil war and the government s espousal of socialism meant that control of the private sector remained largely in non-African hands and that opportunities for African advancement were concentrated in the expanding public sector. By 1990 the collapse of the socialist bloc, the failure of African socialism elsewhere and the pressure for market reforms from the international financial institutions caused the state to abandon its socialist approach. Moreover, the introduction of the ESAP in 1990 meant that the formal sector, and in particular the public sector, was unlikely to provide jobs and opportunities on an acceptable scale. There were also demands from the group of existing and incipient black entrepreneurs for government encouragement and support of black enterprise. Middle-class frustration was perceived to be a danger to the state. The government responded to these pressures by formulating a policy of indigenisation (Raftopoulos and Moyo 1995).

The Indigenous Business Development Centre (IBDC) was launched in 1990, to press for more black participation and control. It has a membership of 4,000 enterprises. In 1992 the government set aside 150 million Zimbabwe dollars for black business people (Raftopoulos and Moyo 1995:28). The government report on indigenisation proposed measures to assist informal-sector business—such as the subcontracting of 30 per cent of government tender work to small firms and an increase in the subsidised credit provided by the Small Enterprise Development Corporation (SEDCO)—as well as measures to advance indigenous management in the formal sector (Zimbabwe 1994a). Other things being equal, we would therefore expect informal-sector growth to have been more rapid after 1990 than before.

We rely on two nationally representative surveys of small enterprises that were carried out in 1991 and 1993. The surveys covered unregistered (i.e.

informal sector) micro and small non-agricultural enterprises (MSEs) marketing the majority of their output. Through extrapolation from a stratified cluster sample of 1991, it was estimated that there were 868,000 MSEs employing 1,351,000 workers (McPherson 1991, revised by Daniels 1994:10). Thus employment in the non-agricultural informal sector exceeded that in the formal sector (1,244,000 workers).

The number of MSEs grew by 9 per cent and their employment by 14 per cent between 1991 and 1993 (Daniels 1994:10). Thus, the informal sector provided more opportunities for the absorption of labour market entrants than did the formal sector. Is this expansion a sign of success or failure? Distinctions can be drawn between demand-pull and supply-push factors, and between high-income dynamic activities and low-income free-entry activities. The evidence from the surveys suggests that on the whole the expansion is a sign of failure: most of it occurred in free-entry activities offering relatively low incomes, such as trade in farm products, crocheting and knitting.

If the population of the communal lands grew at the national rate (3.14 per cent per annum) between the census years 1982 and 1992, then population density in the communal lands increased by 36 per cent over the decade as their population grew by 1.4 million (Zimbabwe CSO 1994a: table 2.2). According to the Rukuni Commission on land tenure, as the population of the communal areas had grown, so people had resorted to farming less fertile and more fragile areas. It found that 'there are over three times as many people now living in the communal areas as their environment can sustain' and that 'land resources are overutilised and their condition is deteriorating at a high rate (Zimbabwe 1994b, vol. 1:27, 28, 36).

As in many developing countries, rural households in Zimbabwe would be able to raise their incomes and spread their risks by diversifying into other activities. There are two main possibilities: non-farm self-employment and migration. The number of rural MSEs implies that 45 per cent of rural households ran an informal non-farm business in 1991 (Daniels 1994:10, Zimbabwe CSO 1994b: 80). However, this may be misleading. The extremely low contribution of income from household enterprises (other than agriculture) to household cash income (3.2 per cent) and total income (1.5. per cent) in the communal lands in 1990–91 suggests that most rural households' non-farm activities were pitifully small (Zimbabwe CSO 1994b: table3.1a).

Workers from farming households often participate in formal-sector employment while remaining part of the household. This takes the form of seasonal migration to commercial farms and longer-term migration to commercial farms, mines and urban areas. A high proportion of households in the communal lands have long-term absentee members. The Rukuni Commission, in a survey of six communal areas in 1989–90, found that 26 per cent of household members were non-resident, that 60 per cent of households had at least one non-resident member ('members' being defined

214

as persons considered by the respondent to be household members) and that 24 per cent of household gross income was received from remittances (Zimbabwe 1994b: tables 11.1, 11.10). However, it may well have become more difficult over time to obtain migrant employment.

A comparison of the two national household surveys suggests that the real income of rural households improved by some 17 per cent between 1984–85 and 1990–91. It can be shown that this was not due to a comparison of bad and good harvest years and that it was not due to improvements on the farms. Although farm income is extremely volatile, the long-run trend in real farm value added per capita in the communal lands has been downwards—by 4 per cent per annum—since 1980. If real income did rise, as the surveys imply, it is because non-farm sources of income improved. This is a crucial issue for Zimbabwe, yet the evidence remains hazy and inconsistent.

The urban informal sector in Zimbabwe is small in relation to those in comparable African economies. This reflects more than the repressed state of the informal sector prior to 1980. It is also due to the relatively advanced formal sector, associated with non-African entrepreneurship and the Westernisation of tastes, and the remaining obstacles to urbanisation and to entry to informal-sector activities.

Nevertheless, the 1980s saw two important urban informal-sector developments. One is the growth of informal manufacturing, for instance furniture-making, repair services and tailoring, assisted by the relaxation of rules concerning the establishment of small enterprises and the weakness of formal-sector competition. Secondly, rural-urban migration and the growth of urban unemployment pushed more people into free-entry informal-sector activities. The informal sector is therefore heterogeneous, ranging from profitable small businesses protected by various entry barriers to low-income activities characterised by underemployment. The small businesses also generated wage employment, often paying wages below the statutory minima. The free-entry self-employed and these wage-employed workers—predominately women and youth—constituted the urban poor.

Before independence restrictions on urban residence prevented Africans from working in town unless they had legal residence and proof of a job. The obstacles were relaxed with the advent of majority rule. Nevertheless, the growth of urban population was not particularly rapid over the inter-censal decade 1982–92. The 1992 population census implies an inter-censal increase in urban population of 5.2 per cent per annum: the urban population rose from 26 to 31 per cent of total population (Zimbabwe CSO 1994a: 24 and table 2.3). The pace of urbanisation remains constrained: government has blocked the establishment of shanty towns near urban areas and continues to enforce the vagrancy laws. This has put a brake on the development of an urban free-entry informal sector.

A survey of small enterprises in Zimbabwe was conducted in 1984 (Moyo

et al. 1984, reported in Zimbabwe, Ministry of Labour 1989). It did not include free-entry activities such as petty trading which were seen as a receptacle for residual labour rather than as productive. The self-employed in this sample were distinctly different from the unemployed as revealed in the 1986 labour force survey. The self-employed were older and less educated: 13 per cent of them were aged 15–24 and 35 per cent had more than grade 7 education, whereas the corresponding figures for the unemployed were 60 and 54 per cent respectively. Contrary to the predictions of probabilistic migration models, this informal sector does not appear to be a stepping stone to the formal sector. No less than 80 per cent of reporting respondents entered it from the formal sector, and only 20 per cent came from unemployment or rural work. Thus the formal sector is generally the stepping stone to the informal sector, possibly because it provides experience and capital. These results suggest that this productive part of the informal sector may not be easily entered by the educated unemployed youth.

The nationally representative survey of 1991 throws further light on urban MSEs. The number of urban MSEs (255,000) implies that 35 per cent of urban households ran an informal sector business (Daniels 1994:10). Their most commonly cited problems were raw materials and stocks (27 per cent), finance (25 per cent) and markets (21 per cent). The lack of training and credit was striking: 75 per cent had never received training, 89 per cent had never received credit and 10 per cent had received credit only from family and friends (McPherson 1991:25–28). The majority of MSEs made low profits in easily entered activities. In 1993, 88 per cent of MSEs secured income for their proprietors which was below the average formal sector earnings from non-agricultural employment, and 67 per cent were below even the minimum wage for domestic servants (Daniels 1994:24–25). To a considerable extent the urban informal sector serves as a residual sponge to absorb surplus labour; only a part of it can be regarded as productive.

The appropriate training of would-be entrepreneurs stands out as a serious but unresolved problem. It appears that much training cannot be left to the market owing to capital market imperfections, informational imperfections, the free-rider problems facing existing firms and the high risks involved. With little government intervention, little has happened. In an ILO survey of the training needs of entrepreneurs, only 6 per cent of the entrepreneurs interviewed had received training related to their business. The authors concluded that 'there appears to be a lack of interest and commitment by government to provide technical and vocational training opportunities to informal sector entrepreneurs' (Siddiqui and Nyaguru 1993:26, 34). Another ILO report (Siddiqui and Matare 1993) concluded that current training efforts in Zimbabwe were reaching only an insignificant proportion of school-leavers. Although the system of youth training centres (YTCs) had been set up in 1981 to help rural school-leavers to gain artisan skills for self-employment, this was a drop in the ocean.

Lessons for South Africa

Zimbabwe and South Africa share a number of relevant labour market features and differ in others. They share the problem posed by the rapid growth of their populations and of their labour forces. The labour force in Zimbabwe grew by 2.8 per cent per annum between 1980 and 1993, and in South Africa by 2.7 per cent (World Bank 1995a: 210). Each country needs to absorb its growing labour force into productive economic activities. The formal sector of the economy has failed to employ the majority of new workers, leaving the others to be absorbed into open unemployment or informal activities. Part of the latter (traditional agriculture and free-entry services) serves as a 'residual sponge' characterised by poverty and underemployment. There is an income gap between these sectors, i.e. between those who are employed in the formal sector (more accurately, the 'bargaining sector') and those in self-employment, casual wage employment and unemployment (which can be referred to as the 'residual sector'). In both countries this income disparity is considerable and deserves policy attention.

Unless the rate of economic growth accelerates greatly, it is unlikely that the response of real wages to government policies of wage restraint will be sufficient fully to overcome the structural unemployment and poverty stemming from the rapid growth of the labour force. This growth rate is itself a long-run policy variable. With the transfer of political power, family planning issues have become deracialised. There is now a strong case for determined family planning policy—providing information, facilities and subsidies—to be implemented in both Zimbabwe and South Africa. This would reduce the future growth of the labour force, albeit with a lag of some two decades.

Both new governments inherited a labour force poorly endowed with human capital, reflecting the racially motivated policies of the past. Associated with the shortage of human capital is the extreme dispersion of earnings in both countries. They differ, however, in that the South African government starts from a larger base but, in the case of black education, with a poorer quality of schooling; improvements in quality may have to precede the expansion of quantity. Education is characterised by externalities and informational and capital market imperfections: the market cannot substitute for government. Addressing the problems posed by the poor quality and quantity of education and training is a crucial government responsibility in both countries.

The new South African government has inherited a political economy similar to that faced by the Zimbabwe government in 1980: high expectations for economic improvement among the newly enfranchised electorate and powerful pressures for egalitarian redistributive policies. But there are trade-offs to be considered. In both countries government has to weigh the benefits of short-term redistribution against the benefits of long-term economic growth.

217

The differences between the two countries are no less relevant. First, South Africa has a much more developed, semi-industrialised economy. Its income per capita in 1988 was 3.5 times that of Zimbabwe (World Bank 1990:178). In its economic structure, in the maturity of its institutions and in the nature of its economic problems, it has more in common with other semi-industrialised ('upper-middle-income' in the World Bank's terminology) countries than with Zimbabwe (Knight 1988). Second, South Africa's political economy differs from Zimbabwe's in one profound respect. The international ideological and policy climate changed dramatically between the early 1980s and the mid-1990s, in favour of less government intervention and greater reliance on domestic and global market forces. Had democratic rule been achieved in South Africa in 1980, the policy options would no doubt have appeared very different from those which face the government today.

No less than 50 per cent of the economically active population of South Africa were in formal sector employment in 1985 (South Africa CSS 1990:7.5, 7.6): the labour force was as much proletariat as peasant. The trade union movement grew to considerable strength over the past decade and was closely aligned to the African National Congress in the liberation movement. Unlike the Zimbabwe unions at the time of independence, the South African unions were a force to be reckoned with.

The wage policy dilemmas that are posed by the bargaining sector—residual sector divide in each country can be illustrated by Figure 10.1. The total labour force, LL', is shown on the horizontal axis. Employment in the bargaining sector is measured rightwards from L and residual employment is measured leftwards from L'. The vertical axis measures the returns to labour. The curve D_b shows the demand for labour, given by its marginal product, in the bargaining sector. The curve MPL_r shows the marginal product in the residual sector and APL_r the corresponding average product. Assume a bargained wage of w_1. Employment in the bargaining sector is LL_1 and residual employment is $L_1 L'$.

In Zimbabwe the relatively unskilled real wage has fallen in recent years; in South Africa it has risen. How can we assess a change in the bargained wage, say a fall from w_1 to w_2? Employment in the bargaining sector increases to LL_2. The area $C+D+E$ indicates the efficiency gain: the increase in output in the economy on account of the difference in marginal products. The area $B+C$ indicates the gain to profits, the rectangle B the loss to existing bargaining sector workers and the rectangle D the gain to workers who transfer between the sectors (the difference between APL_r and w_2). Those remaining in the residual sector $(L_2 L')$ benefit from the higher average product, denoted by the rectangle F.

The effect of the wage cut on overall welfare depends, *inter alia,* on the following:
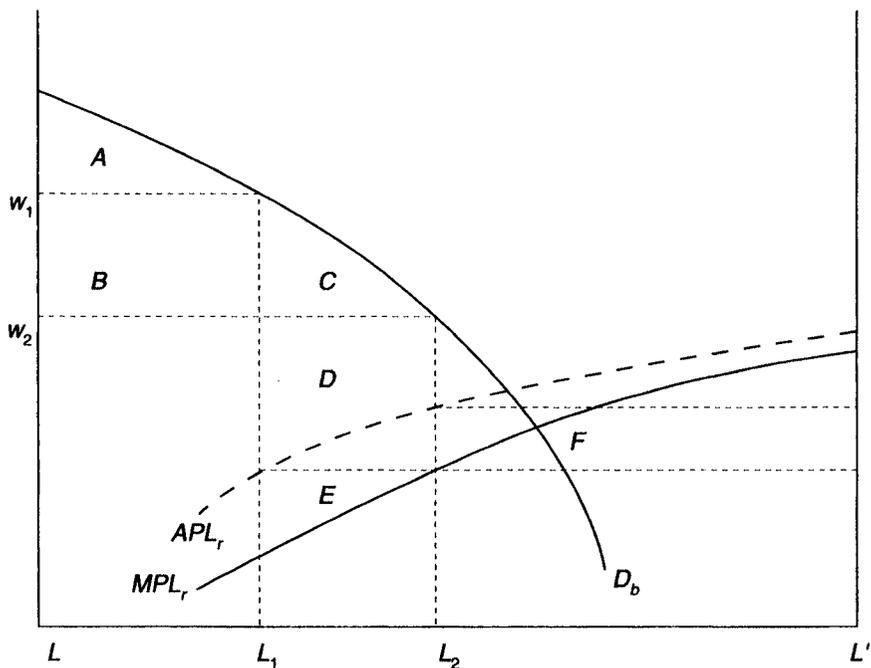
Figure 10.1 The effects of wage policy on economic welfare

1   The slope of the curve D_b, i.e. the long-run elasticity of the demand for labour in the bargaining sector. This reflects the substitutability between labour and other factors, the substitutability between labour-intensive and other industries and the strength of efficiency wage effects.
2   The relative welfare weights to be attached to income changes for the three income groups—the (rich) profit-recipients, the existing wage-earners and the (poor) residual sector workers, both those who transfer to the bargaining sector and those who remain.
3   The extent of informal redistribution among the three income groups, for instance from wage-earners to residual sector households.
4   Dynamic effects, e.g. any effects of these changes on saving, investment and human capital formation.

This simple and abstract analysis is useful because it clarifies the relationships that should concern policy-makers. Differences in relationships may require different policies in the two countries. The countries differ in the level of the bargained wage (higher in South Africa), in the relative size of the two sectors (the bargaining sector being smaller in Zimbabwe), in the elasticity of the demand curve in the bargaining sector (probably higher in Zimbabwe on

account of the importance of commercial agriculture) and in the extent of informal redistribution (rural-urban links are probably weaker in South Africa).[3] These differences cannot provide a clear-cut explanation for the contrasting wage policies. Differences in the social welfare functions of the two governments may be more important, underlying which are the strength of the trade union movement and its relationship with government.

There are probably three main labour market lessons that South African policy-makers can heed from the Zimbabwean experience. First, policies to promote human capital accumulation are important to secure both efficiency and equity objectives. Such policies extend beyond education to formal training and to informal skill acquisition, e.g. encouraging and setting up small entrepreneurs so that they can learn by experience. In all countries training is prone to both market failure and government failure, the former because incentives or funds are lacking and the latter because information about needs is poor and bureaucracy is inflexible. The object is to devise institutions and arrangements that provide both incentives and opportunities for employers and workers to invest in productive human capital. Not all the inequality in earnings is due to scarcity of human capital. Part is due to the racially based labour market policies of the past, including preferential access to jobs that provide opportunities for skill acquisition. These latter inequalities can be rectified both as attitudes change and through government policies.

Second, there are dangers that anti-market interventions, although intended to improve on the market, will be thwarted by unintended general equilibrium effects. A good example of this in Zimbabwe is the strict provisions against the retrenchment of labour which had the unexpected consequence of reducing employment. Another is the attempt to compress the wage structure by decree which had the unanticipated effect of creating misallocation and disincentives. Such experiences suggest the need for effective tripartite consultation between the government, workers and employers, of the sort that was conspicuously absent in Zimbabwe in the first years of majority rule but was introduced in the late 1980s.

The third lesson concerns the relationship between the government and the trade union movement. The poorest group in society are outside the formal sector. It is in the interests of the poorest—the unemployed and the underemployed—that real wages should not be allowed to rise sharply in the formal sector. At some time the South African government—in representing the current and the future poor—may wish to restrain the power of the trade unions. This could be done with political ease, at least for a time, in Zimbabwe; it would not be so easy in South Africa. Yet without trade union acceptance of real wage restraint the prospects for the long term alleviation of poverty in South Africa are dimmer. It is notable that the South African government, in recently opting for trade liberalisation, is indirectly introducing a form of wage policy. In the short term competition from

imports, especially from the dynamic Asian exporters of manufactures, may threaten jobs; in the long term it will impose discipline on collective bargaining.

The basic problem facing Zimbabwe and South Africa—how to provide productive employment for the growing labour force—is faced also by most other countries in the region. Part of the problem stems from labour market inflexibility. Some of this inflexibility is not amenable to policy—arising, for instance, from the nature of technology or employer behaviour. Other rigidities reflect institutions and government interventions which could be changed. In these cases it is worth posing the question: would the freer operation of market forces result in an improvement? This normative question has both efficiency and equity dimensions; both must be addressed.

Notes

1 It contains the empirical evidence which, owing to lack of space, cannot be presented here.
2 We are grateful to the British Overseas Development Administration for financial support under ESCOR grant R5,823.
3 In each case the country mentioned in brackets has the stronger case for wage restraint, *ceteris paribus*.

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221

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Part III

COUNTRY STUDIES

11

THE IMPACT ON BOTSWANA'S ECONOMIC PROSPECTS OF THE ENDING OF APARTHEID

Charles Harvey

Introduction

During the first twenty-five years after the country became independent in 1966, Botswana was the worlds fastest growing economy.[1] GNP per capita grew at an average annual rate of 8.4 per cent from 1965 to 1990; the second fastest growing economy by this measure was South Korea at 7.1 per cent, while Sub-Saharan Africa's per capita income barely grew at all (average annual growth was 0.2 per cent). It would be difficult, therefore, to sustain an argument that economic growth in Botswana was constrained by apartheid in South Africa. Indeed, the era of rapid economic growth in Botswana ended at about the same time as the end of apartheid, as shown in Table 11.1, but it would be equally difficult to argue that the ending of apartheid was bad for Botswana's economic prospects. Economic growth slowed right down for a number of other reasons, which had nothing to do with events in South Africa. Diamond revenues reached a plateau after many years of dramatic growth; a construction boom came to a sudden halt; and a large depreciation of the Zimbabwe dollar reversed the growth of non-traditional exports. These events happened to coincide with each other and with the beginning of the political transition in South Africa.

Table 11.1 Economic growth in Botswana, before and after apartheid (per cent)

	1970–80	1980–91	1991–95
Annual average growth of GDP	14.5	9.8	1.7

An alternative possibility is simply that apartheid was largely irrelevant to the Botswana economy. It will be argued, however, that apartheid had some important effects on Botswana, both positive and negative; and that

some changes can be expected from the change of regime, most notably from the return of South Africa to normal international political and economic relations.

The economic impact on Botswana of apartheid

The Botswana governments hostility to the South African government, and therefore to Namibia which was controlled by South Africa, had some costs, as did the Botswana governments related hostility to the white minority government in Rhodesia before 1980. The most notable costs were the problems created by political refugees, and cross-border raids by the South African army in purported pursuit of African National Congress (ANC) activists (purported because some raids appeared to be motivated more by imminent elections in South Africa than by serious action against the ANC, which was never allowed to undertake military activity in Botswana).

The refugee problems caused by the war in Zimbabwe, hostilities along the Zimbabwe border and the related spread of foot and mouth disease across the border as Zimbabwe controls deteriorated, were until 1980 arguably more costly than those caused by the influx of refugees from South Africa. Indeed, the Zimbabwe war was mainly responsible for the creation of the Botswana Defence Force; until 1978 Botwana had no army. Nevertheless, the costs of refugees from South Africa were not negligible, especially after the Soweto uprising in 1976.

Although Botswana did 'more to implement sanctions against Rhodesia than many members of the United Nations had dared to suggest' (Hermans 1973:200), and steadfastly opposed apartheid in international forums, there were always clear limits to the country's defiance of its neighbours. The combination of being land-locked with its total dependence on transit across neighbouring terrritories for international trade, and of having lengthy indefensible borders, always meant that Botswana had to rely on diplomacy and a pragmatic attitude to its neighbours.[2]

The development of diamond mining reduced dependence on transit routes for the majority of exports by value, because diamond exports can easily be transported by air; but transit facilities remained necessary for beef exports (fundamental to rural prosperity), copper-nickel exports (the country's largest single employer) and nearly all imports. Botswana therefore restrained its overt hostility to the apartheid government because of the pragmatic requirements of economic survival, with evident success.

This pragmatic approach is clearly demonstrated by Botswana's attitudes to membership of the Southern African Customs Union (SACU) and the Rand Monetary Area (later the Common Monetary Area). Botswana chose to remain a member of SACU, despite this meaning that the common external tariff was determined unilaterally by South Africa and that there was no mechanism for allocating investment to SACU's smaller members. Instead,

Botswana played a major role in renegotiating the SACU revenue formula in 1969, with strongly positive effects on Botswana's share of customs union revenues. Thereafter, Botswana was active in demonstrating that South Africa gained significantly from SACU when the South African government complained of the high cost to its own revenues of the formula. This probably postponed renegotiation of the revenue distribution formula, so that Botswana continued to benefit.

On the other hand, Botswana did leave the Rand Monetary Area and create its own monetary system, despite the attraction offered in the mid-1970s of a share in the profits of the rand note issue. However, this was not done until ten years after independence, in strong contrast to most other African countries which created their own central banks immediately after independence. Botswana waited until the recurrent government budget was no longer dependent on British grants-in-aid. Great care was then taken in using the policy instruments made available. Most notably, the nominal exchange rate was moved upwards, lowering domestic inflation below that of South Africa but without allowing any significant alteration in the bilateral real exchange rate.

It could be argued, in fact, that Botswana gained in some ways from its proximity to South Africa. Foreign perceptions of Botswana were exceptionally positive, because of the contrast between its clearly democratic and non-racial institutions on the one hand, and those of apartheid on the other hand. Most dramatically, Botswana received extraordinarily high amounts of Official Development Assistance (ODA). Countries with small populations tend to receive above average ODA per head of population, but Botswana received more than most other small countries, and continued to receive above average ODA per head long after rapid economic growth had transformed the economy from one of the world's poorest to a middle-income economy. For example, in 1989 'net disbursement of ODA from all sources per capita' was US$133, the second highest of all World Bank members with populations above one million; only Israel received more, also for political reasons, since Israel was classified as a high-income economy (World Bank, 1991:243). Yet in 1989, Botswana's GNP per head was already US$1,600, nearly five times the average for Sub-Saharan Africa.

It seems probable that many donors, frustrated by their inability to have much influence on the policies of the South African government, found that they could at least be generous with aid to Botswana. However, this cannot have been the only reason for Botswana's relatively high aid receipts, because Botswana attracted more foreign aid per head than the equally small Lesotho and Swaziland. Botswana's success requires additional explanation therefore. The most important further factor, evident ever since independence, was Botswana's efficient and transparently accountable use of aid finance: government expenditure was always carefully planned, with proper attention

to the recurrent future expenditure necessary to maintain and make full use of capital spending, and corruption was minimal.[3]

It is also arguable that some foreign investment was attracted to Botswana for essentially negative reasons, namely the avoidance of apartheid South Africa. However, sanctions-busting investment was never significant in Botswana, as it was for example in Swaziland. The evidence supporting this point is the transfer of a large number of foreign investments from Swaziland to South Africa in recent years, something that apparently did not happen at all in Botswana. Such foreign investment in Botswana as could be regarded as apartheid-avoiding was mostly small scale, by individuals, and was only a very small proportion of total foreign investment. The more significant small-scale investment from individuals originating in neighbouring countries was from Zimbabwe, attracted by the availability of imported inputs in Botswana with its liberal foreign-exchange controls, and by access to Zimbabwe for exported outputs under a bilateral trade agreeement.

In absolute terms, by far the most important source of direct foreign investment in Botswana was South Africa itself, most notably in diamond mining, copper-nickel mining (initially in partnership with an American corporation) and, to a lesser extent, in manufacturing (for example the largest brewery) and services. For many years, the only large-scale foreign investment in Botswana which was not from South Africa was in banking; the two largest and dominant commercial banks were British, but originally they were simply branches of British-owned banks in South Africa, and recent commercial banking investment has also been from South Africa.[4]

The economic impact on Botswana's economic prospects of the ending of apartheid

Because Botswana maintained normal economic relations with South Africa during the apartheid era, it might be expected that the ending of apartheid would make relatively little difference. Some changes can, however, be expected.

Southern African Customs Union

The new government in South Africa is clearly concerned about the increased cost of the revenue sharing formula in SACU. Very approximately, Botswana receives a revenue share based on total Botswana imports as a proportion of total SACU imports, multiplied by a factor of 1.42 to compensate for the various disadvantages of SACU membership. It has been argued that the multiplier does not compensate even for the delay in receiving increased revenue when imports are increasing (which they have, massively). It has also been argued that SACU benefits South Africa as much as it benefits Botswana, because South African gains previleged access to Botswana's

market for a wide range of goods and services which would be uncompetitive without the protection provided by the SACU common external tariff. Nevertheless, it seems likely that South Africa would never have agreed to the 1969 formula if the government at that time had had any conception of how fast the Botswana economy would grow. Throughout the 1980s, the apartheid government complained periodically about the cost.[5] Renegotiation of the agreement only began, however, under the new South African government. At the time of writing, these negotiations were still in progress, having taken much longer than expected. This indicates that agreement was proving difficult, but the fact that negotiations were not abandoned suggested that agreement would eventually be reached.

It was expected that the revenue distribution formula would be less generous to the smaller members (Botswana, Lesotho, Namibia since 1990 and Swaziland), that the smaller members would have a greater say in customs union policy, and that the free trade which currently exists between members would be maintained. For Botswana, it is the latter that matters most. Although customs union receipts reached 50 per cent of government revenue in the mid-1970s, they have subsequently been overtaken by diamond revenues. Mineral revenue was 52 per cent of total government revenue in 1994–95, while customs revenue was only 15 per cent.

Defence spending

It might have been expected that the ending of apartheid, together with a peaceful settlement in Namibia, would enable Botswana to reduce defence spending. In practice, defence spending increased rapidly throughout the 1980s and continued to increase in the 1990s, apparently completely unaffected by any political changes in neighbouring countries. A military airport was built, with subsequent purchases of military aircraft. The high running costs of both airport and equipment added hugely to the defence budget without there being any apparent rationale. Botswana has no military enemies. Moreover, the country is not easily defended, whatever the level of military spending, because there are few natural barriers along its borders, and because the Botswana population is so small. There were reputed to be more military personnel at times in the South African Defence Force than the entire adult male population of Botswana.

