South African Reserve Bank

Lessons for South Africa from Germany in a challenging global environment

Address by Gill Marcus, Governor of the South African Reserve Bank
at the Southern African-German Chamber of Commerce and Industry
luncheon,
Johannesburg, 19 April 2013**.**

Thank you for the invitation to speak to you today. We meet at a time when the IMF Spring meetings are taking place in Washington. The mood in Washington appears to be less sombre than was the case in the previous meetings, as the three big high-risk, high impact concerns of last year - a possible Eurozone breakup, the US fiscal cliff and a possible hard landing in China - have been avoided or at least postponed for now. However the low growth environment looks set to persist, and the World Economic Outlook of the IMF published earlier this week indicates that global growth is unlikely to be much better than was the case in 2012. Recent political and banking sector developments in Cyprus, Portugal, Spain and Italy illustrate just how fragile the recovery remains.

Although in recent years there have been important shifts in South Africa's trade ties, diversifying away from our traditional partners, Europe remains an important destination for our exports and an important source of both direct and portfolio investment. Germany ranks second in terms of destination of

South Africa's manufactured exports and the outlook for the South African economy therefore remains intricately tied to the fortunes of the region, and to Germany in particular.

In my remarks to you today I will outline how we see the outlook for the global economy. However, beyond our trade and investment relationships, there are a number of lessons that South Africa can learn from Germany's experience with labour relations and skills training, which are important elements of the kind of structural shifts that are required if South Africa is to compete effectively in the international trade arena, and to make appreciable inroads into the country's unemployment problem.

Global developments are critical for the South African economy going forward, and we look forward to a revival in world trade to help drive the domestic recovery. The cautious optimism that was evident at the beginning of the year, what some refer to as the "new year effect", has now given way to renewed concerns. The IMF forecasts global growth this year to average 3,3 percent, compared with 3,2 per cent in 2012 but down on their previous estimates. The IMF still sees the recovery as fragile, with downside risks remaining, particularly in advanced economies. The World Trade Organisation last week downgraded its forecast for growth in world trade in 2013 from 4,5 per cent to 3,3 per cent (well below the long run trade growth of 6 per cent), mainly a result of renewed risks coming from the Eurozone and the impact of rising protectionism.

We are in effect seeing a continuation of the crisis which has mutated between a subprime crisis, a growth crisis, a fiscal crisis, a sovereign debt crisis, a systemic banking crisis and a political crisis. All of these aspects are of course interrelated, and very often the resolution of one creates problems in another sphere. Nowhere is it more evident than in Europe where weak politics and weak economic outcomes and outlooks feed off each other. The banking crisis in Cyprus illustrates clearly how even very small countries can be potentially systemically important.

While it appears that the tail risks related to the Eurozone have receded somewhat, these risks have not disappeared. Recent interventions by governments and the ECB, in particular the OMT, have shown a credible commitment to maintaining the integrity of the region, but important structural changes will need to be made in the medium to long term. In the short term, Europe is experiencing a recession and rising unemployment, due in part to fiscal austerity and banking sector deleveraging. The economic downturn in the periphery has been worse than official projections, and this could reinforce the adverse government debt dynamics and raise anew the questions of the sustainability of the regional arrangements, and the political acceptability of fiscal austerity. At the same time, progress seems to have stalled on banking reforms in the region, and the initial indecision regarding the bail-out of the Cyprus banking system has probably undermined progress on these reforms, as well as raising new concerns about safety of deposits.

The other major lagging economy is Japan, and the outlook is perhaps a bit more difficult to assess following the announcement of significant monetary and fiscal stimulus packages. It is not clear to what extent the massive liquidity injection US$1,4 trillion over the next two years announced by the Bank of Japan will result in higher domestic expenditure. What is more certain is that the monetary stimulus is likely to lead to renewed capital flows to emerging market economies, with their attendant challenges. We have already seen the short term impact of this policy announcement, with the recent recovery of the rand to levels below R9,00 against the US dollar.

