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- The arrangement of and attendance at roundtables and conferences on matters related to politics and governance in or of relevance to South Africa;

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Contact Details

Tel +27 11 646 0150 Fax +27 11 646 0160 Email info@hsf.org.za Website www.hsf.org.za

Postal address Postnet Suite 130, Private Bag X2600, Houghton, 2041, South Africa

Physical address Block A, Anerley Office Park, 7Anerley Road, Parktown, 2193, Johannesburg

the HELEN SUZMAN FOUNDATION

promoting liberal constitutional democracy and human rights

The Helen Suzman Foundation and Gordon Institute of Business Science held a thought-provoking Conference where we probed how we can continue our country's growth trajectory amidst global turmoil and local challenges.

Gordon Institute of Business Science

University of Pretoria

This event was supported by

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PROF LAWRENCE H SUMMERS

CHARLES W ELIOT UNIVERSITY PROFESSOR OF HARVARD UNIVERSITY

Lawrence H Summers is President Emeritus of Harvard University and former Nathaniel Ropes Professor of Political Economy, and in the past decade has served in a series of senior public-policy positions, including Secretary of the Treasury of the United States, from 1999 to 2000. He was recently named as President-elect Barack Obama's choice to head the National Economic Council, which will make him the new president's chief economic adviser.

He holds a BSc degree from the Massachusetts Institute of Technology and was awarded the PhD from Harvard in 1982.

His various public-policy positions include serving as a domestic policy economist for the President's Council of Economic Advisors (1982); Vice-President of Development Economics and Chief Economist of the World Bank (1991); and Undersecretary of the US Treasury for International Affairs (1993). In 1999, the United States Senate confirmed Prof Summers as Secretary of the Treasury.

In 2001, Prof Summers took office as the 27th president of Harvard University. On the conclusion of his tenure as president, Prof Summers accepted a position as a university professor. Additionally, Prof Summers is a part-time Managing Director of the DE Shaw Group and serves on several boards.

He has received many awards, including the annual Alan T Waterman Award of the National Science Foundation and the John Bates Clark Medal.

Prof Summers publishes widely.

NICK BINEDELL

FOUNDING DIRECTOR AND SASOL CHAIR OF STRATEGIC MANAGEMENT OF THE GORDON INSTITUTE OF BUSINESS SCIENCE (GIBS)

After an initial career in the mining and manufacturing industry, in sales and general management in the Barlow Rand Group, Nick has focused his career for the past 20 years on the area of business education

In 1998 he was invited to establish a new business school focused on meeting the individual and corporate needs of business in South Africa.

The school has rapidly established itself as a leading business school in South Africa with a strong focus on partnering with leading South African corporates and providing a high level of local and international business education. It was recently ranked as one of the top 40 global executive-education providers by the London Financial Times.

His academic qualifications include a PhD from the University of Washington in Seattle, an MBA from the University of Cape Town and a BCom degree from Rhodes University.

His area of expertise is business strategy formulation and his academic and consulting work, although dominantly performed in South Africa, includes work in the United States, Europe and Australia.

MS RAENETTE TALJAARD

DIRECTOR, HELEN SUZMAN FOUNDATION

Raenette Taljaard is the Director of the Helen Suzman Foundation. Ms Taljaard, a former Democratic Alliance Member of Parliament, served as Shadow Minister of Finance from 2002 and was a member of the Portfolio Committee on Finance. She also served on numerous other parliamentary committees, including the Standing Committee on Public Accounts during the arms deal investigation.

Ms Taljaard lectures part-time at the University of the Witwatersrand's School of Public and Development Management, and locally and abroad on the regulation of private military and security companies.

She is a Yale World Fellow, a Fellow of the Emerging Leaders Programme of the Centre for Leadership and Public Values (University of Cape Town's Graduate School of Business and Duke University), a Young Global Leader of the World Economic Forum, and an ALI Fellow of the Aspen Institute.

She holds a BA in Law and a BA (Hons) in Political Science, cum laude, and an MA in Political Science, cum laude, from the Rand Afrikaans University (University of Johannesburg); and an MSc in Public Administration and Public Policy, cum laude, London School of Economics and Political Science.

Ms Taljaard publishes widely.

PROF JOHANNES FEDDERKE

HEAD OF THE SCHOOL OF ECONOMICS, UNIVERSITY OF CAPE TOWN

Prof Fedderke holds BCom and BCom (Hons) degrees from the University of Natal; and an MPhil in the Faculty of Economics and Politics and a PhD in Economics from the University of Cambridge.

In 2004 Prof Fedderke became Professor of Economics at the University of Cape Town. Prior to this appointment he held the position of professor at several universities, including Oxford University and the University of the Witwatersrand. He has also lectured at City University, London and at the University of Natal.

Prof Fedderke serves on the editorial boards of several economic journals, including the South African Journal of Economics and Economic Modelling. He was the Convenor of the National Research Foundation Assessment Panel for Economics, Management, Administration and Accounting for 2004–2005.

He has also done work for the South African Parliamentary Sub-Committee on Finance and provided training courses in international finance and econometrics to several governments, including those of Mozambique and Zambia.

Prof Fedderke founded the Macroeconomic Analysis Group at the University of the Witwatersrand in 1997 and ran it until 2003.

DR AZAR JAMMINE

DIRECTOR AND CHIEF ECONOMIST ECONOMETRIX

Dr Jammine matriculated at Pretoria Boys' High School, after which he did a BSc (Hons) in Mathematical Statistics at the University of the Witwatersrand.

During the period 1970–75 he was employed as an investment analyst at Senbank and subsequently at stockbrokers Martin & Co, now JP Morgan. During this time he completed a BA (Hons) in Economics, cum laude, part-time at Wits. In 1976, Dr Jammine completed his MSc in Economics at the London School of Economics, followed by his PhD at the London Business School, after which he was awarded a two-year Post-Doctoral Fellowship at the Centre for Business Strategy of the school. In order to pay his way while working on his PhD, Dr Jammine used his knowledge of six languages to conduct numerous international business-consultancy projects in various countries. Dr Jammine returned to South Africa in December 1985 to take the position of Director and Chief Economist of Econometrix (Pty) Limited.

Dr Jammine has published a number of articles in international strategic-management journals and has conducted approximately 3 500 presentations to leading client corporations and at economic conferences.

Dr Jammine is also a Non-Executive Director of Federated Employers Mutual, AMB Holdings, Netcare, GHG (in the United Kingdom) and Iron Fireman.

PROF RAYMOND PARSONS

NEDLAC OVERALL BUSINESS CONVENER AND ECONOMIC CONSULTANT TO BUSINESS UNITY SOUTH AFRICA (BUSA)

Raymond Parsons presently teaches at the Department of Economic and Management Sciences at the University of Pretoria. He is also currently the Overall Business Convenor at the National Economic Development and Labour Council. He is a key contributor to public and academic debate on a broad spectrum of issues of critical importance to the political economy of South Africa.

Prof Parsons studied economics at the Universities of Cape Town, Oxford and Copenhagen, before playing a leading role in organised business in South Africa for many years. He is a former Director-General of the SA Chamber of Business. From 2000–03 he was a Visiting Professor at the School of Economic and Business Sciences at the University of the Witwatersrand. He is also an Honorary Professor in the Department of Economics and Economic History at the Nelson Mandela Metropolitan University, and holds an Honorary Doctorate from that university.

He is the immediate past-President of the Economic Society of South Africa and a member of the Management Committee and Executive Council of Business Unity South Africa. In 2004 President Thabo Mbeki appointed Prof Parsons to the Board of Directors of the SA Reserve Bank and he was reappointed in 2008. He is the author/editor of several books.

PROF STEPHEN GELB

EXECUTIVE DIRECTOR, THE EDGE

The EDGE Institute's Executive Director is an economist with more than 20 years of experience in South African economic-policy issues. Prof Gelb studied economics in Cape Town and Toronto. He was an activist in the Canadian anti-apartheid movement between 1976 and 1984. Returning to South Africa in 1984, he was an advisor to COSATU, the South African Council of Churches and the United Democratic Front on economic-policy issues until 1990. Prof Gelb then worked as an advisor to the African National Congress government during the early 1990s. He has been a consultant to a number of South African government departments and agencies, including the Treasury, the Department of Trade and Industry, the Office of the Deputy President and Nedlac. He worked with the Office of the President from 1999 as leader of a major study of domestic fixed investment in South Africa, and was research co-ordinator in the government's MAP Technical Team between November 2000 and July 2001.

He has taught at various universities including York University (Toronto), the New School for Social Research (New York City) and the University of Durban-Westville, and is currently Visiting Professor in Development Studies at the University of the Witwatersrand. Prof Gelb also spent more than four years at the Development Bank of Southern Africa..

PROF CHARLES SIMKINS

HEAD OF THE SCHOOL OF COMMERCE, PHILOSOPHY AND APPLIED ETHICS, ST AUGUSTINE COLLEGE, JOHANNESBURG

One of South Africa's best-known development economists, Prof Simkins is an expert in demography, poverty and income distribution, labour-market analysis, and education financing. He is a consultant to the Department of Education and the Treasury, and a member of the Statistics Council. He is also Chairman of the Executive Committee at the South African Institute of Race Relations and a Senior Consultant at the Centre for Development and Enterprise.

Prof Simkins holds a BSc (Hons) in Physics from the University of the Witwatersrand; a BA from Oxford University and a PhD in Philosophy (Economics) from the University of Natal. He also holds a Certificate in Demography from Princeton University.

He has lectured extensively at various universities, including the University of Natal and the University of Cape Town, and was the Helen Suzman Professor of Political Economy at the University of the Witwatersrand from 1991 to 1998. Prof Simkins has also written and contributed to several academic journal articles.

DR NEIL RANKIN

ECONOMICS PROFESSOR AT THE SCHOOL OF ECONOMICS AND BUSINESS SCIENCES, UNIVERSITY OF THE WITWATERSRAND

Dr Rankin holds a DPhil Oxford, an MA Simon Fraser, and BSocSc (Hons) and BSc, both from the University of Cape Town

He lectures in trade and micro-economics and his research areas include applied micro-economics, firm and labour market dynamics, and trade.

Dr Rankin is a subject specialist for the International Trade AERC collaborative PhD programme and Director of the African Micro-Economic Research Umbrella at the University of the Witwatersrand.

He has also performed firm and labour market surveys in Ghana, Nigeria, Tanzania and South Africa, and is currently working on the South African Young Persons Survey with Prof Charles Simkins, the Centre for Development and Enterprise and the Umsobomvu Youth Fund.

Dr Rankin has also published several academic journal articles, research reports and working papers.

MARTIN WOLF

ASSOCIATE EDITOR AND CHIEF ECONOMICS COMMENTATOR, FINANCIAL TIMES, LONDON.

Martin Wolf was awarded the CBE (Commander of the British Empire) in 2000 "for services to financial journalism". He is an Associate Member of the governing body of Nuffield College, Oxford; Honorary Fellow of Corpus Christi College, Oxford University; an Honorary Fellow of the Oxford Institute for Economic Policy (Oxonia) and a special professor at the University of Nottingham. He has been a Forum Fellow at the annual meeting of the World Economic Forum in Davos since 1999 and a member of its International Media Council since 2006. He was made a Doctor of Letters, honoris causa, by Nottingham University and a Doctor of Science (Economics) of London University, honoris causa, in 2006.

Mr Wolf has been presented with many awards including the Wincott Foundation Senior Prize for Excellence in Financial Journalism for 1989 and 1997 and the RTZ David Watt Memorial Prize for 1994. In 2005 he was given First magazine's Special Advocacy Award and in 2008 he won the AMEC Lifetime Achievement Award. He won the Commentator of the Year award at the Business Journalist of the Year Awards of 2008, and was also placed among the world's 100 leading public-policy intellectuals by the British magazine Prospect and the US magazine Foreign Policy in 2008.

TREVOR MANUEL, MP

MINISTER OF FINANCE

Trevor Manuel has served as a member of the African National Congress National Executive Committee since 1991 and a Member of Parliament since 1994. He was appointed as Minister of Finance of South Africa in April 1996.

Mr Manuel was actively involved in the struggle against apartheid and was a Regional Secretary and National Executive Member of the United Democratic Front. He was elected to full-time office in the African National Congress in 1991 where he was appointed as head of the party's Department of Economic Planning, and was appointed as Minister of Trade and Industry in 1994.

Mr Manuel has served as Governor on the boards of the World Bank, African Development Bank Group and Development Bank of Southern Africa. He has also chaired several international organisations, including holding the post of Chairman of the Board of Governors of the International Monetary Fund in Prague in 2000. In 2008 Mr Manuel was appointed Special Envoy for Development Finance by the United Nations Secretary-General.

He has been awarded several doctorates, including in commerce, honoris causa, from both the University of Stellenbosch and the University of the Western Cape, and law, honoris causa, from Rhodes University.

Mr Manuel has been presented with an array of awards since 1994. Most recently he was named the Africa Finance Minister of the Year (2007) and won the Woodrow Wilson Public Service Award (2008)

Professor LAWRENCE SUMMERS

We are in times of a kind that I do not think any economist would have forecast even six months ago. It has been estimated that the wealth losses worldwide are measured well into the tens of trillions of dollars. We are very likely facing the most serious global recession since in the last generation.

There are enormous distortions and abnormalities in the financial markets. Perhaps one way of conveying the distortions is to observe that several weeks ago there was a period in the United States when interest rates and US government bonds, US treasury bills, were actually negative for a time. That meant the people were paying to have the government store their money because it was inefficient to keep their money under their mattress and because they thought that it would not be safe with any private financial institution.