Migrant labour

There was a possibility that the new South African government would reduce the inflow of migrant workers from regional countries, mainly to work on the mines, in order to make those jobs available to South African workers. However, higher wages would have to be paid. Real wages were sharply incrased in the early 1970s, in order to reduce South Africa's dependence on

foreign migrant workers. This was successful, in that the proportion of foreign mine workers fell from about 90 per cent to about 50 per cent. Clearly, a comparable increase would be necessary to induce even more South Africans to work on the mines. Unemployment in South Africa has been reported to be above 40 per cent for some years, without any increase in the proportion of South Africans working on the mines. A large wage increase seems unlikely because of extreme pressure on the gold mines to reduce costs, and because dependence on foreign migrant workers appears less risky since the ending of apartheid and therefore reduced hostility among neighbouring countries. In practice, the number of migrant mine workers from Botswana has been declining for many years, starting before the ending of apartheid, with recruitment only of experienced workers (returnees). This trend continued in the 1990s.[6]

Cost of expatriates

A final factor concerns the cost of expatriate labour in Botswana. The proportion of expatriates in the labour force fell from about 12 per cent at its peak in 1968, to about 2.5 per cent in the early 1990s. Because of extremely rapid growth of total employment (roughly tenfold), the absolute number of expatriate employees in 1994 was some two and a half times higher than in 1968. Although many of these expatriates were from South Africa, especially in the private sector, there was some tendency to prefer expatriates from other countries for political and ideological reasons, despite higher costs. The ending of this bias could reduce Botswana's costs, to the extent that South Africans replace non-Africans. Presumably experienced Africans, from countries with lower wages and much worse economic conditions, will continue to be recruited. On the other hand, the ending of apartheid could induce a brain drain from Botswana to South Africa, a problem which did not exist at all previously.[7]

Prospects for non-traditional exports

Meanwhile, Botswana's economic prospects depend heavily on the growth of non-traditional exports. The era of rapidly increasing diamond exports cannot continue unless a major new mine is discovered. A fourth production line at Jwaneng has been developed, and the doubling of production at Orapa has been announced which when completed will make Orapa the world's biggest diamond mine. Nevertheless, even these large developments cannot have as large a relative impact as the earlier mining developments, because of the huge growth in the Botswana economy since then. Moreover, although the spending (and lending) of diamond revenues, which also generated a large part of the rapid economic growth, can continue for a few years out of accumulated financial surpluses,[8] the overall budget is forecast to move into

deficit for the first time in many years in 1996/97 (Bank of Botswana 1995: S60). Future economic growth, although almost certainly slower than previously, will nevertheless require imports because the Botswana economy is so import-dependent. Very little development can be based on the small domestic market. In other works, future growth depends on developing non-traditional exports of goods and services.

In the 1980s, manufacturing exports grew very fast. Excluding beef products, which are really one of the trio of traditional exports (with diamonds and copper-nickel), manufactured exports grew at 8 per cent annum from 1981 to 1990. The principal export market was Zimbabwe, which took some two-thirds of manufactured exports, with South Africa taking 25 per cent. This distribution changed fundamentally in the 1990s, when the Zimbabwe dollar depreciated rapidly. Much of this export trade was in clothing and textiles; exports of these products fell by nearly 40 per cent in 1992, from 123 million Pula to 77 million Pula. It seemed probable that this whole sector had been based on the combination of an artificially overvalued exchange rate in Zimbabwe, the Botswana—Zimbabwe Trade Agreement and investment from Zimbabwe attracted by liberal foreign-exchange controls in Botswana (as already noted above). Two of these factors ended with the Zimbabwe structural adjustment programme, which devalued the Zimbabwe dollar and liberalised the foreign-exchange market.

However, somewhat against expectations, and despite the closure of many textile firms, textile exports had recovered and exceeded their previous peak by 1994. This remarkable display of adaptability depended crucially on access to the South African market under the SACU rules. Basically, many textile firms survived by proving to be sufficiently competitive to switch successfully to exporting to South Africa. This demonstrated very clearly the enormous importance to Botswana of maintaining free trade with South Africa, whatever happens to the SACU revenue formula.

It is possible that the large cost to Botswana of buying expensive South African goods, protected by the SACU common external tariff, will be reduced. South Africa has joined GATT and is committed to reducing its tariffs. This will reduce the SACU revenue pool and therefore Botswana's share of that pool. It will also reduce Botswana exporters' competitive advantage in the South African market by reducing protection in the entire SACU area. On the other hand, Botswana suffered from paying higher prices in the South African market for imports, because of the protection offered by the SACU common external tariff; indeed, it has been argued that this effect completely offset the gains from the 1.42 multiplier.

Although the liberalisation of trade policy in South Africa began before 1990, and continued through the subsequent political changes, it can be argued that South Africa's acceptance into the World Trade Organisation would not have occurred without the ending of apartheid. Potentially, of all the changes arising from the ending of apartheid, the liberalisation of South

Africa's international trade with the rest of the world could have the largest impact on Botswana. The net effect on Botswana depends most crucially on whether Botswana producers respond positively to greater international competition or lose their recently won markets in South Africa.

Economic recovery in South Africa?

The other potentially important factor is that the ending of apartheid could end the long period of economic stagnation in South Africa. From 1980 to 1994, the South African economy grew by a total of only 16 per cent. In the five years to 1994, it did not grow at all. Whereas in 1970, some 90 per cent of those entering the labour force found jobs in the formal sector, by the 1990s less than 10 per cent were finding formal-sector employment.

A considerable part of the reason for South Africa's economic stagnation was the economic isolation imposed by many countries, in particular trade and financial sanctions. The role of trade sanctions was not entirely clear; much trade continued, although there was some cost to getting round sanctions. Financial sanctions, combined with commercial caution, forced South Africa to borrow increasingly short in the first half of the 1980s. This led to the 1985 debt crisis, which in turn contributed to low growth thereafter, as did the drying up of direct foreign investment. More generally, lack of both domestic and foreign investment limited the capacity of South Africa to respond to trading opportunities.

The rate of economic growth improved slightly in 1995, to an estimated 4 per cent, but clearly it would be premature to identify this as indicating a lasting recovery. Foreign investors are not yet confident in the stability of the new South Africa, whether of economic policy or of the political situation. There has been some inward portfolio investment, via the Johannesburg Stock Exchange, but this is unreliable because it can easily be reversed. Another indicator of lack of confidence in 1996 was the instability of the rand exchange rate.

If economic growth really is resumed in South Africa, Botswana would benefit. The South African economy is some 80 per cent of the GDP of the Southern African Development Community (SADC), and prosperity in South Africa would create the potential for prosperity in the region. This factor would overwhelm any negative effect from foreign investment being attracted to South Africa in preference to Botswana.

The conversion of SADC into a regional free trade area

SADC countries are currently negotiating regional free-trading arrangements. It would be risky to expect significant economic benefits for Botswana from this. South Africa has joined SADC in preference to the PTA/COMESA,[9] which could be positive for Botswana because Botswana is a member of the

first but not the second. However, there is a long history of failed attempts to create lasting regional economic groups in Africa, including the Federation of Rhodesia and Nyasaland, and the East African Economic Community. The one lasting arrangement is SACU, but its successful survival can be argued to be because one member is overwhelming large in relation to the other members and has therefore felt able to provide financial transfers.

It could be argued that adding members one by one to the successful SACU agreement would stand a greater chance of success than trying to create a SADC trading arrangement. However, precisely because SACU s durability depends on financial transfers, adding new members would risk destroying SACU because South Africa would not be able to afford equivalent transfers to new members. This argument is strengthened by South Africa's current unwillingness to maintain the current revenue distribution formula, even for the existing small members which are all much smaller than the non-SACU members of SADC.[10] In order to believe that the SADC attempt to create some form of customs union or free trade area will succeed, it is necessary to argue strongly that the circumstances are significantly different from those of previous failed regional trading agreements.

It is possible to argue that SADC will be different from past trading agreements, because the non-SACU members of SADC fear being excluded from access to the South African market for their exports. However, it is rumoured that South Africa is not at all willing to concede that access, even though South Africa's economy is so much larger than the combined economies of the other members of SADC, and even though South Africa has large trade surpluses with each neighbouring economy. Individual South African industries may feel threatened and be able to lobby successfully for protection. Moreover, even if some sort of SADC trade agreement is reached, those same large bilateral trade imbalances, together with the strong likelihood that South Africa will attract a large proportion of investment from outside the region, would very likely create feelings that the benefits of association were being unfairly distributed. As already argued, South Africa feels that it cannot afford to buy off these feelings of injustice, and non-SACU member countries are all too poor and financially constrained to accept certain short-term national costs in order to gain future, and uncertain, group benefits. A further possible problem is that if South Africa succeeds in negotiating some sort of free trade agreement with the European Union, the other members of SACU would be exposed to European competition, from which they are currently protected by the common external tariff of SACU. This protection is decreasing as South Africa reduces tariffs, but it remains significant.

A decidedly positive regional development is that South Africa's policy towards regional transport has been completely reversed. Under the previous government, South Africa's policy of destabilisation was pursued by promoting civil wars in Angola and Mozambique. This destroyed almost all

their role as transit routes for the land-locked countries in the region, which were therefore forced to use the railways, roads and ports of South Africa. In direct contrast, the new South Africa is directly involved in rehabilitating and managing railways and ports in neighbouring countries and is actively promoting a regional electricity grid.

Liberalisation of South African exchange controls

Another change in South Africa with possible benefits for Botswana is the liberalisation of South African exchange controls on capital account transactions; this would probably not have occurred without the ending of apartheid. In principle, this removes an administrative constraint on outward investment from South Africa into Botswana. In addition, outward investment was made less profitable by the dual exchange-rate system in South Africa, now abolished. Companies wishing to invest abroad from South Africa had to pay a premium for the financial rand, although in practice companies were allowed to invest using the cheaper commercial rand for that proportion of investment abroad which used South African equipment. In any case, the large amount of investment in Botswana from South Africa demonstrated that these apparent constraints were not effective in the past. Further investment in the period when these constraints were supposed to have operated would have exceeded Botswana's absorptive capacity during most years of the last twenty.

The liberalisation of exchange controls in South Africa may have a further minor impact on Botswana's own exchange control policy. Botswana has been concerned that liberalising its own capital account might result in Botswana's banks being used to facilitate capital flight from South Africa. This problem would no longer exist if capital outflows from South Africa become legal. However, the greater concern in Botswana is whether the monetary system would be able to cope with large short-term capital inflows. It could be argued that the most likely source of such flows is South Africa and that exchange control liberalisation in South Africa would therefore increase this problem.

Comparative advantage in negotiation

A further, apparently minor, factor concerns Botswana's successful record of negotiations with South Africa. It is impossible to quantify, or even to provide documentary evidence, but it has been frequently noted that Botswana achieved a high proportion of its objectives in dealing with South Africa, as for example in detailed negotiations over SACU matters. It has been argued that Botwana assigned its best possible team to such negotiations, while South Africa assigned third or fourth level people. While South Africa restricted recruitment to government service mainly to Afrikaans-speaking

whites, the civil service lacked depth in quality. Under a democratically elected government, recruitment will be from all language and ethnic groups, which would eliminate some of Botswana's historical advantage (if not immediately, then over the medium term). However, Botswana will continue to give much higher priority than South Africa to negotiations between the two countries, so that Botswana's comparative advantage should not all be ended in practice.

Conclusions

Botswana's economy was not seriously disadvantaged by apartheid. It was undoubtedly difficult having a large neighbour, on whom Botswana was dependent in many ways, with a philosophy so completely opposite to that of Botswana, and individual Botswana citizens suffered all the personal indignities of the system when travelling in South Africa. There were also real economic costs, but also some benefits, while the really important factors of trade and investment were very little affected by apartheid. They are therefore unlikely to be seriously afffected by the ending of the apartheid era, while Botswana would gain enormously from a resumption of economic growth in South Africa. Whether the ending of apartheid will generate such an economic recovery remains, unfortunately, in doubt. The biggest potential impact of the new regime in South Africa could flow from new regional trading arrangements and cooperation, but the new structures have not been established at the time of writing. Even when they have been completed, it will be some time before their effect can be gauged.

Notes

1　This statistic comes from successive issues of the *World Development Report,* the comparison excludes a number of countries even smaller than Botswana, namely those with populations less than one million.

2　Botswana owes its existence as a separate territory to a diplomatic initiative by three chiefs in the late nineteenth century; they successfully sought protection from the British to prevent takeover by the Germans in what is now Namibia and by the Boers in the Transvaal.

3　There were exceptions to both these generalisations, most notably the loss of control of government spending in the late 1980s (Harvey 1992:18–23) and the Botswana Housing Corporation scandal in the early 1990s (there was a clear connection between the two). A Directorate on Corruption and Economic Crime was established in 1994 and had recovered about 7.4 million Pula in fines etc. by early 1996 (Economist Intelligence Unit, *Botswana and Lesotho Country Report,* second quarter, 1996).

4　A curiosity is that the two original banks were Barclays and Standard. They incorporated locally and severed their connection with Barclays and Standard in South Africa, in 1975. In the 1990s, the successor banks in South Africa, now wholly South African owned, invested in Botswana, which now has four large commercial banks of which two were originally Barclays and two were

originally Standard. However, the recent entrants compete vigorously with their former associates.

5 South Africa was to some extent deceived by its own propaganda as to the cost of the SACU revenue distribution formula. The apartheid government included grants to its 'homeland' governments in its SACU distribution; these payments were simply the grants necessary to sustain those governments which the South African government would have had to have made, with or without the existence of SACU, with which they had no logical connection.

6 Mine workers were not the only migrants from Botswana working in South Africa. It was known that many were also working on farms and in service sectors, but there were no official statistics because it was illegal. It seems likely that these migrants diminished in the last twenty years because of growing unemployment in South Africa and rapidly increasing formal-sector employment in Botswana.

7 There is some anecdotal, but as yet no statistical, evidence that this has already started.

8 At end-1994, foreign-exchange reserves covered more than two years' imports of goods and services, and government deposits at the central bank covered nearly two years of recurrent government spending.

9 Preferential Trading Area of Eastern and Southern Africa/Common Market for Eastern and Southern Africa.

10 A possible exception is Mozambique. Although Mozambique's population was fifteen and a half million in 1994, and the smaller members of SACU all have populations less than two million, Mozambique's GDP is smaller than that of Botswana and Namibia and less than twice as big as GDP in Lesotho and Swaziland.

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12

LOCALIZATION AND INTEGRATION BETWEEN UNEQUAL PARTNERS: POLICY IMPLICATIONS FOR LESOTHO

Lennart Petersson

Introduction

As an enclave of South Africa, and because of the political and historical heritage of the Basotho nation, Lesotho has always been closely integrated with South Africa. Legal and de facto integration arrangements and other close economic and institutional links between Lesotho and South Africa have been operating for more than a century. The present agreements comprise Lesotho's membership in the Common Monetary Area (CMA) and the Southern African Customs Union (SACU), a labour agreement, which set out the conditions of labour migration between Lesotho and South Africa, and the Treaty on the Lesotho Highlands Water Project (LHWP).[1]

The main features of Lesotho's economic relations with South Africa have long been large-scale migration to the South African mines and close trade patterns, facilitated by customs union agreements. These relations are argued to have transformed Lesotho into a Reservoir of unskilled labour for South Africa' and to have discouraged indigenous and autonomous economic growth. While Lesotho's domestic market has been part of a much larger market, industrial development has been polarised, reflected in limited exports and heavy dependence on imports. The regional disparity, as a consequence of which Lesotho is by far the poorest administrative region within South Africa's border, has developed during a period of import substitution policy within the customs union area and the use of extensive tariffs and other forms of protection, tailored to the interest of South African industry. The main part of the trade deficit, at present of the same magnitude as the country's GDP, is covered by migrant remittances and customs union revenue, largely determined by the country's commodity imports. The development conforms to the general experience of regional groupings among developing countries, namely that distribution of industries and expanded employment and wage incomes tend

disproportionately to favour regions and states with relatively high per capita incomes and relatively large domestic markets.

Since independence in 1966, Lesotho governments have consistently stressed the need to lessen the country's extreme dependence on South Africa by expanding the domestic productive base. However, since the early 1980s, when the trend of increasing external sources of income was reversed to show a significant decline, the economic outlook for Lesotho has been very bleak. It became evident that domestic employment programmes will not be able to create sufficient jobs to reduce the growing unemployment and underemployment and to absorb the rapidly growing labour force. Therefore, a need arose to examine employment opportunities that might be offered by closer regional integration and the potential of South Africa to lead the region out of stagnation into a period of sustainable growth.

The discussion has included the formation of a common market with free labour mobility and also the establishment of an economic union between Lesotho and South Africa with a single economic policy and a supranational government of this union with great economic authority. These alternatives, which have been discussed since the late nineteenth century, are being conducted with renewed interest in the post-apartheid era, providing Lesotho with an historic opportunity to review its relationship with South Africa.

Since industrialisation is a primary concern of regional integration among developing countries, and in particular between unequal partners, the location of industry in the region is a key issue. In the context of the past industrial development and the constraints on the pursuit of an independent economic policy in Lesotho, the present study will analyse the various options for a more equitable and non-polarising development. A main question is whether the drawbacks of the country's small size can be overcome by increased economic integration with South Africa or whether there exists an optimal divergence from the South African policy.

The paper is structured as follows. This analysis will be performed in the framework of Krugman's core-periphery model, presented in the next section. Then, in the light of the long-standing tradition of integration between Lesotho and South Africa, two subsequent sections will discuss and analyse industrial development and trade integration and Lesotho's domestic resource base and labour market integration. Integration of government activities and regulation, alternatively known as cooperation, will be included in the analysis.

Krugman's core-periphery model

In the context of the traditional analysis of the gains from trade, enhanced access to the relatively large South African market would provide an impetus

for export-oriented industrialisation for the small economy of Lesotho. Exporting in a large market presents the only chance to reap the benefits of economies of scale, increasing returns and the resulting source of capital accumulation for economic development.

In the framework of Krugman's (1991) centre-periphery model, the interaction of increasing returns, transportation costs and demand result in a geographical concentration of production and population leading to differential development of huge regions. Assuming sufficiently strong economies of scale, each manufacturer wants to serve the national or regional market from one single location and to choose a location with a large local demand in order to minimize transportation costs. A cumulative process of regional divergence may arise because a core area, once established, has a tendency to attract new industries and workers. Both firms and the labour force are anxious to exploit the huge market for goods, services and employment and to benefit from the external economies of scale produced by the concentration of industries and well-developed infrastructure.

The basic model is built on a number of simplifying assumptions. In the context of our study, we think of Lesotho and South Africa as two regions, with South Africa having the larger initial population, and assume that there are only two kinds of production. Agricultural goods are produced using a location-specific factor, land, and as a result the agricultural population is exogenously divided between the locations. Manufactured goods can be produced in either or both locations. Compared to production in one single location serving both markets, producing a variety of manufactured goods in both locations reduces transport costs but incurs an additional fixed set-up cost. We assume that transport costs are incurred only to service the other market and that the demand for manufactured goods in each location is strictly proportional to the population of that region. The model produces the possibility of multiple equilibria with production concentrated to Lesotho or South Africa, as well as the possibility of production in both locations in relation to the population of the two regions.

This is illustrated in Figure 12.1. On the horizontal axis we measure the share of the manufacturing labour force of the two regions employed in Lesotho, L_M, and on the vertical axis the share of Lesotho in total population, L_p. The line $P_1P_2P_3$ represents the relationship between the manufacturing labour force employed and total population. It is an upward-sloping line, flatter, however, than a 45-degree line. Assume that the share of the total population of the two regions engaged in Lesotho's agriculture is L_A, equal to O_LP_1 in Figure 12.1, and let y be the share of total population engaged in manufacturing. Then the share of Lesotho in population will be: $L_p=L_A+_yL_M$.

The line M_1M_2 represents the dependence of the distribution of manufacturing on the distribution of population. If Lesotho's share of the total population is very small, it will not be worthwhile incurring the fixed
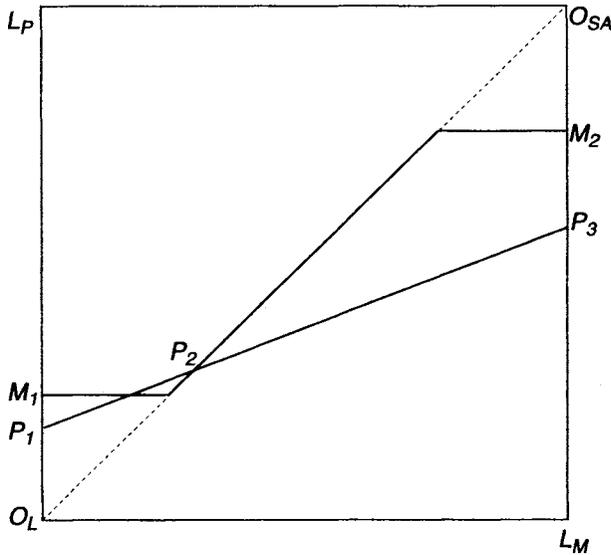
Figure 12.1 Geographic concentration between two countries of different sizes
Source: Based on Krugman 1991

costs of establishing a manufacturing facility there. Let x be the sales of a typical manufacturing firm, F the fixed cost of opening a branch plant and t the transportation cost of transporting a unit of manufactures from Lesotho to South Africa or vice versa. It is cheaper to serve the market from facilities in South Africa as long as $L_p xt<F$, i.e. if $L_p<F/tx$. This gives an equilibrium at P_1.

Given the fixed costs relative to transportation costs, as presented in Figure 12.1 $(F/tx=O_L M_1)$, a sufficiently equal division of population will lead manufacturers to produce locally for both markets. This gives an alternative equilibrium at P_2 under the condition:

$$L_M=L_p \ if \ F/ \ tx<L_p< \ [1-F/tx] \ =M_2.$$

The large agricultural population of South Africa means that P_3 cannot be an equilibrium with Lesotho serving the combined market of the two countries. This would, however, be the result if $[1-F/tx] < L_p$, leading to $L_M=1$.

In applying the model to regions of two or more countries, nations will be defined by those restrictions which act as barriers to trade and factor mobility. National boundaries, differences in national currencies, immigration restrictions and most types of trade barriers affect the economy in a similar way to 'transport costs', producing advantages for local producers. In the context of the core-periphery model, the effect is equal to a reduction of the

relation between set-up costs for new local enterprises and transport costs, F/tx. In addition to transport costs, the parameter t can be interpreted to include the amount of all transfer and transaction costs between countries exceeding those of trade within countries. The overall result of these various obstacles to international trade is to increase the diversification of national markets so that national markets become far more integrated than international markets.

Complete economic integration, on the other hand, means that restrictions on trade and factor mobility will be removed between participating countries, exchange-rate risks eliminated and transaction costs of different currencies reduced. Hence, integration brings us back to the original one-country analysis of production in space with physical transport costs as one of the main variables for the choice of location. A common external tariff and other selective measures may influence total production and by its protective structure also the location within a common customs union area. Another key variable is the size of the market. In a multiregional framework we assume that the economy of the area, comprising two or more countries, can support multiple cores.

Industrial development and trade integration

In the context of Krugman's core-periphery model, the question arises if small countries should fear integration, in particular, taking part in integration between unequal partners. Does the core-periphery model explain uneven development at a national as well as a regional level, and are there any implications for policy that can be learned from the model? This and the decisive role of history will be discussed in the case of integration between Lesotho and South Africa.

The rise of market integration and prosperity, 1868–1884

By a combination of their own military strength and diplomatic manoeuvrings and the rivalry between the British and the Boers, since the 1830s the Basotho people have been able to establish and maintain themselves as a political entity (Lundahl and Petersson 1991:20–34). However, after a considerable conflict with the Boers, as a result of which the Basotho lost most of their fertile land, they were forced, in 1868, to accept colonial dependence on Britain to prevent total conquest. After the start of British responsibilty followed a period of prosperity for Lesotho (then Basutoland). This was largely due to the impact on the entire region of discoveries of diamonds at Kimberley in 1867 and gold on the Witwatersrand in 1886 which paved the way for a new era in South African history. The large forces of organised labour required and the need for supporting equipment and a power supply created large urban concentrations, commercial farming and a manufacturing

interest in a hitherto sparsely populated part of the country. In the beginning of this era, the growth of the core area was considerably hampered because of high transport costs and because its needs could not be adequately supplied by the ox-wagon transports from the coast (Van der Poel 1933:7). The Basotho took advantage of the relatively close and rapidly growing market in Southern Africa. Agricultural production increased rapidly with a rise in the amount of land coming under cultivation and with the introduction of imported ox-drawn ploughs. Export incomes were also used for imports of improved breeds of sheep and goats on which today's wool and mohair industry is founded. Consequently, Lesotho managed to capitalise on the creation of a core area in the interior of South Africa and the resulting increasing demand for food in the expanding mining area. There was also a rapid growth both in commodity production and in labour migration to the core area, where chronic shortages of labour resulted in relatively high wages. The economy became highly monetised and commercialised.

The emergence of a core-periphery relation and stagnation, 1884–1966

For a number of reasons, still largely prevailing, this period of prosperity was short-lived. A key factor of change was the development of transport networks that largely by-passed Lesotho. As a result of the railway links between the mining centres and the coast Lesotho faced competition from cheaper overseas products. The price of grains for export from Lesotho fell dramatically (Bardill and Cobbe 1985:21). Thereafter, increasing population, eroding soil and scarcity of land have gradually transformed the country from a net exporter to a major net importer of grain. With few local sources of employment, the Basotho became increasingly dependent on labour migration to South Africa and migrant remittances to provide the income to pay taxes and to buy imported commodities.

   Another problem for Lesotho in the late nineteenth century was that the Cape and Natal used high railway rates and customs duties on imports, including those in transit, both to give their own industries a competitive edge in the inland markets and to finance their budgets (Ettinger 1974:55). The question was raised of how to give the land-locked states and territories their share of the customs duties collected on goods imported from overseas and passing through the ports of the Cape and Natal. The natural outcome was a legal customs union agreement. The agreements of 1891 and 1910, where the common external tariff was determined as part of South Africa's import-control policies without the other members' consent, were largely pragmatic administrative arrangements for the collection and distribution of customs and excise duties among members whose economic integration was a *fait accompli*.[2]

While in principle the agreement offered Lesotho access to the large and growing South African market for all its products, few manufacturing industries were established. At independence in 1966 Lesotho possessed only twelve manufacturing establishments employing about 500 people, and manufacturing accounted for less than 1 per cent of total output. More than 90 per cent of the population were classed as rural dwellers (Bardill and Cobbe 1985:27, 48, Knight and Lenta 1980:186). In Figure 12.1, the situation was more or less the one described by P_1, with production concentrated to South Africa.

Lesotho had to compete with producers in South Africa who were increasingly favoured by economies of scale, modern technology, a developed infrastructure and rapidly growing markets. After 1925 the South African manufacturing sector was promoted by the import substitution policy under the responsibilty of the newly reconstituted Board of Trade and Industry and other direct state involvement. This policy created large disparaties in the regional distribution of economic activities and in standards of living. As a result, the South African manufacturing industry became highly concentrated in spatial terms at principally four metropolitan regions, namely Pretoria-Witwatersrand-Vereeniging (PWV), Durban, Cape Town, and Port Elizabeth-Uitenhagen (Black 1989).

In this development, the transport and communication sectors played an important role in the government policy of maintaining white hegemony over the economy and for the outcome in terms of polarisation of activities. The road and railway systems created a network of well-developed and connected core areas. In economic terms such metropolitan areas will then, in effect, form a single location (Krugman 1991:24). This means that irrespective of the relative size in population or purchasing power of these cores, all of them will be more attractive places to locate manufacturing than the rest of the country, because producers will have better access to the combined markets. This 'textbook' economic development made possible a second spatial characteristic, namely the trend of increasing regional specialisation and spatial/sectorial division of labour (Black 1989:124).