The outlook for the United States is a bit more positive, with the worst of the fiscal cliff scenarios having been averted. The nascent recovery in the US housing market, the pick-up in private sector investment, and the recovery in the banking system point to a more favourable outcome than was feared in the latter part of last year. But some of the fiscal issues have merely been delayed and not fully resolved, so the potential for a further negative shock to growth remains. The so-called ‘sequester’ came into effect a few weeks ago, and the negative impact of this will become apparent in due course. The most recent data coming out of the US suggest a moderation in the second quarter following weak retail sales in March, slower employment growth and the fall in the Michigan consumer confidence index to a nine-month low in April, as the effects of higher taxes begin to take effect.

Even in the event of a relatively positive growth scenario, US monetary policy is likely to remain highly accommodative for some time to come, with implications for the persistence of capital flows to emerging markets. The recently published minutes of the FOMC suggest that there has been consideration given to moderating the pace of quantitative easing, and there are fears that this could result in significant reversals of capital flows from emerging economies. However, we believe that for this reversal to occur will require a sustained improvement in the unemployment situation. Any exit strategy is likely to be measured, to ensure that it does not undermine any nascent recovery. The eventual normalisation of US monetary policy is likely to signal a return to sustained growth, which will contribute positively to the global recovery. Furthermore, an early reversal of quantitative easing may also be offset by quantitative easing in Japan.

Fears of a hard landing in China have abated, and although a return to previous elevated growth rates is unlikely, the expected growth rates of around 8 per cent should help to underpin the demand for and the price of commodities, which is critical for South Africa's growth outlook.

There is little doubt that there has been a tectonic shift in the drivers of global growth. The emergence of countries such as Brazil, Russia, China and India, for example, has changed the epicentre of global economic activity. The Brics share of global GDP has increased three-fold in the past 15 years, and this share is currently around 20 per cent in market terms and about 30 per cent in PPP terms. According to Arvind Subramanian of the Peterson Institute of International Economics, this latter share is expected to increase to as much as 45 per cent by about 2030.

South Africa is now part of the BRICS grouping, and although a relatively small partner, we are full members and are working to maximize the opportunities that present themselves. We are also aware that there are other countries that are also deserving of being members of this club, and a further indication of how a growing number of emerging markets are part of the shifting economic paradigm. Our membership should also be seen in the context of the economy being a gateway to Africa, which has been one of the outperforming regions in the past number of years, and which is expected to continue to grow at rates of around 5 per cent.

As a region, Africa is the most important destination of our manufactured exports, and China has now become South Africa's largest trading partner, although much of our exports to that country are commodities or commodity based. Despite these developments, the experience of the past few years has shown that emerging markets cannot completely decouple from the advanced economies. But the continued weakness in South Africa’s traditional trading partners in the Eurozone and the UK underlines the need to seek new markets for manufactured exports.

Germany has long been one of South Africa's traditional trading partners, and remains the second largest destination by country for South Africa’s manufactured exports, after the United States. In 2012, the value of these exports, mainly machinery and electrical equipment, amounted to R21,8 bn and accounted for about 60 per cent of our total exports to Germany. On the trade front, we still run a fairly large deficit with Germany, with total exports of R37,8 billion, and imports of R84,0 billion. Most of these imports are manufactured goods. In addition, Germany is one of the most important sources of direct foreign direct investment, with around 620 German companies operating in the country, employing approximately 90,000 people. German firms have invested R33.7 billion in South Africa since 2003.

Trade and investment flows are important not only for employment, but also from a balance of payments perspective. Since the crisis, the weak recovery in the advanced economies constrained South Africa’s export growth which impacted adversely on the trade account of the balance of payments, particularly at a time when the exchange rate was relatively strong in response to strong capital inflows to emerging market economies.

The current account of the balance of payments widened significantly in 2012 when it measured 6,3 per cent. This deterioration was driven in part by strong import growth, particularly those related to infrastructural expenditure investment by the state-owned enterprises. These imports will contribute to expansion of existing capacity and efficiencies in the economy as well as to future growth, but are likely to remain at elevated levels and relatively insensitive to exchange rate developments. However, the disturbing aspect of recent trends has been the weak recovery of South Africa’s exports despite a marked improvement in our terms of trade since 2010.