So this is a global event that will have very far-reaching ramifications. Why do we have this global event? Keynes's central insight was that markets were not in and of themselves self-stabilising, that they could on rare occasions be significantly destabilising; that, if you like, they were prone to vicious cycles — and it is vicious cycles that we are observing right now. A vicious cycle with respect to liquidation as assets that go down in value prompt margin calls that prompt sales. A liquidation cycle in terms of declining capital-asset values, which lead to institutions being less well capitalised. Institutions being less well capitalised leads to their being in a position to lend less, which in turn reduces asset values and reinforces the cycle. A cycle, also, within which you have what might be referred to as the credit-accelerator vicious cycle, in which a declining financial system leads to increasing problems in the real economy, and that in turn exacerbates the difficulties in the financial systems. A Keynesian vicious cycle in which declining levels of income lead to declining levels of employment, lead to declining levels of income — and, finally, a panic vicious cycle in which fear about the health of financial institutions leads to further fear about the health of financial institutions, because of which, in turn, as each person or each agent seeks to withdraw money from a financial institution or from a merging market, others are encouraged to do the same so that they are not the last one to the exit.

These five vicious cycles together create a situation that is prone to enormous instability, and what will be important will be to recognise, as former Mexican President Zedillo once said, is that markets often over-react and that is a reason why policy must over-react.

South Africa, of course, as an important emerging market, will be affected in a number of ways. It is, like all markets, dependent on the global economy. Given the structure of your economy you are particularly prone and sensitive to developments in commodity markets, which in turn are dependent upon the behaviour of the real economy. As one of the member nations in the G20, South Africa will of course be represented at the meeting that will be convened in the United States on November 15 to discuss this crisis. This is an important event for the United States, an important event for the global economy, and it is certainly an important event for South Africa.

> "It means seeking transparency about realistic assessments of where banks' accounts are, and crucially it means insisting on adequate levels of capital"

I had the privilege of visiting your country just a few months ago, in June. At that time I was struck by the economic progress that South Africa had made since my last visit a decade ago, but at the same time very much aware that you had your domestic uncertainties and fragilities, events that were related to ongoing political uncertainties, to the health of your fiscal situation and to your inter-relationships with the global economy. It is not for an outsider to prescribe the specific content of policy for any country but it seems to me that there are a number of imperatives for all countries in this global economy.

Firstly, trust in the financial system has to be rebuilt. That means, where necessary, providing government guarantees of deposits or of liabilities, as many of the industrialised countries have done. It means seeking transparency about realistic assessments of where banks' accounts are, and crucially it means insisting on adequate levels of capital — capital that comes from the private sector where possible, and the public sector where necessary. This is not a uniquely South African imperative, it is an imperative on a much more broad basis.

Secondly, countries around the world will find it desirable, if they are able to do so in a credible way, to provide stimulus to their economies in the short run while at the same time buttressing credibility with measures to support fiscal consolidation in

the long run. This, given its history, will be a particular problem for South Africa, since markets are probably less likely to be in a position to give you a lot of time to achieve deficit reduction relative to what they might be prepared to give some other countries.

Thirdly, at a time when there is an enormous focus, if you like, on Wall Street, it is crucial not to ignore the needs of Main Street. In many ways, in most ways, a period of economic downturn and weakness like the present is challenging and difficult, but if there is a silver lining it is that with increased unemployment and reduced private-sector demand, there is more room to do things that are crucial in any society. To rebuild the schools and strengthen the educational systems; to restructure and address the challenge of providing health care; to make more tangible and real government technological innovations; to rebuild infrastructure. This is really a moment when government is going to have to do more than it has traditionally done, and where people are rightly going to look for government to fill up a certain amount of the demand slack, and in the process address a range of issues that have been of long-term social concern for a long time. Of course, if that effort is going to be successful it will be necessary not just that government be active

> “Many have said that the economic development of sub-Saharan Africa is the principal, most important moral challenge facing mankind.”

but that governance be strong. That means a renewed focus on reducing corruption. That means great emphasis on assuring that the highest quality and most thoughtful people are put into positions of central importance so that there can be, at a time when it has been more necessary than in a very long time, a renewal of trust in the public sector.

If there is one regularity that comes out of the study of past financial crises and of the experience of earlier periods in which I was involved it is this, ultimately international money follows the money of a country’s own citizens. If a country’s own citizens have confidence in it so that they are bringing money back from abroad into a national economy, international money will follow, but international money rightly is very reluctant to finance the capital flow of domestic money. And so a crucial task, it seems to me, in South Africa, as it has become a crucial task in the United States, is creating a policy environment in which local money wants to stay at home, wants to invest in building a stronger economy.

I say all of this because in what is a difficult moment in my country and in yours I am very much aware of the tremendous stakes in what happens in South Africa. Many have said that the economic development of sub-Saharan Africa is the principal, most important moral challenge facing mankind. Logic and history suggest that there is likely to be convergence over the next generation between South Africa and the remainder of sub-Saharan Africa. Nothing could be more important for human well-being in aggregate than that the convergence take the form of a very strong and rapidly growing South African economy that serves as a hub and a pull as growth accelerates on the African continent. The alternative, growth in South Africa lagging to a point where it contributes to downwards convergence, is frankly too horrible to contemplate — horrible to contemplate in terms of what it would mean for South African society, horrible to contemplate in terms of what it would mean for Africa, and horrible to contemplate in terms of what it would mean for the global system.

So my plea to you is to remember in difficult times, in times where some part of what happened will seem terribly unfair and driven by impersonal markets thousands of miles away, that those who respond most effectively to crises are almost always those who respond most vigorously to crises. I would like to express the strong hope that you respond with a vigorous and strong policy programme directed at doing what is most essential at this moment, restoring trust.

Prof. Larry Summers was appointed as Head of the National Economic Council (NEC) from where he will direct fiscal policy in US President-elect Barack Obama’s White House on 24 November 2008.

QUESTIONS & COMMENTS

PROF BINEDELL: I am interested to get a sense of your view about the response so far, partly about what you expect to come out of 15 November and your interpretation of what has happened in the European Union in terms of trying to co-ordinate a response. How effective and, to use your word, vigorous has that been?

PROF JOHN KRANSDORFF: The question that worries me is this massive involvement of government in funding the banking sector and other programmes. How is that going to be funded? Presumably it is going to be through increased taxes, a lot more debt. What are the long-term implications of this?

MS TALJAARD: If I may add a rider to that question, Kenneth Rogoff a while ago wrote a very thought-provoking piece in the Financial Times in relation to the estimations of the possible debt and bad asset figures, estimating a possibility of even US$2 trillion. Is that a figure that the market is actually looking at with any degree of seriousness?

PROF SUMMERS: US$2 trillion as an estimate of total losses is certainly not something to be ruled out. It probably would be at the high end of most estimates of losses on lending by US financial institutions, but given everything that has happened one has to be very agnostic about what is going to happen.

The question before that, and I am rephrasing it: "What about the socialism risk here, and is the socialism not going to bankrupt us?" I would give two answers. I think it is crucial that this programme be designed right, that this be a financial defibrillator, not a financial chronic-care centre, and that the structure of capital infusion, the structure of policies, be pursued in a way that makes the government involvement transient rather than permanent.

There are a variety of ways you can do that. Some of them happened to some extent at the United States's instigation in the mid-'90s: the IMF [International Monetary Fund] started designing the its emergency lending programme so that there was a premium interest rate that rose rapidly the longer you borrowed the money, so the countries had a strong incentive to pay it back. I think it is important to do things to make it transient, and that the government role not be one of taking voting stock, but rather being one of taking, if you like, an anonymous interest in the company.

With respect to the cost there is one unambiguous lesson of global economic history, and it is pointed up by the work of Professor Rogoff and other people, and that is that the countries that intervene in financial crises sooner and more vigorously end up paying smaller total bills than the countries that answer slowly and with long delays. So whatever the expense is, I would suggest that it is probably cheaper to act than it is to not to act. And I think it is very important to distinguish between the sticker figure and what the ultimate cost to tax payers will be. After all, when I spend money on a vacation then I am poorer, when I buy a house, I have changed from holding my wealth in one form to holding my wealth in another. Now obviously if I overpay for the house I am poorer, and one suspects that there is going to be some ultimate tax cost here, but the US$700 billion headline figure, for example, is not even good as a start in estimating the magnitude of that total tax-payer cost.

How would I evaluate the response so far? Hindsight is really easy and foresight is really hard, and if I learned anything during my time at the Treasury [in the Clinton administration] it was that battlefield

From left: Prof Binedell and Prof John Kransdorff address Prof Summers.

From left: Prof Fedderke, Dr Jammine and Mr Max Sisulu

medicine is never perfect, and so it is very difficult to second-guess from the outside. That said, I think that there has been a tendency — with respect to providing for fiscal stimulus, in respect of the guarantee question, with respect to containing what is happening in the financial sector — for policy to be a little bit late and a little bit short, and so I hope to see a more proactive and vigorous posture in the future.

PROF FEDDERKE: This is a question with respect to the regulatory environment that we are likely to face in the future. Given the experience that we have now had with this particular financial crisis and the role that new financial instruments have played in the unfolding of the crisis, does this carry any specific lessons about the conduct of monetary policy in future, and any particular changes to the way in which monetary policy might best be thought of?

DR JAMMINE: The actions currently being taken are clearly directed at trying to avoid a repetition of what was seen as the lack of action in 1929–33. Is there not a danger that we might be overlooking the fact that there has to be a price paid for the enormous excesses of leverage that have been incurred over the past 20 years, and that the actions currently being taken to intervene with massive doses of injections of new capital might resurrect a new inflationary spiral in due course, that will ultimately force interest rates up to levels that bring about an even worse downturn?

PROF SUMMERS: Once one is in financial crisis, as I know your country has learned in its experience, as I learned in the context of the international financial difficulties during the 1990s, one is talking about least-worst alternatives, one is not talking about hugely attractive alternatives. I would note first, recognising that it is a cheap shot, that this is the kind of thinking that, maybe, the depression brought in the 1930s, and it seems to me we have learnt some very important lessons since that time. Anything is possible, but it seems to me that deflation is a rather larger risk at this moment than excessive levels of inflation. It is not usually thought that the fact that people smoke in bed occasionally is a reason to abolish the fire department, and so without in any way meaning to deny the validity of the various concerns about private-sector behaviour I do not think there is a viable alternative to governments trying to contain this situation.

What about regulation and all of that going forward? I will just say here that I think we need to focus less on any individual institution and more on the health of the system, and a systemic focus in financial regulation could go in a number of different directions, including a focus on establishing clearing houses rather than bilateral bases for trading, and including a greater emphasis on resolution procedures [so that the problems of] institutions who find themselves in serious trouble can be resolved without doing damage to broader financial systems.

MR MAX SISULU: Coming from a small vulnerable country called South Africa, and the whole of Africa actually is very vulnerable, our currency is going up and down, volatility is high, interest rates are high — in fact, we are worried about whether we will have a viable economy tomorrow. A lot of it has nothing to do with our shortcomings, of course, but because we are part of a global world, what happens in America or Europe affects us, indeed adversely so. So we are concerned about what is going to happen tomorrow, and we are looking at hopefully not at a recession in America or a recession anywhere else in the world, but maybe with some confidence in the future about a collective working together in terms of trade, in terms of everything. What is happening today simply confirms what we have been worried for a long time as a developing country. The only good thing for me coming out of this is the role of the United States. I never thought that the American government would come out in support of the private sector. The role of the state has been very, very important here, and coming from the background of wanting to see a stronger role for the state, I think this has been very instrumental for us and very instructive. All the countries in Europe and America are coming out to say we will save the system, we will save the country, we will save everything. Maybe we also in South Africa might want to look at how best the state can be mobilised in order to address the problems of the economy and the problems of our country. So I am happy that at least the role of the state has been highlighted by the crisis.

QUESTIONS & COMMENTS

MR RAYMOND LOUW: My thought, as a journalist, is number one that this is almost a vote of no confidence in capitalism. Number two, does it lead to what Max Sisulu has just been saying, greater regulation by the state, and is that in fact advisable? It does look as if the state in fact had been rather laggardly in dealing with the situation, considering that they must have known that something was going wrong in advance.

MS TALJAARD: Perhaps you could also comment on whether or not some of the incentives actually provided by the state, including in the form of the creation of Freddie [Mac] and Fanny [Mae], actually contributed to some of what we have seen evolving.

[UNIDENTIFIED SPEAKER]: Can we get a sense of when things may bottom out? What does it mean? Have we seen the worst? Are we coming out of it?

MR HARRIS: Following on the last question and looking forward to how the First World can stimulate growth in Third World economies, in developing economies such as ours, how long do you think it is going to take the United States to get back to the 2–3% growth band? To what extent do you see the growth of the European Union and other critical economies like China dropping? Is it far below the 9% that was announced earlier this week, and when do you see that turning? Is the time-frame two years, three years or longer?

"Is this a vote of no confidence in capitalism? I would not go that far."

PROF SUMMERS: How long will this last? Three to six months is the wrong best guess. No one knows, but this is likely to be the most serious economic downturn since the 1982 recession. [That was a] period of great economic difficulty in the United States and global economies, so I think it would be a mistake to minimise the economic risks in this. Is this a vote of no confidence in capitalism? I would not go that far. Life is about choices, and I do not see a lot of success in non-capitalist modes. I would prefer to think of it as a set of events that demonstrate that capitalism needs periodic saving from itself. That is a process that involves many different things. It involves rescue plans at moments like this. It also involves structures of regulation, and then addresses systemic aspects that I was referring to earlier. But I do not think that it is necessarily realistic to think that there is an alternative to capitalism.

After all, if you think about really dramatic economic collapses, the set of events that took place in the formally communist countries after 1989 was really a dramatic collapse that obviously did not have anything to do with free financial markets. What about the role of the state? I think this is a reminder that things move in pendulums and we are well past high tide for the doctrines of Thatcher/Reagan anti-state anti-government market forces, unregulated above all, and we are going to see much more emphasis on the government role in the future. At the same time I do not think anybody is talking about going back to a fully government-controlled economy.