Lesotho's industrial development became severely disadvantaged *vis-à-vis* South Africa, due to a combination of a poor internal transport system and the roundabout way in which several parts of the country have to be reached by a relatively well-developed South African transport system. At independence, Lesotho's road transport system consisted mainly of gravel roads, predominately in the lowlands, and the rest of the country was only accessible by tracks and earth roads. There are still no railway links within the country and therefore no internal rail transportation. Lesotho is, however, connected to the South African railway system by a line which crosses into the country at Maseru and terminates at a station immediately adjacent to the border.

Since, over long distances, freight in Southern Africa is basically carried

245

by rail, most of Lesotho's imports, even though reaching Lesotho by road trucks, have ultimately also been transloaded from trains arriving at the railheads close to the border but located in South African towns. Because of the regulations of the customs union, these deliveries are made without great formalities and usually handled by South African trading companies. The goods are normally first stored in these towns and are then individually delivered to Lesotho. Furthermore, people in quite large villages along the 'border', away from border posts, cross illegally into South Africa where there are no control posts, to buy from the many shops on the South African side. Areas near the border can be more cheaply supplied from South African towns than from the domestic marketing system, due to lower transport costs.

Another key factor for the location of industry was that railway rates were used extensively to promote the concentration of production near the centres of demand, since the production input could be transported more cheaply than finished goods. The rates varied widely among different types of goods, with many consumer goods charged about fifteen times as much per ton as the lowest-rated agricultural and raw materials (Ettinger 1974:247). The reloading of inputs at the South African railheads and the poor transport system in Lesotho also produce, in certain cases, a cost disadvantage for local production for the domestic market in Lesotho. Rates for the transport of consumer goods (such as food) may be lower than those for the inputs needed to produce them. At the same time, the policy of the state-owned railway company was protected in several ways by restrictions placed on the use of other transport modes.[3]

SACU and industrial development

In 1969, the Southern African Customs Union Agreement between South Africa and Botswana, Lesotho and Swaziland replaced the 1910 Agreement. Namibia has been a member since its independence in 1990. The new agreement emphasises equitable treatment and also contains special provisions intended to deal with the disparity in economic development between South Africa and its partners.

South Africa's trade policy has been a major instrument for promoting industrialisation. The policy is designated and implemented by agencies with great discretionary powers to change tariffs and non-tariff barriers and to encourage export promotion incentives. While the import policy of South Africa is largely extended to the whole SACU area, no common approach to export promotion exists. The existing South African trade regime is marked by complexity, large variations in effective rates of protection and the imprint of special interest and uncertainty, because of frequent changes in response to the business community. Protection may be granted as long as the requesting firm is able to supply a 'substantial' part of the market or to protect local firms from 'disruptive' competition (MERG 1993:234, Belli *et al*

1993:4). The system requires a complex administrative apparatus to enforce and handle it. This obviously works against smaller enterprises, which cannot afford the expense necessary to negotiate a change through the administrative steps and to become familiar with the numerous rules and loopholes. In particular, this works against the small enterprises of Botswana, Lesotho, Namibia and Swaziland (BLNS), which are not represented at the South African Board of Industry. The problem is that the Board has tended to adopt procedures and make decisions that reflect national rather than regional interest, although its jurisdiction in several important areas covers the entire customs union.

Although the 1969 agreement provides the smaller members with a few measures related to the establishment of new industries and infant industry protection, these have met with very little success. Experience suggests that South Africa has not been favourably inclined to assist smaller partners in exploiting opportunities to produce for the customs union area (McCarthy 1992:17). There are also inconsistencies and contradictions in the legal provision which have been used to the detriment of the smaller partners of the union. In several cases, attempts to supply the broader SACU market have been blocked by various devices such as local content regulations, aggressively retaliatory action by South African producers, alleged cases of 'price dumping' and pressure on retail outlets (Davies 1994:5). Protection also has a tendency to increase the costs of inputs. The implicit taxation of (export) production has been offset by a number of South African incentives, which Lesotho cannot afford to match. Thus, in addition to being less developed than South Africa, Lesotho is also placed at a disadvantage by its larger neigbours' trade regime.

Trade and industrial policy and performance since independence

At independence, the structural weakness of Lesotho's economy and its openness in trade and factor movements have resulted in heavy dependence on South Africa. In spite of a high growth rate, until the early 1980s most indicators of Lesotho's economic structure exhibit an increasing degree of dependency. This trend is principally explained with reference to two crucial areas of the country's dependency, the customs union and labour migration. In particular between 1972 and 1977, the country benefited from increased migration and dramatic increases in real mine wages and, since the implementation of the new customs union agreement of 1969, significant increases in customs and excise revenue. After 1983, the trend of rapidly increasing net factor incomes from abroad has, however, been reversed to show a significant decline (see Figure 12.2).

Most of the rapidly increasing private and public incomes in the early 1970s went to increased consumption and rapidly increased imports. Gross

domestic investments also increased substantially with an increasing government share in total capital formation. However, increased purchasing power also produced positive linkage effects for the domestic economy and a high growth rate of GDP (World Bank 1994). This development created formal employment in sectors producing non-traded goods and services, largely in construction, retail trade and in the growing public sector which increased the domestic base of the economy. In our core-periphery model, this employment and the raised household incomes from migrant remittances can be interpreted as an upward shift of $P_1P_2P_3$. When the domestic economy reaches a critical mass, it may become worthwhile for manufacturers to produce there.

This was also the framework for the industrialisation strategy of the first post-independence administration. It was also a period of extensive public-sector involvement in production (GOL 1994: chapter 6). The government reserved the right to hold equity in certain industries such as grain milling which were considered strategic in the national interest. As a result, food production became dominated by public enterprises. In the private sector, import substitution was encouraged by the promotion of non-agricultural activites with emphasis on small-scale indigenous industries. Exports were to be based on local resources with the focus on labour-intensive handicraft activities, such as weaving and leather processing. It was argued that this strategy would permit the decentralisation of industry. In order to implement the strategies, the government developed an institutional and legal framework for the support of its industrial policy. In 1967, the Lesotho National Development Corporation (LNDC) was created as a statutory body charged with the responsibility for projects in the field of manufacturing and distribution (Baffoe 1989:70). The result of the inward-focused strategy of promoting small-scale industries to serve the small domestic market was very limited. The underlying assumptions of the strategy were inconsistent with the condition of the customs union, where Lesotho had to compete with long-established large-scale industries in South Africa. Neither did the investments in the handicraft sector for export production produce any spectacular growth in employment. In spite of a high growth rate of production, largely explained by the very small size of the sector, in the mid-1970s people employed in the manufacturing and handicraft sectors numbered around 2,000 (GOL 1994:114).[4]

In the late 1970s, it was obvious that a new, outward-oriented strategy was necessary to take advantage of the country's increasing access to international markets through bilateral and multilateral trade arrangements. The efforts of the LNDC were refocused to support medium-to large-scale enterprises, while the small-scale sector became the responsibility of a newly created institution (1975) with the objective of assisting development of the indigenous business sector: the Basotho Enterprise Development Corporation (BEDCO). The new approach to industrialisation and the creation of domestic
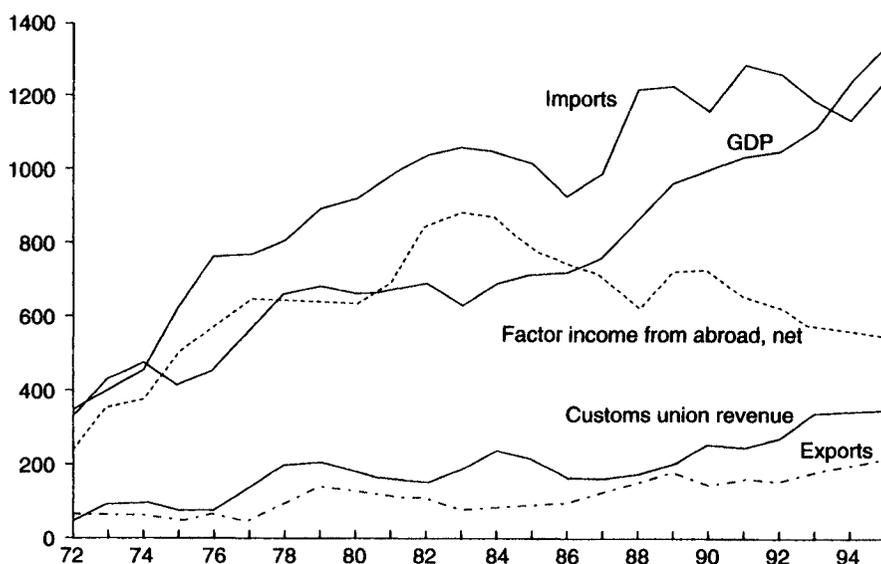
Figure 12.2 Growth of factor income, customs union revenue and trade, 1972–1995 (1987 prices)
Sources: CBL 1996; World Bank 1994

employment has increasingly meant encouragement of foreign direct investment in labour-intensive manufacturing production with large export market potential (Baffoe 1989). Since the implementation of structural adjustment programmes in 1988, this policy has been further strengthened. In support of this policy, an investment promotion capacity and investment incentives have been developed. The major efforts to attract direct investments have been directed towards South Africa and, in the 1980s, towards the Far East. In addition to tax holidays, training grants and an export finance scheme, incentives were introduced to reduce the fixed costs of investments: concessional long-term loans for acquisition of capital equipment for manufacturing; purpose-built factories for rental at very attractive rates; and well-serviced industrial land for own development (GOL 1994:117). Several of these incentives are well in line with the implication of our core-periphery model, where the fixed cost of opening a branch plant is a key variable for the spatial location of production. On the negative side, however, production in these footloose industries becomes highly mobile and can respond very quickly to adverse changes in the investment environment.

Another important factor, which has to be added to the model, is wage differentials between various locations. The disadvantage of less good access to markets in a peripheral nation can be counterbalanced by lower labour costs. Relatively low wages in Lesotho have been used as a key argument in the country's investment promotion of labour-intensive sectors such as

249

clothing and footwear. In the 1990s, wages in Lesotho have been at a level around one-third of those in the core areas of South Africa. However, Lesotho competes largely with the former Bantustans, where wages were about twice the level prevailing in Lesotho.

Since the implementation of the new policy, the level of foreign ownership in the field of manufacturing of non-agricultural products has been growing rapidly, and a shift has taken place towards new export markets and investors outside Africa. The new strategy resulted in high and increasing growth rates in value added and employment in the manufacturing sector, and significant changes in production and the composition and destination of exports (Petersson 1994:14–16). During the 1980s, textile, clothing and leather products have increased their share from less than 10 per cent to about one-third of value added in manufacturing industries. Between 1985 and 1994, the number of workers employed in these industries increased from about 3,000 to 11,500 (BoS 1987a:40, LNDC 1995) Most of the increased production is sold on overseas markets, largely to the US, Canada and the European Union. The share of total exports to these markets has increased from 5 per cent in 1984 to around 50 per cent in the 1990s (BoS 1987b:127, CBL 1995:19).

This is a remarkable change in export composition and destination. Until the mid-1980s, Lesotho's trade was entirely dominated by food, beverages and raw materials, almost entirely sold to South Africa, sometimes for re-export (Lundahl and Petersson 1991:64–66). With regard to imports, the SACU area continues to be the dominant trading partner of Lesotho. Various estimates of the distribution between intraregional trade and overseas trade shows that until the late 1980s about 95 per cent of Lesotho's imports came from South Africa. However, in the 1990s, Asia has become an increasingly important new source of imports, a change which is associated with increased investments in Lesotho from the same region.

Until the late 1980s the agri-industrial subsector (food and beverages) also continued to expand. Production, largely in public enterprises, was oriented towards the domestic market. Thereafter, production has declined, and currently most of these industries are designated for privatisation as their performance has been poor. The food security strategy has lost its rationale since the industry depends heavily on imported grains and, recently, also because of the political changes in South Africa (Petersson 1995:4–16).

Regional integration and options for industrial and trade development

The period of improved export performance has coincided with increasing non-traditional exports sold on markets outside the SACU. However, the success was largely due to very special circumstances, and in the last few years manufacturing exports have stagnated in real terms. A main explanation

for the early encouraging performance was that Lesotho took advantage of the opportunities created by trade and investment sanctions imposed on South Africa and quotas against the Far Eastern textile and clothing exports in the US and Western European markets. Because of low per capita income Lesotho enjoys preferential access to industrial economy markets through various agreements, and the country has duty-free access to the SACU market.[5] As a result, companies from Hong Kong and Taiwan established production in Lesotho to avoid the quota which, under the Multifibre Agreement, applies to production located in their home countries. As far as sanctions were concerned, Lesotho provided an ideal production base because of its geographical location, relatively good access to the world markets due to links through the South African infrastructure network and currency under the CMA. Compared to South Africa and other countries in the region, production in Lesotho also benefits from cheap labour. This advantage is, however, largely offset by higher utility charges.

The effects of these favourable conditions for Lesotho will gradually disappear in the post-apartheid era. Furthermore, if the results of the Uruguay Round are fully implemented, Lesotho may face increased competition for its exports of manufacturing products with the ten-year phase-out of the restrictions on textiles and apparel which operate under the Multifibre Arrangement, where Lesotho has been favoured by preferential arrangements. Lesotho must be cost-competitive against South Africa and other competing countries in some labour-intensive subsectors and exploit not only the international market but also its huge neighbouring market. Lesotho may also need to compete harder for foreign capital owing to the expected granting of trading privileges to South Africa by the implementation of a mix of incentives and cost control measures. These include wage negotiations in line with productivity increases. What is most important for success is, however, to ensure and maintain improved security and political stability in the country.

A key factor for the success of an export strategy oriented towards the customs union area is the regional transport network. This is well known from the attempts to create growth points in the South African periphery. The long distances between markets and suppliers are considered to be major disadvantages, because local markets are relatively insignificant, as is the proportion of inputs derived locally (Black 1989:137). As a result, the majority of decentralised companies are confronted with increased transport costs, partially compensated for by transport consessions, which Lesotho cannot afford to match.

A principal question for Lesotho is whether improved access through reduced transport costs might actually help, not hurt, a peripheral industrial development in the country. Reducing transport costs has two effects. It facilitates locating production where it is cheapest, while at the same time it facilitates concentration of production in one location in order to exploit

economies of scale. If transport costs are high for a certain product, production will take place in both countries, while insignificant transport costs mean that comparative costs of production are the decisive factor of location. However, in the case of medium transport costs, these may be low enough to make it worthwhile to concentrate production but still high enough for access to markets to outweigh production costs as a determinant of location. Consequently, in the context of Krugman's core-periphery model, the relationship between transport costs and a country's output is U-shaped rather than monotonic: 'over some range closer integration actually leads production to move perversely from the point of view of comparative costs' (Krugman 1991:97). The conclusion to be drawn for Lesotho is that it must in its present situation, which is characterised by the 'medium case', choose closer integration or increase various types of transaction costs between the two countries in order to exploit its own small market. Experience has shown that the latter case is hardly a realistic alternative. Lundahl and Petersson (1991) estimate that Lesotho would lose customs union revenue by withdrawing from the customs union and establishing its own administrative system. This would largely be due to collection difficulties and because tariffs exceeding those of South Africa would induce large-scale smuggling over the rather open borders between the two countries.

In the alternative of closer integration, an improved transport system between Lesotho and the core areas of South Africa is central for the development. However, in the transport sector, Lesotho as a land-locked state is dependent on the policy of South Africa. Article 15 of the SACU agreement prohibits transport rate discrimination on goods in transit through a particular country, complemented by Article 16 which guarantees freedom of transit going to and from other union countries (Lundahl and Petersson 1991:134). However, transportation was until recently a frequent issue of complaints from the smaller countries seeking control of the means of transportation of their foreign trade. The discord was solved in 1990, and a multilateral agreement on road transportation in the SACU area was signed (Bruzelius 1992:25). The agreement enables each country to authorise its own bus and track operators to enter into the other countries within a quota system. It is also envisaged that harmonisation of national regulations on such things as the dimensions of vehicles and the requirements for licensing of drivers and vehicle inspection can be negotiated and agreed upon in the future. This is one of the results of a reassessment of transport policy that has been ongoing since the mid-1980s. The new policy is based on commercial principles with fewer regulations and less interference in prices, investments and the provision of services (Bruzelius 1992: chapter 3). It has also included extended interaction with the region and high ambitions for selling know-how and services. In railway transport, a one-stop service for transport across borders is suggested, managed by a company equally owned by all administrations in the Southern African region.

The conclusion is that Lesotho will benefit by developing an efficient internal road transport network that links it at all possible points to the well-established network of South Africa, in order to foster trade. It implies closer cooperation between the two countries, and means that Lesotho can negotiate with the South African authorities regarding financing, construction and maintenance. Increased cooperation can also be motivated by the weak performance and low functional capacity of Lesotho's own authorities in the road transport sector. Internally, a single coordinating body needs to be established to deal with the sector, a task which is currently carried out by different ministries and agencies.

In other economic areas also, democratic South Africa is expected to act as a partner with neigbouring countries in an equitable and mutually beneficial programme. This provides an opportunity for the SACU to be democratised in an arrangement which would provide for an effective voice for Lesotho and the other smaller partners at the final decision stage for changes in the level and nature of trade policies and ensure that they are included in the development in collective regional positions, prior to negotiations with outside multinational institutions.

In the renegotiation, Lesotho must opt for the removal of restrictions on trade between the partner countries of the SACU and use its voice to ensure fair trade practices. The creation of an 'internal regional market' will require the removal of all non-tariff barriers as well as the coordination and harmonisation of certain taxes and subsidies, public administration rules, transportation policy, technical, health safety and environmental standards of traded products and measures that facilitate unsubsidised promotion of exports within the area.

Two related issues of principal importance are regional support programmes for industrial development and incentives aimed at encouraging investments. The option may be a combination of the removal of distorting incentives with the reintegration of the former Bantustans and the introduction of regional incentives schemes that are standardised throughout the customs union. This includes the harmonisation and uniformity of investment incentives in the common customs union area in terms of subsidies, rail and road tariffs, import control and indirect taxes and discounts concessions. The emphasis of a new SACU area should be on greater export orientation and more competitive efficiency in a regional development strategy. This would mean a trade liberalisation with lower tariffs and a simpler, uniform and stable tariff structure. This would lower the costs of imported inputs, thus supporting the import-and labour-intensive export-oriented production in Lesotho.

Domestic resource base and labour market integration

Location-specific factors and demand for manufactured goods, assumed to be determined by the population or the national income and a high degree of labour mobility, are central to our core-periphery analysis. Until 1963, when border control posts were established for the first time, the movements of Basotho migrants into South Africa were both unrestricted and unrecorded.[6] This meant that the Basotho could emigrate and settle permanently in South Africa (Gay and Hall 1994:37). Since 1963, passport and detailed travel documents are required for Basotho, and legislation restricts employment of foreign labour in South Africa essentially to mining and agriculture, both characterised by relatively low wages (Stahl 1981:29). Under the provisions of the South African Bantu Laws Amendment Act of 1963, no migrant labour contract may exceed two years, and, incidentally, no migrant may enter with his wife, change his employer or reside anywhere except in a bachelor hotel; contracts may be renewed any number of times. These regulations created a system of temporary labour migration, where the migrants retained their homes in Lesotho. This was also the case before 1963, because of the land tenure system of Lesotho where no land is privately owned but is allocated by the chiefs in accordance with individual family needs. The tradition that migrant workers could retain their land if someone else looked after it and cultivated it encouraged temporary instead of permanent migration.

Lesotho's resource base

Lesotho's immobile resource base is extremely limited. The important exception is water in the mountains, which will be exploited by the multipurpose scheme of the LHWP which comprises the export of large quantities of water to the PWV-core of South Africa and the generation of hydropower for local use. Apart from some diamond and clay deposits and its eroding soil, Lesotho has few other known natural resources. Its population of around two million people has been driven by force of historical circumstances into a mountainous terrain. At present some 9 per cent of the area is suitable for crop cultivation, largely found in the lowlands, which are also the area with the greatest population growth and density. Rural areas are mainly rangelands used for communal grazing.

Extreme pressure on the land, primitive methods of cultivation and free grazing have, over the years, led to acute erosion problems, resulting in a shrinking resource base for agriculture. The agricultural censuses held since 1950 show that yields, areas under cultivation and production have had a declining trend (World Bank 1974:38–40, Bojö 1991: chapter 3).

Despite the low level of returns from agriculture, in 1993 an estimated 81 per cent of the population lived in the rural areas and about 72 per cent

of Lesotho's labour force worked in agriculture and the informal sector (World Bank 1995: vii, xv). The agricultural sector thus provides an important socio-economic base, but its contribution to GDP has declined from about 40 per cent in 1966 to around 15 per cent in the 1990s (Bardill and Cobbe 1985:47, CBL 1996). Only 28 per cent of the workforce held formal wage jobs; half of those people worked in the South African mines, generating one-third of Lesotho's gross national income. Roughly 4 per cent of the workforce was employed in the public sector and 2–3 per cent in domestic manufacturing. The remaining 7 per cent of those with formal jobs worked in the private service and construction sectors or held non-mining jobs in South Africa.

Since independence, the dynamics of the labour market in Lesotho has been characterised by an unskilled workforce increasing much more rapidly than employment opportunities. The small size of the modern sector means that even high growth rates in regular wage employment add only relatively few new jobs. Various estimates, presented since 1980, have predicted that the formal sector would absorb no more than 20 per cent of the annual increase in the workforce (Kingdom of Lesotho 1980:83, Petersson 1993:18).

The informal sector and micro-enterprises have been responsible for a growing proportion of employment in Lesotho and other peripheral areas of Southern Africa (Fisseha 1991, Gay and Hall 1994:130–32). Estimates indicate that around one-third of all Basotho households are currently engaged in some small-scale, non-farm activity. They play an important social role by creating self-employment and redistributing income. However, the choice of product and the ability to expand is constrained by low technology (hand tools) due to lack of electicity and water, and constrained markets. The rural enterprises produce low-quality items from agricultural and/or natural resource materials, almost entirely produced for a very local market protected by a poor transport network.

The information collected by Fisseha (1991) shows that almost 80 per cent of the enterprises were one-person operations. Another 10 per cent was dependent on (not fully paid) family members and trainees or apprentices. This category with no hired workers reflects primarily survival activities to sustain people until something better comes along (supply-push activities). Underemployment and its by-product, poverty, are widespread in rural Lesotho, and open unemployment is growing in urban areas (World Bank 1995:47). In 1993, unemployment and underemployment was estimated to be in the range of 35 to 45 per cent.

Labour migration

Lesotho's capacity to generate income-earning opportunities at home is very limited and is certainly out of all proportion to the income-earnings of

continued mine migration to South Africa. Lesotho has benefited significantly from the steep rise of gold prices in the 1970s and from the South African exchange policy between 1979 and 1988, directed towards maintaining a rising or at least a constant real rand gold price, which protected and prolonged production in low-yield mines (Petersson 1993:25). As a result of the increase in the price of gold and a more active and increasingly unionised black labour force at the mines, real wages for black miners increased by over four times between 1971 and 1990. The main increase was between 1971 and 1975, when real wages almost trebled, and after the strike in 1987 (Crush *et al* 1991:198–202). However, the gold-mining sector is in long-term decline, and since the late 1980s, the position of the industry has deterioriated significantly (MERG 1993:217). From 1990, real wages have declined by around 10 per cent.

After 1963 and the introduction of legislation which restricted migration to contract migrants, mine migrancy entered a new phase in Southern Africa. The changes in the demand for black labour in the mines comprise three interrelated topics, namely internationalisation, stabilisation and mechanisation (Petersson 1993:25–27). The policy of internalisation meant that labour migration from abroad became confined to a supplementary supply role *vis-à-vis* the South African labour force. The policy after the 1987 strike in the mines has, however, aimed at 'heteregenous sourcing' to ensure that the industry does not become too dependent on any one source. Substantial wage increases have resulted in attempts to mechanise and to rationalise production, which requires training in skills and a more professional work force in the mines. Consequently, the industry has encouraged longer contracts and high return rates by the introduction of the Valid Re-engagement Guarantee (VRG), which carries entitlement to re-employment at the former job rate, assuming a shorter leave break (stabilisation).

Since 1987, the number of unskilled and semi-skilled worker at the gold mines has declined by around 175,000 (Head 1995, TEBA Maseru 1996).[7] The decline was less than proportional in the foreign labour force, which actually increased its share of total mine employment from about 40 per cent to almost 60 per cent in 1995 (TEBA Maseru 1996). The stabilisation policy has resulted in longer service for foreigners in particular, while declining demand has resulted in a low intake of novices. In 1995, the proportion of novices in the total number of engaged mine workers was around 5 per cent, and less than 2 per cent for Basotho mine migrants (TEBA Maseru 1996). As a result, in the short term the number of foreign workers tended to stagnate and declined only in the 1990s. The long-term effect will, however, be a substantial and large yearly decline in their number. This means that Basotho and other foreign migrants in the South African mines are being phased out by a process of natural attrition and retrenchment. Since 1990, the number of Basotho mine migrants has declined by about 24,000 or by 19 per cent.
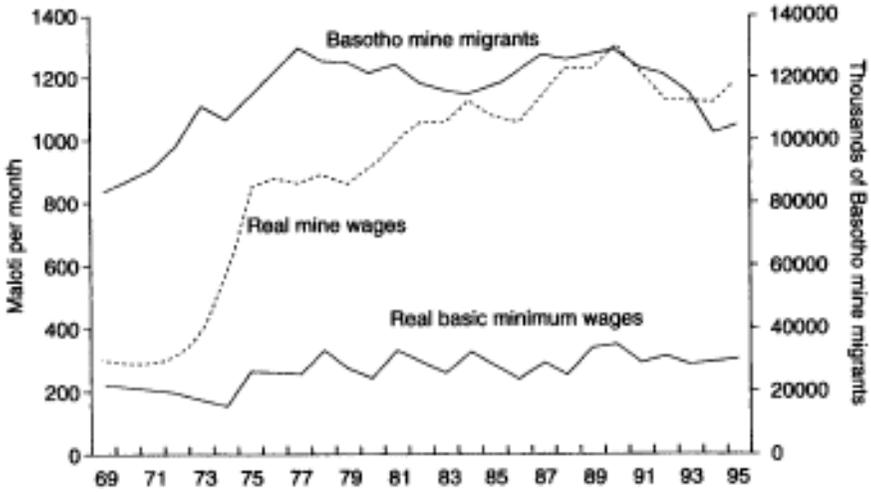
Figure 12.3 Basotho mine migrants, real mine wages and real basic minimum wage, 1969–1995 (1993 prices)
Sources: Computed from data provided by the Ministry of Employment and BoS 1983:66; Cobbe 1977:453; Crush *et al* 1991:19; CBL 1966 and estimates for 1995 (mine migrants and mine wages) provided by the Central Bank of Lesotho

Independently of the new government's thinking on the question, the repeal of apartheid constraints in the South African labour market and the reintegration of the Bantustans into South Africa will result in another principal change in mine migrancy. In a 'free' labour market men can be hired at the gates of the mines, thus by-passing the mine labour recruiting organisation: The Employment Bureau of Africa (TEBA). Since the mid-1970s, the number of recruiting stations across Southern Africa run by TEBA has already been halved, and the organisation is in the process of restructuring (Davies and Head 1995:442). Foreign labour without VRGs will be at a disadvantage, because they still need a written contract to enter the South African labour market. Another related change is that there is no longer any reason for the mines to provide housing for their permanent staff, which increasingly includes unskilled and semi-skilled labour. This factor may result in a new phase of permanent migration to the mining areas from the former Bantustans and the neighbouring countries which gradually replaces temporary migration. By gradually moving away from institutionalised migrant labour, the industry can restructure in a cost-effective way with a minimum of disruption.

This pattern suggests that mine migrancy from Lesotho and other neighbouring states will in the long run be phased out. The recent decision by South Africa to grant residency to Basotho miners adds another dimension to Lesotho's future, with the obvious risk of increased marginalisation of its

257

economy. Of the total Basotho mine migrants processed through TEBA, just over 62,000 qualify for pemanent residence in South Africa (TEBA Maseru 1996). This may, however, exceed the number who actually register and finally gain permanent residence from the Department of Home Affairs in South Africa. At the cut-off date at the end of March 1996, the number of applications from Basotho was 31,481, and by that date 16,278 had been granted residence permits.