Part of this has been due to the slow global recovery. But this is not the whole story, as South Africa’s export performance has lagged that of its emerging economy peers who have faced the same global environment. Slow export growth was also an outcome of the widespread stoppages in the mining sector last year, which adversely affected the export performance of our main source of exports. But non-mining exports have also underperformed, and we need to learn from the experience of countries such as Germany as to how to improve competitiveness under adverse circumstances.

The main export sectors of the South African economy therefore face a challenging outlook, from both external and internal sources. Commodity prices, apart from the gold price, have not generally recovered to pre-crisis levels, and their volatility is illustrated by their sharp decline in recent days. At the same time input costs, particularly electricity and wage costs, have risen significantly and the sector is beset by an increasingly difficult labour relations environment. The manufacturing sector remains vulnerable to the continued weak demand from Europe while its import and export competitiveness was also adversely affected by the appreciation of the currency in 2010/11. Following the recent depreciation of the rand the outlook for the sector is more positive, but nevertheless fragile.

The exchange rate is an important part of this story. As we have seen the rand has been on a depreciating trend over the past few months, but has also been highly volatile.
The Consumer Price Index increased by 5,9 percent in March this year, the same increase as in February. The year-on-year price increases were mainly driven by the categories of housing and utilities and transport, with the higher petrol prices impacted by the weaker exchange rate, and the exchange rate remains an upside risk to the inflation outlook. These factors are expected to contribute to a temporary breach of the inflation target during this year. It also appears that medium term inflation expectations remain anchored inside the inflation target.

Although the depreciation of the exchange rate does create challenges for monetary policy because of the adverse impact on inflation, a floating exchange rate acts as a shock absorber and is an important part of the adjustment process in dealing with a deteriorating current account deficit. Nevertheless the underlying structural issues remain, which will make it all the more important for South Africa to improve its domestic savings performance, as well as to continue to attract sufficient volumes of foreign capital, preferably in the form of direct investment, an area where German companies have been particularly strong.

But the importance of Germany goes beyond simply looking at our economic ties. There is a lot that we can learn from the German experience. This is particularly the case with respect to labour relations and skills training.

Much of Germany’s post war economic success can be attributed to its Social Market model. While this model is peculiar to Germany, there are many lessons for South Africa. Allow me to expand on three of these aspects – industrial relations, training and investment in continuous competitive enhancements. Naturally, these three aspects are mutually reinforcing.

Germany’s industrial relations are characterised by a high degree of cooperation between employer and employee organisations. Both workers and firms take a long term view of the economy and both parties recognise the importance of continuously raising productivity. Both parties understand the need to share the productivity gains. This allows for an alignment of incentives between workers and employers. At a micro or firm level, there are appropriate mechanisms to resolve disputes early and in a win-win spirit. In South Africa, we need to find models that enable earlier dispute resolution in the workplace before labour disputes affect the broader economy. We also need to find ways that enable the work force to have greater knowledge of the financial affairs of the company and sector, while management needs to better appreciate the living and working conditions of their employees.

Germany has a dual training system with high quality vocational training institutions complementing on-the-job training by firms. In Germany, nearly two-thirds of the country's workers are trained through partnerships among companies, technical schools and trade guilds. In 2011, German companies took on and trained nearly 600 000 paid apprentices. The schools provide theoretical lessons on the side, while trade unions help ensure training is standardised. German firms take in young work-seekers and provide a period of training and induction in order to prepare young workers for the rigours of work and to give new workers the skills required to raise their own productivity. These apprenticeship schemes are based on a partnership between the state, employers and training institutions. Firms benefit by receiving support from the state to take on new work seekers.

More importantly, they benefit from the high quality training provided both by public training institutions and by on-the-job training provided by the firm. The outcome for the firm is a steady supply of young workers with the knowledge and training to fit into a globally competitive economy. The outcome for society as a whole is that new entrants can gain access to work and training quickly, meaning that long term unemployment is low. Germany has amongst the lowest youth unemployment rates in the world, currently standing at 7,7 per cent, compared with the Eurozone average of 23,9 per cent.