MS TALJAARD: We were very tempted to ask you a variety of questions and predictions about the US elections

PROF SUMMERS: I am, as some of you may know, a strong supporter of Senator [now President-elect] Obama. I have advised him during his campaign on a range of economic and financial issues. I think he is going to be a superb president. I think he has the combination of concern, vision and deep commitment to working through issues that are serious in a thoughtful way. That is what the United States needs right now in the economic area and beyond. I think the United States has important repair work to do in the world. Ten years ago we were the strongest country in the world, today we are bogged down in Iraq and Afghanistan. Ten years ago we were in important respects a moral beacon to the world, today we are increasingly defined by Abu Grave and Guantanamo. Ten years ago we were unambiguously the world's strongest economy. Our model of capitalism has certainly taken some hits in the last year, and that is why its repair will be so essential. I think Senator Obama is going to be terrific on all these issues. I think he is going to present a very different face of the image of America to the world and so I hope very much for his election, and believe it will be a very good thing for United States, for South Africa and for the whole world.

Welcome
RAENETTE TALJAARD AND NICK BINEDELL

MS RAENETTE TALJAARD: Welcome to this economic policy conference hosted by the Helen Suzman Foundation in consultation with the Gordon Institute of Business Science (GIBS). It is held at a very interesting period in economic policy making as the election in 2009 heralds a new administration and attendant opportunity. The deepening of the global financial crisis in the past three weeks has prompted us to focus on the impact the global financial crisis will have on emerging market economies and therefore on South Africa's growth path. This will include looking at South Africa's growth path historically, and examining areas of macro and micro policy where there is room for improvement or accelerated reform. We have succeeded in attracting a very high-profile panel of speakers. Those of you who joined us for dinner last night would have shared in the insight of Professor Larry Summers of Harvard University who examined the impact of the global financial crisis. Other speakers follow today.

PROF NICK BENEDELL
I am not an economist, I am a strategist, I spend my time helping companies and looking at national competitiveness from a strategy point of view. In the work we do at GIBS we spend a lot of time abroad, overwhelmingly in emerging markets. In my reading and experience in these emerging markets there have been a few highlight thoughts I would like to share with you before we engage in the conference proper.

The first thing that strikes me about emerging economies has to do with whether in South Africa we have really grasped our identity, whether we have really understood what an emerging economy actually is. In my many years of experience in corporate life in South Africa, my general view would be that our model is based on the Western model, the Western business model, and that our approach to most things comes from that root (naturally, I suppose because of our history). However, what I have seen in Asia, in the Middle East, and in other parts of the world shows that there are many other models. One of the conclusions that I want to put forward is that politics drives economics in emerging economies and that is the central driver of outcomes. In developed economies there is a much more nuanced and complex flow between economics and politics. In emerging countries the quality of political leadership – and therefore obviously the state – play a very differing role in creating value or destroying value. When I think of South Africa I think of Indonesia, Malaysia, Brazil, Turkey, since those countries have very turbulent politics, as we do. Any debate on policy and execution of response to the global financial crisis has got to be dealt with in the realm of politics, including looking at policy formulation in parties, and the link between parties and the state (particularly in emerging economies).

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> What is fascinating me at the moment is why there is this variety and what is right for South Africa.

The second thing that interests me is how strong and how quick our institutions are, and how quick the processes are to respond. Having come back from Singapore, Indonesia, and India, I feel that we are quite slow to respond (as Larry Summers noted). A vigorous response in a crisis, even though it may be slightly wrong, is much less damaging than a very slow response, and so I am interested in speed and I am interested in the institutional linkages. Who in business is talking to government right now and what processes have been set up starting from scratch to say, “We have a new set of conditions, we need new systems, new processes and new dialogues”?

My observation is that in the past few years we came from a sort of zero/one debate about models. You were either a market-based economy or you were a state-led economy. What struck me is that there are many forms of political economy, successful and unsuccessful. To give you just a crude classification – if you think about it regionally, we would say the US is one form of political economy (right now in a very exciting place). Europe, as a social market economy, is very different than the US in almost every strategic way. Japan has a unique history, set of political institutions, economic structure and factors driving its development; China presents us with a unique model. South East Asia has very interesting relations between the state and economics. In Singapore, business and state partner for the nation in an incredibly intimate strategic partnership. The economies of the Middle East are dominated by families, this is unique. Anyone trying to engage with Nigeria around policy, not understanding the history of Nigeria, the complexity of it, the dynamism of its people, and its political structures, is not going to understand what policy steps to take now. What is fascinating me at the moment is why there is this variety and what is right for South Africa.

When Napoleon had conquered Europe in a mere twelve years it was the Germans who studied him and it was Von Clausewitz who really became the master strategist in thinking about concepts for warfare. Napoleon’s gift was to read every battle, knowing that no two battles are the same and that when two armies plan a battle the outcome is a third thing. In this respect Von Clausewitz had a dictum that “no plan survives the first gunshot”.

Now I do not know if the economists have models to explain what is happening around us today. My sense is that we are in a different kind of world in which perhaps the models do not work any more. Von Clausewitz said, “It is the duty of all generals to fight the previous battle,” because their models come out of a world that no longer exists. What Napoleon was very gifted at was inventing the model for the present battle. After planning the battle and laying out the strategy with his generals, he would retreat from the battlefield. Later he would re-enter the battle and re-energise a strategy for the facts of the situation.

I am interested here in the most important facts about the South African economy, able to inform our debate, and that are different from all the general prescriptions found elsewhere. What is different about our approach?

Professor
JOHANNES FEDDERKE

I will be speaking about South Africa's growth experience and above all about the determinants of South Africa's growth performance.

The history of thought in economics over the 20th century might arguably be said to be dominated by two intellectual poles, one constituted by John Maynard Keynes and the other by Joseph Shumpeter. After a long period of hiatus for Keynes, we are now firmly back in his world. We are, in the short run, confronting a set of questions about how to make sure that the system stabilises on an acceptable equilibrium with good growth prospects going forward.

What I am going to be saying today is not at all in the world of Keynes. It is firmly and unambiguously in the realm of what Shumpeter was interested in – and that was the very long run. How the fundamental performance of the economy gets driven by the characteristics of the economy is what will determine whether you are going to be richer or poorer at the end of it. If you get the long run right, the short run takes care of itself, so I am going to be talking unapologetically about the long run.

I am going to be focusing firmly on empirical evidence on the growth performance of the South African economy. I will be looking specifically at innovation and human-capital formation. I will be examining a range of different institutional features of the South African economy that are particularly important. Prof Benedell mentioned the importance of politics and the importance of institutions. In fact, as it turns out, institutions are the bedrock of South African economic performance. Understanding what our institutional structure actually is, and what features of our institutional structure matter for economic performance, is vital if you want to understand the growth performance of the South African economy. I will be looking at investment performance and also touch on how geography and space affect the policy context in South Africa.

Whenever you encounter the South African policy debate the big catchword is always poverty, it is the big thing that we have to resolve. So the first question to ask is, "Why worry about growth in the first instance? Does it matter at all in the context of poverty?" And the answer always is, "Of course." There is not one country in the world that has addressed the problem of poverty without first getting on to a high growth trajectory. Growth is not a sufficient condition for solving the problem of poverty but it is certainly a necessary condition. Unless you grow the pie that you have to distribute, redistribution cannot in the long run resolve distributional questions that are inherent in poverty. So I am going to take it as a given that poverty, even if that may be our long-run objective, has to take second seat until you have solved the question of how you get on to a high growth trajectory.

Here is another way of putting it, based on evidence that has emerged from the work of Prof. Angus Maddison, who over his lifetime devoted himself to collecting data on the economic performance of countries over the very long run. What I am summarising here is really the ratio of richest person in the world to the poorest person in the world from 1820 through to the 1990s. The richest person in the world in 1820, at least according to the Maddison data, was roughly about four times as wealthy as the poorest person. So take the person in Luxembourg or in Switzerland in 1820, compare him to the person in a poor African country, and that ratio would have been about four to one. Over time the movement has been unambiguously one-sided. The rich people have gotten comparatively speaking very much richer so that now that the ratio of the richest person to the poorest person in the world is roughly 40 to 1 The source of that is straightforwardly the different growth trajectories of different parts of the world.

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One way to show this is to take a look at the reason why Africa particularly performs badly, which relates to the fact that over the past half century, and in fact over a relatively long period of time before that, its economic performance has been very, very poor. In particular, if you take a look at the distribution of countries that experienced negative per capita growth (where on average people got worse off over time) there were only two countries in the world that lay outside of Africa that experienced negative per capita growth; they are Venezuela and Afghanistan. Every single other country with a negative per capita growth rate lay in Africa, and the proportion of countries in sub-Saharan Africa that were experiencing poor growth performance was particularly large. It is one significant explanation why the welfare of citizens of Africa is as low as it is.

Now, as it turns out, Africa has begun to turn the corner and its recent performances encourage hope. But certainly if you are worried about poverty, growth is a necessary precondition. If you compare the self-reported happiness of people against their per capita income you can see that there is a positive relationship, not a perfect one, but nonetheless more money, more happiness as well, so you know per capita income at the end of the day translates into welfare.

Fundamentally and conceptually, what drives economic growth is remarkably simple. It really depends on three straightforward factors. It depends first of all on the factors of production that we use, what we use in order to produce: the capital stock, the labour input and the technology used in production. Production, at the end of the day, is the use of capital together with labour, combining it by means of the technology of production to produce the output. Based on this understanding of production there are only three possible sources of growth: investing in physical capital stock so that you get more out of it, getting better at employing the labour that you have available for production, and improving the technology that you use for production.

You can therefore order the way in which you approach the question of what is driving the growth performance of a particular country in terms of these three broad features. Factors to be investigated are what drives the investment performance, what drives the performance of the labour market, and the rate at which you improve the efficiency of the technology with which you produce in order to gain output. So I am going to order my discussion along those three categories, looking at capital accumulation then considering some of the evidence on our employment performance, and then thinking about what drives our efficiency gains.

The first thing to note is that South Africa's structure of growth over the past 30 years has changed quite fundamentally. In the '70s we relied primarily on accumulation through expanding our capital stock and expanding the labour force that we used in order to produce output, so the main drivers of growth were first of all the labour input and secondly, capital input into production. In fact, over time, we were becoming less efficient in production rather than more efficient. However, as we go from the '70s to the '80s to the '90s, once you decompose South Africa's growth performance that structure changes absolutely fundamentally. Labour disappears almost entirely as a source of economic growth. By the 1990s, because we were shedding formal-sector jobs in the economy, labour was actually contributing negatively to our output growth because we were employing fewer people over time. Capital accumulation investment, expanding our capital base, was also becoming less important. From contributing 2,5 percentage points of growth in the 1970s it declined to less than half a percentage point in growth. By contrast, what has been a rising trend has been technological process or efficiency gains in production This picture is absolutely standard for a process of development. As a country develops and goes towards the international production possibility frontier, it switches from a reliance on factor accumulation to a reliance on improvement in the technology of production in its growth performance. What is unusual is that the aggregate average growth rate of the South African economy (the sum of the three factors) was growing slower and slower as we got to the 1990s. That is atypical when we compare ourselves either to the world as a whole, certainly when we compare

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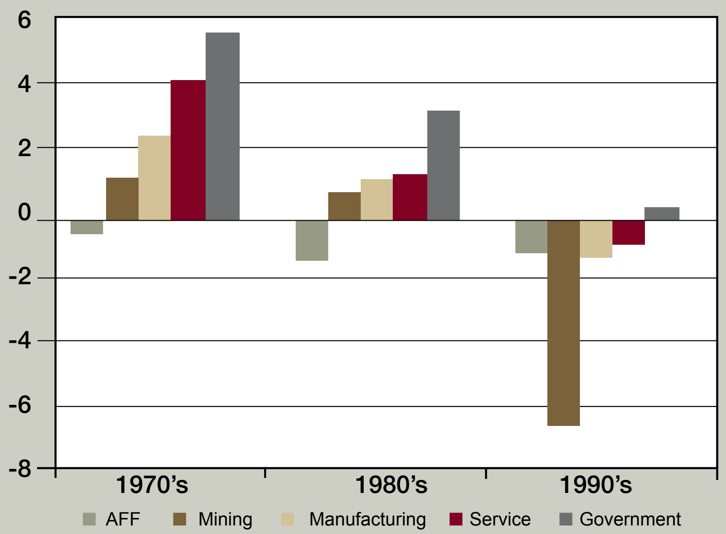
With the associated declining capacity to create employment



ourselves to middle-income countries, and very depressing indeed when compared to East Asia. So our natural comparators and particularly the middle-income countries were actually accelerating through the same time period, rather than decelerating, as we were.

Walter Knirr/Solly van Staden: City of Johannesburg

We have paid a significant cost as well in terms of our ability to create jobs. In the '70s every single major sector except agriculture, forestry and fishing in the economy was positively contributing to employment growth. By the 1980s that contribution to employment growth was considerably lower, and agriculture and forestry and fishing were beginning to shed labour quite substantially. By the time that you hit the 1990s every single formal sector of the economy except the government sector was shedding jobs. So the slowdown in the growth performance of the economy had significant implications, and if you look at the distribution of where those job losses actually are you find that it hurts those who are most vulnerable the most. it is the unskilled who have been most heavily affected.

In terms of capital accumulation we can examine what determines the investment performance of the economy. The determinants of investment include determinants of portfolio capital flows, foreign direct investment [FDI] the impact of economic policy, market structure and financial structure.

Fundamentally the underlying economic theory is straightforward: investment takes place if it pays you to invest (if the rate of return on investment more than compensates you for the cost of undertaking that investment). The modern theory of investment has emphasised a third element, that being uncertainty. Because investment is typically undertaken over a long period of time, the investor faces the difficulty of having to project the expected rate of return and the cost of undertaking the investment expenditure over a fairly long time horizon into the future, and that introduces in and of itself the problem of uncertainty. If you look at what drives investment in South Africa and decompose the drivers, it is certainly true that the standard drivers, in particular the rate of return on capital and the cost of undertaking the investment, do drive investment. They are statistically significant and they are important economically in determining the level of investment expenditure. However, what is far more significant as a determinant of investment in South Africa is precisely a range of measures of uncertainty that are related both to the volatility of demand for output (what I call sectoral uncertainty), and even more to systemic uncertainty. What we use is a measure of political uncertainty in a particular regression analysis. So the level of political uncertainty in South Africa has a particularly powerful correlation with investment. It is the single most powerful determinant of the investment expenditure.