The remittances that will be foregone by the phasing out of temporary migration and/or permanent migration to South Africa will have negative impacts on the living standards of the population, particularly in rural areas where most miners are from, and on the demand for domestic production. It is estimated that each rand of migrant earnings generates an additional value added within Lesotho of some 0.25 rand, mainly in transport, retail trade, construction, catering, services, and products and services related to agriculture and the informal sector of the economy (Carvalho 1988:251, Petersson 1993:30). While labour income from abroad contributes substantially to imports, remittances are also an important source of foreign exchange. Since the early 1980s, with substantial yearly fluctuations, remittances have covered about two-thirds of Lesotho's disbursement on imports of goods and services, including the debt service. Furthermore, by increased consumption of imported goods, labour incomes from abroad contribute significantly to customs union and sales tax revenues. It is estimated that a 10 per cent reduction in migrant remittances represents a direct reduction in government revenue of about 3 per cent, corresponding to almost 1 per cent of GNP (Petersson 1993:31).

While legal migration to relatively well-paid jobs in the mining industry has gradually declined, there are indications of significantly increased clandestine or illegal migration to South Africa (Davies and Head 1995:443–45). In addition to retrenchment and the very low intake of novices from abroad in the mines, the increase from Lesotho is due to a high population growth and limited potential for agricultural development, which together have resulted in increasing landlessness among the young population, drought and other reasons for poverty and unemployment. For over a century, the Basotho society rested on the combined income from these two sources: agriculture and mine migrancy.

The skilled and well educated have had the opportunity to live and work more or less openly and permanently in South Africa, particularly in the former Bantustans, for decades. The main reasons for migration are improved quality of life, higher salaries and lack of jobs in Lesotho (Prah 1989:58). As a result, the unemployment rate is very low for skilled labour and insignificant among men with the highest level of education in Lesotho.

The common market approach

The dynamic and fundamental changes that are taking place in the labour market call for an appropriate response by Lesotho and South Africa and a strategy that is in the mutual interest of both countries. It is particularly important that Lesotho acts quickly in order to avoid becoming increasingly marginalised economically and politically. The situation has created a lively debate, largely among international organisations and academic forums in the two countries.

South Africa's investment and output growth performance has been depressingly weak over the past two decades, resulting in rising unemployment. The political changes have created expectations, not only within South Africa but also among the unemployed and underemployed in the neigbouring countries, of a new era of increased job opportunities, better working conditions and brighter economic prospects in South Africa. The massive inflow of people from the regions places a heavy burden on the country and pressure on the government to restrict immigration and to repatriate illegal migrants. It can be expected that unskilled illegal immigrants will deprive poor locals of their employment opportunities, and depress wages and working conditions because they tacitly accept the status quo in the host country. In the past, disincentives to discourage people from migration to South Africa have had very little success.

Robert Davies and Judith Head (1995) point out that the migration issue in Southern Africa is relevant in a wider context of future regional economic cooperation in two main ways. First, the future of legal migration to South Africa and the attitude of a democratic South Africa to the employment of migrant workers is a test of its real commitment to 'reconstructing regional relations on new lines'. Second, 'the prospect of escalating clandestine migration has been seen as a real or potential threat which underscores the need for an equitable and mutually beneficial programme for regional cooperation' (Davies and Head 1995:439). Consequently, they stress the need for providing incentives for prospective immigrants to stay within the borders of their own country. Concerning the SACU area, the strategy is based on a renegotiated agreement which minimises the existing industrial polarisation within the SACU area.

This is also the position taken by the African National Congress (ANC), which has emphasised that before free movements of labour across all borders in the region can be introduced, new opportunities for income and employment must be created in labour-supplying states. This would reduce migration and make it possible to avoid the maintainance of a segmented labour market, where migrants can be expected to be involved in low-pay and low-skill activities with little security, as well as hard and unpleasant working conditions at the bottom of the labour market. The domestic South African labour force may also fear competition, because the Basotho have a

reputation of being a disiplined workforce, relatively highly educated and less politicised compared to large groups of Africans in South Africa. This means that in the short and medium term, some type of restrictions on labour migration (excluding the mine migrants) between Lesotho and South Africa is likely to be maintained, but it will create a growing clandestine migration.

Among various strategic options considered in Lesotho it has been suggested that the best alternative after the renegotiation of the SACU agreement is either to form a common market in the medium term or an economic union with South Africa in the medium to long term (Molapo 1995:6–9). Considering that most of Lesotho's discretion on fiscal and monetary policies is already lost, the economic union is preferred because it will remove uncertainties that have always been associated with the important sources of the country's purchasing power abroad: remittance income and customs union revenue.

Increased economic and even political integration with the surrounding country would be an attractive alternative for a large part of Lesotho's population. The significance of the borders is psychologically minimal in a region where both skilled and unskilled labour movements have been part and parcel of life and where many have immediate kinship ties in South Africa (Prah 1989:34). It would widen the choice of employment, in particular in better-paid jobs and provide more opportunities for promotion. For the unskilled it would mean working openly rather than illegally in South Africa. In the short term they would probably be commuting migrants with their families in Lesotho, but the granting of rights identical to those of South African workers would in the long run result in permanent migration.

This proposal may be unacceptable for South Africa, given that its own problems of unemployment and uncontrolled labour mobility may adversely affect Lesotho's economy. The core—periphery relation may remain and even be reinforced with little or no industrial development. In order to avoid this scenario, it is suggested that at the initial stages of the common market both countries work out arrangements for controlling labour movements. Furthermore, a regional policy is proposed with the objective of reducing economic disparities between the two countries by generating employment in Lesotho.

It must, however, be asked whether this strategy would produce the desired result because free labour mobility would further reduce Lesotho's ability to establish an independent wage and salary structure. The integration of Lesotho's trade unions with their South African counterparts would be a likely result. For Lesotho to be competitive, the substantial differences in productivity must be matched by real factor price differentials between the two countries. This is difficult to achieve because free trade within the customs union area and monetary integration have resulted in nominal and real interest rates and a rate of inflation in Lesotho which by and large follow those of South Africa. However, since the early 1970s, which saw rapidly

rising mine wages combined with the introduction of legal constraints and reduced opportunities for migration, real wage differentials between Lesotho and South Africa gradually increased (see Figure 12.3). After 1978 the basic minimum real wage for unskilled labour (heavy physical work) has stagnated at the practically constant level of real mine wages over the period 1911–71 (Knight and Lenta 1980:172), paving the way for the successful cheap labour strategy which, in turn, has led to export-oriented industrial development. In this way, Lesotho has tried to make the most of the relatively high wage levels in South Africa, which, owing to an inflexible labour market, do not reflect the relative abundance of unskilled labour. With free labour mobility, the success of the cheap labour strategy would be eroded, leading to a cumulative process of decline in Lesotho.

Assume, however, that controlling movements of labour in the initial stage towards the formation of a common market leads to maintained wage differentials. In the short term, such a situation would create incentives for migration to South Africa with higher productivity and wages. In the medium to long term, and with the introduction of free labour mobility, the effects on industrial localisation depend on rational expectations of workers and firms and on whether the manufacturing industry of Lesotho will be able to catch up with South African productivity. It is hardly likely that such an outcome will be realised and that the public can be convinced that in the future Lesotho will be able to compete with the established core areas of South Africa with respect to equal real wages and returns on investments. One should also take into account that South African trade unions would prefer to export South African labour practices into the region, a factor which may lie behind their request for free labour mobility. This approach would result in increased polarisation of productive resources, and skilled and educated labour would be the first to leave Lesotho, further impoverishing those who stay behind. South Africa's tight fiscal situation means that Lesotho can expect very little in aid, nor can it hope to receive significant access to redistributive transfers from richer to poorer regions within a common market. In the light of this analysis of the labour mobility approach, the alternatives for Lesotho seem to be increased, but controlled, labour movements or incorporation into South Africa.

The first alternative, which is recommended if Lesotho is to survive as an economic entity, points to a need for increased cooperation on labour market issues. Low wages, in particular in the public sector, and a poor working environment compared to South Africa have contributed to a severe shortage of skilled labour caused by exports of trained and educated manpower. This migration is likely to increase once the South African government starts to upgrade rural schools and its health care system. In these two sectors, Lesotho has in the past lost many of its trained personnel to South Africa. To be competetive in the region, Lesotho must itself improve the quality of education and adapt training to occupational and social realities and its

development strategy. Health care and other public services must be impoved to make the country more attractive for firms and their labour force. Demand-side concern includes a public sector which, in the future, must reward and retain professional skills.

While it may be difficult to avoid the loss of trained teachers and nurses, Lesotho must opt for greater access to tertiary education in South Africa. The domestic higher education system, with relatively few students and a broad programme, is very expensive for the government. Education at this level must be evaluated from an international perspective with increased regional cooperation. Otherwise, the education in a small country such as Lesotho will be costly and of low quality, partly as a result of an increasing brain drain of the best teachers and researchers. Furthermore, cost-recovery measures must be found, given the high costs of a place at the national university, the low proportion of that cost born by the student beneficiary and the high private benefit often produced as a result of employment abroad. In this context, cooperation with South Africa can be developed to improve the loan repayment mechanism and to shift some of the costs of vocational and tertiary education to South Africa, which benefits substantially from the immigration of educated Basotho.

Summary and policy implications

The dynamic and fundamental changes that are taking place in South Africa, the uncertainites over the SACU, especially over revenue-sharing, the declining opportunities for legal migration to South Africa and rapidly rising unemployment and underemployment create an urgent need for an appropriate response by Lesotho. This requires a timely and consistent policy framework. In this context, closer integration, and possible economic union, with South Africa has been an important underlying theme of the options recommended.

For closer integration to become feasible, conditions must be found under which such a policy is attractive for both countries. From a South African point of view increased illegal immigration of unskilled labour, which has replaced legal immigration as the main form of migration, underscores the need for an equitable and mutually beneficial programme of regional cooperation. A likely policy response by South Africa would be to take part in integration schemes that focus on employment creation in Lesotho and other neighbouring states, combined with measures to improve the status of legal migrants in order to reduce the pressure on them to undercut local workers.

Free movements of labour betweeen the two countries would reinforce the core-periphery relation between the two economies. If migration to an increasingly attractive post-apartheid South Africa were to take on a more permanent character, remittances would be reduced, and the tax base of

Lesotho would be depleted. Skilled and educated manpower would be the first to find relatively well-paid jobs and be able to exploit better working and social environments in South Africa and the personal advantage of virtual dual citizenship rights. Their departure would reduce job opportunities for the less skilled workers who remain. A dramatic deterioration of the post-apartheid Lesotho economy might lead to mass migration, which eventually would lead to incorporation in South Africa as the only remaining alternative. Free labour mobility would also lead to reduced wage differentials and more uniform labour standards, which would eliminate Lesotho's advantages of cheap labour.

Restriction on labour mobility in order to maintain real wage differentials to counterbalance differences in labour productivity between the two economies does not exclude deepened integration in other economic areas, usually connected with economic unions. In the context of our core-periphery model, high transaction costs between different locations lead to essentially self-sufficient regions. Assuming increasing returns to scale in the production of manufactures, closer integration, which reduces transport and other transaction costs, may make it worthwhile to concentrate production, since access to the core markets of South Africa still outweighs production costs as a determinant of location. However, as these costs continue to fall, the importance of being close to the markets and suppliers will decline. In that situation, Lesotho can offer potential producers the advantages of lower wages, which, in turn, may require restrictions on labour movements to maintain wage differentials. Thus, we conclude that, excluding free labour mobility, a more complete integration into the South African market and the elimination of non-tariff barriers to trade and investments may favour peripheral location of manufacturing in Lesotho. This might eventually lead to convergence of real wages. Furthermore, increased integration of government activities would reduce costs and increase efficiency, largely to the benefit of Lesotho, and make the country more attractive for its people and potential foreign investors.

Notes

1   In terms of the SACU agreement, South Africa sets customs and excise policy and duty rates. Lesotho's currency, the loti (plural: maloti) is pegged at par to the South African rand, the exchange system is free of restrictions on payment and transfers for current transactions within the common monetary area, and maloti issues are required to have a 100 per cent backing by holdings of South African rand, rand assets or, since 1989, other convertible currencies (Lundahl and Petersson 1991: chapter 9). The LHWP consists of a large component that will export water to South Africa and a smaller one that will generate electricity for Lesotho and for export.

2   The customs union agreement of 1910 consisted of six articles, all of which were brief and phrased in general terms. It provided for the free interchange of products and manufactures within the common customs area and, with certain

exceptions, for the uniform application of South African customs and excise tariffs. After allowing for these exceptions, all revenues from customs and excise duties were pooled by South Africa, and a fixed share of 0.47093 per cent was returned to Lesotho. The remaining three articles are relatively less significant.

3   The transport of goods by road was permitted only for distances of less than 30 miles, or to the nearest railhead, and road haulers were subject to licensing for particular routes. In certain cases Lesotho was also discriminated against by higher railway rates than those charged on transport within South Africa, while at the same time rebates were granted to industrial products manufactured in specified Bantustans or border areas within South Africa. (Ettinger 1974:276).

4   During the period of rapidly increasing external incomes, 1972–77, imports of goods and services grew annually by 17.2 per cent, while exports declined on average by 5.9 per cent annually.

5   These include the Lomé Convention and the General System of Preferences which provide access to European and North American markets respectively.

6   The mining component was, however, recorded by the mining companies.

7   The figures refer to employment as recorded by the South African Chamber of Mines between 1987 and July 1995, presented by The Employment Bureau of Africa Limited (TEBA) and provided by TEBA Maseru (1996).

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TRADE LIBERALISATION IN MAURITIUS: EFFICIENCY GAINS AND LABOUR MARKET EFFECTS*

Chris Milner and Geoffrey Reed

Introduction

There has been a considerable amount of interest in academic and policy circles about why a small, remote island in the Indian ocean like Mauritius, relatively poorly endowed with natural resources, should have been so successful in the last decade in promoting its economic development and non-traditional exports (Romer 1993, Greenaway and Milner 1991). Indeed the island's performance is even more remarkable given that when James Meade examined the island's problems in the 1960s, he was very pessimistic about the prospects for development and for avoiding the 'Malthusian solution' (Meade 1961, 1967). In the mid-1960s per capita income in Mauritius was about US$175 and there were no manufactured exports. By 1990, however, per capita income had risen to US$2,225, and manufactured exports accounted for over 60 per cent of total exports.

A range of internal and external factors and of policy and non-policy influences have been suggested as at least contributory factors to this unexpected success story. The role of preferential access for manufactured exports (mainly clothing) to the European Union (EU) market has been seen as a major influence on the incentive for Hong Kong entrepreneurs to invest in Mauritius. Alternatively, high external aid per capita—directly, or indirectly through the long-term sugar price agreements under Lomé—has been seen as a helpful factor. Favourable external conditions were arguably necessary but not sufficient conditions for the kind of growth and trade effects in recent years. (See Dabee and Milner 1995, for further discussion on this point.) Growth-enhancing supply-side policies, including trade policy reforms, also appear to have played a role. However, the shift in the 1980s (albeit a relatively gradual one) towards more liberal or market-oriented policies in Mauritius needs to be seen alongside interventionist, even paternalistic, labour market policies. In such a setting, one might have anticipated that the

government in Mauritius, as in a number of other countries receiving external advice to reform, would have resisted trade liberalisation (lowering of tariff and/or non-tariff barriers), fearing the political costs of short-run labour market disruption and unemployment. Given that a substantial adjustment programme was implemented and that there were not significant unemployment problems, we need to consider how the characteristics of the labour market and of the trade and related liberalisation fashioned this outcome.

The aim of this paper is to investigate the relationship between trade policy reform and labour market policies and adjustment. The main focus is Mauritius, but there is also some attempt to review what trade theory leads us to expect. The paper is organised, therefore, as follows. The next section sets up an analytical framework for investigating the labour market effects of trade liberalisation, using a specific factors approach to capture the adjustment process. The following two sections respectively describe (briefly) the process of structural adjustment and trade liberalisation and the nature of the labour market and labour market policies in Mauritius. Next, we attempt to relate the evidence on employment and real wage adjustment during the liberalisation episode to the earlier analytical framework. The final section provides some summary conclusions.

Labour market adjustment to trade liberalisation: The analytical framework

The analysis of the effects of changes in trade policy on the labour market follows closely that of Edwards (1988) but distinguishes between traditional and non-traditional exports. We start with short-term effects, assuming that capital is immobile between sectors, but also consider the long-term effects in qualitative terms.

The initial labour market equilibrium

In describing the initial equilibrium we assume that a set of border taxes is already in place: specifically, traditional exportables, S, face an export tax and importables, M, a tariff. Non-traditional exportables, Z (from the Export Processing Zone), are assumed to be exempt from border taxes, and there are no domestic taxes either on these tradable goods or on non-tradables, N.

In Figure 13.1, the total (fixed) labour supply is shown by $O^T O^N$. L_S is the (derived) demand function for labour in the traditional exportables sector, and is a decreasing function of the real wage rate measured in terms of traditional exportables, ?. L_Z and L_M (not shown) are the demands for labour in the non-traditional exportables and importables sectors. Both are
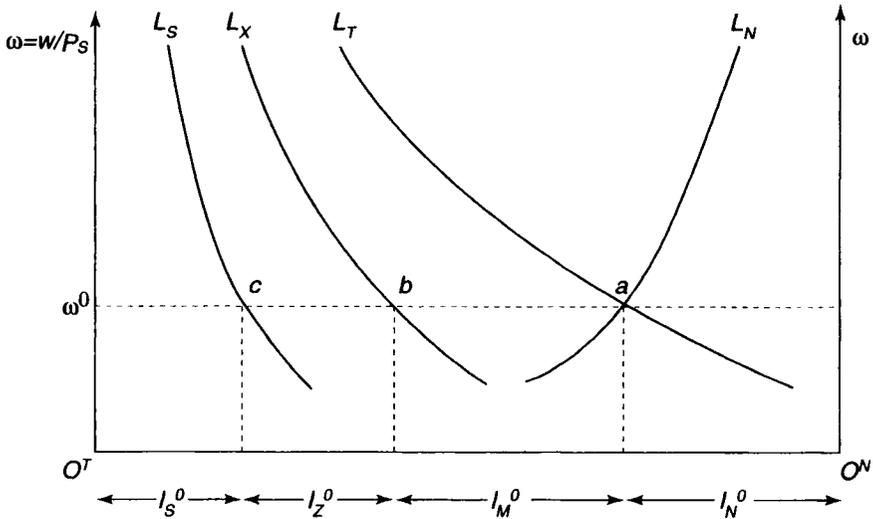
Figure 13.1 The initial labour market equilibrium

decreasing functions of the wage rate relative to the price of their own products and, hence, provided that the price of their own products relative to the price of the traditional exportables is unchanged, decreasing functions of ω. L_X $(=L_S+L_Z)$ is thus the aggregate demand function for labour in the two exportables sectors, and $L_T(=L_S+L_Z+L_M)$ the aggregate demand function for labour in the three tradables sectors. L_N, drawn relative to the right-hand vertical axis, is the demand function for labour in the non-tradables sector. Again, this is a decreasing function of ω, provided that the price of nontradables relative to that of the traditional exportables is unchanged. We assume that initially there is full employment. The real wage, ω^0, that clears the labour market is given by the intersection of L_T and L_N. At this real wage, employment in traditional exportables is l_S^0, and in the non-traditional exportables, importables and non-tradables sectors, $l_Z^0, l_M^0 l_N^0$, and respectively.

Reducing the tariff on importables

The effects of a reduction in the tariff on importables[1] will be discussed in terms of Figure 13.2. The immediate effect will be to reduce the domestic price of importables relative to that of the traditional exportables, so that the labour demand schedule for the importables sector expressed in terms of ? (not shown) will move downwards, and hence so will the aggregate demand schedule for labour in the tradables sectors, from to, L_T say, L_T^1.

The price of non-tradables is of course endogenous, so that the labour demand for the non-tradables sector will shift as a consequence of the fall in

the domestic price of importables. Following Edwards (1986), provided all goods are gross substitutes in consumption and production, and that the income effect does not exceed the substitution effect, the price of nontradables will fall relative to the price of the traditional exportable (and hence relative to the price of the other exportable) but will rise relative to the price of importables. The fall in the price of N relative to that of S will lead to a downward shift in the labour demand schedule for the non-tradables sector to, say, L_N^1.

The new labour market equilibrium must obtain at a lower real wage (in terms of traditional exportables). Employment in each of the two exportables sectors must increase, the relative size of the increases depending on production conditions in the two sectors. Employment in the importables sector must fall, but employment in the non-tradables sector is indeterminate (in the example shown in Figure 13.2 it falls, but a sufficiently small shift in L_N would lead to an increase).[2]

We may deduce the direction of capital movements (assuming that land is specific to the traditional export sector) by reference to the changes in employment reported on above. First, since labour has moved into both exportables sectors, the real return to capital must rise in those sectors, while the outflow of labour from importables will reduce the real return to capital in that sector; in the longer term, therefore, there will be capital inflows into exportables and out of importables (inducing further labour flows, and so on).[3] Whether there is a movement of capital into or out of non-tradables will reflect the direction of labour movements in that sector: if labour moves out in the short term then so will capital in the long term, and vice versa. In the long run (as capital specificity disappears), factor returns will move in
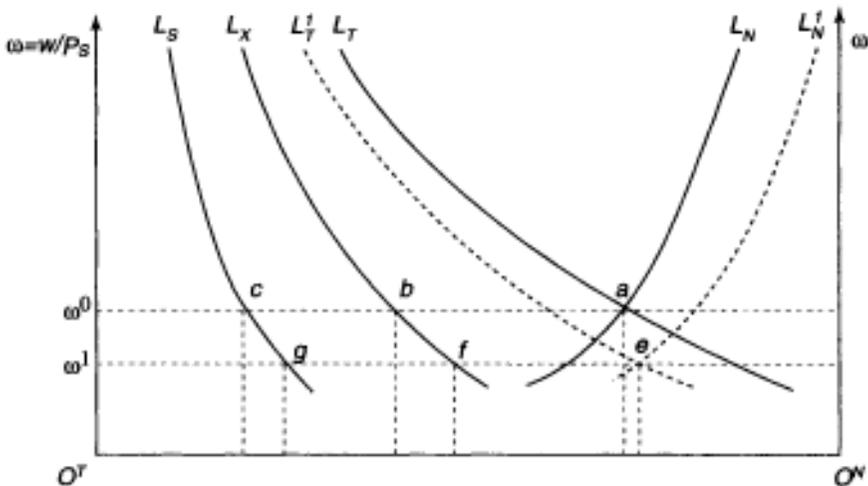
Figure 13.2 The effects of reducing the tariff on importables

the same direction. Under the present assumptions regarding capital intensity, real wages will rise in all sectors as the labour-intensive exportables sector expands.

Minimum wages, expansion of non-traditional exportables production and unemployment

Edwards (1988) discusses how the existence of an economywide minimum wage that was previously not binding may generate unemployment when capital is immobile and the price of importables falls (for convenience we assume that the minimum wage is set in terms of traditional exportables). We use the same analytic framework to discuss how an economywide minimum wage that is binding, and so has resulted in unemployment, will allow an expansion of production in one of the exportables sectors without reducing production of the other tradables. Specifically, we consider an expansion in the production of non-traditional exportables, Z, in response to a rise in the world price of those goods.

Figure 13.3 shows the initial situation. As before, L_s, L_X, L_T, and L_N are the initial labour demand schedules for the traditional exportable, both exportables, the three tradables and non-tradables respectively. The minimum real wage, ω^{MIN}, is such that, with capital sectorally immobile, there is unemployment (U) equal to distance cd. Suppose now that the domestic price of non-traditional exportables rises, so that L_x shifts upwards to L_X^2, and L_T upwards to L_T^2. Other things being equal, this will reduce unemployment to fd. The final effect on unemployment will depend on
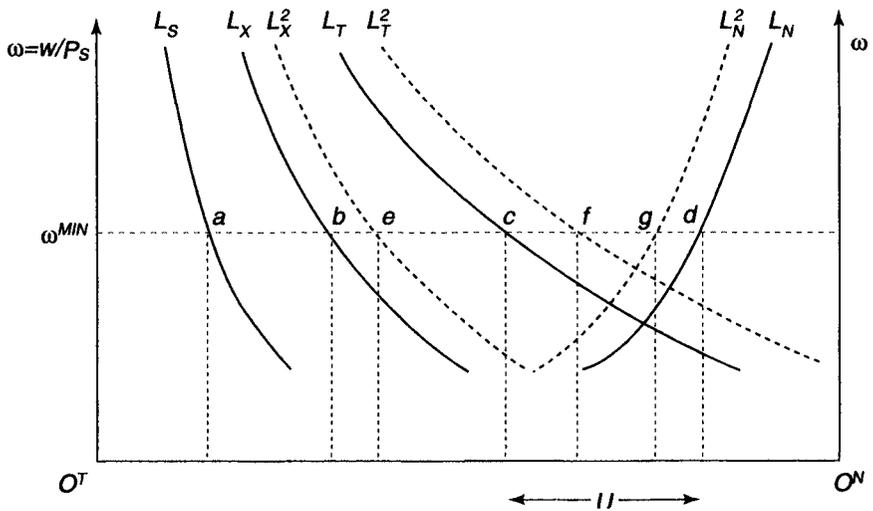
Figure 13.3 Expanding non-traditional exportables when there is a minimum wage

271

the reaction of the non-tradables sector. If the assumptions made in the previous analysis hold, then the labour demand schedule for non-tradables will move upwards from L_N to, say, L_N^2, reducing unemployment yet further to fg. (Of course, L_N could move downwards, thus offsetting some of the unemployment-reducing effect of the expansion of the non-traditional exportables sector.) Note that in either event there is no reduction in output or employment in the other tradables sectors.

Trade and foreign investment policies and liberalisation in Mauritius

There are a number of distinctive features of Mauritian experience of structural adjustment and trade liberalisation. These are gradualism, the existence of export incentives for non-traditional exports prior to direct import liberalisation and the significant role of foreign direct investment and foreign entrepreneurial skills in the export sector.

The distinction between adjustment and the structural adjustment programme can and should be drawn in the case of Mauritius: not because the programme of the 1980s was not associated with adjustment but because the process of adjustment may have begun earlier. Mauritius did experience a period of sustained stabilisation and exchange-rate adjustment starting in 1979 which was followed by a period of substantial import liberalisation between 1983 and 1987. This corresponds with the Structural Adjustment Lending (SAL) agreements in 1979, 1981 and 1983. However, attempts to reduce the trade regime bias against exports predate this episode of policy reform. Mauritius had operated an Export Processing Zone (EPZ) scheme since 1970. The presence of approximate free trade status and favourable fiscal incentives for export firms meant that Mauritius had attracted foreign investment and know-how, from Hong Kong in particular, and acquired some (non-negligible) non-traditional export capacity by the beginning of the SAL programmes. (EPZ exports—mainly knitted textiles—already accounted for 24 per cent of total exports by 1979.) Thus one might date structural adjustment in a narrow sense to cover the period 1979–87. However, one should be aware of the longer-term dimension of adjustment within the Mauritian economy from 1970 onwards. Indeed, since the abolition of import permits, full liberalisation of foreign exchange and further import tariff reductions came in the 1990s, one might view 1987 as a premature fixing of the end-date for structural adjustments.

The prestructural-adjustment trade policy regime in Mauritius is summarised in Table 13.1. It was typified by mixed and variable measures of import substitution, export-promotion assistance for manufactured goods and non-traditional agriculture, and export taxation of the traditional export (sugar).