South Africa by contrast, has amongst the highest rates of youth unemployment in the world at 51 per cent, with our young people locked out of the workplace both due to poor skills and a lack of suitable experience. The pre-1990 system of apprenticeship that prevailed, although by no means perfect, was abandoned without an adequate replacement being put in place. The record of the SETA's has been patchy at best, so there is no overall coherent focus on skills training in the country. The result is that when large scale infrastructure projects are undertaken, many of the skills have to be imported.

Germany is one of the few developed countries to maintain a globally competitive manufacturing sector. It has done this because it has been able to invest in capital to continuously raise productivity and because of its ability to produce a steady stream of competent and appropriately skilled young workers. Germany has used the furnace of an open economy to put pressure on both workers and firms to remain productive and remain at the cutting edge of technology. While several sectors in South Africa are globally competitive, there are too many sectors that are not. South Africa has to raise its competitiveness across the board, but particularly in the tradable goods and services sector. This is the only long term solution to structural weaknesses in our economy that presents itself through large current account deficits.

The combination of these three policies; industrial relations, training and competitiveness has allowed Germany to emerge from the global financial crisis in a much better position than almost any other advanced economy. When demand for goods and services fell in 2008 and 2009, many countries saw large-scale job-losses. In most countries, including South Africa, it is seen as normal for firms to reduce staff numbers when demand falls. During the crisis, almost one million jobs were lost in South Africa, and we are still not back at pre-crisis levels. The unemployment rate measured 21,8 per cent in the third quarter of 2008, but deteriorated during the crisis to reach a peak of 25,7 per cent in the second quarter of 2011, and currently stands at 24,9 per cent.

In Germany, both firms and workers opted to reduce working hours and hence income, rather than face retrenchments. Government supported firms by subsidising training, allowing firms to use the period of slower demand to retool and to raise the skills profile of its workforce. The result was that unemployment increased moderately from 7,1 per cent in October 2008 to a peak of 8,0 per cent in July 2009, and in February of this year measured 5,4 per cent, compared with a Eurozone average of 12,0 per cent. Low unemployment in turn meant that domestic demand held up more strongly than in other comparable countries. And despite significant pressure from new emerging market competitors, Germany has remained competitive in its key high tech, specialised manufacturing sectors.

In South Africa, we too introduced a training lay-off scheme whereby firms would move workers from production to training when demand was low, partly subsidised by the Unemployment Insurance Fund. Sadly, this scheme was not subscribed to as widely as the policy-makers intended. This is partly due to uncertainty on the pace of economic recovery and partly due to low levels of trust between firms, workers and government.

We have seen some aspects of these policies applied by German firms in South Africa. There has been considerable success in raising productivity in the motor industry, thanks in large part to the training model of many German firms. Our challenge is to broaden these lessons. When economists talk of the benefits that foreign direct investment brings, they do not only talk about the direct benefits of capital and machinery. They also talk about technology, management practices and systems of innovation. When these occur, the recipient country benefits far more than can be measured by the amount of money that has flowed in.

In order to tackle high levels of unemployment in South Africa, we seek not just foreign investment. We seek long term partnerships, partnerships that will be mutually beneficial. South Africa has a huge skills mismatch. This mismatch will not be resolved overnight, but firms can take the lessons from Germany and help to build a workforce that is skilled, satisfied and globally competitive. Unless firms realise that it is in their long term interests to develop their workers, we are not likely to benefit from the synergies of public education and training and firm level training.

The year ending March 2013 was declared the German – South African year of science. This partnership between our two countries to advance scientific cooperation and development is a practical example of how our countries can cooperate to achieve mutually beneficial outcomes. We call on both South African and German firms to use partnerships such as these to pursue scientific and technological cooperation to the benefit of all parties.

We trust that our strong relationship can and will be further strengthened in the coming years through deeper cooperation, higher bilateral trade and greater investment in capital and people.

Thank you.