By contrast, the cost of investment – the interest rate – is statistically significant but much, much smaller as a determinant. So it comes back to what Professor Benedell was saying earlier. In emerging markets the level of certainty that you face, the level of predictability of the environment that you face, is fundamentally going to be influenced by the political environment in which you find yourself, and it is going to make a difference to how fast you are going to be able to add to your capital stock. This matters. What these findings mean is that the impact of uncertainty is going to be such that the standard policy interventions that you can use in order to try and stimulate investment expenditure are going to be less powerful than they would normally be. It is certainly true that you can try to use the interest rate to stimulate investment expenditure but that it is a much smaller determinant of investment expenditure than uncertainty. There is also a secondary impact that uncertainty has, and that is an indirect effect. Basically, what it means is that the threshold rate of return that investment has to meet in order to be able to become profitable becomes higher than it was before, so that the effectiveness of policy handles that you have to try and influence investment expenditure is lowered.

All of this carries the implication that macroeconomic stability – the credibility of your macroeconomic policy environment and good governance in the environment within which the investment expenditure takes place – is raised in its significance; it becomes more, rather than less important. Talking about macroeconomic policy, we often hear that it would be desirable for the growth performance of the South African economy that government expenditure should be larger than it is and that the inflation rate in the economy is not that significant as a deterrent of economic growth. Nothing could be further from the truth. In work done by Martine Mariotti, the core finding is that when it comes to government-consumption expenditure, (and I emphasise consumption, rather than investment expenditure, such as expenditure on infrastructure), the optimal government consumption expenditure, at least for growth purposes, lies somewhere below 12% of GDP [gross domestic product] rather than the much higher figures that we have. Furthermore, the optimal level of inflation, at least for growth purposes, lies somewhere below 3%. So macroeconomic policy matters not only in terms of rendering the environment predictable, but also directly, by influencing the level of growth as well.

We also face quite a crucial savings constraint in the South African economy. If you want to invest you need to have the resources to be able to do so. Since South Africa consistently invests a greater proportion of its GDP than it saves, that gap in savings has to be filled somehow. Since domestic savings does not fill it, one has to rely on international capital flows, which can take one of two forms: either FDI, or portfolio flows. The evidence that we have here emphasises the importance of an institutional framework. It is certainly true that there is a response to the rate of return on assets, and there is a negative response to the cost of buying those assets, but what also plays a significant part is risk – the riskiness of the assets that you are buying. The same thing is true for FDI, which I will discuss later.

Evidence shows that the interest rate differential between the United States and South Africa certainly drives capital flows, no matter how you measure it. We use a range of different methodologies to capture that. Capital flow also responds to the rate of return on South African assets as captured by the growth rate of the economy, but again a range of uncertainty measures dominate the determinants, including the role of institutions. A predictable, reliable institutional framework that renders the prospects of the investment more certain is crucial for improving capital inflows into the South African economy.

Turning to FDI, this is really just another form of capital. The only distinction between FDI and the physical capital stock of the economy is that it happens to be owned by foreigners. It has exactly the same impact and output as any other piece of capital would, at least in principle. Empirically, the impact of FDI in South Africa has two channels, a short-run channel and a long-run channel. In the short run, the impact of FDI is such as to crowd out some of the domestic capital investment, and you can see why that might be the case. The foreign investor may be more efficient, may have better technology, may have better know-how on how to produce, and may supplant the South African producer. However, the long-run effect is quite different. It serves to improve the productivity of all capital and labour in the South African economy. You get spillover effects. The FDI comes in, it does bring in new know-how, it does bring in new technology and new production techniques which are more efficient, but over time the domestic producers learn how to compete and the net effect is therefore to improve the productivity of all capital and labour in the economy. The net impact of the FDI is a positive one on output growth. What matters in the context of what drives FDI are these institutional factors, the instability or stability of the domestic economy. In this particular context the quality of property rights is an important and extremely powerful driver of FDI with a strong elasticity well above that usually associated with a measure of property rights.

I am going to skip crime as a factor in investment, and look briefly at infrastructure investment. When we started this work it was not so clear that infrastructure investment was going to be taken seriously, while it now is very much more a part of the policy agenda. In our work we point out that infrastructure investment in South Africa actually began to decline very alarmingly from the mid-1970s onwards, with the net consequence that the infrastructure stock of South Africa began to decline, after taking into account depreciation, from the mid-1980s. What you can show is that that

carries growth consequences. We have a range of 19 different infrastructure measures, including measures of infrastructure related to rail, roads, ports, and air transport as well as telecommunication infrastructure and electricity generation. The basic point is that infrastructure matters for productivity, so it matters for output growth as measured output per labourer. It is also important for a secondary measure of productivity called "total factor productivity", the productivity with which you employ your factors of production.

What remains a source of concern is not so much a lack of recognition that infrastructure is important, but the level of investment in infrastructure. We have got a fairly big backlog. We did some projections and forecasts on what the infrastructure requirements would be for the South African economy. Simply taking two infrastructure measures, power generation and telecommunications, and predicting what the needs would be for the South African economy, a growth scenario which only has a 3,6% growth rate of the South African economy would require, just for those two infrastructure measures, an investment of 1% of GDP per annum. Once you want to realise

a much higher growth path, such as 6% per annum, power and telecommunications alone would require 2,4% of GDP per annum just on those infrastructure measures to be able to catch up on the backlog. South Africa is beginning to take it more seriously. Have we taken it seriously enough? That is an interesting question, as you will see right at the end when I talk a little bit about the spatial question in South Africa. We have an unusual configuration of our economy which differs from that of many other countries and that carries implications for infrastructure investment as well.

Regarding employment, one of the standard debates in South Africa over the past 15 years has been whether the cost of labour actually matters for employment. Now this may seem bizarre because the economist's gut reaction always is "of course it has to matter", but the policy environment certainly did not seem to recognise that very much. However, I think the debate has shifted now. In the recent contribution by Abhijit Banarjee, Jim Levinsohn et al of the international panel of experts, as regards labour market policy, one of the core recommendations is that a wage subsidy be introduced in order to improve employment prospects or the employment performance of the South African economy. This is implicitly a recognition of the fact that wage costs are a significant deterrent to employment.

In the context of the labour market, it is also worth mentioning that trade liberalisation has not been the main source of job losses. The main sources have been related to the nature of technological change, which has been labour saving, and the cost of labour. There are many ways of showing that. You can show this in gold mining, for instance, where you can see that the point where the real remuneration of work has begun to climb in the mid-1980s was the point where employment began to reverse.

You can look at it in terms of the degree of distortion in the labour market, as seen in the correlation between the rate of increase of remuneration and productivity growth. The more distorted it is, the lower the growth in employment is going to be, and the more strongly correlated productivity increases and wage increases have been, the more employment has grown. I can also point out that the elasticity of employment with respect to the cost of labour is, at least in some sectors, actually fairly high; it is not true to say that the wage elasticity is low. So the cost of labour matters. What we have faced over the last 20 to 30 years is a situation where we have mispriced our labour, and it is hardly surprising therefore that we have managed to put a lot of the labour force into unemployment.

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Another source of market distortion relates to the trade context. We have seen some degree of trade liberalisation, but it is questionable just how far that has gone. We tend to note this as one of the policy successes in the South African economy, that we have liberalised and have liberalised substantially. It is true there has been liberalisation, but the question is: "How much, and is it enough?" Even Lawrence Edwards, who disagrees with me on the extent of this liberalisation, admits that we have liberalised no more than the average of all countries.

What I would like to focus on a little more is output markets, because while it is true that we face a lot of constraints or a lot of distortions in our labour markets, we also face substantial distortions in our output markets. This relates essentially to the fact that there appears, at least on the empirical evidence, to be a substantial degree of pricing power in the South African economy. Most importantly what we find is that mark-ups (at least in the manufacturing sector) of price over the marginal costs of production tends to be two to three times as high as it tends to be in the United States. This suggests that the degree of competitive pressure in the South African economy is considerably lower than it is elsewhere in the world, and the consequence of that is a growth cost. So we see considerable pricing power, which is related to the market structure of our output markets, too high a degree of concentration, and an insufficient degree of openness to trade, with the consequence that our competitiveness on international markets is not what it should be. The first paper that we did together with Philippe Aghion and Matias Braun for the international panel of experts looks at the impact of these mark-ups. In the latest investigation we re-computed by a range of different methodologies whether or not these mark-ups are indeed as high as those found in the first round of work. Using a range of different data sets, the answer was broadly the same: mark-ups are high and considerably higher than they are in comparator countries. Importantly, in this paper the question was: "Does it matter that we have such high pricing power?" And the answer is that we pay a price in terms of our growth performance. The pricing power translates into a loss in growth of between 1,6 to 2,4 percentage points per annum in our manufacturing sector, so it is a large price we pay.

We have also done some follow-up work since the growth panel disbanded, which added the treatment of the economy under an open-economy context, which the first paper did not. In fact, the effect does not become weaker, it becomes even stronger once you take into account the extent of the opening up of the economy, so the growth costs may very well have been even higher than it appears at first sight. So in terms of the degree of market distortion, what we find in the South African economy is that we remain with very significant distortions in the labour market with respect to our interaction with the rest of the world. We find that we have moved in the right direction, but that the extent of the liberalisation is still incomplete.

When it comes to pricing power in our markets there is now mixed evidence. The most recent [2001] data that we can get access to in terms of market concentration in the South African economy shows that there may well have been some degree of diminution in the degree of concentration in the South African economy. However, one immediately needs to add a qualifier to that, in that the 2001 data is not really compatible with the earlier data, so one is not quite sure whether this is an artefact of the data, the methodology that drove the data collection, or whether it is a true reflection of diminished concentration in the manufacturing industry. It will be useful to compare this with the most recently released data, released last week, for 2005, to be able to compute these concentration indices.

We have so far examined two factors in economic growth, capital accumulation and labour stock. Looking at capital accumulation, we have made the obvious point that the rate of return on capital drives capital accumulation, but, importantly, the institutional context, and above all the certainty or uncertainty that surrounds investment projects, is a further factor that drives capital accumulation. Whether you are talking about physical capital accumulation by domestic residents, FDI or portfolio capital flows, the institutional context matters significantly.

Looking at the second factor, the labour market, in examining the extent of distortion there, the mispricing of labour is a major source of concern. We have also noted that the market structure in output markets is a significant source of concern, in that we have significant degrees of inefficiencies that arise from the degree of concentration that we face in our output markets.

The last of the three elements in economic growth that we are going to discuss is the process of technological change. Remember, the three legs of growth are capital accumulation, employing more people, and then thirdly, the ability to use those factors of production more effectively. As it turns out, innovation has been quite a contested terrain in the international literature. The fundamental driver of innovation is often argued to be human capital, and the skills constraint of the South African economy has been identified as a potential significant constraint on our growth as well. Strangely, it turns out to be quite difficult to isolate this effect on growth, and what you see in the international literature is really a sequence of developments that have tried to grapple with the question of whether or not skills actually matter for economic growth.

The early evidence, arising from cross-country studies, tended to say that skills do matter for economic growth. The measurement of human capital was usually through school enrolment rates, and the first reports were of a very strong positive impact on growth. This is what you would expect – a more skilled, better-equipped labour force is likely to produce more efficiently and generate a better output.

However, right from the outset there were questions about whether or not this result was robust and about the empirical methodology used in the estimation. And, in fact, it did not take very long for quite a lot of evidence to accumulate which suggested that human capital – skills – did not matter very much at all. At best they had no effect at all, and at worst they actually detracted from the growth path – and there are many potential reasons why that might be the case. Education need not necessarily be used in order to enhance productivity or to improve the skills set of the labour force; it could be used for quite other reasons.

In the third round, however, we have begun to see a new set of evidence which looks intensively at a very wide range of potential determinants of economic growth and in that context education is back, you will be pleased to know. It is in the evidence of [Xavier] Sala–i-Martin and others, which considers a total of 67 potential drivers of growth on the basis of the growth experience of a large number of countries (something like 124 countries in this particular data set). They searched comprehensively over every single possible combination of these factors that might be driving growth. The most important thing is to be in East Asia, it is the best determinant of growth. If you are in East Asia you are likely to grow faster, but the second most important thing is human capital.

What has been pointed out is that perhaps the problem all along has been how we measure skills. It is not enough simply to measure school enrolment, you have got to figure out what is going on inside people's heads once they are in school. So it is a question of

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quality rather than quantity of education that may count. Once you take that into account, the argument on the impact of education is back, and so what I am going to look at is the question of whether this holds true for South Africa. Does the quality of education matter and if so, by how much?

What we did here was effectively to look at output growth in South Africa. We considered impacts on that output growth that might be driven by research and development, but also by human-capital measures, in terms of both quantity and quality. The result is essentially this: what matters in South Africa for growth purposes is not the quantity of human capital we produce, but the type of human capital. So what is an important positive determinant of growth is the proportion of our matriculants that are sitting mathematics and the proportion of our degrees that are in the natural sciences, the mathematical sciences and the engineering sciences. Those are the important determinants. The total number of degrees that we issue matters not at all; it is statistically insignificant as a determinant of economic growth. Some of the school enrolment rates, if anything, have a negative impact. The suggestion is that we may well be putting more people through our schooling system, but we are doing so relatively inefficiently and without necessarily generating the right sets of skills. So the way in which we have interpreted this is that taking the proportion of matriculants that are sitting mathematics or the proportion of degrees that are in the scientific disciplines into account is a measure of the quality rather than the quantity of education.

The magnitude of the economic impact is large. I have a graph that I like because it is magnificently depressing in the right way. It looks at the proportion of matriculants in our schooling system that have sat mathematics over the last century, and disaggregates the proportion of matriculants in the best part of the schooling system (the white schooling system) that was doing mathematics, and the proportion of the black matriculants. In the white schooling system in 1930 we had the best possible outcome, 100% of matriculants sat mathematics. By the time we were heading into the 1990s it was below 50%. In the case of the black schooling system we never really maximised mathematics education. So the performance in terms of the crucial dimensions of skills creation (crucial at least for growth purposes, acknowledging that education can do many things) is relatively poor.