Table 13.1 Pre-trade liberalisation pattern of assistance to Mauritian industries

Sector	Main form of assistance	Subjective ranking of protection levels
Manufacturing **Import-substituting**		
• Large new activities (e.g. foodstuffs), assembly of colour televisions	Development certificates scheme, tariff and import quota protection	Assisted at a very high rate
• Other	Import licensing and tariff protection	Assisted at high but variable rates
Export-oriented		
• wholly (e.g. knitwear)	Export Enterprise certificate scheme	Assisted but at low rate
• partially (e.g. furniture)	Tax rebate based on export growth	Disadvantaged at low rates
Agriculture		
• Sugar – large growers	Tax of 23.625% on gross export receipts	Severally disadvantaged
– small growers	—	Approximately zero rates
• Rice	Subsidised exchange rate and subsidy payments on rice	Severely disadvantaged
• Other agriculture	—	Approximately zero

Source: *Dabee and Milner 1995*

Pre-reform import substitution measures

The Development Certificate Scheme was initiated in 1963—the pre-SAL legislation was set out in the Development Incentives Act 1974—and was designed to encourage the establishment of import-substitute industries in Mauritius. Its primary objective was to create employment in the manufacturing sector. Incentives to companies with Development Certifications (DCs) included a tax holiday on corporate profits, exemption for a period from income tax on dividends, advanced factories, investment finance at preferential rates, investment allowances and import duty relief (or exemption) on machinery, raw materials and semi-finished products. Protection from foreign competition was given through tariff and quota restrictions on imports.

At the start of the 1980s about 150 companies with Development Certifications (DC) were in operation, employing a total of about eight thousand people. The main concentrations of the manufacturing companies were in food and beverages and engineering. Both DC and non-DC firms received additional assistance/protection through tariff and non-tariff restrictions on imports.

The Mauritius tariff schedule included general customs duty and fiscal duty. The (unweighted) average nominal rate of visible (fiscal and customs) duties was 55 per cent in 1980. In addition, a number of supplementary duties had also been applied after the mid-1970s to all imports, including an import surcharge (10 per cent), a special levy (10 per cent) and stamp duty (12 percent).

In addition to import duties levied for general protective and revenue purposes, specific quota protection of up to 80 per cent of the domestic market was offered on a discretionary basis to companies with DC status. Import licensing was also used in a less specific manner to provide protection for all local production in the manufacturing sector and non-traditional agricultural activity.

It should be noted also that there was significant escalation in scheduled tariffs which was exaggerated further by the presence of quantitative restrictions generally on imports of final goods and the pervasive use of import duty exemptions on imports of intermediate goods and raw materials for DC firms and other firms on a discretionary basis. These factors contributed to producing very high and variable (within and across industries) effective rates of protection for import substitute activities (see Table 13.2).

Export promotion measures and foreign investment

The Export Processing Zone[4] Act (1970) was intended to encourage the development of export-based manufacturing and a processing industry in Mauritius through local and overseas investment. The incentives offered at this time to companies under the Act included a tax holiday on corporate profits (longer than that available for DC firms), exemption from income tax for distributed dividends (again for a longer period than for DC firms), advanced factories, investment and export finance at preferential rates, investment allowances, import duty exemption on machinery, components, raw materials and semi-finished products, and no restrictions on ownership or repatriation of profits.

Romer (1993) sees the attraction of foreign investment and entrepreneurialism into the EPZ sector (specifically and predominantly in garments and knitwear) as the key distinctive reason for the Mauritian success. The fiscal incentives for this inward investment are set out above, but Romer also emphasises the role of low wage costs in the development of the EPZ: a policy of centralised wage setting by the government gave implicit assurance

Table 13.2 Average rates of effective protection in the Mauritian manufacturing sector, 1980 and 1990 (per cent)

Sector	1980	1990
Beverages and tobacco	123	182
Textile yarn/fabrics	77	11
Wearing apparel	99	4
Leather products	269	8
Footwear	158	88
Wood products	191	38
Furniture	130	241
Paper products	131	57
Printing/publishing	75	7
Chemical products	38	21
Rubber products	125	144
Plastic products	89	59
Non-metallic products	77	48
Iron/steel	154	73
Fabricated metal products	156	48
Machinery (excluding electrical)	62	3
Electrical machinery etc.	179	181
Transport equipment	23	4
Optical goods, watches, etc.	266	9

Sources: *Greenaway and Milner 1989, for 1980 rates; Dabee and Milner 1995, for 1990 rates*

to foreign investors of moderate wage increases and control of industrial unrest. No doubt there were some other favourable aspects of the domestic 'environment' that enhanced the attractiveness of Mauritius relative to alternative locations for foreign direct investment, but external trade relations were also favourable.[5] Although both domestic and foreign investment in the EPZ grew sharply, and there was some diversification of activities after trade liberalisation,[6] the preliberalisation EPZ was dominated by foreign investment and concentrated almost exclusively on garment production.

At the start of the reform period about 130 firms were operating with EPZ status, employing about 24,000 people, with the vast bulk of the production in spinning, knitting and made-up garments. Thus, although there was a strong bias in the policy regime in favour of import-substitution activities (for domestic investors in particular), the EPZ sector was significantly larger than the DC sector in employment terms. In production terms the picture is less clear, since manufacturing as a whole accounted for 14.9 per cent of GDP (at current and policy-distorted factor cost) in 1979, while the EPZ sector contributed only 3.4 per cent of GDP (with sugar processing accounting for 3.9 per cent).

Timing, sequencing and extent of trade liberalisation

During the period 1979–83 the emphasis was on macroeconomic stabilisation and exchange rate adjustment. Indeed, during this period trade policy (in particular import duties) was used in a more restrictive manner, with stamp duty on imports progressively increased and an import surcharge applied in 1983. Trade liberalisation did not start therefore until after 1983. The initial period between 1983 and 1985 was concerned mainly with some liberalisation of foreign exchange and import licensing restrictions, and with the reform of the border taxation of imports. This latter element was rather more focused on simplification of the duty structure than on reduction of average rates of duty. Indeed, import surcharges were increased further in 1984 and 1985 for fiscal reasons. A planned consolidation of some duties, the reduction of the spread of rates and reduced exceptions (e.g. on intermediate imports) were aimed at reducing the spread and level of effective protection in import-substitute sectors (though little progress was made on this). The main phase of import liberalisation and reduction of protection for local firms came in the period 1985–87 with the progressive dismantling of quantitative import restrictions.[7]

The post-reform estimates of effective protection (1990) are reported in Table 13.2. Average rates in some non-export industries remain absolutely high, with rates in excess of 100 per cent in the case of beverages and tobacco, furnitures, rubber products and electrical machinery. But, in general, significant declines in rates of effective protection relative to 1980 levels are identified. In five industries the fall is at least 100 per cent (wearing apparel, leather products, wood products, fabricated metal products and optical goods/watches), and there are six further industries where the fall is in excess of 50 per cent. Indeed the estimated rate of protection is higher in 1990 than 1980 in only four cases.[8]

Changes in trade volumes

The stabilisation episode of the early 1980s is captured by the importto-GDP ratio recorded in Table 13.3, the ratio falling from 0.57 in 1980 to 0.42 in 1983. After 1983 the ratio increases continuously until 1988, rising particularly quickly during the quantitative restriction (QR) liberalisation period between 1986 and 1988. This growth may be accounted for in greater measure by the export-induced growth of intermediate and capital goods imports between 1982 and 1988. Note that the share of final consumer goods in total imports fell from 30.3 per cent to 15.5 per cent over this period. Table 13.3 shows that the share of exports (in particular manufactured/EPZ exports) in GDP grew rapidly after 1983: from 0.44 to 0.61 in 1987. Thus the pattern of actual trade expansion corresponds quite closely with the dating of liberalisation indicated earlier.[9]

Table 13.3 Volume and composition of Mauritian trade, 1979–1990

Imports

	Ratio to GDP	Share of imports (%)		
		Intermediates	Capital formation	Final consumption
1979	0.52	57.7	12.1	30.3
1980	0.57	60.7	10.8	28.5
1981	0.49	62.0	9.5	28.4
1982	0.43	63.2	6.5	30.3
1983	0.42	64.3	8.7	27.0
1984	0.47	68.9	8.3	22.8
1985	0.52	69.2	9.2	21.7
1986	0.55	72.4	11.5	16.1
1987	0.60	67.6	14.5	17.9
1988	0.72	62.9	21.6	15.5
1989	0.70	66.2	16.1	17.6
1990	0.70	64.9	17.3	17.8

Exports

	Ratio to GDP	Share of exports (%)	
		Sugar	EPZ
1979	0.39	61.8	24.1
1980	0.49	60.6	24.8
1981	0.37	49.6	33.2
1982	0.44	56.5	28.3
1983	0.44	57.8	28.2
1984	0.46	46.0	39.2
1985	0.51	41.0	46.6
1986	0.57	38.0	53.0
1987	0.61	36.3	55.0
1988	0.60	32.2	59.0
1989	0.58	31.8	58.4
1990	0.57	28.2	63.5

Source: *Dabee and Milner 1995*

Characteristics of the labour market and policies in Mauritius

Mauritius has evolved an extensive set of legal and institutional arrangements for the exercise of governmental influence over the determination of wages and working conditions. Trade union activity and collective bargaining are protected but subject to elaborate conciliation and dispute settlement procedures, including provision for compulsory arbitration.

The National Remuneration Board (NRB) sets both a general minimum wage level and detailed minimum wage scales and other working conditions for various industrial and occupational groupings covering most of the blue-collar employees in the private sector.[10] As a major employer, the government exercises both a direct and an indirect influence in the labour market through employment policy decisions and periodic salary revisions.

The extent of governmental involvement in industrial relations has constrained the development of private collective bargaining arrangements and processes. While employer organisations are strong and function effectively, trade unions are, with a few notable exceptions, generally weak and fragmented. The proliferation of trade unions has been substantial in recent years, but most unions continue to be small with limited organisational resources. This fragmentation and organisational weakness have tended to encourage unions to seek their bargaining objectives through governmental intervention in the form of NRB minimum wage orders or compulsory arbitration awards rather than by voluntary negotiation of collective bargaining agreements.

Despite the pervasiveness of interventions in the form of NRB remuneration orders, the evidence would seem to indicate that NRB remuneration orders have been a minor or at least a declining factor in determining the structure of relative wages. Most workers have traditionally been paid well above these minima. The structure of occupational and industrial wage averages is now primarily dependent on relative supply and demand conditions. The substantial increase in labour demand that has taken place in the 1980s has reduced further the influence of government on wages in the private sector.

The changes in the level and the broad structure of employment in Mauritius over the last two decades are shown in Figure 13.4. There are a number of distinctive features of the changes. First, there are the three phases or episodes: overall employment growth up to 1978, stagnating growth between 1978 and 1983 and rapid growth after 1983. Second, agricultural employment, although relatively stable in absolute terms throughout (with a slow decline after 1978), has declined steadily over the period from over 30 per cent to about 17 per cent in 1990. Third, the expansion of employment in the 1970s was accounted for by tertiary-sector expansion rather than by manufacturing employment (which still only accounted for about 17 per cent of total employment by 1978). Finally, the rapid expansion of total employment after 1983 was largely accounted for by manufacturing employment growth, with the share of manufacturing employment rising to 39 per cent by the late 1980s.

There are two major distinctive features of the post-1983 growth in manufacturing employment. One is the dominant role of one industry or sector, namely clothing and textiles, in that growth. Figure 13.5 shows that employment in this sector grew from about 20,000 in 1983 to over 80,000 in
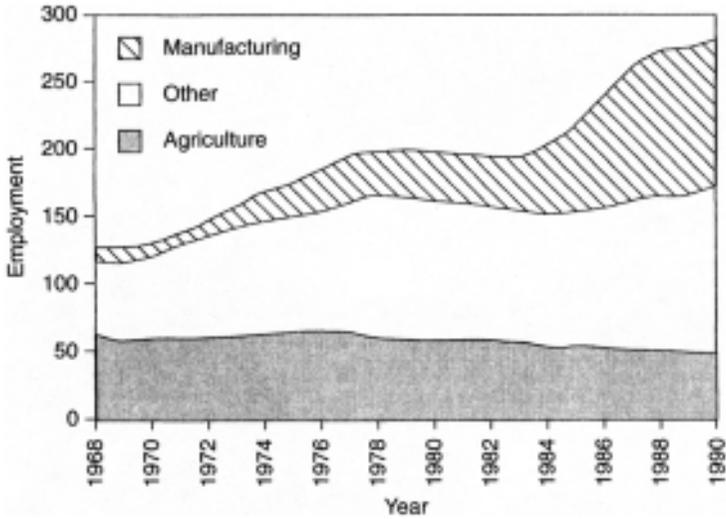
Figure 13.4 Broad level and structure of employment, 1968–1990 (thousands)
Source: Milner and Wright 1995

1988. (Employment in other manufacturing activities rose from about 15,000 to just over 20,000 over the same period.) The second distinctive feature is the disproportionate growth in female employment in clothing and textiles in this period. The post-1983 experience of Mauritius is consistent therefore with trade liberalisation increasing the demand for labour (particularly female labour) in labour-intensive manufacturing (exportables) activity. Although there is some redistribution of labour from agriculture during the 1980s, and recorded unemployment fell to virtually full employment conditions by the late 1980s, the period also witnessed a large growth in the labour force associated with increased female participation.

The effect of changing domestic and external demand conditions on real wages within the manufacturing sector is illustrated by Figure 13.6.[11] Declining unemployment and increasingly inflationary conditions in the first half of the 1970s resulted in sharply rising wages in most manufacturing sectors (especially non-EPZ) up to about 1978. During the stabilisation period (1979–83), the upward movement in real wages was sharply reversed.

The post-stabilisation period is typified by rising real wages (albeit with inter-sectoral variation). Interestingly, wages in the EPZ sectors, especially clothing and textiles, display less volatility than those in the non-EPZ sectors throughout the period, and (but for a short period up to 1970) are consistently lower than in non-EPZ manufacturing. This feature is captured by Figure 13.7, which plots real wages in the non-clothing/textile (manufacturing) sectors relative to clothing/textile real wages. Although

(a) Clothing and textiles industries
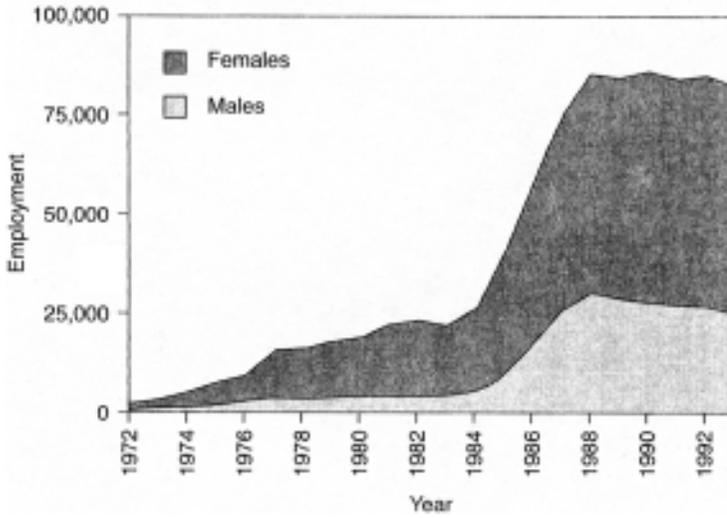
(b) Industries other than clothing and textiles
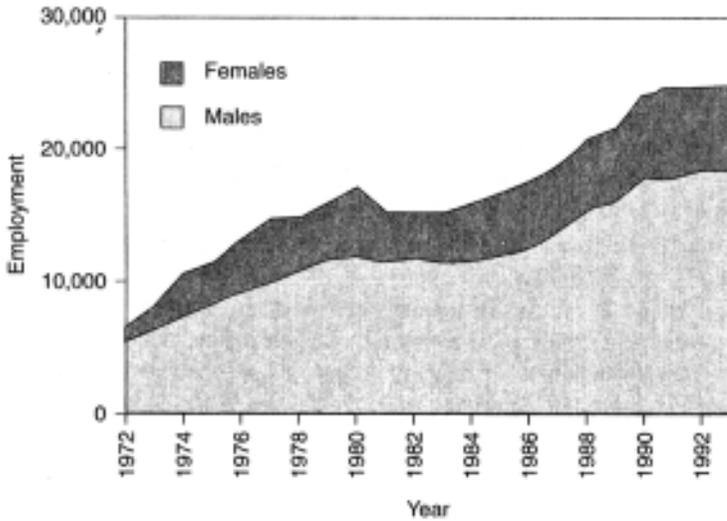
Figure 13.5 Employment by gender in manufacturing
Source: Milner and Wright 1995
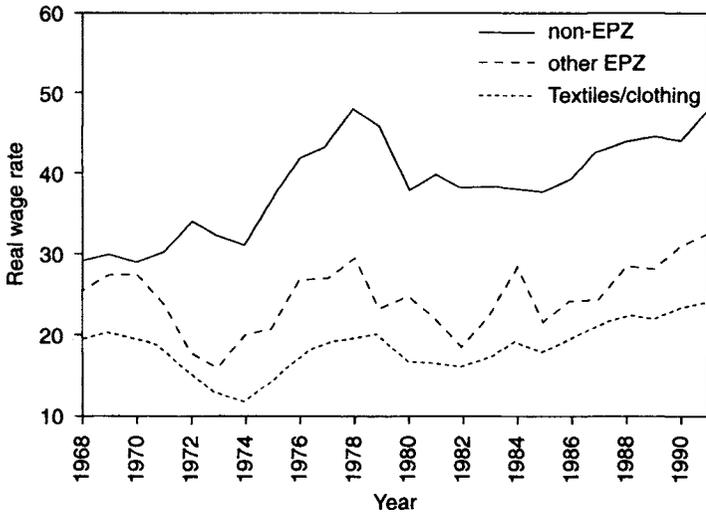
Figure 13.6 Average real wages in manufacturing by sector, 1968–1991 (rupee thousands)
Source: Milner and Wright 1995
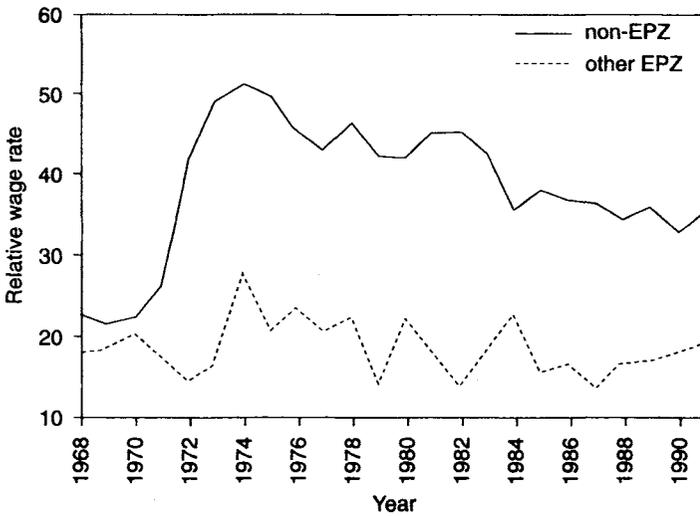
Figure 13.7 Real wages relative to those in textiles/clothing, 1968–1991
Source: Milner and Wright 1995

real wages in clothing and textiles remain relatively low in the post-stabilisation/ liberalisation period, there is apparently some convergence of real wages after 1983.

Wage and employment response to trade liberalisation: Mauritius 1979–91

We seek in this section to bring together the analytic framework set out above with the experience of liberalisation or structural adjustment we have described. We therefore report evidence on employment and average real wages changes in the four broad sections used in the analytic framework—importables *(M),* non-tradables *(N),* traditional exportables *(S)* and non-traditional exportables *(Z).* (The components of each category are described in Table 13.4.) The changes are identified for alternative reform episodes over the period 1979–91; a stabilisation period (1979–83), an initial liberalisation phase (1983–85), the major liberalisation of quantitative restrictions (QRs) on imports (1985–87) and a post-QR liberalisation period (1987–91). This allows some flexibility in the dating of trade liberalisation but also allows us to distinguish between short- and medium-term effects of the structural adjustment programme. Actual data on employment *(L)* and real wages *(w)* for the full period are set out in Table A. 13.1 in the Appendix. For ease of interpretation, we summarise the direction of change for *L* and *w* for each phase of the reforms in Table 13.4 (as a general rise (?) or fall (?) or approximate constancy (–)).

It is evident from Table 13.4 that the rise in demand for labour in the non-traditional export sector was not induced only by import liberalisation. There was expansion of L_z during the stabilisation period (1979–83), prior to any import liberalisation, and throughout the two liberalisation periods and thereafter. Conversely, employment in the traditional export sector fell during the stabilisation and liberalisation periods, stabilising in the final period. Both L_M and L_N fell prior to liberalisation, and both rose after the initial liberalisation phase (1983–85). Thus we appear to have a story of a mixture of growing external demand for non-traditional exports and import liberalisation which in the context of unemployment—registered (see Table 13.5) or hidden in the form non-participation by females—meant that expansion of non-traditional exportables could be achieved without contracting the importables sector. Indeed the resulting positive income effects may account for the expansion of importables production that occurred after the mid-1980s.

Of course, as noted above, the expansion of non-traditional exportables was accompanied by a contraction of the traditional (sugar) sector in employment terms. But this was not the result of short-term changes in the pattern of relative prices, given the long-term agreement with the EU

Table 13.4 Summary of employment and real wage changes over reform, 1979–1991

Employment effects[a]	*Sectors*[b]			
	Importables	Non-tradables	Exportables	
			Non-traditional	Traditional
Reform periods	L_M	L_N	L_Z	L_S
Stabilisation period (1979–83)	↓	↓	↑	↓
Initial liberalisation (1983–85)	—	—	↑	↓
QR import liberalisation (1985–87)	↑	↑	↑	↓
Post-QR liberalisation (1987–91)	↑	↑	↑	—

Real wage effects[a]	*Sectors*[b]			
	Importables	Non-tradables	Exportables	
			Non-traditional	Traditional
Reform periods	w_M	w_N	w_Z	w_S
Stabilisation period (1979–83)	↓	↓	↑	↓
Initial liberalisation (1983–85)	—	—	↑	↓
QR import liberalisation (1985–87)	↑	↑	↑	↓
Post-QR liberalisation (1987–91)	↑	↑	↑	—

Notes: [a] *Based on annual information on employment and real wages given in Table A. 13.1 in the Appendix;* [b] *M=non-EPZ manufacturing sectors; N=all tertiary sectors; Z=EPZ manufacturing sectors; S=all agricultural sectors*

guaranteeing the export price of sugar. It reflects rather a long-term technological effect with increased mechanisation reducing labour demand.

The effect of import liberalisation, or an exogenous expansion of demand for non-traditional exports on non-tradables employment (L_N), was ambiguous in the analytical framework. With or without binding minimum wages, an expansion in employment required substitution effects that resulted in the rise in the price of non-tradables (relative to the price of traditional exportables and importables). The evidence suggests that this may have been the case for Mauritius: L_N rises after 1985. Positive growth or income effects may also have played a role in this outcome, however.

Table 13.5 Unemployment in Mauritius, 1979–1991

	Numbers of registered unemployed ('000s)[a]	Rate of unemployment (%)[b]
1979	22.8	10
1980	37.6	16
1981	60.1	23
1982	75.1	28
1983	70.7	27
1984	65.9	25
1985	58.4	21
1986	49.5	17
1987	39.0	13
1988	22.0	8
1989	15.4	5
1990	11.3	4
1991	11.0	4

Notes: [a] *Data supplied by Ministry of Economic Planning, Mauritius;* [b] *Registered unemployed as a share of the number employed in labour enterprises plus the number of registered unemployed*

The sharp declines that took place in real wages across all sectors over the stabilisation period suggest that the minimum wage structure did not generally much influence the pattern of real wages. This may have been in part because minimum wages were set in nominal terms, but it also reflects a tendency for nominal rates to be set at non-binding levels. Indeed after the mid-1980s the upward movement in average real wages across all sectors served to reduce the significance of this form of wage rigidity even further.

The general real wage effect post-liberalisation is consistent with a long-term effect in an Heckscher-Ohlin world where the demand for labour has been increased by the switch in demand towards the more labour-intensive EPZ sector. Certainly L_z more than doubled between 1984 and 1990. But, as argued earlier, the relative importance of endogenous policy-induced relative price effects and exogenous external demand effects is ambiguous. Besides which, it should be recognised that technology (including improved management methods) and capital accumulation effects were also likely to have exerted upward pressure on real wages over this period. These are not simple, static effects of trade liberalisation, though it does not mean that such dynamic real wage gains were necessarily independent of the policy environment.

Summary conclusions

A 'full' explanation of changes in the Mauritian labour market in response to import liberalisation obviously requires augmentation of the simple analytics

given earlier. However, it is not difficult to envisage how that would proceed. Growing external demand for, and foreign investment in, the non-traditional exportables sector and technical and managerial progress there and elsewhere have tended to shift the labour demand functions upwards, except in the case of traditional exportables, where technical progress and largely inelastic demand conditions have had the opposite effect. The ensuing rise in real wages in all but the traditional exportables sector has both reduced registered (mainly male) unemployment and increased participation by females.

Changes in the Mauritian labour market cannot, however, be attributed to import liberalisation alone, and certainly not to pure 'market-based' liberalisation. As we have argued, the stabilisation that took place before liberalisation, the policy measures directed at establishing and promoting non-traditional exports even before that and the encouragement of inward investment all contributed to the growth in real wages and employment. Moreover, the role of the government in the labour market seems, despite the apparent 'ineffectiveness' of minimum wage legislation, to have contributed to increased foreign investment in the EPZ through the implicit assurance of stability in the labour market.

Notes

* We are grateful to our discussant, JefFery Round, for his comments and suggestions. Any remaining errors or omissions are, of course, our responsibility.
1 Used to represent any trade liberalisation that reduces the domestic price of importables.
2 The present analysis focuses on comparative statics, where it is assumed that income effects of trade policy reform are not important. Where reform has major positive income effects, the decline arising from relative price effects, even in importables employment, may be obscured by a general rise in the demand for labour.
3 Ultimately such capital movements may lead to complete specialisation in the two exportables.
4 There is no special geographical zone on the island. Rather EPZ firms have a specific legal status. The government has encouraged the dispersal of establishments, with designated factories and sites being bonded.
5 Mauritius was not subject to Multifibre Arrangement (MFA) quota limits in the US and the EC, and the Lomé agreement also provided Mauritius with a tariff preference.
6 The rate of investment in manufacturing overall rose about threefold in real terms between 1982 and 1987. In the same period, real investment in the EPZ rose twelvefold. About a third of this expansion in EPZ investment was from foreign sources.
7 Milner and McKay (1996), however, identify an improvement in the real exchange rate for exportables after 1983 and up to 1987.
8 It should be noted, however, that the average figures capture not only the effects of the changes in the trade policy interventions associated with liberalisation but also the resulting changes in the distribution of sales between the protected home market and export markets.

9 Of course, issues of counterfactuals and causality arise. The expansion of exports may have been assisted (in part at least) by other external and non-policy factors, and the resulting easing of the foreign-exchange constraint facilitated the expansion of imports.

10 There are separate and 'more favourable' (to employers) labour regulations including minimum wages and, in the case of the EPZ, covering working conditions.

11 Note that real wages refer here to nominal wages deflated by the consumer price index, rather than the relative price definition of the real wage used in the analytical framework section.