Subsequent to this work, the work of a range of other people (Charles Simkins, Servaas van der Berg) looking at the education system has emphasised that things have not necessarily got much better. In terms of the number of degrees we are certainly beginning to lose far more people through our university system. The number of degrees is climbing all the time, but the proportion that are in the natural, engineering, and mathematical sciences is declining. Remember that human capital is the second dimension as an important driver of economic growth, so in terms of the crucial skills set that we require for growth purposes things are not necessarily looking that healthy. In terms of the R&D [research and development] output of our universities things are not looking very healthy either. It basically peaked in the mid-1980s and has been completely static since. There has not been an upward trajectory. You can repeat this exercise in a number of different ways and come to much the same sort of results. If you look at the patent registrations of South Africa a similar picture emerges.

The institutional story is really the sub-text running through this entire exposition. Institutions matter on a range of different levels. They matter at the meta level, that is the big macro level, such as the property-rights regime instituted. Property rights matter for the FDI that we are likely to attract. Meta institutions also matter in the form of the stability we manage to generate for the system. The political stability will influence fundamentally the uncertainty that investors face. Institutional features of the South African economy also matter at what I call a meso level, an intermediate level which is reflected in the sort of macro policy that we pursue. Stable, predictable macro policy of the sort that we have had is precisely what is required. The financial structure matters, the extent of trade liberalisation matters. But institutional features also impact at the micro level. Import parity pricing, marketing pricing, the degree of distortion that we get in terms of the extensive pricing power that producers in the economy have, matter fundamentally. Distortions in the labour market matter fundamentally for our growth performance.

QUESTIONS & COMMENTS

SALIEM FAKIR – STELLENBOSCH UNIVERSITY: The one thing that you did not really describe is the difference between capital investment in production versus the financial sector. Looking at that distinction, how does that relate to the amount of capital that actually left South Africa in the last 20 years?

PROF FEDDERKE: The distinction between physical capital and financial capital is implicit in the distinction between what I call physical capital accumulation, and that in the portfolio flows, and arguably you can also say that FDI takes the form of investment in physical capital. Now unfortunately it is not quite as simple as that because the way in which foreign direct investment gets classified is really by means of a convention that is determined by the IMF. The distinction between a portfolio flow and FDI is determined by the fact that the portfolio flow is less than 10% of the equity holdings of a company, while FDI is more than 10% of the equity holdings of a company. As soon as you cross that threshold it gets classified as FDI. It may also, of course, take the form of actual investment in physical plant, a green-fields investment. So strictly, the distinction between the financial and the physical capital stock is seen in the very first set of evidence where we talked about physical capital accumulation (where it was essentially the rate of return on the capital given the cost of investing) and then the uncertainty factors driving that investment. The structure is much the same. It is somewhat differentiated, for instance exchange-rate risk is an important determinant when you come to portfolio flows. The over-valuation of the currency is an important determinant of those portfolio flows.

I am not familiar with the numbers right off the top of my head, but certainly for a long period of time, say in the late '90s or early 2000s, investment was dominated by financial flows rather than physical investment. However, that has begun to turn around. The investment rates in physical capital have actually risen during the course of the 2000s, so there has been a claw-back there.

The 1990s saw a reversal of the capital-flight phenomenon, meaning a return of capital to South Africa, in part because the circumstances in South Africa stabilised. The certainty was considerably higher than it had been during the course of the 1980s.

MPHO MUTHUBI: Given the scenario that you have just painted regarding the mathematical prowess of students in schools and the declining standards that we have seen over the years, what is the direct national input, if any, that industries concerned with this growth can make? What is it that they can do and what are they doing presently to enhance or make sure that there is improvement in that regard?

Mpho Muthubi

PROF FEDDERKE: When it comes to mathematics education, the private sector can intervene to some extent and can try to address the quality of the human capital that they receive when they start employing people. The most fundamental thing, I think, has to be that we have to pay closer attention to the quality of education our schools. What we saw during the course of the 1990s was in a sense the culmination of the widening of access to education, so that we essentially now have 100% access to primary and secondary education, at least in principle. The next thing has to be thinking about the quality of what goes on there, making sure that not only do people go to school, but that they get the right skills in the schooling system. So the first response has to be a public response, and it has to start with very fundamental things like getting appropriately skilled school teachers in place. You will not be able to teach mathematics if you do not have peopled trained in mathematics teaching mathematics. We know that the quality of the teaching staff, particularly in disciplines like mathematics and science, is not of a sufficiently high standard in our schooling system.

It is not as if we are not spending enough money, we spend a vast proportion of our GDP [gross domestic product] on education – close to 10% of GDP. South Korea spends something like 4% of GDP on education.

The problem is we do not get "bang for our buck". What happens in our schooling system is that the money spent disappears into a morass of inefficiency, so we have to make sure that what is spent is spent better. So by whatever means, even if it means importing a whole lot of mathematics teachers from India, we need to get maths teachers in place in our schools to be able to address that particular skills shortage.

MR MUTHUBI: This is a direct challenge to the universities and other institutions of higher learning. Supposing in one area of our country we organise teachers who are teaching mathematics or science subjects and get universities to be involved in trying to teach those teachers, will that be a viable suggestion or feasible thing to do?

PROF FEDDERKE: It depends whether the incentives are right for the universities to take it seriously. Academics and universities are under a lot of pressure in terms of the teaching volumes that they face as it is, so it has a resource implication. You would have to make some resources available to the universities. Does that mean redirecting expenditure from elsewhere from within the education system to the universities to do that? Possibly. But it is not clear to me that that is necessarily the best way to do it. If you have got a set of people who are not trained in mathematics in the first place it is probably very difficult to get them to be sufficiently skilled. It may be better just to hire people who are trained properly and to make sure that they get paid properly so they do not immediately leave for the private sector because they can get paid better there. So you may have to accept differential pay scales across different skill sets, so maths teachers get paid more than teachers of certain other subjects, so that you retain them.

Another possibility that is not very often explored in our teaching system is that of paying in relation to performance. One could have more standardised testing, and more frequent intervals of testing, to test learners' core skills of numeracy and literacy all the way through the schooling system, and then make the teachers' pay dependent on how well their pupils do on those standardised tests. In that case, teachers' pay increases would, as for the rest of us, depend on the quality of performance. I am sure the political economy of that would be interesting, but it is quite possible.

PROF KRANSDORFF: I started my career in the late '60s, and as an engineer what I remember in those days was the excellent apprenticeship system, sponsored by the mining industry, by the government and semi-government institutions, and by other private-sector companies. What I have noticed over 30 years is a massive decline in the system. I think that has had a massive detrimental effect on the manufacturing and engineering sectors in this country. From my personal experience one of the great successes in the German system has been the amazing apprenticeship system which they have and which most people go through. I think the apprenticeship system has contributed to the success of the medium and small-sized companies in Germany.

PROF FEDDERKE: The peak of our apprenticeship system was in about 1957 – that was when we peaked in terms of the per capita number of apprenticeships in South Africa. Since then it has been a one-way decline, so I did not show that particular information in my presentation. I think it is true. We have a very significant focus on academic education, particularly at tertiary level. What we have done is tried

QUESTIONS & COMMENTS

> "From a pure economic point of view I would prefer removing the rigidity from the labour market …"

to re-engineer all of our technikons to be universities without necessarily equipping them with the necessary capacity to be able to compete effectively as universities, yet not recognising that in fact the technikon system actually produced a significant body of skills sets which was important to the economy and was in demand. I am not aware of anybody who has done a detailed study to look at the rates of return to these different types of tertiary education and whether it is necessarily better to come out of an academic institution as a really bad lawyer, or to come out of a technikon as a really well-trained technician in computer hardware. I agree, it might well be the case that there is a much higher rate of return to that.

MS TALJAARD: In the context of the medium-term budget policy statement and debates in the aftermath, the MTBPS, there has been a lot of discussion about a labour-intensive growth path. Given some of what we have been discussing in terms of skills, what are your views on this discourse and what manifestations this may or may not take, and the realistic nature of those aspirations given what is happening globally at this stage?

PROF FEDDERKE: It is a great idea, and of course it has to be something that we take seriously, given our unemployment rates. You are not going to address poverty unless you get the people into jobs, but you have got to get them into jobs in the first instance. So if you do not take into account the labour market mispricing, if you do not take into account the impact of the increased rigidities that the labour market has faced in the 1990s, you are not going to get that labour-intensive growth path. The basic problem is that if you have people who have been given very few skills from the schooling system, and who do not have job market experience, you cannot then price them at a level that obviously makes them internationally uncompetitive and expect them to be employed. So it needs a combination of addressing the skills dimension of labour, if you want to get them into higher-paying jobs (or desirable jobs, if you wish), and removing the rigidities from the labour market. I am not a great fan of the wage subsidy because it is one of those interventions which you know is going to develop interesting dynamics over time in terms of how it unfolds, but the big advantage of the wage subsidy is that at least it takes seriously and recognises the fact that the cost of labour is an issue, and needs to be addressed. From a pure economic point of view I would prefer removing the rigidity from the labour market and allowing the price of labour to settle where the market determines it to be, but that is probably not feasible in the political environment.

Panel on Macro-Economic Reform:
Professor Raymond Parsons,
Professor Charles Simkins,
Dr Azar Jammine

Professor RAYMOND PARSONS

Johannes Fedderke and other speakers deal with certain important aspects of the macro economic framework which in their view will maximise South Africa's economic performance in the years ahead. We may well find, as the Minister of Finance also found in his mini-budget this week, that in a time of global economic shocks one's room to manoeuvre does narrow; there is less scope to make mistakes. Flowing from this, any new government in South Africa will face some tough choices, much tougher choices than we have faced up until now. You will know from the medium-term budget statement that the Treasury's forecast of our growth rate for this year is 3,7% and 3% for next year, showing another area which has narrowed for us.

Of course this is not a reason to despair, in fact one can argue that one should use this particular situation to apply a few reality checks which may prove valuable for when we come out of the current phase. In this regard I want to remind you of the message of ASGISA [Accelerated and Shared Growth Initiative for South Africa] which was published in 2006. I hope we are not going to spend all day rediscovering or re-inventing the binding constraints that were identified. Interestingly, and very perceptively, ASGISA put the volatility of the currency at the top of the list in examining the six major binding constraints that prevented South Africa from growing even more rapidly. ASGISA outlined a vision of a development path that would allow South Africa to become more globally competitive, reduce the cost of doing business in the country, create more jobs and overcome the skill shortages.

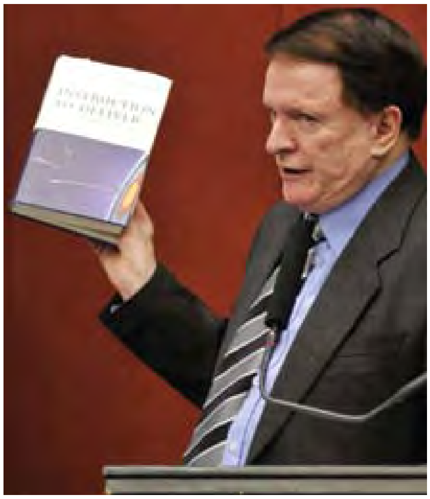
Very importantly, ASGISA pointed to the need to improve the capacity of government to support economic development through measures such as the deployment of professionals and skills to other levels of government that were failing in the delivery process. A good state institution is one that transparently and efficiently serves the needs of its clients, that is the citizens of the state, but success in trying to improve our performance there must be slower and it is much more difficult than simply raising public-sector investment.

While ASGISA did identify the six binding constraints to economic growth, ASGISA and its other arm, JIPSA, the Joint Initiative to Promote Skills Acquisition, have not in any way made the promise that the constraints that were identified would magically go away. Critical to addressing these so-called binding constraints, in my view, is defining the role of the state, both currently and in the future. I wish today to focus exclusively on the role of the state.

Some within the new leadership of the ANC have argued that the state should and will take a central role in any future economic policy. I agree, but I do not agree because I desire or foresee the state in some massively heroic role in a future development state, as perhaps some others might. Rather, I believe, and the evidence does suggest, that the success or the failure of the state to deliver its core responsibilities will be a key determinant of whether or not we grow at sustainably higher rates of growth in the future. A critical issue which has emerged from every study that has been made in recent years of our economic performance as an emerging market is that what is hampering a large part of our economic development is inadequate state capacity to successfully implement the programmes and projects that have already been agreed upon, and the functions for which the state alone, rightly or wrongly, is solely responsible.

In a sense what I am going to be talking about in the next few minutes straddles both the macroeconomic and the microeconomic and is by nature a hybrid subject. I would argue that we by now ought to know what needs to be done. From the RDP [Reconstruction and Development Programme] in 1994, GEAR [Growth, Employment and Redistribution]

Panelist Prof Raymond Parsons.



in 1996, the job summit in 1998, the growth and development summit in 2003 and ASGISA [Accelerated and Shared Growth Initiative] in 2006, to the analysis of the Harvard Group as well as the OECD [Organisation for Economic Co-operation and Development] and the international growth report of 2007/2008, everything that needs to be done has been pronounced upon again and again. Leaving aside the external or exogenous factors, our growth has been hampered not by our lack of imagination but by our unwillingness or inability to follow through on much of what we have decided needs to be done and by a refusal to accept responsibility when there is a failure of delivery. This is important for a developing economy to secure its place and improve its place in a world of globalisation. I want to refer here to a quotation in a very important book that should be on the desk of every new cabinet minister, *An Instruction to Deliver*. It was written by an advisor to Tony Blair and who headed up a delivery unit in the Prime Minister's office. Just to emphasise why this issue of delivery, even in a mature economy like the United Kingdom is important, I want to read what Blair said, which is quoted in the book:

Globalisation is profoundly changing the nature of our society. It forces businesses and people to step up a gear simply to keep abreast with the pace of change and commercial transactions are completed without delay, the communications happen instantly, goods can be moved rapidly across huge distances. Government is not immune from these changes. For it to continue to maintain its legitimacy it needs to change its outlook radically. The technological innovations driving global change have not just opened up new opportunities for delivering services but increased people's expectations of what they want from those who serve them. To meet these challenges the State must provide the same level of customer service as the public have come to expect in every other aspect of their lives. To achieve this the role of the State is not to control but to enable, making modern public services the cornerstone of the enabling State where the State provides a strategic direction, not micro management, requires a transformation of how we deliver our services.

So in that context, and allowing for differences between countries and country-specific factors, I think it is essential at this stage that we ask ourselves three key questions. What should the state do? What should the state not do? (And it is interesting that at the back of the Harvard report they actually list a number of things that the government should not do if they wish to grow rapidly and share that growth.) And thirdly, and importantly, what should the state ensure is done?

Ideally I think one must look for the answers in a pragmatic way. We are a mixed economy. We need to unpack the different dimensions of stateness to understand how they relate to the field of economic development. We should not allow the necessity of implementation, which we see on all sides, to become a casualty of ideological thought lines, but the mere fact of asking those questions I believe opens up a range of possibilities. Most importantly, once it has been decided what the government should do itself and what it should ensure is done by others, mechanisms must be put in place to ensure that this delivery takes place. There is no point in arguing that the state should do something and then not doing it; this is to accept a failure up front. For example, the increased use of public-private partnerships [PPPs] is one such mechanism. Only about 3–5% of infrastructural expenditure by general government is presently allocated to the PPPs in terms of ASGISA and the latest national Treasury figures. By world standards this is very low. A more positive attitude towards the use of PPPs is necessary and any remaining obstacles should be addressed. A target closer to, say, 20% of infrastructural spending would mobilise private financing flowing into public assets on a much larger scale. I estimate it could over time be as much as R100 billion. Apart from its other advantages, this could be even more helpful in a period in which global financial developments will make public financing in fact much more difficult. Yet we find that the roll-out of PPPs is being seriously hampered by lack of capacity and skills in government departments and provincial authorities. So, realistically, what is the capacity of the state actually to deliver in the greater efficiencies in which we in South Africa repeatedly fall short?

“Over the past two years there have been an estimated 2 000 civic protests, some violent, about the lack of delivery.”

In its recent policy critique of South Africa, the OECD, for example, argues that the principal weakness of ASGISA is not a failure to identify any of the binding constraints to future higher growth; indeed the OECD agrees with most of the diagnosis of the challenges which are facing us. A weakness the OECD suggests is that the policy responses to what are difficult questions are "too feeble". Importantly, having identified a chronic weakness in the capacity of the state to carry out its role in supporting economic development, ASGISA then assigns to that same state the primary function of implementing the programmes to address those constraints. It is a Catch 22 situation. The recent summit declaration of the ANC/COSATU/SACP [African National Congress/Congress of South African Trade Unions/South African Communist Party] alliance does likewise. There are some useful and important suggestions about restructuring the functioning of government in that document to ensure a greater efficiency of delivery, but it then imposes on the existing over-burdened State institutions the additional requirement of implementing a sophisticated industrial policy, which quite frankly is beyond the capacity of state institutions to execute successfully just about anywhere in the world.

So we must remain realistic. When there is simply non-delivery there must be accountability and action. We need to ask ourselves why, of all the government functions, the department that stands head and shoulders above all others in terms of delivery is SARS [South African Revenue Service]. Why is it that we are excellent at collecting taxes, which presumably most people really do not want to pay, but often poor at educating our children who are eager to learn, or fighting crime which we all support? Rather tongue-in-cheek, I have suggested that perhaps Pravin Gordhan, having done such a good job on tax collection, should now be transferred to handle all government spending to make sure that we get value for money in that area as well.

Residents dance and chant around a burning tyre during protests over poor service delivery in Protea South, Soweto. Police fired rubber bullets and water bombed the crowd, who had earlier barricaded roads, vandalised lamp posts and thrown stones.

> "… what should the state do, what should the state not do, and what should the state ensure is done."

But what this is really telling us when we look at the delivery scenario in South Africa is that our citizens are impatient for change and are sceptical about the collective capacity to deliver. Over the past two years there have been an estimated 2 000 civic protests, some violent, about the lack of delivery. With the publication of the latest mini-budget it is now more than ever the quality of execution that will decide whether future funded development and other policies really bite and make a real difference on the ground. Delivery requires really sustained prioritisation, it demands a consistent focus on the targets and the data that show what progress is being made, or will be made, over the next few years. It is not just a money problem, it is rather I think something that might be called too much money which is chasing too little capacity.

And what about the issue of centralisation? I would suggest that South Africans — and I include business here, have grown far too used to delegating upwards to national government the task of supplying services on demand and then complaining bitterly when they are not adequately delivered, yet behind this apparent support for centralisation is a growing disaffection which reflects in a mismatch between what the citizens claim they want from public services, usually locality, convenience and access, and the ambitious proposals which are now being debated to have a two-tier cabinet and a planning commission. I think we have got to

OR Tambo Airport could be a 2010 hub of economic activity.

Walter Knirr: SA Tourism

ask ourselves whether that is the best route to follow if we want to improve delivery and co-ordination. Might the trouble be, not a lack of sufficient command and control of the centre, but too much of it? Is this partly the cause of the perceived lack of co-ordination in outcomes?

From the standpoint of economic efficiency is it more important to reduce state scope or increase state strength to ensure that what it does, it does well? The global evidence suggests that state strength is more important than scope in determining long-term growth rates. The question I pose to you is, is this true of South Africa or not?

Certainly at the present juncture in South Africa's political and economic cycle it seems a good moment to ask this question and to come up with answers, after debate, that will better serve the cause of delivery and economic performance in South Africa. And global experience also suggests that the best public-sector structure is one that is able to shift flexibly from one level of centralisation to another in response to changing circumstances. Of course this is a formidable area of economics and public administration. There are a host of complex technological and other factors bearing on the appropriate degree of centralisation and decentralisation at different levels of government. But in addition, and we see this often in the correspondence and the op ed pieces of our leading newspapers, the issues of delegated authority are not only approached from a functional point of view but also from a normative standpoint. Today decentralisation is more often associated with higher levels of popular participation and control, and hence with positive values like democracy, and is desired as an end in itself.

But for the moment we have to deal with the immediate reality. As long as we choose as a country to be reliant on the public sector for much of our transport, power and infrastructural requirements, it is critical that the necessary investment to expand our capacity in those areas efficiently, and I emphasise the word efficiently, must take place. We acknowledge that the public sector also has large social-delivery obligations, yet it is going to be increasingly squeezed in the period ahead between the financial stresses on the one hand and the citizens' expectations on the other. It will be held accountable for effective delivery.

Seen as a whole, I would suggest it would be more realistic and strike more resonance with the population at large and other stakeholders if we in future spoke more about the need for a "delivery state". To this I think many people would be able to relate. It is a state in which the quality and the impact of the public sector is given overriding priority, especially at the local level. In short, meeting the delivery challenge is inextricably linked to the socio-economic goals of any new government in South Africa. A week, a British Prime Minister once famously said, is a long time in politics, but five years is unbearably short in the process of delivery. The numbers are important and we will need to monitor them, but it will not be enough. What is important is that the citizens have to see and feel the differences, and that in this process expectations are well managed.

You will need discipline, you will need creative thinking about new mechanisms to answer those three questions that I gave you: what should the state do, what should the state not do, and what should the state ensure is done. You will need creative thinking and persistence. That book, for example, is one of the best you could have on the challenges facing anyone who undertakes in government to improve delivery. We must draw those lessons to our country because where we have got delivery failing, there is acute social distress. We have to defeat the cynics. So much else depends on it, and the capacity of the State to deliver is an essential element in accelerating macroeconomic reform as well as microeconomic reform in South Africa. I think it is a challenge we need to take up as we debate today what is possible and what is not possible in the future.

Professor CHARLES SIMKINS

I have been more than 30 years at the economics trade and I still do not think I really know where macroeconomics starts and finishes. What it is centrally about is the internal and external value of the currency, and with it the balance of payments, and it is also about fiscal and monetary stance. That is, in broad terms, the details of fiscal policy are really addressed using microeconomic techniques, such as what would happen if we increased VAT by another percent or what would happen if we increased or decreased top marginal tax rate. Those are all really microeconomic questions, but the overall fiscal and monetary stance — whether it is restrictionary, neutral or expansionary — that is taken as a macroeconomic issue. I think probably the best macroeconomic framework is like the best butler, they provide the services unobtrusively. The macroeconomic framework is really what allows firms and households to get on with their projects with maximum facilitation and minimum intervention. That is another dimension of the thing.

Keynes famously said in relation to macroeconomic policy that in the long run we are all dead. I think that has changed in the past few weeks, the way the market is behaving. I think in the short run we are all dead.

When we think about South African macroeconomic policy we probably have to divide it into two phases for two reasons. Firstly, macroeconomic policy really has to concern itself with navigating the current turmoil in world markets. That is going to be its principal objective for the next year or two, and that is reinforced by our particular political circumstances. We have a sort of caretaker government at the moment, and a new one will only start to get going in the second half of next year.

In navigating the current economic turmoil it comes as no surprise really that the rand has taken the hit. Remember the rand, as our little currency, was introduced by Afrikaner Nationalists 50 years ago as part of the project of being independent of the British crown and empire, and it has given trouble ever since, really. Now we have seen this substantial depreciation and the turmoil for the rand is by no means over. I think what comes with it on the balance-of-payments front is trade disruption. There are two dimensions to this. Firstly, a global economic recession, which is coming, of course, will lower aggregate demand in the world economy and in particular demand for our exports, but in addition to that, globally there is going to be an issue with trade financing. We may be able to run credit pretty well as normal internally, but as soon as we start to get involved with the rest of the world through imports and exports, then the question comes of foreign counter-parties and counter-party risks and all of that. So there will be an additional financing constraint. It is not very clear which way it will work, because I think it will affect both exports and imports. We are going to have to navigate through this and there is a possibility that some extraordinary measures in the management of the balance of payments and the management of the rand's external value may become necessary.

We also think that globally, in fashions of macroeconomic management, the key thing that is going to change is banking supervision, broadly speaking. That is what has got to change in the world economy after the current experience, and that is what people are going to talk about. It is not obviously the case that other aspects of macroeconomic policy are going to change internationally, but we are going to see a great swing in what banks do. The Federal Reserve, for instance, had a long-standing mandate to strike balances among various things, such inflation and level of activity in the domestic economy. It's not clear that the objective is going to change. Obviously in the short term the Federal Reserve, like other reserve banks, is going to have to move into a more expansionary mode to offset the global recession, but that is just the application of a long-standing rule. And, certainly, changes in bank supervision are going to have to be internationally negotiated. We can expect to see a Basle III in the conduct of banks, we can expect to see new higher IMF guidelines, a whole series of things, and that will have implications even for what we do domestically.

“And, certainly, changes in bank supervision are going to have to be internationally negotiated.”

So now I think we have to turn to the domestic scene and talk about the political economy of macroeconomic reform. It has been notable that since Polokwane it has been fashionable to beat up the Treasury. Wherever you go you find rather harassed

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But what Polokwane says is that what should be central in all our economic policy is the labour market.

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Treasury officials, and we are being told that we are these terrible people who sit on money, keep development from happening etc, etc. Some of the pressure is coming off because the budget surplus that was there has disappeared, and the medium-term expenditure framework expects, effectively, no budget surplus this year, and that we will be moving into a budget deficit. None of this is crisis; as we move into these recessionary conditions this is entirely normal. But what Polokwane says is that what should be central in all our economic policy is the labour market. So what are the implications of looking at the labour market, and conditions in the labour market, as the central drivers of policy? Up to now, or up to very recently, we have had a twice-yearly labour-force survey which has tended to come out several months after the actual survey date. And because it is only twice yearly, it has had a limited role in short-term macroeconomic policy. Just recently Stats SA has moved to a quarterly labour force survey, which is supposed to be more for short-term economic management. Whether it will work that way is another matter.

A couple of technical issues. For instance, in the quarterly labour force survey in August they released figures for the first and second quarter, and the second quarter unemployment figure was lower. Most people will read that and say well, here you are, unemployment is low. But if you dig around further into the technical notes and look at the standard errors of the unemployment estimate, there was in fact no significant difference between them.

That was a problem with the old labour force survey: that the standard error was so large that you would really have to have a big measured move in unemployment to conclude that the underlying unemployment rate had changed. The design of this new thing is a bit better, the standard errors are lower, but they are still there and they will still have to be taken into account.

Furthermore, the use of this labour force survey estimate of unemployment is going to have to be thought about rather carefully. You cannot say that the labour force survey tells us that for the second quarter we have got 23% unemployment, so we go on and on expanding the economy until the unemployment rate comes down to full employment, like 5%. You cannot use it like that. So how do you use it over economic cycles? That will only become apparent in a few years' time, when you have had some experience of how this thing behaves and how you interpret it in the context of short-term economic management.

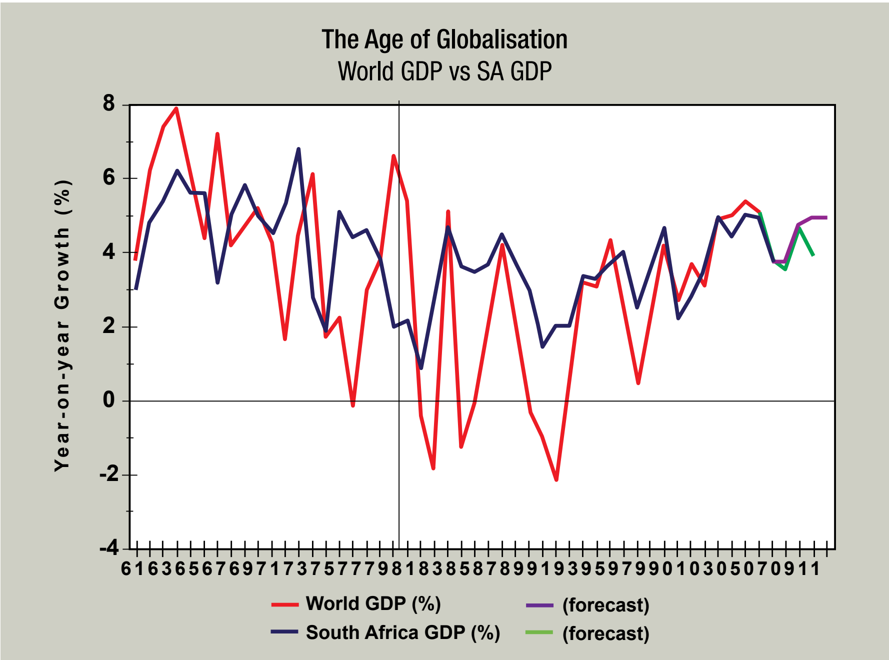
But it seems to me, and it is not the first time, that you get a little left-foot shift in your political system playing right into very difficult economic circumstances. What hit Harold Wilson in 1964, when he took over from the Conservatives, was that the first thing he had to do was devalue and tighten economic policy. That's not at all what his government had been set up to do, and I think the new ANC is going to find itself in quite a similar position.