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Appendix

Table A. 13.1 Sectoral employment and real wages, 1977[a]–1991

Employment (L)

	L_S	L_N	L_Z	L_M
1977	65,140	89,152	17,722	24,029
1978	59,158	95,116	18,106	22,401
1979	55,866	100,036	19,085	22,920
1980	54,478	99,485	20,314	22,616
1981	57,922	95,967	22,852	20,657
1982	52,700	95,912	24,018	20,689
1983	52,714	93,821	25,670	20,986
1984	50,195	92,945	34,049	20,854
1985	49,143	94,951	53,454	21,121
1986	47,686	95,558	70,499	22,142
1987	47,337	100,907	82,601	24,458
1988	44,462	106,425	86,978	25,959
1989	44,744	108,598	88,519	26,439
1990	44,406	115,792	86,890	27,847
1991	44,665	119,312	89,112	28,726

Real wages (w)

	w_S	w_N	w_Z	w_M
1977	31,661	45,409	19,269	43,441
1978	28,195	43,038	20,227	47,994
1979	25,733	43,044	20,226	45,715
1980	20,611	36,491	16,994	37,776
1981	27,609	41,617	16,821	39,720
1982	21,347	37,875	16,127	38,378
1983	22,196	39,443	17,165	38,379
1984	23,416	38,516	19,356	37,892
1985	22,702	37,779	17,827	37,523
1986	23,203	39,644	19,177	39,214
1987	24,440	41,110	20,955	42,587
1988	27,060	47,715	22,400	43,842
1989	28,453	50,191	22,009	44,171
1990	25,960	46,291	23,346	43,743
1991	31,049	49,258	24,085	47,846

Note: [a] *The data relate to large enterprises only. In the case of non-agricultural establishments, this covered those employing at least ten persons. Continuous information on employment in small enterprises is not available. A census in 1986 indicated that about 150,000 people were employed in small enterprises*

14

MOZAMBIQUE: MACROECONOMIC PERFORMANCE AND CRITICAL DEVELOPMENT ISSUES

Finn Tarp and Morten Igel Lau*

Introduction

Complete transformation of a seriously distorted colonial economy was what the Mozambican liberation movement 'Frente de Libertação de Moçambique' (Frelimo) set out to achieve after independence in 1975. However, the command-type economic policies adopted by Frelimo proved unsuccessful. A bloody war and a range of deep-seated structural problems inherited from the colonial era also helped to pave the way to economic collapse. As a result, a fairly typical stabilisation and structural adjustment programme, the Economic Rehabilitation Programme (ERP), was launched in 1987 with the assistance of the International Monetary Fund (IMF) and the World Bank. Subsequently, focus in the economic reform effort in Mozambique has so far been on: (1) macroeconomic attempts to stabilise the economy, (2) liberalisation, through reductions in centralised administrative controls and increased use of indirect price and credit policies, rather than direct administrative intervention in the allocation of resource and (3) a process of privatisation.

Assessments of the impact and degree of success of the ERP vary. Some observers take note of the fact that there are now more goods in the shops in Mozambique than ever before in the post-independence years. They also support the claim that the reforms have secured the much needed turn-around in economic trends (USAID 1996). Others such as Green (1992) are less sanguine. They point out that the overall macroeconomic and social situation in Mozambique remains precarious and vulnerable to shocks. They also refer to the deterioration of various social indicators, and they argue that the rate of robbery and urban crime is rising sharply and that urban people are becoming wary about going out at night. This was not the case before 1987.

In sum, it is clear that the social fabric of Mozambique is threatened and that Frelimo's nation-building efforts as originally designed have failed. Mozambique's economy is characterised by very low levels of output (National Planning Commission 1994), and 60–70 per cent of the population live in absolute poverty (Fortes 1995). According to Fortes the average calorie intake is less than 77 per cent of the estimated daily requirement, and social indicators are worse than the averages for Sub-Saharan Africa.

In spite of the above affirmations, the macroeconomic performance of Mozambique and the underlying causal mechanisms that drive actual economic outcomes are poorly understood. Statistical data are scarce and susceptible to error, even when they are compared to the figures for other African countries, and it is difficult to separate the economic effects caused by structural poverty from those caused by prereform economic policies, the economic recovery programme and exogenous factors such as the security situation and the weather. Thus, at this stage it cannot be expected that a complete and fully reliable picture can be pieced together. Nevertheless, as peace has now returned to Mozambique after more than a decade of damaging internal strife, it is particularly pertinent to review past policies and try to assess their effects. A sound basis for future policy formulation can only be formed by appreciating fully the complex circumstances that led to the breakdown in 1986 and the subsequent policy reforms.

Hence, what this paper will do is to present the results of a careful analytical review of the Mozambican economy based on the scattered evidence available at the time of writing. For this purpose we will draw upon a recently published set of national accounts data, covering the period up to 1993. However, the objective is not to reach a final position on whether adjustment has worked or not. Rather, the issues to be addressed are (1) to find out what can be said about the macroeconomic performance of Mozambique over the past decade in the light of the events that led to the ERP and the actual reform policies pursued and (2), on this basis, to identify some of the more critical macroeconomic problems facing the Mozambican government in the short to medium term.

Accordingly, the next section takes a look at macroeconomic and political developments from independence to 1986, followed by an overview of the ERP policy measures. The subsequent section investigates the macroeconomic consequences of the reform efforts followed by a description of current imbalances. Finally, the last section presents the conclusions that we have drawn.

Macroeconomic and political trends before 1987

Mozambique became independent from Portugal on 25 June 1975. The liberation movement Frelimo took office in a chaotic atmosphere. Some 90

per cent of the 200,000 Portuguese settlers—i.e. the majority of the skilled and semi-skilled labour force and most experienced managers—left the country after destroying much of the capital stock. The main effects of the exodus were felt in the civil service, plantation agriculture, rural marketing and distribution and the administration of enterprises, ports and railways. Hence, the exodus created a vacuum in public and private administration and left Mozambique practically without skilled workers in production and service activities.

A new constitution was introduced at independence with a 230-member People's Assembly as the supreme state authority. However, effective control of the highly centralised political and executive system of government was vested in the central organ of the ruling Frelimo party, the ten-member Standing Political Committee. Administrators were appointed by the state to run abandoned companies, and the Third Congress of Frelimo in 1977 outlined the strategy and policies for a radical transformation of socio-economic structures. The establishment of the material and ideological basis for a socialist society became an overall goal, and emphasis was laid on the role of the state in savings, investment, production and trade. Thus, state control permeated almost all commercial activities in the economy. Private companies remained in existence, but as small-scale entities, and they were subjected to strict regulation.

By the early 1980s the rebel movement 'Resistencia Nacional de Mozambique' (Renamo) reinforced the efforts to destabilise the Frelimo government. Renamo had been created by the white regime in Rhodesia in the late 1970s, but was mainly financed and trained by South Africa after Zimbabwe gained independence in 1980. The economic and social infrastructure was severely damaged by the war as Renamo sabotaged schools, health clinics, railway lines, electricity pylons and destabilised much of the countryside. Defence expenditures by the government surged, leaving little or no room to rehabilitate depleted human and physical capital resources, and millions of people were displaced from rural districts, externally and internally.

The government launched an over-ambitious ten-year development plan, Plano Perspective Indicative (PPI) in December 1981, and the 1980s were expected to become the 'Decade for the Victory over Underdevelopment' with annual GDP growth rates of 17 per cent and a fivefold increase in agricultural production by 1990. Four key programmes formed the core of the plan: (1) cooperativisation of the countryside, (2) creation and development of heavy industry, (3) development of a state agricultural sector and (4) massive human resource development. Large, centralised investment projects were designed, including big state farms and plants to produce iron and steel, aluminium, chemicals and fertilisers from gas, paper and heavy engineering goods. However, Mozambique lacked human and capital resources to achieve growth rates of the above order, and the war totally

disrupted production and marketing. Hence, Mozambique entered a deep recession in the early 1980s. Moreover, the tendency to rely on direct, centralised administrative allocation of resources was—as is normally the case—reinforced as the war effort escalated and financing became scarcer.

Agricultural policies were focused on big state-owned farms and production cooperatives. Numerous communal villages were established, but the inability of the government to provide adequate support on a continuous basis for their development gradually undermined peasant confidence in Frelimo. Moreover, the heavy government investment in state farms led to the accumulation of substantial foreign debt. In the end, this debt became unsustainable, as mechanisation and irrigation schemes did not yield expected economic returns owing to the lack of experienced commercial farmers and the absence of economic incentives.

Furthermore, while the smallholder sector accounted for almost the entire food production of Mozambique, basic agricultural services were lacking. The trading network broke down when the Portuguese left the country, and the war made it even more difficult to trade goods and services. Frelimo tried to promote agricultural marketing through a parastatal company (Agricom), but its activities were largely unsuccessful. Consequently, peasants became more and more isolated from markets during the first half of the 1980s. The government increased its support for private farmers in 1983 by improving allocations of machinery and inputs, but producer prices for marketed crops were kept below market clearing prices which discouraged farmers to sell their output on official markets. Finally, the drought in 1983–84 had a disastrous effect on agricultural output. Hence, officially marketed production of agricultural products fell by more than 50 per cent during the first half of the 1980s, and food aid grew to more than 500,000 tons on an annual basis (Tarp 1990). In fact, food aid grew to more than 85 per cent of the total official grain supply and became an important source of government revenue, while per capita food consumption probably fell by more than one-third from 1979–86.

The industrial sector was unable to cope with the large investment projects initiated by the government in 1981. The Portuguese exodus left the country without the necessary human capital, and centralised control of prices and distribution, lack of foreign exchange, shortage of inputs, the disruptive effects of war, irregular power supplies and the world recession in the early 1980s made it impossible to maintain production levels. Thus, industrial activity fell rapidly during the first part of the 1980s, and by 1986 industrial output was less than half its 1981 level.

Frelimo recognised some of the shortcomings of the PPI already in 1983 at the party's Fourth Congress. Excessive centralisation of decision-making and the rigidity of the management system were identified as key internal problems alongside external factors stemming from South African destabilisation. Frelimo also realised that the economic system adopted was

inflexible and extremely vulnerable to economic shocks. Consequently, Frelimo called for a reordering of priorities and prepared an economic action programme for the 1984–86 period. Renewed emphasis was laid on the importance of the peasant sector, and private initiative was to be promoted in all sectors of the economy. Nominal consumer and agricultural producer prices were raised, prices of some crops were liberalised and producer incentives came more into focus as an issue. Several of the huge state farms were divided into smaller and more manageable units and some plants were rehabilitated.

However, the relatively limited measures taken were not sufficient to reverse the negative economic trend. The centralised control and structure of the economy remained intact, and real GDP decreased at an average rate of 3.5 per cent per year from 1981 to 1986. Moreover, while a decisive political move to stop the war was made by the Frelimo leader Samora Machel signing the so-called Nkomati Accord with South Africa in 1984, hostilities did not come to an end. South African backing of Renamo continued and rendered major parts of the countryside insecure.

Many of the more difficult constraints to developing Mozambique are related to the structural deformation of the economy which took place during the colonial period. The economy was mainly organised to serve the needs of South Africa and Southern Rhodesia and enabled the colonial power to extract most of the economic surplus. Hence, transport links running east—west were developed by the Portuguese to connect the hinterland with the ports on the coast, while north-south communication was neglected. Indeed, it remains a major problem for agricultural producers in the more productive north to reach markets in the south, and considerable price differentials exist across different regions in the country. The transport infrastructure was also affected by widespread sabotage by Renamo during the war, and the tense political relationship with South Africa implied that South African traffic through Maputo harbour by 1986 had been reduced to only 10 per cent of the 1973 level. The sharp decline in agricultural and industrial production had negative spillover effects as well, and transport earnings fell drastically during the first half of the 1980s.

The above trends contributed to the accumulation of substantial debts by state-owned companies. In addition, public deficits averaged no less than 16.6 per cent of GDP from 1981 to 1986, while the fiscal deficit, including grants from foreign donors, averaged 11.1 per cent of GDP during the same period. More than 40 per cent of the public deficits including grants were financed by expanding the domestic money supply, the rest by foreign loans.[1] Hence, domestic credits tripled from 1981 to 1986. Meanwhile, the official exchange rate of the metical was kept fixed in relation to the US dollar and exchange rate adjustments hardly ever occurred. Thus, parallel markets for goods and foreign exchange emerged owing to the combination of fixed prices, loss of monetary control and an increasing excess demand for

consumer goods and marketed crops. Prices surged on the parallel markets, and by 1986 the price of foreign exchange on the black market was fifty times higher than the official rate.

The recession caused by the war and the grossly overvalued exchange rate had disastrous effects on exports, and the increasing difficulties in trading made the situation even worse. By 1985 exports of goods and services were less than 30 per cent of the 1980 level, and imports contracted as well. The drop in imports was more limited than that in exports and meant that total exports covered less than 25 per cent of total imports by 1986—down from 50 per cent of total imports in 1981. Consequently, Mozambique became heavily dependent on foreign grants and loans. At the end of 1986, Mozambique had a total outstanding international debt of US$3.4 billion as compared to US$750 million in the early 1980s, and scheduled debt service reached 275 per cent in 1986. Moreover, aid flows accounted for more than half of GDP, and capital expenditures—which remained stagnant in monetary terms during 1981–88—were almost completely donor-financed by 1986, leaving little room for the government to manoeuvre (Tarp 1990).

In sum, the command-type strategy adopted by Frelimo at independence had shortcomings that are clearer today after the upheavals in Eastern Europe than they were at the time they were introduced. Moreover, these problems were seriously aggravated by the war and the structural problems inherited from the colonial era. Thus, the economic policies pursued by Frelimo failed. By 1986 internal and external economic balances had become close to impossible to manage, while the majority of the small peasants were left in an extremely vulnerable situation. Some 60 per cent of the population were poor in absolute terms, and social indicators were among the worst in the world. Generalised shortages were epidemic, parallel markets grew rapidly, the exchange rate was grossly overvalued and dependency on donors for financial assistance and food aid was excessive. Hence, crisis management had become the order of the day with little attention to medium- and longer-term needs. Finally, the government was losing effective control of the economy, and popular support for Frelimo dwindled.

Macroeconomic policy reforms

To counteract the disastrous economic situation described above, the government of Mozambique introduced a comprehensive market-oriented 'Economic Rehabilitation Programme' in 1987, with the assistance of the International Monetary Fund and the World Bank. Subsequently, the reform effort was renamed 'Economic and Social Rehabilitation Programme' (ESRP) in 1989 to emphasise the social dimension of the adjustment effort. The objectives of the reforms were initially to raise production levels by 1990 to those of 1981, reduce financial imbalances, eliminate parallel markets and create a basis for future economic growth. In particular, the plan was to

increase marketed agricultural production by the family sector by an average growth rate of 29 per cent per year between 1987 and 1990 and to boost industrial output and transport activity by average annual growth rates of 12 per cent and 23 per cent, respectively (Economist Intelligence Unit 1996).

Mozambique had joined the IMF and the World Bank in 1984, but received no financial backing from the Bretton Woods institutions before the introduction of the ERP. Extensive discussions with the IMF and the World Bank preceded the adoption of the ERP, and the first agreement was signed in March 1987. Since then Mozambique has received a series of Structural Adjustment Loans (SALs) and Sectoral Adjustment Loans (SECALs). IMF credits have also been relied on, including both the Structural Adjustment Facility (SAF) and the Enhanced Structural Adjustment Facility (ESAF). The introduction of the ERP and the agreement with the IMF and the World Bank were instrumental in facilitating debt-rescheduling negotiations with external creditors. Debt-rescheduling agreements on concessional terms were reached with Western countries and private banks in 1987, and there has been some progress on bilateral debt reductions since 1990. In addition, the composition of foreign resource inflows has also been modified in the direction of flows with a higher grant element. Hence, the foreign debt-to-GDP ratio has generally stayed around 400 per cent in recent years, despite substantial trade deficits.

The ERP as originally conceived was fairly standard in design. It included a series of stabilisation measures such as fiscal adjustments, monetary restraint and devaluation of the exchange rate. In line with the market-oriented nature of the programme, substantial price and trade liberalisation has also been pursued with a view to promoting a more efficient allocation of resources and increasing production in all sectors of the economy. Similarly, institutional reforms of the financial sector and a privatisation programme have been key components of the ERP.

Few prices are by now set centrally by the government, since most state farms and many small and medium-sized enterprises have been privatised. Yet, approximately two-thirds of gross industrial output was still under state control at the end of 1993. Although a considerable part of the retail sector had been privatised at that stage, the larger industrial enterprises were mainly under state control. The privatisation process accelerated during 1995, but such institutional changes remain of key importance on the reform agenda.

On the fiscal side, the government tried to enforce more rigorously the fixed limits on expenditures by state-owned companies after the adoption of the ERP. In particular, direct subsidies and credits were cut, and interest payments on credits were introduced. Indeed, explicit budgetary subsidies to parastatal companies were reduced from 11.6 per cent of GDP in 1986 to less than 1 per cent of GDP by 1991. Yet, earnings by the state-owned companies have not improved correspondingly, and some sources indicate that direct subsidies have to some extent been replaced by indirect credits

from state-owned banks (USAID 1996). On the revenue side, little permanent progress has so far been achieved, despite various attempts which will be discussed later, and there is an evident need to rationalise the tax system, and especially to strengthen the weak customs administration. Public-sector budget deficits before grants increased substantially during the first years after the introduction of the economic reforms in spite of tightened budget controls. On the other hand, foreign grants rose as well, so public budget deficits after grants have decreased on average since the prereform period.

Financial-sector reforms were speeded up in 1992 with the separation of commercial and central bank functions of the 'Banco de Mozambique'. However, both banks remained under government control, and the commercial bank, 'Banco Comercial de Mozambique', has not performed well, despite tightened lending criteria and credits to public enterprises since 1993. Private bank activities have expanded since the introduction of financial reforms, and interest rates were fully deregulated in June 1994. Indeed, real interest rates on loans became positive in late 1991 for the first time since independence, in order to promote savings and make credit allocation more efficient.

The official exchange rate was brought to more realistic levels after the introduction of the ERP, and an official market for foreign exchange was introduced in 1990. The foreign exchange rate is now floating and decreased from 40 meticais to the US dollar in 1987 to 5,918 meticais in 1994. As pointed out above, the government gradually controlled fewer prices, and subsidies were progressively lifted from food and other items. Consequently, consumer prices of imports and domestic goods and marketed crops rose considerably towards commercial market clearing rates during the early reform period, and the annual inflation rate reached almost 182 per cent in 1987. Moreover, current account deficits have since 1987 been well above prereform levels, despite realignments of the foreign exchange rate and the liberalization of foreign exchange markets in 1990.

The liberal constitution adopted by the Mozambican government in November 1990, after discussions at the Fifth Congress of Frelimo, was an important additional step in the attempt to promote economic and social recovery. The introduction of the new constitution marked a critical move towards political pluralism and democracy, and executive, legislative and judiciary powers were separated. A peace accord was agreed upon by Frelimo and Renamo in October 1992, and the United Nations installed its third-largest peacekeeping operation ever in 1993. Even so, the demobilisation of the Frelimo and Renamo armed forces did not begin until March 1994. The new constitution and the peace accord paved the way for the first free general election in October 1994, and President Chissano of Frelimo stayed in power. Frelimo acquired 44 per cent of the parliamentary vote, and Renamo became the leading opposition party after doing well in key central provinces. Problems with dual administration in central regions have, however, existed since the election, and basic institutions and democratic practices remain weak at present.

Macroeconomic performance after ERP

Statistical data in Mozambique are particularly unreliable, even compared to other African countries. Technical statistical expertise is lacking in the country and data on output, marketing and expenditure, in particular, are uncertain owing to the war and the large extent of informal sector activities. National accounts statistics have been revised a number of times after 1986, but contradictions within official sources and between official and alternative sources remain. Moreover, data have until recently only been available on the expenditure side (i.e. consumption, investment and international trade), precluding separate estimates of value added from the supply side. Nevertheless, concerted efforts have been made by the government to improve statistical data since the October 1994 elections, and it is the latest data released that we refer to in what follows. It must be kept in mind, however, that statistical figures provide at best indications of general trends.

Judging from the available data, it appears that the economic reforms had a positive effect on aggregate production. Real GDP growth rates were high during the first three years after the ERP was introduced (Table 14.1), and real GDP grew by no less than 44 per cent from 1987 to 1993. However, the objectives set by the ERP were not met.[2] The ongoing war was a major obstacle to economic recovery, and the worldwide recession and the 1991–92 drought in Southern Africa added to existing problems such as administrative chaos and shortages of foreign exchange. Hence, economic growth slowed down in the beginning of the 1990s, and GDP actually fell in 1992. The peace accord, better weather conditions and the establishment of the UN peacekeeping operation meant that GDP increased by almost 20 per cent in real terms in 1993, but this appears to have been a temporary boost only (see also the Economist Intelligence Unit 1996).

As a consequence of the war and the enormous number of displaced people, no reliable census data exist. Almost half of the population were displaced internally or externally at the end of the war, and income data are, as noted above, uncertain. However, the figures in Table 14.1 do illustrate the extreme poverty in Mozambique. Indeed, Mozambique is clearly one of the poorest nations in the world in terms of GDP per capita, and this is so, even if GDP data are underestimated, as is argued in recent World Bank studies.

High population growth rates are obviously of great concern when ways to improve the average living standards are considered, and Mozambique must achieve an annual real GDP growth rate of no less than approximately 2.6 per cent just to maintain the standard of living. The average annual growth rate of real GDP between 1987 and 1993 was 7.5 per cent when measured in local currency, indicating that an increase in real income per capita took place during this period. The metical depreciated rapidly right after the economic reforms were introduced because the currency had been kept at an artificially high rate prior to the adoption of the ERP. Hence, real income per capita

Table 14.1 Gross domestic product (MT[a] billions)

	1987	1988	1989	1990	1991	1992	1993
GDP at market prices	393.3	631.2	990.7	1,340.7	2,056.3	3,125.5	5,463.0
Real GDP (1980 prices)[b]	57.3	62.0	66.0	66.6	69.9	69.3	82.7
Real change in GDP (%)[b]	14.7	8.2	6.5	1.0	4.9	–0.8	19.2
GDP per capita (US$)	140	110	80	80	80	70	80

Sources: *National Planning Commission 1994; World Bank 1994*
Notes: *[a] Mozambique Meticais, [b] At current-weighted constant prices. Refugees not permanently settled in the country of asylum are assumed to be part of the population of their country of origin.*

measured in US dollars decreased considerably from 1987 to 1989 and has remained at approximately US$80 since 1989—except in 1992 when real GDP per capita fell to US$70, because of the drought. It must be kept in mind, however, that the purchasing power in terms of US dollars prior to the reforms was clearly overestimated, so the real average living standard measured in US dollars may still have increased since 1987 if this is taken into account.

Many official prices were, as we have already stated, liberalised and adjusted towards market prices in the early years of the ERP-reform period. As a consequence, consumer prices increased by almost 182 per cent in 1987. The rate of inflation fell to 48 per cent in 1988 after the initial adjustment, and has varied between 34 per cent and 53 per cent from 1988 to 1993 with an average annual increase of approximately 46 per cent (National Planning Commission 1994). Domestic credits to state-owned companies, periodic shortages of foreign exchange, the depreciation of the metical and the drought in the early 1990s contributed to keeping inflation rates high.

The high real GDP growth rates in the first couple of years after the implementation of the economic reforms may well reflect increasing incentives to sell products through official market channels rather than on parallel markets. However, informal-sector activities have so far been estimated as a constant share of formal-sector activities in published data, so the GDP growth figures for the late 1980s are from this perspective too optimistic. But, according to the National Planning Commission (1994), informal-sector activities did in fact increase their relative share of economic activity in the early 1990s. If this is correct, GDP growth in recent years would tend to be underestimated. It is still too early to tell what the trend in informal-sector activities is, but the latest report by the National Planning Commission must

give rise to great concern because the tax base will shrink relative to the size of the real economy when informal-rather than formal-sector activities increase.

Official data do not include an explicit input-output table, but the National Planning Commission (1994) has made a rough estimate of sectoral value added at aggregate sector level by multiplying gross output figures with fixed coefficients to take account of intermediate consumption. The fixed coefficients vary across sectors and periods, capturing especially technological differences and various other developments. However, the method used is a rough approximation, owing to the large fluctuations in the production of almost all items which must have caused significant variations in real value-added coefficients. In particular, the war and the drought in the early 1990s had devastating effects on production and trade, and the lack of foreign exchange when needed made it even more difficult to maintain a stable level of production. Nevertheless, the National Planning Commission has at least tried to provide an estimate of sectoral value added which certainly gives a better idea of the actual sectoral performance than related gross output figures.

Agriculture is clearly the most important sector in the Mozambican economy and far more important than the figures in Table 14.2 reveal.[3] The agricultural sector—including agro-processing activities and commercial fishing—accounted for approximately 80 per cent of employment and 70 per cent of foreign exchange earnings in 1993. The relative share of industrial gross output has decreased consistently since the early 1980s except for a brief period of recovery after the ERP was introduced. Transport did very well after 1990. In particular, donor-financed investments in ports and railways, large amounts of food aid for distribution in Southern Africa in 1991–92 and the peace accord in 1992 helped improve the performance of the transport sector. Commerce and service activities were positively affected by the peace accord and the installation of UN peacekeeping forces in 1993 and therefore accounted for approximately one-third of total value added in 1993.

Estimates of real changes in sectoral value added can be derived by subtracting appropriate deflators provided by the National Plannning Commission (1994) from the growth rates in sectoral value added at current prices. The real growth rates in GDP by origin are, however, rough approximations and should not be taken too literally. In particular, the estimated figures in Table 14.3 tend to overestimate actual figures and trends, owing to the corrosive power of inflation on nominal values within periods.

Prices of agricultural products have in general increased considerably since the introduction of economic reforms; prices of export crops, in particular, rose substantially. However, it is difficult to assess to what extent the price increases have been passed on to farmers. It seems likely that the extraordinary increase in agricultural value added in 1987 to some extent

Table 14.2 Gross domestic product by origin (current producer prices, MT billions and per cent)

	1987	1988	1989	1990	1991	1992	1993
Total (MT billions)	379.6	606.1	940.8	1,276.0	1,950.0	2,945.3	5,089.3
Agriculture	42.5	40.2	43.1	40.3	38.0	32.3	33.1
Industry and fishing	13.3	16.3	15.2	14.8	15.6	14.2	12.0
Construction	7.3	7.5	6.9	7.0	7.1	7.5	7.0
Transport and communication	6.7	6.8	6.4	7.7	11.6	13.1	12.5
Commerce and services	30.2	29.1	28.3	30.2	27.7	32.9	35.3
Total (%)	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: *National Planning Commission 1994*

Table 14.3 Real changes in gross domestic product by origin (per cent)

	1987	1988	1989	1990	1991	1992	1993
Agriculture	61.3	6.0	5.0	–0.8	–4.8	–16.1	27.9
Industry and fishing	18.6	3.5	1.4	–17.7	–0.8	–10.5	–10.8
Construction	–136.6	–10.9	0.9	–1.0	1.0	–2.9	10.5
Transport and communication	–39.6	6.4	12.0	24.5	22.7	15.9	23.7
Commerce and services	11.8	–2.1	5.1	5.9	–1.2	26.0	38.5
GDP at producer prices	20.9	–0.4	6.2	–1.1	–2.7	–0.2	24.2

Source: *National Planning Commission 1994*
Note: *All growth rates are measured at current-weighted constant producer prices*

reflects substitution between formal and informal markets as a reaction to modified price signals. Subsequently, the combination of war and drought in 1991–92 meant that agricultural output declined in the early 1990s, but the rare combination of better weather conditions and peace had a very positive effect on agricultural production in 1993. Nevertheless, Mozambique remains heavily dependent on food aid, and some 8 per cent of total imports of goods consisted of food aid in 1993.[4] Hence, revised price policies have so far by themselves been unable to ensure a breakthrough in agricultural production.

Industrial output surged right after the ERP was introduced because increased foreign grants and credits renewed the access to imported raw materials and spare parts. However, industrial production has decreased

continuously since 1990, and industrial output in 1994 was almost equivalent to its 1986 level. Industry has been constrained by lack of access to foreign imports when required, management problems, administrative chaos and poor industrial policies. In addition, industrial performance has been negatively affected by tightened lending criteria and credits in recent years, and the privatisation programme has forced some companies to close down. The negative effect of all this has not yet been counteracted by the positive effects expected from the ERP Thus, the extent to which the ERP has so far managed to achieve the desired switching in the traded/non-traded balance of goods produced, as a consequence of relative price changes, is at best debatable.

Sabotage of the transport infrastructure and insecurity in rural areas had severe effects on transport earnings, and value added in the transport and communication sector declined by almost 40 per cent in 1987. From the mid-1980s major efforts were made in rehabilitating ports and railways and improving security along the main transport corridors. In particular, a ten-year donor-financed plan was initiated in January 1986 to rehabilitate the port of Beira and improve transport links to Zimbabwe. Transport links to the two other major ports were also improved, and foreign-backed investment projects were initiated recently to improve the capacity and management of the Maputo and Nacala ports. Hence, transport has performed well, especially since 1990, and the significant increase in transport volumes of food aid in. 1991–92, as a consequent of the Southern African drought, was successfully handled.