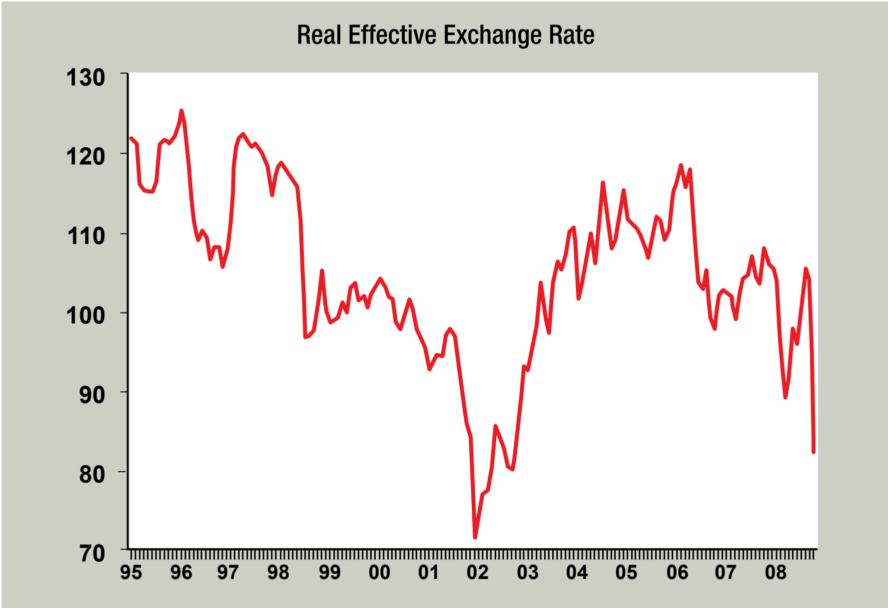
Finally I would like to talk about one thing on the policy agenda that will have quite big macro impacts, and that is any kind of social-insurance scheme. What is being mooted at the moment is that you pay into a social-insurance scheme, and part of that goes into building up a retirement annuity. Quite how that is done, finance and so forth, will have macroeconomic implications. The other part will go into three insurances: against unemployment, against mortality, and against disability. The trouble with the insurance side of it is that the risks the South African population faces are very heavy. Roughly speaking it would be as though you were wanting to introduce life insurance in the Germany of 1939, because excess AIDS mortality is about equal to excess German war mortality rates. And you will be introducing unemployment insurance in Germany in the middle of the depression, with unemployment rates as high as they were then. Those are two very big risks, and they leave a limited amount for everything else, particularly for the retirement annuity. And, of course, if you introduce some sort of central social-insurance contribution, that is going to have effects on consumption, and that is macroeconomic and will have wide implications. What there will effectively be is redistribution of consumption from least fortunate to the unfortunate, and almost certainly to a degree from the rich to the poor as well. If we want to do this, we are inevitably drawn into analysis of the macroeconomic consequences.

This is roughly what is going to be on the macroeconomic agenda, and it is going to be a question of how skilfully a new government, in the middle of next year, is going to enter into the scene and deal with these issues under rather difficult global economic conditions.

Dr AZAR JAMMINE

The first important point I would like to make is following up on something Professor Simkins mentioned, and that is the new administration and the kind of economic policies that it might introduce. There is one very important point to make in this regard, and that is that I am not quite sure just how much the new administration recognises the extent to which the South African economy's performance is likely to be hostage to that of the global economy, and in particular the fact that the new administration, unlike the Mbeki administration, is going to be operating in a much more hostile and difficult global economic environment. Many people kind of pat the fiscal and monetary policy over the past 14 years since the ANC came into power, saying what an outstanding performance the South African economy has been able to achieve over this period — without recognising that actually it is not so much to do with the fiscal and monetary policy and economic management that has been pursued, as with the fact that the administration until now has been operating in a very favourable economic climate. An amazing correlation has existed between South Africa's GDP [gross domestic product] growth over the past 14 years and that of the world economy. The fact that South Africa's economic growth has improved so significantly since 1993/94 has more to do with the fact that the world economy has seen faster growth over that period than anything else. What is interesting, though, is to notice how this correlation did not exist in the olden days. In fact, in 1981 it was directly the opposite, when the world went into a deep recession South Africa had its biggest boom in half a century. It is just that when sanctions were lifted the economy became more integrated into the world economy, so you got this huge increase in correlation. Secondly, that correlation is even greater if you look at South Africa relative to other emerging markets, which have continuously exceeded South Africa's performance. But let us not get too depressed about that; it has more to do with the fact that [other emerging markets include] the Chinese and Indian economies, which have been growing at 10% and 8% respectively over a long period of time. But the message is very clear that we are more likely to follow what goes on in other emerging markets than anything else, and things such as the political environment in which we operate tend to become subservient in relation to what the performance of the entire emerging-markets universe is all about. And that is linked,





> … the primary determinant of the movements in the rand is the movements in global financial markets, especially American equity markets.

obviously, to commodity prices. When the world is doing well, when there is a high level of demand for commodities, we benefit as a primary commodity producer because we earn enough foreign exchange with which to pay for investment goods that are needed to sustain higher economic growth. There are many other avenues through which one can draw on that correlation.

Linked to that correlation is the whole question of why the rand is plummeting the way it has been doing in recent times. As much as people think that it is Zuma, Mbeki, Motlanthe, Lekota and so on that are determining which way the rand is moving, the primary determinant of the movements in the rand is the movements in global financial markets, especially American equity markets. When sentiment towards global markets improves, risk aversion decreases, and international investors become more willing to invest in risky assets. What falls under the umbrella of risky assets are your emerging markets.

Why the rand specifically? Firstly, because South Africa is an emerging market. Secondly, because the rand represents a wonderful vehicle for speculation for three principal reasons. Firstly, South Africa is running one of the largest current-account deficits of all emerging markets. In fact the majority of emerging markets are exporting more goods and services than they are importing. South Africa and, to a lesser extent, countries like Hungary and Turkey are running huge deficits on the current account, and that means that they are proportionately more dependent on foreign-capital inflows to accommodate the shortfall between imports and exports, and that means that as soon as there is a slowdown in the rate of capital inflows into the country the currency takes the knock. And in particular this year we have seen a significant decline in the level of inflows into our equity and bond markets compared with last year and the year before, and as a result the rand has been hammered.

But why the rand being hammered even more than other emerging markets? There are two additional reasons.

Firstly, South Africa's foreign-exchange reserves, even though they have quadrupled in the past four years, are still among the lowest of any central banks' reserves in the world, and that means that speculators have full confidence that poor old Tito can do very little to intervene to support the value of the rand. Interestingly, this morning I was doing a presentation showing South Africa's reserves versus other emerging markets, and I knew that one of the reasons why the rand recovered yesterday evening was because there were rumours about central-bank and IMF intervention to help the currencies of all sorts of emerging markets, such as the Brazilian real and Turkish lira and the rand, which had come under tremendous pressure. When news came out that the Brazilian central bank itself had intervened to buy reals and sell dollars, I said how come they were able to do it? Then I looked at the list of foreign-exchange reserves: Brazil has US$200 billion worth of reserves, South Africa has US$31 billion.

The third point to make regarding this is that the rand is probably the best Mickey Mouse currency one can think of. Why Mickey Mouse? Obviously because it is very volatile, one can play around with it, but also Mickey Mouse is international. The South African rand is one of the most international currencies, one of the most highly traded currencies among emerging markets. In the first nine months of this year, the average daily trade in the rand internationally was US$17,2 billion. In other words, our foreign-exchange reserves cover less than two days' worth of trade in the rand, therefore it is a speculators' paradise through which they can buy and sell the currency to reflect their

risk aversion. That in turn has led to this sharp fall in the value of the rand.
The majority of people see this as mainly bad news — this means we are going to have to pay a fortune for imports, inflation will soar, interest rates will not be able to decline as much — without recognising that the fall in the rand is precisely the manner in which international investment markets adjust for imbalances in the world's economies. And in particular, the fall in the rand is acting as a shock absorber, insulating real economic activity in South Africa from the worst ravages of the financial fall-out that is taking place internationally. All the world's leading countries are now threatened with severe recession. Despite this, forecasts for South Africa remain relatively positive, and one of the reasons is because the rand has fallen so sharply and that is likely to provide some boost to exports in an export environment that is very weak. And it does mean, for example, that in the run-up to the 2010 Soccer World Cup foreigners will find it incredibly cheap to come and stay a few weeks in South Africa. It means not only tourism will pick up, but mining companies, which are suffering from a huge decline in commodity prices at present, will be insulated from the full effects of that by the fall in the value of the rand. So in many respects it is good news.

We had a not totally dissimilar experience in the early part of this decade when the rand last collapsed, to 13,85 to the dollar and 12,25 to the euro. That was also in part due to a sharp decline in global economic growth which depressed commodity prices. But what happened was that because the rand fell so steeply, the South African economy did not suffer anywhere near the extent of the decline of our leading trading partners, that is the United States, United Kingdom, Germany and Japan.

Looking a little further ahead, to what is for me the fundamental challenge in South Africa, there have been lots of complaints that the upswing in economic growth that we have seen over the past decade under the ANC government has not produced the commensurate number of jobs. When you analyse it, you see why. Which have been the strongest growth sectors? Retail and wholesale trade, tourism, transport and communications, financial services and, to a certain extent, personal services and government. The top three laggards have been agriculture, mining and manufacturing. Construction has kind of fallen in between. It used to be a laggard, but it has [recently] been the big growth sector because of the residential building boom we had a few years ago. The problem is essentially that those sectors of the economy that are in decline are precisely those sectors that can absorb unskilled labour most easily. The economy has been moving progressively towards a services orientation in line with many other countries in the world; unfortunately, services require a greater skills intensity, and that is where South Africa is lacking. We have an abundance of unskilled labour, we have a shortage of skilled labour, yet the economy has been moving in the direction of activities that absorb skilled labour proportionately more than unskilled labour.

> “The problem is essentially that those sectors of the economy that are in decline are precisely those sectors that can absorb unskilled labour most easily.”

That is also reflected in the fact that if you relate levels of unemployment to levels of education the message becomes quite clear. The unemployment rate for persons with Grade 10 or 11 and nothing more was 48,5% in 2005. For persons with matric and nothing more, 37,8%. For persons with tertiary diplomas or certificates, a skill, it was 13,2%. For persons with university degrees, unemployment was 4,4%. The message is quite clear, and ironically for persons with no education at all unemployment was a little lower — so either you have to have no education because you will be prepared to do any job whatsoever, or if you do get some education you better get a skill to go with it, and a tertiary qualification. The

Courtesy of Samancor

problem is, the progress the country has been making with tertiary qualifications is abysmal. Thirteen years ago 1,7 million students began public schools, the first post-Mandela school intake; 13 years later 31% only of those students wrote matric. Of those, only 65% passed matric and a mere 15% got university exemption. So of those who originally started school 13 years earlier, 5% got university exemption. Worse still, only 25 000, or 1,5%, of those who began public school 13 years ago got university exemption in higher-grade mathematics with which to study engineering, information technology, medicine, accountancy or the like, and of that proportion, a tiny proportion were black African.

Yes, one can look back to the legacies of apartheid and the educational system that we had then, but this is now 14 years onwards and the results are appalling. It also calls to question how it is practically feasible to accommodate the requirements of employment equity and black economic empowerment [BEE], the goals that have been set, when so few people of colour are actually qualifying in the skills that are needed to fill the appropriate situation.

That brings me to the final point, lack of service delivery, which is said to be one of the driving forces for the political changes that have taken place in the past year. If one looks at the trends of social amenities that are available for the poor, in virtually every category, based on the general household survey, there has been a significant improvement over the past five/six years, whether you are talking about sanitation, housing, energy supply, refuse removal, water availability, hunger etc. Despite that there are huge complaints about lack of service delivery. You do not need to look very far: it is not that the amenities have not been made available, it is that the people entrusted with the job of managing these amenities, the roll-out of these amenities, are lacking in very basic skills. According to the South African Local Government Association one in three municipal councillors cannot read or write. Half of local government officials do not have post-matric qualifications. Two out of ten local government officials understand how tariffs are set. Two-thirds of councillors do not understand their roles and responsibilities or local government legislation; 32% require adult basic education and training.

> “Yet we keep getting told government has to play a bigger role in the economy. How can it if it does not have the manpower with which to do so?”

Cosmo City: 100 000 low-cost houses to be built by 2010.

A lot of the problem lies with a lack of comfort with the English language, but what it results in is that many of your local government officials entrusted with rolling out service delivery sit like hares in front of headlights, frozen. They do not have the confidence to take decisions and implement and manage projects, and at the same time they are too embarrassed to speak out, so nothing gets done. The question I pose is, is changing from Mbeki to Motlanthe or to Zuma going to make any difference to the roll-out of social delivery?