According to the figures in Table 14.3, none of the optimistic sectoral objectives set out in the ERP in 1987 were achieved—and this is so in spite of growth rates which may have been overestimated. Total marketed agricultural production increased by an average of 15.5 per cent per year from 1987 to 1990, indicating that average annual growth rates of marketed agricultural production by the family sector may have been far from the original growth target of 29 per cent per year. Industrial output increased by a poor 0.6 per cent on average during 1987–90, but industrial production fell substantially in the early 1990s, and so far without any signs of recovery. Growth rates in the transport and communication sector increased steadily from 1988–90, but the drastic fall in 1987 means that value added fell by more than 10 per cent from 1987 to 1990. The transport and communication sector did well in the early 1990s, and the large donor-financed investment projects in transport infrastructure are likely to help establish a sound base for further growth in this sector.

Annual growth rates in real GDP by expenditure categories are shown in Table 14.4. Real changes in private consumption have followed the pattern of real changes in GDP albeit at slightly lower growth rates; fiscal restraint meant that wages and salaries in the civil service fell in real terms after the introduction of the economic reforms. Public consumption in real terms has

increased moderately during the reform years, except in 1989 and 1991–92, where increases were substantial. Indeed, public consumption was the only expenditure component that grew in 1992, because of large emergency expenditures related to the drought.

The increased access to foreign exchange had a positive effect on investment, and real growth rates in investment were high during the first couple of years after the ERP was initiated. Investment grew moderately in the beginning of the 1990s but fell in 1992 owing to the recession and the increased emergency expenditures which meant that imports of food increased at the expense of investment goods. However, investments soared in 1993 as the economy recovered from the drought.

As part of the economic reforms, the Mozambican government has introduced incentives such as tax holidays and absence of withholding taxes in order to attract foreign investment. Yet, it was difficult to attract private foreign direct investment in the late 1980s and early 1990s. The war raged and investors perceived investment regulations as inconsistent (Economist Intelligence Unit 1996). Thus, inflows from this source have remained very low. As far as public investments are concerned, they are to a large extent financed by foreign donors. Accordingly, many investment projects are directed towards rehabilitating and expanding the economic, social and institutional infrastructure. According to Wuyts (1995) the donor projects drain skilled labour from the civil service, which is critical for the remainder of the public sector, given the extremely small supply of skilled labour in Mozambique. In addition, the large inflows of foreign grants and credits keep foreign exchange rates above levels that would prevail in the absence of foreign aid. Hence, while the large extent of foreign aid is necessary to avoid a collapse of the economy, it may worsen prospects for the production of traded industrial goods in the short term.

Table 14.4 Real changes in gross domestic product by expenditure (per cent)

	1987	1988	1989	1990	1991	1992	1993
Private consumption	15.9	7.7	2.7	–4.0	0.0	–5.5	20.1
Public consumption	2.2	4.5	12.0	1.0	0.0	8.9	5.8
Gross domestic investment	15.0	9.9	5.9	3.6	3.0	–4.1	15.5
Exports of goods and services[a]	7.5	9.8	9.2	11.6	27.5	–1.2	3.4
Imports of goods and services[a]	4.4	8.2	3.9	0.0	1.9	–5.9	8.5
GDP at market prices	14.7	8.2	6.5	1.0	4.9	–0.8	19.2

Source: *National Planning Commission 1994*
Notes: *[a] Factor income is not included. All growth rates are measured at current weighted constant prices*

According to Table 14.4, exports of goods and services in real terms performed well in the late 1980s and early 1990s. Indeed, real growth rates of exports were considerably higher than real growth rates of imports during the reform period, except in 1993. The war continued in the late 1980s and early 1990s and disrupted production and marketing of goods and crops. Hence, exports of traditional export products such as cashew and sugar performed poorly, while exports of prawns surged following the introduction of the ERP. The production of prawns was not directly disturbed by the war, and exports of prawns in terms of US dollars increased by an impressive 79 per cent from 1987 to 1993. Indeed, the fisheries sector is the most important export category in Mozambique, with prawns accounting for more than half of total export earnings in 1993 and almost the entire growth of total exports in US dollars since 1987.

Imports of goods measured in US dollars have also been increasing since the economic reforms began, except in 1992 when imports fell by almost 5 per cent. According to the Economist Intelligence Unit (1996), prevailing levels of imports were not sufficient to provide raw materials, spare parts and equipment to maintain production even at very depressed levels. Hence, multilateral and bilateral donors provided foreign capital during the transition towards a market economy to finance an increase in imports and thereby underpin the reform effort. Accordingly, imports of raw materials, spare parts and equipment increased considerably between 1987 and 1993, while imports of food have been relatively stable.

The trade deficit increased in absolute terms by more than 50 per cent from 1987 to 1993 despite high real growth rates of exports after the introduction of the ERP. The realignment of the foreign exchange rate was not sufficient to avoid a deteriorating trade balance (USAID 1996) which clearly aggravated the overall external balance of payments position. However, it is difficult to assess this more precisely as statistics on terms of trade have not been compiled systematically.

The deficit on the service account, including net factor payments, fluctuated between US$102.7 and US$148 million during the reform period without any increasing trends in recent years (Table 14.5). Foregn receipts from transportation have recovered somewhat since the late 1980s thanks to improved security along the main transport corridors and rehabilitation efforts, while workers' remittances from abroad declined by 22 per cent from 1988 to 1991, as workers returned from East Germany. The main factor behind the movement in total service and factor payments has been interest payments. Indeed, interest payments have in general been at approximately the same level as total exports of services and labour remittances from abroad.

Since the colonial years the OECD countries have been Mozambique's most important trading partners. However, trade with neighbouring African countries increased after Mozambique joined regional organisations such as

Table 14.5 Export and import of services and net factor payments (current prices, US$ millions)

	1987	1988	1989	1990	1991	1992	1993
Export of services:							
Transport	35.1	41.5	52.9	63.1	60.2	69.5	78.2
Labour remittances	58.0	71.6	71.3	70.4	55.6	58.0	59.6
Other services	43.9	43.5	42.5	39.9	87.0	95.1	102.0
Total export of services	137.0	156.6	166.7	173.4	202.8	222.6	239.8
Import of services:							
Interest payments	148.4	116.7	169.3	142.4	135.9	171.2	165.0
Transport	33.9	41.3	37.5	39.8	50.2	48.5	51.3
Labour remittances	25.0	25.3	27.5	25.4	29.6	26.6	21.3
Investment	54.7	45.0	47.1	47.8	44.5	43.0	47.0
Other services	23.0	31.0	30.1	30.6	52.2	66.2	76.8
Total import of services	285.0	259.3	311.5	286.0	312.4	355.5	361.5

Source: *National Planning Commission 1994*

the Preferential Trade Area of Eastern and Southern Africa (PTA) and the Southern African Development Community (SADC). Close ties with communist countries after independence in 1975 led to some diversification of trade towards Eastern European countries, but this trade collapsed in 1990 after the upheavals in Eastern Europe and the reunification of Germany. Improved relations with South Africa in the late 1980s and South Africa's membership of the SADC in 1994 boosted trade between the two countries. In particular, exports to South Africa almost tripled between 1989 and 1994, and South Africa was the second most important export market of Mozambique in 1994.

Current macroeconomic imbalances

Despite the macroeconomic reform measures undertaken since 1987 within the context of the ERP, Mozambique is still one of the poorest countries in the world in terms of GDP per capita, and structural problems go deep. Moreover, the rate of inflation is high, industrial performance has been poor, public budget deficits are huge and Mozambique's dependency on foreign aid and credits has increased. Indeed, the most pressing macroeconomic structural problems relate to the external balance, the public budget and, more generally, the mobilisation of domestic savings.

The current account deteriorated considerably during the first couple of years after the ERP was adopted. Current account deficits before grants reached more than 60 per cent of GDP in 1988, and there have been no signs of improvement since then (Table 14.6). According to the national

Table 14.6 Savings-investment and the current account (per cent of GDP)

	1987	1988	1989	1990	1991	1992	1993
Private gross savings	0.7	–1.4	–5.6	2.5	1.8	2.0	2.6
Private investment	28.2	33.8	33.3	32.9	36.4	41.3	44.7
Private net savings	–27.5	–35.2	–38.9	–30.4	–34.6	–39.3	–42.1
Public gross savings	–6.2	–2.9	–2.0	–3.4	–0.5	–3.5	–1.4
Public investment	17.3	23.5	22.9	26.1	24.4	23.2	20.8
Public net savings	–23.5	–26.4	–24.9	–29.5	–24.9	–26.7	–22.2
Total net savings	–51.0	–61.6	–63.7	–59.9	–59.5	–66.0	–64.4
Grants	22.4	31.6	29.1	31.1	35.0	38.9	34.3
Other transfers	–4.0	–1.2	3.0	1.7	–6.0	–4.3	0.8
Current account	–32.6	–31.2	–31.6	–27.1	–30.5	–31.4	–29.3

Source: *National Planning Commission 1994*

accounts statistics available, both private and public investment surged in nominal and real terms after 1987. This is in part due to the high import content of investments in combination with the realignment of the exchange rate and the increased access to foreign exchange. However, the level of investment is evidently overestimated,[5] and GDP growth rates were not pushed up in accordance with the figures in Table 14.6. On the other hand, it is clear that domestic savings remained low. Indeed, public gross savings have been negative since the ERP was introduced. Private gross savings were also negative in the late 1980s but have been positive since 1990, reaching the limited level of 2.6 per cent of GDP in 1993. Hence, almost all investment expenditures have been financed by foreign capital inflows.

Although foreign grants rose in real and nominal terms after the first agreement with the IMF and the World Bank, current account deficits, including foreign grants, almost doubled in 1987 and have remained at approximately 30 per cent of GDP during the reform period. A number of agreements concerning debt rescheduling and debt reductions have been reached with Western creditors and private banks. However, the foreign debt continued to increase to a level of 4.2 times the size of GNP in 1993, while debt service payments were equivalent to 20.6 per cent of earnings from exports of goods and services (Table 14.7). According to the Economist Intelligence Unit (1996) the ratio of foreign debt to GNP was the second highest in the world in 1992, and the external debt remains a heavy burden on the Mozambican economy.

The problems related to the extremely high level of foreign debt can be illustrated by a simple dynamic budget constraint:

CA=(X-M)-rFD+FG

where *CA* is the current account, *X* is exports of goods and services, *M* is imports of goods and services, *r* is the actual interest rate on foreign debts, *FD* is the level of the foreign debt and *FG* is the level of foreign grants including debt reductions. According to the National Planning Commission (1994) GDP was equivalent to US$1,043 million in 1993, while the current account deficit before grants was US$949.6 and foreign grants were US$628.3 million. In addition, the foreign debt reached US$5,263 million in 1993, but debt rescheduling agreements with foreign creditors meant that interest payments were only US$45 million, i.e. the actual interest rate on foreign debts was less than 1 per cent. The very low interest payments during the post-reform period indicate that Mozambique has actually defaulted and is extremely dependent on foreign aid. Hence, Mozambique is vulnerable with respect to external shocks, and considerable debt reductions are necessary to achieve a sustainable external debt position in the short term. Moreover, in the context of decreasing foreign aid to developing countries in recent years, it will be essential for Mozambique to reduce the dependency on foreign aid, and this can only be achieved by increasing exports and mobilising private and public net savings.

Given the need to reconstruct Mozambique after the long period of war and the unsuccessful economic policies pursued by the Frelimo government following independence, it is essential to maintain a high level of investment. Nevertheless, there is an evident need to increase the productivity of investment, and the inter-sectoral allocation of investments has also given rise to concern. For example, only 10 per cent of the 1996–98 public investment plan is geared towards agriculture, which is small relative to the critically important role of this sector in the development process. However,

Table 14.7 The external debt (US$ millions)

	1988	1989	1990	1991	1992	1993
Long-term debt	3,788	3,948	4,189	4,139	4,531	4,668
Short-term debt	373	523	507	460	480	407
Use of IMF credit	41	56	74	118	175	189
Total external debt	4,201	4,527	4,770	4,717	5,186	5,263
Public and publicly guaranteed long-term debt	3,770	3,937	4,170	4,123	4,514	4,650
Debt service payments	56	69	57	57	50	77
Principal	23	26	30	35	28	32
Interest	33	43	27	22	22	45
Ratios (%)						
Total external debt/GNP	403.9	406.6	380.7	376.4	484.3	419.2
Debt-service ratio	21.6	25.4	18.9	15.5	13.7	20.6

Source: *The Economist Intelligence Unit 1996*

more detailed assessment and analysis would be required to estimate the appropriate level and kinds of investments required.

On the savings side, private savings increased but remained small, despite attempts by the government to promote private savings through real interest rate adjustments and deregulations since 1991. The effect of interest rate adjustments on private savings interest rate adjustments is probably small, because the share of income affected by changes in real interest rates is smaller in developing countries compared to industrial countries, and financial markets are rudimentary in Mozambique. In addition, private savings were discouraged by expansionary bank credits to the economy and permanent high rates of inflation. Hence, a more efficient credit allocation and a reduced rate of inflation are necessary to help improve private savings. Thus, a financial sector reform is an indispensable part of the policy reform package.

Public deficits before grants have approximated 25 per cent of GDP since the introduction of the economic reforms because the government was unable to improve fiscal receipts, while public expenditures increased moderately. Public expenditures have remained above 40 per cent of GDP since 1987, and this share only increased slightly when compared to average preform levels—when the exceptional low public expenditures in 1985 are disregarded. Current expenditures were frequently cut to levels below established target levels since the ERP was introduced owing to revenue shortfalls, and public investment expenditures have, as we have noted, largely been financed by foreign grants and loans. Interest payments increased faster than other expenditures since the economic reforms were introduced, while expenditure cuts fell mainly on parastatal transfers (Table 14.8). Military expenditures accounted for almost 40 per cent of total current spending during the years of war, but expenditures on defence and security have declined relative to GDP since peace negotiations began in 1990. Yet, there is still room for further cuts in defence and security expenditures.

Given the severe level of poverty and the urgent need to improve the social, institutional and economic infrastructure it will be difficult for the government to cut overall expenditures in the near future. Indeed, cutting public expenditures may create social tensions, especially in the major cities. For example, there have been several outbreaks of riots in Maputo in recent years. It will therefore be essential to improve fiscal revenue.

Public receipts decreased considerably in the mid-1980s due to increasing war activities and the surge of informal sector activities. The government emphasised the need to revive tax revenues from the outset of the structural reforms, and revenue grew strongly during the late 1980s. In particular a strengthened tax base, following the realignment of prices and exchange rates and the strong growth in trade during the early years of economic reform, led to strong growth rates in revenues from indirect and trade taxes. However, public receipts fell from 22.9 per cent of GDP in 1989 to 21.2 per cent of GDP in 1992 because industrial activity slumped and permanent high

Table 14.8 Public receipts and expenditures (per cent of GDP)

	1987	1988	1989	1990	1991	1992	1993
Public receipts:							
Income taxes	3.8	4.7	4.6	3.9	3.8	3.3	2.9
Indirect taxes	7.5	9.3	10.6	10.2	8.6	9.0	9.8
Trade taxes	2.5	2.9	4.5	4.9	5.3	5.4	5.1
Other taxes	0.9	0.5	0.5	0.9	0.7	0.7	0.4
Fiscal receipts	14.7	17.4	20.2	19.9	18.5	18.4	18.2
Non-fiscal receipts	2.7	3.3	2.7	2.3	3.3	2.8	1.8
Total receipts	17.4	20.7	22.9	22.2	21.7	21.2	20.0
Public expenditures:							
Wages and salaries	3.8	3.9	4.4	4.9	4.9	4.6	4.4
Goods and services	3.2	4.1	4.3	4.6	4.4	5.5	4.2
Defence and security	10.6	9.2	10.3	10.1	8.6	8.3	7.6
Interest payments	2.8	2.5	3.1	3.3	2.2	4.0	3.6
Parastatal transfers	2.3	1.8	1.2	1.1	0.6	0.8	0.4
Other expenditures	0.9	2.1	1.6	1.6	1.5	1.5	1.2
Total current spending	23.6	23.6	24.8	25.6	22.2	24.7	21.4
Capital spending	17.3	23.5	22.9	26.1	24.4	23.2	20.8
Total expenditures	40.9	47.1	47.8	51.7	46.6	47.9	42.2
Deficit before grants	23.5	26.4	24.9	29.5	24.9	26.7	22.2
Grants	13.0	14.5	16.1	16.9	18.6	20.9	17.0
Overall deficit	10.5	11.9	8.7	12.6	6.3	5.8	5.2

Source: *National Planning Commission 1994*

inflation rates eroded the tax base. The introduction of tariff exemptions during the drought in 1992, and increased smuggling owing to the improved access to neighbouring countries with the return to peace, meant that customs performance deteriorated since 1992. Indeed, the tariff exemptions have not been lifted after the weather conditions improved, and customs controls remain problematic. The suspected increase in informal-sector activities in recent years will make it even more difficult to strengthen fiscal revenues.

Nevertheless, given the need to increase public savings it will be essential to increase the tax base especially through reduced tariff exemptions, improved customs controls and a more efficient tax administration. In addition, privatisation of some of the remaining loss-making state-owned enterprises may reduce public expenditures and indeed increase the tax base by allowing private companies to compete on equal terms. Moreover, financial sector reforms may promote investment by improving the allocation of credits through the financial system, creating a basis for increased growth and saving in the longer term.

Conclusions

The long-term growth potential of Mozambique is promising. Mozambique has a rich natural resource base, and the country is strategically situated along the east coast of Africa with harbours that can serve several neighbouring nations. Yet, Mozambique is the poorest country in the world and the economy is ravaged by colonial exploitation, a long period of war and misguided economic policies. Population growth rates remain high, while millions of refugees and displaced people are in a process of being reintegrated. Furthermore, most of the rural and economic infrastructure is in ruins. Hence, the recovery of production for domestic consumption and export is bound to be difficult.

The Mozambican government will have to address the urgent social needs under tight budgetary controls and pressing macroeconomic imbalances. Financial resources are extremely scarce, and the debt burden has serious long-term implications for Mozambique's development efforts. Furthermore, the lack of skilled labour and widespread institutional weaknesses owing to the lack of trained staff in combination with inappropriate management systems are serious constraints. Hence, it will take many years to generate enough wealth in Mozambique to (1) realise a real breakthrough in terms of social indicators, (2) put an end to absolute poverty and (3) achieve the objective of a secure food supply at national, provincial and household levels.

In terms of macroeconomic management and performance, a series of steps have been taken since the introduction of the ERP in 1987. Some progress has been made as regards price and trade liberalisation, but results have in general been below those targeted. Real growth in the agricultural sector has been moderate at best, in particular when population growth is taken into account, and industrial activity has experienced a serious contraction since 1990. Exports have not increased sufficiently to avoid a significant deterioration of the trade balance, public sector deficits remain large and inflation continues to be an endemic problem. Mozambique is, in other words, caught in an international debt trap, and dependence on foreign aid is excessive.

While debt service has been brought down thanks to debt rescheduling and reliance on capital inflows with a relatively high grant element, the debt overhang is large and continues to make the debt situation unsustainable. Moreover, the issue of how to handle the increasing multilateral debt is looming in the background. Hence, further debt relief is certainly called for. This would also be necessary with a view to furthering private investment incentives, considering that rehabilitation and development cannot be realised through stabilisation alone. The supply side of the economy needs to be built up, and this will require continued investment at a high level.

At the same time, Mozambique will have to make a concerted effort to mobilise domestic savings and improve the allocation of resources. The

country cannot continue to rely on foreign aid in the long term, and domestic savings are in any case far below critical levels. This points towards the need to promote private savings through financial-sector reform, which is an issue that merits further study, and the implementation of a series of measures to expand the tax base as well as the growth-enhancing initiatives already referred to. Underpinning this with improved effectiveness of recurrent and capital investments will also be essential.

Notes

* The paper was presented at the sixteenth Arne Ryde Symposium on PostApartheid Southern Africa—Economic Challenges and Policies for the Future arranged by the Department of Economics at Lund University, 23–24 August 1996, Lund, Sweden. Comments and suggestions by participants at the Symposium, an anonymous referee and Thomas Thygesen, Chief Economist at Svenska Handelsbanken's Copenhagen branch are appreciated. The usual caveats apply.

1 Domestic bond financing could not be relied on because such markets did not exist.

2 The production level in 1990 was equal to 96.6 per cent of the production level in 1981.

3 The definition of agriculture in the Mozambican accounts does not incorporate important agricultural activities such as agro-processing activities and commercial fishing.

4 Agricultural data, in particular, should be interpreted with caution because the war made it impossible to collect reliable data in rural districts.

5 Investment often includes costs which are in effect recurrent. For example, donor-financed projects are registered as capital investments regardless of the nature of the project and its costs. Private investment in Table 14.6 is calculated as the difference between total investment and public investment and, as such, captures errors and omissions in the sectoral investment allocation.

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15

DEBT RELIEF AND STRUCTURAL ADJUSTMENT IN TANZANIA*

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Introduction

Tanzania has pursued economic reforms under the auspices of the Bretton Woods Institutions (BWI) since 1986. The results so far are mixed. Positive economic growth has been restored, although per capita incomes still grow at a very slow pace; far-reaching deregulation has taken place in markets for food and cash crops, financial services and social sector inputs; the public sector has been slimmed with a retrenchment of some 50,000 civil servants being finalized in 1995; exchange rates have been unified and the value of the shilling is now determined on a day-to-day basis in an interbank market; and a large share of the notorious parastatal sector—a major source of economic instability and inefficiency in the past—has been removed from government control, via privatisation, liquidation and various lease agreements.

However, while progress has been made with regard to structural reforms, attempts to stabilise the economy have not been successful: inflation remains around 40 per cent; with export proceeds paying for less than half of imports, the external position is not viable; the fiscal gap is large and growing and there are signs that the government has lost virtually all control of expenditures; moreover, foreign aid as a share of GDP remains one of the highest in Sub-Saharan Africa (SSA). Table 15.1 provides further details.[1]

One reason for the unsustainable external position is the large external debt. Although Tanzania managed to service its debt throughout the 1980s and most of the first half of the 1990s, arrears started to accumulate in mid-1994. Since there is no current formal agreement between the International Monetary Fund (IMF) and the government of Tanzania, programme aid and multilateral loans are not forthcoming, nor is Tanzania allowed into Paris Club negotiations. In addition, the successful negotiation of an Enhanced Structural Adjustment Facility (ESAF) requires Tanzania to clear all debt arrears; as shown below, this is likely to put substantial pressure on the government budget.

Table 15.1 Selected macroeconomic indicators, FY 1976-FY 1994 (constant prices; average annual rates of growth unless otherwise indicated)

	FY 76–80	*FY 81–85*	*FY 86–90*	*FY 91–93*	*FY 94*[a]
GDP at factor cost	2.0	1.8	3.9	4.5	3.6
GDP per capita	−1.5	−2.2	0.6	1.4	0.7
Exports	−5.7	−3.3	4.4	4.9	12.8
Imports	2.1	−6.9	2.3	−0.3	22.6
Current account deficit[b]	2.5	8.8	15.7	22.0	22.6
Fiscal deficit[b]	3.8	10.6	7.6	5.4	10.2
Total expenditure[b]	14.2	29.1	23.2	20.2	23.0
Revenue[b]	10.9	18.3	15.8	15.2	15.0
Terms of trade	−5.7	−7.9	−5.0	−4.5	−1.9
Inflation	16.5	29.7	28.6	22.0	36.0
Investments[b]	24.7	21.6	27.7	32.8	31.3
Domestic savings[b]	19.1	13.2	7.6	4.7	3.3

Source: *Danielson 1996*
Notes: [a] *Estimates;* [b] *Per cent of GDP*

This paper asks to what extent debt relief may assist in stabilising the macroeconomy.[2] Although the 1982 debt crisis generated a substantial literature regarding debt strategies, most of those analyses were in a Latin American context (a survey is found in Cline 1995: chapter 4). The SSA debt problem differs from the Latin American one, mainly because SSA countries in general are less industrialised and because most of the SSA debt is multi-and bilateral. Hence, SSA debt is not traded in secondary markets; so buybacks—a rather popular, although disputed, method for solving the Latin American debt crisis—cannot be used in the SSA context. Three issues are addressed here. First, how does the existence of a large external debt affect the possibility of the successful completion of economic reforms? Second, how does debt relief affect the government s incentives for pursuing economic reforms and what is the role of conditionality? Third, under a floating exchange rate regime, there is in principle no foreign exchange constraint; so what constraints are released by debt relief?

The paper is organised as follows. The next section discusses how the debt affects adjustment, while the following section analyses the impact of debt relief on adjustment effort. This is followed by an outline of the relation between the fiscal gap, inflation and the external debt under a floating exchange-rate regime. A final summary principally concludes that it is possible to construct a case for large-scale debt relief in Tanzania, mainly because the large external debt undermines stabilisation efforts and thus renders successful adjustment even more difficult and painful to attain.

The economics of debt relief

If we define debt relief as a reduction in the present value of creditors' future claims, this means that a reduction of the debt stock is treated on an equal footing with a reduction of interest rates. Then, if adjustment is taken to mean the achievement of a sustainable balance of payment position, debt relief obviously reduces the need for adjustment since a given improvement in international reserves may be achieved with less adjustment (defined as, say, depreciation of the currency).

So, while a large debt may be a sign of failure to adjust in the past, it seems that debt relief reduces the need for current adjustment (Woodward 1992:13). However, this way of reasoning assumes that the behaviour of the debtor government does not change as a result of relief, and, more importantly, it ignores changes in expectations. These qualifications are incorporated in the Debt Relief Laffer Curve (DRLC), associated with Krugman (1989).

The basic idea of the DRLC, which is rather simple, is outlined in Figure 15.1. As the face value of the debt grows above a certain level, D^*, creditors do not expect it to be repaid in full; for commercial bank debt, this expectation is reflected in the price of the debt in secondary markets. The expected value of the debt, E, is thus the probability of full repayment, p, times the face value: $E=pD$. As debt is accumulated above D^*, P falls and thus E increases more slowly than D. It is theoretically possible that, as the debt accumulates, p falls so much that the expected value of the debt actually starts to fall as the face value increases (in the figure beyond $D1$).

From the point of view of the DRLC, it would seem possible that debt relief might benefit both creditors and debtors. Assume that debt is at $D2$. Forgiving an amount *(D2-D1)* reduces the debtor's obligations while increasing the value of the debt to creditors. Hence, as Krugman (1989:265)
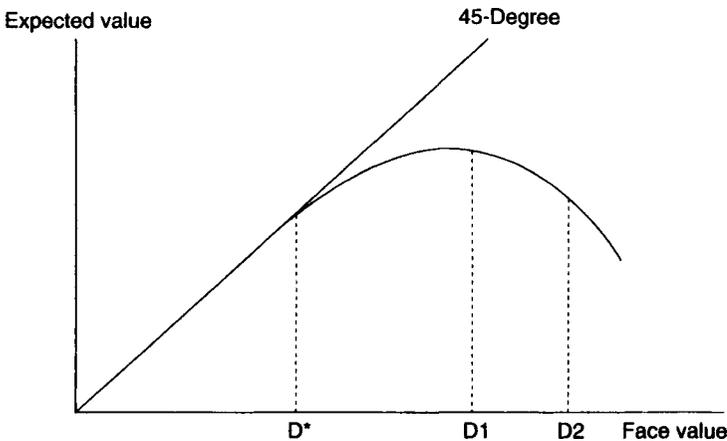
Figure 15.1 The Debt Relief Laffer Curve

puts it, 'arguments that debt relief is in everyone's interest are, in effect, arguments that countries are on the wrong side of the Debt Relief Laffer Curve'.

Even though the DRLC was originally constructed with Latin American debt in mind, it seems that it gives insight into the debt problems of the SSA as well. Actual repayment of debt is determined by two factors: the willingness to service the debt and the ability to service the debt. Debt relief may benefit creditors when the latter constraint is binding.[3] In the SSA context, the reason is as follows. For several SSA countries, the external debt is roughly equally owed to multi- and bilateral lenders. Loans from the IMF and the World Bank have precedence; hence, debt arrears fall upon bilateral lenders. Debt relief (from bilaterals) can have two favourable effects in foreign exchange constrained economies. First, the foreign exchange constraint is immediately slackened and to the extent that the country imports commodities without domestic substitutes (oil, capital goods), investments and/or capacity utilisation may increase, so the country's debt servicing capacity may increase in the future. Second, formal agreements with the IMF (in the form of ESAFs) often require the clearance of debt arrears.[4] Since most lenders and donors (including the World Bank) accept IMF conditionality as a prerequisite for disbursal of programme aid, debt relief may increase the prospects for performance with regard to IMF conditions and thus increase the inflow of future loans.

Turning now to the situation in Tanzania, it is instructive to start by comparing Tanzania's debt situation with that of other SSA countries and also with countries classified by the World Bank as Severely indebted Low-Income Countries (SLICs).[5] Table 15.2 shows two indicators for the debt burden: the size of the debt in relation to GDP and actual debt servicing in relation to export revenues; and two indicators for the structure of the debt: the share of concessional and multilateral debt, respectively.

It is quite clear that Tanzania's debt burden is heavier that that of most other indebted economies; it is also clear that the present debt problem is a rather recent phenomenon. In fact, the external debt started to grow rapidly only after the introduction of the IMF/World Bank-endorsed Economic Recovery Programme in 1986. Moreover, multilateral debt comprises a significantly larger share of total debts in Tanzania than in other SLICs or in the rest of SSA. As noted above, this creates a special problem, as the multilateral institutions lending to Tanzania—primarily the IMF, International Bank of Reconstruction and Development (IBRD), International Development Association (IDA) and the African Development Bank (ADB)—do not engage in debt relief. Hence, the scope for reducing the debt is smaller for Tanzania than for other countries.

One interesting question here is whether Tanzania is on the wrong side of the DRLC. It is a difficult question to answer, since the estimation of the DRLC requires knowledge of the probability of full repayment and also

Table 15.2 Debt indicators: severely indebted low-income countries (SLICs), Sub-Saharan Africa (SSA) and Tanzania (selected years)

	1980	*1987*	*1990*	*1991*	*1992*
EDT/GDP (%)[a]					
SLIC	35.9	101.4	121.9	124.7	113.8
SSA	30.1	73.3	72.2	72.3	69.7
Tanzania	48.3	89.8	256.8	215.6	268.4
TDS/XGS (%)[b]					
SLIC	10.5	23.4	12.4	21.7	8.3
SSA	9.7	19.6	18.0	17.1	16.9
Tanzania	19.6	29.2	27.0	24.6	32.5
Concessional/EDT (%)[c]					
SLIC	33.3	28.9	31.7	32.7	34.2
SSA	18.1	24.9	29.0	30.9	32.6
Tanzania	55.3	53.3	59.3	60.7	64.6
Multilateral/EDT (%)[d]					
SLIC	13.2	14.7	16.6	17.2	18.0
SSA	9.0	17.0	19.4	20.7	21.7
Tanzania	21.4	27.1	29.8	31.3	32.7

Source: *World Debt Tables 1994*
Notes: [a] *Total debt stock (EDT) as percentage of GDP;* [b] *Total debt servicing as percentage of exports of goods and services;* [c] *Concessional debt as percentage of total debt stock;* [d] *Multilateral debt as percentage of total debt stock*

because the debt has no explicit secondary market price, since only an insignificant share of Tanzania's debt is owed to commercial banks. However, using estimates from studies of Latin American debt, it may be possible to get an idea of orders of magnitude.

Thus, for instance, from the Sachs and Huizinga (1987) estimate it is possible to calculate that the DRLC turns down at a debt-to-GDP ratio of somewhere between 1.83 and 2.72, depending on whether countries are classified as non-suspending or suspending (Cline 1989).[6] Since Tanzania has not been accumulating arrears on the long-term debt (ignoring 1994), it should be classified as non-suspending. If the coefficients from the Sachs and Huizinga estimate are valid for Tanzania, then the Tanzanian DRLC would turn downwards at a debt-to-GDP ratio of around 180 per cent. However, the turning point in Tanzania may be at an even lower debt-to-GDP ratio, mainly because the Sachs and Huizinga exercise assumes that there is a positive relation between the secondary market price and the rate of growth of GDP; and the calculations assume a per capita average annual growth rate of 2 per cent, something which Tanzania has failed to attain (cf. Table 15.1). Hence, since the ratio of total debt to GDP in Tanzania has been well over 200 per cent for the 1990s (see Table 15.2), the conclusion

seems to be that Tanzania is on the wrong side of the Laffer curve and thus that everyone would gain from debt relief. Again, however, this conclusion is based on the implicit assumption that negative incentive effects do not dominate. This is the issue to which I now turn.

Incentives and debt relief

Much of the literature on debt strategies and debt relief has attempted to show that a reduction of external debt may be beneficial for both creditors and debtors. This is understandable in view of the fact that the majority of Latin American debts are owed to commercial banks and so most debt strategies require cooperation by those. Superficially, it may seem as if the mutual benefit argument is less relevant in the SSA context: it may be assumed that foreign aid is given with some degree of altruism and so the existence of creditor benefits is not a necessary condition for debt relief.

However, provided that ability, rather than willingness, to service the debt is the binding constraint, any benefits that accrue to the debtor will necessarily also benefit the creditor. This is because a successful debt strategy will increase the ability to pay, increase the prospects for economic growth and thus decrease the future needs for grants, concessional loans or debt relief.

Most attempts to model the incentives effects of debt relief have concentrated on the effects of investments. A simple model, adapted from Sachs (1989), may serve to clarify the issues.

The model is in two periods. The debtor agrees to pay at most the fraction a of second-period output (Q_2). We write output as a function of the capital stock, K, such that $Q_1=F(K_1)$ and $Q_2=F(K_1+I_1)$, where I_1 represents investments made in period one. Creditors may decide to forgive part of the debt stock, D, down to a level, R. New loans given in the first period, inclusive of interest, will not exceed the maximum the country is prepared to repay in the second period. Hence,

$$D_1(1+r)<aQ_2-R. \qquad (1)$$

New investments in the first period are a positive function of the amount of new loans attracted in the first period and a negative function of the level of R. There is a relation between R and D_1 such that for $R>R^*$, $D_1=0$.

In the second period the country repays S, which is the lesser of full legal claims and the country's repayment ceiling. Creditors thus select R so as to maximise $S-(1+r)D_1$. The country can invest $I_1=Q_1+D1-C_1$ where C_1 is domestic consumption, and if the country maximises the present value of future consumption the problem is to maximise $U(C_1)+bU(C_2)$ subject to the constraints $C_1=Q_1-I_1$ and $C_2=(1-a)F(K_1+I_1)$, where b reflects time preference. The maximum occurs when

$$U'(C_1)=(1-a)F'(k_1+I_1)bU'(C_2). \qquad (2)$$

The argument now is that if creditors forgive enough debt, the term aQ_2 will no longer be a binding constraint; with a large enough debt reduction, the country will be able to pay all legal claims. Thus, (2) is replaced by

$$U'(C_1)=F'(K_1+I_1)bU'(C_2). \qquad (3)$$

The value of the right-hand side of (3) is larger than the right-hand side of (2). Consequently, the marginal utility of consumption in period one is higher in (3) than in (2). This means that consumption in period one will be lower, and investment in period one higher, when capacity to pay, aQ_2, is no longer a binding constraint. The reason is that a acts as a marginal tax on period-two output; removing it encourages period-one investment. Or, as Sachs (1989:94) puts it, 'by writing down the debt to a level that will actually be paid, the debt becomes a lump-sum burden rather than a marginal tax. It thus becomes profitable to invest more.'[7]

Writing down the debt to a level that allows full repayment ensures that all the benefits from adjustment do not accrue to the creditors. This is the core of Sachs' argument and it may well increase the willingness to service the debt. However, the particular formulation of the model makes the beneficial effects of debt relief rather small. Consider the following: according to Table 15.2, Tanzania's debt is around 250 per cent of GDP; according to the World Debt Tables (1994:445), the average terms of new commitments include an interest rate of 1.1 per cent. This means that the interest rate obligation is around 2.75 per cent of GDP, or a=0.0275. As argued by Diwan and Rodrik (1992), it does not seem likely that such a low marginal tax rate would affect investment behaviour seriously.

However, this argument seriously underestimates the power of Sachs' model, at least in the SSA context. To understand why debt relief can have significant incentive effects, turn to Table 15.3. Here, I have calculated sources and uses of foreign exchange for a few years in the 1990s with projections for 1995–96 and 1996–97. These estimates are based on benchmarks in the current informal agreement between the Government of Tanzania (GOT) and the IMF. The Bank of Tanzania has a clearly defined order of priority regarding the use of foreign exchange. For the purposes of this exercise, most important are: (1) clearance of debt arrears (this is a benchmark in the agreement with the IMF) and (2) restoration of foreign exchange reserves to the equivalent of sixteen weeks of imports. The data in Table 15.3 are based on the assumption that this reserve accumulation takes place during 1995/96, so no accumulation is needed during 1996/97.[8]

Ultimately, and irrespective of the foreign exchange regime, debt servicing will imply an internal transfer of resources from the private to the public sector. This is essentially because in SSA in general and Tanzania in particular

Table 15.3 The foreign exchange gap (US$ millions, selected years)

	FY1992	*FY1994*	*FY1996*[a]	*FY1997*[a]
A. Forex uses	1,715.2	1,785.4	2,792	2,621
Imports of G&S	1,444.4	1,435.8	2,041	2,189
Debt servicing[b]	446.3	481.3	472	433
Reserve accumulation (+ inc)	−175.5	−11.7	279	0
B. Forex proceeds	1,621.2	1,634.4	2,598	1,888
Exports G&S	414.1	485.9	1,141	1,220
Transfers	1,025.4	909	826	886
Loan inflow	288.6	206.6	272	285
Direct investments	15	63	71	55
Arrears (+ inc)	−121.9	−30.1	289	−558
Financing gap (A − B)	94	151	194	733
(A − B) as % of Tax revenues[c]	24.5	32.9	38.3	88.1

Source: *World Debt Tables 1994; IMF; Danielson 1996*
Notes: *[a] Projected; [b] Including amortization; [c] For FY 1996 and 1997, the exchange rate of TZS550=1US$ has been used*

virtually the entire debt is public or publicly guaranteed. Hence, the existence of a large debt means that tax revenues will have to increase in the future. The last row in Table 15.3 indicates the size of the foreign exchange gap in relation to total tax revenues.[9]

It is clear that closing the forex gap by purchases of foreign exchange from the private sector, financed by tax revenue, implies substantial increases of taxes in the future. To the extent that the private sector realises this, debt relief lowers expectations of future resources transfers to the public sector and hence may twist the private sectors incentives in favour of investments. It should be noted that this argument turns Corden on his head; for in his model, investments will fall when the debt overhang is reduced:

> debt service obligations in the future would increase investments now, and this can be interpreted to mean that current 'adjustment effort' has increased…It follows that debt relief would reduce investment and adjustment effort…This is the *disincentive effect* of debt relief.
>
> (Corden 1989:245; emphasis in original)

Corden s mistake is that he does not realise the importance of the internal transfer problem: if the debt is public or publicly guaranteed, it has to be paid by the government and ultimately this implies a transfer of resources from the private sector. In this sense, the external debt problem of Tanzania is just another aspect of the fiscal gap. This is a relation which is explored in more detail in the next section

Even though the preceding analysis suggests that positive incentive effects outweigh negative ones (at least as far as Tanzania is concerned), the possibility of falling investments as a result of debt relief cannot be ruled out. Hence, it is possible to argue that some kind of policy conditionality should accompany debt relief. There are two questions of importance here. First, what performance indicators should be addressed? Second, how should conditionality be designed?

It seems reasonable to assert that policy conditionality associated with external debt relief should address some aspect of inflation—either changes in the price level *per se* or underlying factors, such as the budget deficit, which may be thought of as affecting inflation. The reason for this is that the government has obligations not only towards foreign lenders but towards domestic lenders as well; the debt has an external and a local component, and changes in the structure of the debt affect the government's incentives for fighting inflation. As we have seen, a rate of inflation which is higher than that of trading partners is likely to lead to a depreciating currency and therefore to an increasing debt service burden on the external part of the debt, measured in local currency. Therefore, the larger the external component of the debt, the stronger are the government s incentives for fighting inflation.

On the other hand, a high rate of inflation may erode the real value of the domestic debt. This is clearly the case in Tanzania, where lenders, at negative real interest rates, actually pay for the privilege of holding Treasury bills (Danielson 1996). Hence, the larger the local component of the total debt, the weaker the government's incentives for fighting inflation.[10]

Consequently, the incentives for fighting inflation are conflicting and the 'net incentives' are likely to be affected by a change in the composition of the debt. Specifically, writing off part of the external debt is likely to weaken the governments incentives for fighting inflation, *ceteris paribus*. In so far as the private sector realises this, external debt relief, if unaccompanied by policy conditionality, may lower the credibility of the government's stabilisation and adjustment efforts. This is the reason why inflation-related policy conditionality is an important part of any strategy aimed at decreasing the debt burden under floating exchange rates.

As for the design of conditionality, the present system is based on the IMF mandate. The Fund specifies a number of quantitative and structural benchmarks, decides—nominally together with the government in question— on the measurement of these, and most bi- and multilateral donors accept these benchmarks as conditions for releasing programme aid or concessional loans. The purpose and the advantage of the system is that it punishes reluctant governments and provides incentives for taking politically unpleasant decisions. The snag is that the system is potentially self-defeating.

Consider the following situation: Tanzania is presently required to increase substantially the amount of tax revenues raised. To facilitate that objective, the current informal agreement with the Fund specifies as a structural

benchmark the institution of a Tanzanian Revenue Authority (TRA), which is supposed to be responsible for collection of all taxes. At the same time, the Fund's conditionality requires tax revenues to increase to a certain amount of GDP before a new ESAF can be negotiated. If bilateral donors follow the IMF's policy conditions, no programme aid will be released until the TRA has been established. It is not difficult to imagine a situation in which benchmarks cannot be met, precisely because programme aid (which might facilitate the establishment of an efficient TRA) is not forthcoming. These funds can be substantial: for Tanzania, the counterpart funds generated by programme support amount to some 10 per cent of total revenue. It is easy to imagine a vicious circle under these circumstances: the country does not receive funds because it is not performing and it does not perform because of lack of funds; and it is equally easy to imagine a situation in which this may jeopardise reforms already accomplished.

One possible way out has recently been proposed by the Swedish International Development Cooperation Agency (Sida). Here, the system of cross-conditionality—where all donors accept the Fund s policy conditions and either disburse in full or nothing at all—is replaced by a system of 'matching funds' where the government's performance with regard to some quantitative benchmark is matched, shilling for shilling or dollar for dollar, with donor disbursal. This system would retain the Government's incentives for adjusting while releasing the financing constraint.[11] As will be seen below, debt relief may here act as a substitute for programme aid and may, under a floating exchange rate regime, be a very powerful instrument for attaining macroeconomic stability.

Stabilisation, adjustment and the debt problem

Under a fixed exchange rate regime, the existence of an external debt tightens the foreign exchange constraint and, as argued above, in this situation debt relief may allow for increased imports and investments. In contrast, under a floating exchange rate regime there is in principle no foreign exchange constraint. It is always possible to raise the required amount of foreign exchange if the currency is freely convertible. Hence, under a floating exchange rate regime there is in principle no difference between balance of payments support and budget support; the fiscal gap and the forex gap merge.

What is the role of debt relief in this situation? Write the government's budget identity as

$$\dot{L}_t + \dot{B}_t + e_t \dot{F}_t^g + A_t = G_t - T_t - N_t + i_t B_t + i_t^* e_t F_t^g + i_c L_t \qquad (4)$$

where L_t is the nominal stock of credit allocated by the central bank, B_t is the stock of domestic currency-denominated interest-bearing public debt, F_t^g is the stock of foreign currency-denominated interest-bearing public debt,

A_t is transfers from abroad, G_t is public spending on goods and services (including current and capital expenditures), T_t is tax revenue, N_t is non-tax revenue, i_t i^*_t and i_c are interest rates on domestic, foreign and central bank loans, respectively. A dot denotes a time derivative.

The right-hand side of (4) shows the excess of expenditures—capital and current expenditures plus debt servicing—over tax and non-tax revenue; the left-hand side shows how this is financed—by foreign aid and additional loans. This is a very general formulation and, for the present purposes, we may simplify a bit. First, assume that the government cannot borrow from the domestic non-bank public. This may be because of underdeveloped financial markets. Second, assume that the country is not creditworthy and finds it impossible to borrow money in international capital markets.[12] Third, ignore non-tax revenue. Now, (4) may be written as

$$\dot{L}_t = G_t - T_t - A_t + i^*_t e_t F^g_t + i_c L_t. \tag{5}$$

If foreign aid aimed at supporting the budget is taken as exogenous and determined by political decisions in donor countries, the budget deficit is necessarily financed by borrowing from the central bank. This is a potentially explosive situation. Assuming that output is exogenous in the short run and that the velocity of money is stable implies that prices will grow in proportion to the money supply. Further, assuming that the value of the currency adjusts instantaneously to its PPP-level and that the government does not amortise its foreign debt, it follows that the domestic currency value of foreign debt servicing increases according to

$$\dot{I}_t = i^*_t \dot{L}_t F^g_t, \tag{6}$$

where I indicates the local currency equivalent of servicing the foreign debt. Hence, if the government runs a budget deficit, the money supply will increase, as there are no alternatives for financing the fiscal gap. This, in turn triggers inflation, which causes the exchange rate to depreciate. This increases the local currency equivalent of foreign debt servicing which—*ceteris paribus*—increases the budget deficit. Hence, the existence of a large external debt under a floating exchange-rate regime may create a situation where the economy moves away from macroeconomic stability towards escalating inflation and growing budget deficits.[13]

Now the role of debt relief should be clear. Forgiving debt implies either a fall in i^*_t, or in F^g_t or both. In both cases, the governments financing needs decreases and, consequently, the rate of growth of the money supply may fall. This halts inflation and thus the depreciation of the currency. Hence, the accumulation of the local currency equivalent of foreign debt servicing decreases.[14]

The structure of the government budget in Tanzania is presented in Table 15.4 and from here it is possible to get an idea of the orders of magnitude involved. First, it is quite clear that the situation is unsustainable: in fiscal year (FY) 1995, tax revenues financed less than two-thirds of total expenditures and less than four-fifths of non-interest expenditures. Even though measures are being taken to correct the situation on both the revenue and the expenditure side (Danielson 1996), it should be clear from the data that new loans, or rescheduling of existing loans, do not solve the problem: such measures would merely push it into the future.

On the other hand, debt relief might be a solution. Looking at the composition of expenditures, we find that debt servicing accounts for a rising share of total expenditures: in FY 1995 close to 20 per cent of total expenditures was made to service the existing debt. If half of the debt was written off, donors could discontinue balance of payment support, and, even then, the budget deficit would shrink. Alternatively, writing off 50 per cent of the debt would virtually eliminate the need for domestic bank lending (which is almost entirely from the central bank) which would therefore decrease inflationary pressure. As can be seen, in FY 1995 the total amount

Table 15.4 The government budget, FY1991-FY1995 (TZS[a] millions, current prices)

	FY1991	*FY1992*	*FY1993*	*FY1994*	*FY1995*
Total revenue	137,092	173,565	223,861	349,233	389,744
Tax	118,257	153,255	146,200	220,357	299,899
Non-tax	18,835	20,209	17,689	22,086	31,340
Grants	0	0	59,751	106,790	58,505
Total expenditure	206,574	261,051	336,015	485,216	469,660
Recurrent	162,294	204,905	235,905	338,364	407,858
of which: debt servicing	*45,948*	*33,417*	*41,583*	*82,116*	*91,690*
Capital	21,640	31,199	60,343	74,689	31,692
Deficit	69,482	87,486	112,154	135,983	79,916
Financing					
Foreign	51,756	84,351	108,284	141,114	100,870
of which: programme[b]	*45,570*	*72,348*	*48,533*	*40,577*	*46,400*
Domestic non-bank	5,784	8,713	6,055	26,557	5,800
Domestic bank	–15,080	–10,833	38,088	14,000	55,800
Other[c]	27,022	5,255	40,273	–45,688	–82,554

Sources: *Data provided by the Bank of Tanzania; IMF*
Notes: [a] *Tanzanian shillings;* [b] *Counterpart funds generated through balance of payment support;* [c] *Includes expenditure float, debt arrears (+inc) and tax reserve certificate*

of debt servicing exceeds the budget deficit after grants. Since one of the major problems in Tanzania is high inflation—it hovers around 30–40 per cent annually—it may seem as if any measures that reduce the rate of inflation will move the economy towards a sustainable situation and thus improve the prospects for successful structural adjustment.

Further, it seems as if the key to bringing down inflation is bringing down the budget deficit. Apart from foreign financing, virtually the only source available for the government—pending tax and expenditure reforms—is resorting to borrowing from the central bank. In fact, the relation between the fiscal gap and macroeconomic instability seems fairly well established for countries with unsophisticated financial markets, a point forcefully made by Fischer and Easterly:

> Milton Friedman's famous statement that inflation is always and everywhere a monetary phenomenon is correct. However, governments do not print money at a rapid rate out of a clear blue sky. They generally print money to cover their budget deficit. Rapid money growth is conceivable without an underlying fiscal deficit, but it is unlikely. Thus rapid inflation is almost always a fiscal phenomenon.
>
> (Fischer and Easterly 1990:138–39)

Concluding remarks

Tanzania has for a long time been one of the most popular targets for foreign aid. The reasons need not concern us here, but it should be noted that the large and persistent budget deficits are to some extent caused by the huge amounts of project aid, with associated demand for local cover of recurrent costs, that have been flowing in since the mid-1960s. Moreover, the fact that donors have at most times been willing to supply additional resources has allowed the government to run expenditures without looking for viable sources of financing.[15]

The major problem created by the large budget deficit is that it adds to inflation and thus renders successful reforms more difficult to achieve. Hence, any measures that improve the fiscal position are likely to facilitate structural adjustment. The argument in this paper is that debt relief may prove to be a powerful instrument for this.

Under a fixed exchange-rate regime, a large external debt may hamper growth by tightening the foreign exchange constraint and diminishing import capacity. When exchange rates are market determined, there is no foreign exchange constraint, so lack of import capacity cannot be regarded as hampering growth. Rather, under floating exchange rates, the money supply is endogenous, and if the government cannot finance the fiscal deficit by non-bank lending, there will be a direct link between the size of the fiscal

deficit and the rate of growth of the money supply. This, in turn, may create a vicious circle in which inflation causes the currency to depreciate, which, in turn, increases the local currency equivalent of debt servicing. Denoting the foreign currency denominated debt by D, the mechanism is in easily understood notation:

$$(G\text{-}T) > 0 \Rightarrow \dot{M} > 0 \Rightarrow \dot{P} > 0 \Rightarrow \dot{e} > 0 \Rightarrow \dot{e}D > 0 \Rightarrow \dot{G} > 0.$$

The villain is of course the fiscal gap but closing that rapidly and without social conditions deteriorating may prove difficult in an economy with limited administrative capacity Outright debt relief provides a solution to this problem.

What about possible negative incentive effects of debt relief? As noted above, it has been suggested in the literature that the existence of a large debt may actually increase adjustment effort; by implication, then, debt relief may decrease such effort. As far as Tanzania is concerned—and probably other countries, too, where the currency is floating and the fiscal gap large— the possibility of decreased investments as a consequence of debt relief seems rather remote. Under a floating exchange rate regime, the publicly guaranteed debt is serviced out of tax revenues. Hence, a smaller debt means smaller tax hikes in the future. As long as the private sector realises this, the likely consequence of debt relief is increased, not decreased, investments.

Notes

*   Helpful comments from conference participants, particularly Morten Lau, Oliver Morrissey (discussant) and Hildegun Nordås, are gratefully acknowledged.
1   Although remarks on low data quality in low-income countries have almost reached the point of being trite, such complaints are probably more relevant for Tanzania than other countries. Not only is the 'second economy' estimated at some 50–70 per cent of GDP (Sarris and van der Brink 1993), but official data are rather shaky as well: the 1994 revision of the national accounts puts official GDP in 1990 some 50 per cent higher than the earlier estimate (Bureau of Statistics 1995). Furthermore, estimates made by donors and multilateral organisations are not always consistent with the data published by Tanzanian authorities. This implies that the data in the various tables in this paper are not necessarily mutually consistent.
2   Although issues of the pace and sequencing of economic reforms remain unresolved, it seems that the possibilities of successfully completing structural reforms are substantially enhanced if inflation is low, the fiscal gap small and the external position viable (IMF Institute 1992, Funke 1993, World Bank 1994, Corbo and Fischer 1995).
3   Debt relief may of course affect the political willingness to service the debt as well if, for instance, the present government is not responsible for past debt accumulation as is arguably the case in Tanzania.

4   During the spring 1996, the Government of Tanzania (GOT) had an informal agreement with the IMF (a 'shadow programme') with the condition that if monthly benchmarks were met between March 1996 and June 1996, negotiations for a formal ESAF would commence. One of the benchmarks was clearance of debt arrears during FY 1996.

5   SLICs are countries with a 1992 GNP per capita of less than US$675 where either the present value of debt service to GNP exceeds 80 per cent or where the present value of debt service to exports of goods and services exceeds 200 per cent. There are currently twenty-nine countries classified as SLICs; of these, twenty-four are in Africa.

6   The low reliability of this type of estimate is illustrated by the fact that a study by Claassens and Diwan (1990) found the turning point to be at a debt-to-GDP ratio in the range of 700 to 900 per cent, and Cohen (1990) found no support for the proposition that any countries are on the wrong side of the DRLC. Both these studies, however, deal exclusively with loans from commercial banks.

7   An alternative to writing off debt might be to increase the country's ability and willingness to pay by trying to increase capital productivity, $F'(K)$, and/or time preference, b. The World Bank-endorsed Structural Adjustment Programmes may be seen as an attempt to do the former; and efficient policy conditionality may be interpreted as a method for increasing b. However, one argument in favour of debt relief might be that the debt overhang renders it more difficult to attain growth, that is to increase $F'(k)$, so growth promoting policies and debt relief are complements, not substitutes. Moreover, structural adjustment policies are formulated by the Bretton Woods Institutions in collaboration with the government, and issues concerning the country's ability to service the external debt are not necessarily high on the agenda: debt owed to the BWI has seniority, so the cost of default is carried by bilaterals.

8   With weekly imports at around US$30 million, it is a simple exercise to show that this conclusion is not dependent on the accumulation strategy of the Bank of Tanzania: even if we assume that the Bank of Tanzania runs down reserves completely (they are currently at around seven weeks of imports) and does not accumulate them in 1996/97, the orders of magnitude in Table 15.3 do not change significantly.

9   Two things should be noted here. First, if the GOT buys foreign exchange from the private sector to cover the entire forex gap, the exchange rate is likely to be affected. Hence, the estimates in Table 15.3 should be regarded as minimum figures. Second, the tax system in Tanzania is presently characterised by huge inefficiencies; removing these may increase tax revenues substantially without increasing tax rates or broadening the tax base. In this sense, the figures in the last row of Table 15.3 may overestimate the financing needs. The point, however, is that debt relief may decrease the need for future increases in tax revenues; and the data indicate that we are very far from the insignificant marginal tax suggested by Diwan and Rodrik (1992).

10 The value of the domestic debt in Tanzania has increased rapidly following the introduction of Treasury bills in 1993.

11 See Danielson (1996) for a critical analysis of the system of matching funds.

12 It may still receive concessional loans from international financial institutions; these, however, are frequently aimed at creating projects, so capital expenditures then increase by the full amount of the loan. The existence of such loans does not affect the analysis here.

13 The situation outlined in the text may in fact be interpreted to represent a conservative estimate of the effects on inflation and exchange-rate adjustments. Given that the currency depreciates, it seems reasonable to assume that the current account will be improved which will further add to the growth of the money supply.

14 An interesting issue which is not considered here is that of international incentive effects of debt relief: how the behaviour of other debtor nations is affected by the extension of debt relief to Tanzania.

15 A history of aid to Tanzania is provided by Doriye *et al.* (1993). See also the assessment by Helleiner *et al.* (1995).

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INDEX