Yet we keep getting told government has to play a bigger role in the economy. How can it if it does not have the manpower with which to do so? And part of the problem for that, in turn, is linked to employment equity and BEE. One can understand the logic for such policies to redress the imbalances of the past, but they have had a perverse effect. Employment equity has

resulted in the private sector going out of its way to attract the best brains from among previously disadvantaged societies in order to meet the private-sector score-card requirements, but at the expense of what? It has absorbed all the best brains and left the public sector with relatively few, and so there is a huge chasm between public-sector delivery on the one side and the high level of efficiency of the private sector on the other side, and unfortunately there is a lack of trust between the two. The private sector has the skills with which to help the government to improve service delivery, but the government does not have the trust to pass some of that responsibility on to the private sector, and so we do not get progress on that score.

On a completely different topic, the whole question of inflation targeting. There are pro- and anti-inflation targeting camps. I fit into neither, really, because I can see the fallacies of inflation targeting and at the same time I can see the merit of having some system to maintain some monetary discipline. What has really drawn my attention to the difficulties involved is that we have now been told that Stats SA is going to change the weight of the consumer price index [CPIX] as from January next year. Investec then said that means that if those weights had been introduced today inflation would have been 2,2% less than it is right now, and therefore why were interest rates increased in the first instance by the Reserve Bank? Surely the whole fault lies with Stats SA. No. It lies with the whole concept and methodology of measuring inflation.

Inflation is going to fall sharply by 2,2% suddenly in January because the weighting of food in the CPIX is going to be reduced from 26% to 16%, and the weighting of motor cars is going to be increased from 5,5% to about 13%. And yet, if you look at the situation right now, the food inflation

“… instead of locking on to people’s spending patterns in the year 2000, which we have been doing until now, we will now lock on spending patterns that existed in 2005/06.”

rate is much higher than the overall inflation rate, but the vehicle inflation rate is zero. So clearly you are reducing the weight of the very high inflation number and increasing the weight of the zero inflation number. The farce about this is why we are changing the weights. Well, we are supposed to do so every five years. So instead of locking on to people’s spending patterns in the year 2000, which we have been doing until now, we will now lock on spending patterns that existed in 2005/06. In 2005/06 everyone was spending on buying a new car and relatively little was being spent on food. Look at the situation today. Car sales have plummeted by 32% and proportionately, because food prices have risen so sharply, people are spending much more on food. We are introducing the new weights just as they have become obsolete, and yet monetary policy is going to be based upon this new inflation basket and the targeting that that number should be between 3% and 6%. So we are chasing a completely nebulous target.

It is just that that particular measurement of inflation that might drop by 2%. There are other measures of inflation that show that inflation has been very much higher. If you subtract the growth in the physical volume of manufacturing production from the growth in sales of manufactured goods, manufacturing inflation is 21%. Wholesale inflation is 21%. Producer-price inflation is 19%. Inflation is nothing more than the loss in the purchasing power of money. We should be targeting a basket of inflation numbers if we are going to be targeting an inflation rate.

I wanted to reflect on the problems that I have conceptually with dealing with this concept of inflation targeting, yet we have got ourselves into a mess because if we abandon inflation targeting right now all hell will break loose. People will lose confidence in the monetary discipline of the country. So I desperately call for a revision of the kind of inflation target that we are using at present.

QUESTIONS & COMMENTS

PROF FEDDERKE: I have two questions. One relates to the revision in the fiscal policy stance that we have just seen introduced. From the running of a mild surplus [we have shifted] to deficit expenditure now, and it has been quite a substantial shift, all the way to 1,6% of GDP. The worry, I suppose, is whether this is a commensurate rebasing of fiscal policy or whether it is too much of a shift, particularly given the continuing inflationary pressures in the economy that we have just seen. The more expansionary fiscal policy is certainly going to add to that. Is it an appropriate response on the part of the fiscal authorities? Is it the right amount of a good thing, too much of a good thing, too little of a good thing?

I also want to come back to the closing remarks on inflation targeting. I am definitely in favour of inflation targeting, and one has to remember what it is. We have struggled for a long time with the question of how optimally to ensure price stability in the domestic economy, because the fundamental insight is that there is no pay-off to inflation. It does not do anything for you very much, and certainly there is no wealth gain, there is no growth gained from inflationary pressure. And there are certainly substantial costs, and the most vulnerable to inflation are the poor, so you might as well get rid of it. The big question is how?

The entire point about inflation targeting is that it is a smoke–and-mirrors affair. If you establish a credible target you do not need to do anything, because the people buy the target, and if they accept the target, they will build it into their expectations. Wage settlements and price changes will automatically reflect the anticipated target, and as a consequence the entire approach to monetary policy becomes much less costly on the real economy if it works — if you believe the target and if you believe the credibility of the central bank.

That is the justification for inflation targeting. Why do we target something like CPIX? Because you have got to get people to accept the target that is being set. A crucial part of inflation targeting is a communication story. In principle, it is absolutely right that you should have this entire plethora of inflation rates that you take into account, and the decision-making surrounding the interest rates that you use in order to control the inflation rate should be based on the full information set. But, so the argument goes, you cannot do that because it becomes too complex, people get confused. So that is the reason why you have to pick on the CPIX. Anything that you pick, any particular inflation rate, any index number, is a problem because it washes out detail. But you have to pick something and so, in principle, yes on the fuller information set, but in practice there is a good reason to stick with a particular number in the communication in order to get the credibility of the monetary policy framework in place.

PROF KRANSDORFF: One of the weaknesses in this economy is the huge current-account deficit. What are we going to do to cope with this situation? Professor Summers said, get your deficits under control. What are we going to do in this current world, with the problems in credit markets? Nobody is talking about it and it is clearly a very serious problem. Maybe it is a question about future vision.

PROF PARSONS: To start with inflation targeting. I think it is an absolutely necessary tool for us. There are countries that have low inflation that do not have inflation targeting, so I think one must not be illogical about it, but we have had it for eight years. After eight years we can debate it, I think that is quite useful, and if you want to tweak it, that is fine. But I think the basic concept as a tool for policy-makers, as a concrete predictable and certain message that goes out to the markets, to business, as to how monetary policy decisions are going to be driven, we should certainly not contemplate in any way trying to abandon that particular system. One can certainly have a debate about some of the technical aspects, but that apart, fundamentally it has been of benefit to South Africa. On the fiscal side, I think the so-called mini-budget has proved its worth once again in terms of a three-year rolling picture of how we are going to handle public finance, especially on the spending side. I am a Keynsian and so I can live with a 1,5% deficit. I think you must roll with the cycle, and you must be anti-cyclical at this point.

More importantly, the whole changed global scenario and the domestic scenario are narrowing your options, and so where do you go from here? We have a new government coming in, we have elections, and all sorts of new thinking about economic policy needs to be debated, but the fact is that we do not have as much room to manoeuvre as we had on the fiscal front. Therefore we cannot go much further unless we make other structural changes that will enable this economy to grow more rapidly in the future and therefore generate the tax revenues, etc, that we want. That comes back to the binding constraints which I think are really quite important.

> “So we need to make sure that we come out of this being able to do much better after the crisis is over.”

On a third point, I would like to respond to the questioner. Whatever the current difficulties, real as they are, the fact is we must concentrate on what we need to do. That is indeed what the message was in the mini–budget. We have got to concentrate on what we do when this is over and in this process we must not throw the baby out with the bath water. There are certain fundamentals we need to address.

I think I have told the story before of the Chinese economist who came to see me and before I could speak he was all excited and said, “We have a runaway train in China — it is growing at 11%, what are we going to do?” I said, “Give me that problem.” For South Africa to go from 5% to 3% is much more traumatic than going from 11% to 9%. So we need to make sure that we come out of this being able to do much better after the crisis is over. In that sense we should go down on our knees and thank the New Zealander who voted against us for the World Soccer so that we did not have it in 2006, because I think 2010 is one of the shock absorbers.

PROF SIMKINS: Yes, I think there are some issues about what happens now. I think the Treasury’s model and everybody’s models are probably less reliable in prediction now, and probably will be for the next year or two, than they have been. The Treasury and the Reserve Bank are going to have to watch how things unfold week by week. We are off V-shaped recessions, but we might a U-shape, or we might get an L-shape, and just roll along for a decade like Japan did after its property bubble burst. So I think there will be frequent revisions to any forecasts that are made, and quite what control the government is actually going to have on all of this in positioning the economy just where it wants to is going to be one set of issues.

The second set of issues is what happens now politically, because it is not entirely clear, but it looks as though the sort-of Polokwane coalition were looking forward to expanding state expenditure. They have

a whole shopping list of projects, some which are very expensive. They may arrive in circumstances in which that is not appropriate, and then what do they do? Do they get going anyway, with adverse shocks for macroeconomic variables down the line? Or do they rein in? I do not think we have a sufficient reading on that one and we will not have it until the new government is there. So what Trevor Manuel does in the remainder of his term is just hold the thing pretty much to its course. If you read his medium-term budget statement, essentially he says we have done the right things, we are doing the right things, so he has got his orientation until the end of the present government. But I think we will see quite interesting developments during the political campaign and it can affect things. I think, for instance, this crisis in the United States probably handed the elections to Barack Obama, but even that is not entirely clear. So the experience we go through over the next six months and how that impacts on the political campaign will be a very interesting variable to watch.

DR JAMMINE: Prof Fedderke’s questions are actually to some extent interrelated: the inflation targeting and fiscal policy, and whether it has become too expansionary. My initial reaction to the move from a small budget surplus to a 1,6% budget deficit was that it makes a lot of sense if you bear in mind the fact that your mines are going to have so much less revenue. In the past few years the revenue has been coming to a significant extent from the extra revenue from our mining industry as a result of the commodity-price boom. So yes, we are going to have a sharp decline in those revenues, especially company-tax revenue, and that means that the only way then of reining in your fiscal balance is to reduce expenditure. In fact, expenditure is virtually staying the same as was originally budgeted for, so the question to ask is, in current circumstances, would it really have been the correct thing to be pro-cyclical and rein expenditure in, just as the economy itself is reining in?

I looked at the growth parameters, and they seemed reasonable. The inflation parameter, however, looks totally unreasonable. The Reserve Bank itself, in its model, is looking for inflation to get back within the target range by the second quarter of 2010; Treasury is saying by the third quarter of 2009. My model, with the rand at 11 to the dollar, says there is no way either of those can be achieved. If inflation turns out to be a lot higher than forecast, then it is conceivable that government revenue will actually grow a lot faster than the government itself is setting out right now. And that might indeed mean that we do not go into a budget deficit, but we may still achieve a surplus.

Walter Knirr/Solly van Staden: City of Johannesburg

Related to that, I ask myself why the inflation forecast by Treasury is so optimistic. Maybe that comes back to the point that you are trying to send a message, trying to convince your workers not to demand excessive wage increases, by projecting an unrealistically low inflation forecast?

On the inflation targeting, I was not arguing for the abolition of inflation targeting, I am just saying frankly my mind is all over the place now with this re-weighting. It has been so dramatic and it is going to have such a hugely distortive affect. To me, deep down I feel it is almost being dishonest to say that we are now targeting a particular number and that is what we are going to achieve. I do not know what the solution should be, other than taking an eclectic approach of getting a group of measures and working that one out. But, as you say, it might be too complicated for the man in the street to understand.

As regards the current-account deficit problem, it comes back to what I see as the most fundamental problem facing the long-term future of the South African economy, and that is the lack of skills. The reason we have such a large current-account deficit is in part because we are trying to build up the infrastructure of the economy, which was badly neglected. But we are being forced to buy imported infrastructural equipment because we cannot make it ourselves, and in part that is because we do not have enough skills to make it ourselves. You take that argument through, and it is not just infrastructure, but many intermediate goods. We have become more and more reliant on imports rather than being able to produce the stuff ourselves, partly because of the erosion of our skills base.

That brings me to the final point on a future vision, a long-term vision for the country. I think we need leadership to get the population to recognise that the way to prosperity in this country is not through buying a lotto ticket or waiting for handouts to be doled out by the government, but to build up one's own skills, become educated, to become more productive to be able to earn

one's place in the sun, so to speak, and that will in due course give people their own self-respect. At the moment we are increasingly breeding a dependency syndrome: let government dole out everything and we will take it and survive accordingly. I was very grateful to read in the medium-term budget policy statement that number one of the five priorities was education and skills development, number two was health development, which also ties in with that. But we need that message to come across not only from Trevor Manuel. Where Thabo Mbeki really failed, in my view, was on the educational system, and sending the wrong message to the people. There is a huge anti-education atmosphere in this country, a protest atmosphere towards education, that needs to be turned on its head, towards a mindset that says the way we progress is to build up our own skills in something that the economy needs so that we are no longer unemployable.

[UNIDENTIFIED SPEAKER]: There has been a lot of talk on dealing with inflation through monetary policy. Are there are other measures that the State can take in dealing with inflation, and what are they?

MS TALJAARD: If I may add one small question which really relates to certainty and continuity, I think that there is a lot of speculation about the future cabinet incumbents, and particularly, also, the expiration of the mandate of the current Governor of the Reserve Bank. What are your views on managing the personality uncertainties, let alone any market uncertainties that are emanating from the global economy?

PROF PARSONS: Wearing my Reserve Bank hat I cannot say more than that the contract of the current governor expires on 8 August next year. So it is now a question of whether he will be re-appointed or not, but others may want to say more about that. More broadly speaking, this issue of personalities looming large out of all proportion to policies is something we need to look at. Perhaps in an emerging market this is a little more likely, simply because, once again, [the size of] the pool of skills and experienced people whom you wish to put into senior positions does sometimes make succession planning very difficult. I think it would be helpful if one could have more succession planning for some of these key posts so that you do not have so much speculation as far as personalities are concerned. But quite clearly the new cabinet team will have to grapple with a lot of the issues that we have raised here, and the one point that I would like to add to the previous answers is that the country needs to carve out its place in the sun to a far greater extent. It will have to be more globally competitive if it wants to manage the current-account deficit better, accepting that a developing country will run a deficit, which brings me to my next point.

We have been able to run the deficit because other people have been prepared to put their money into our portfolio investments, and as long as they were prepared to do that we could continue as before. But coming back to a question Johan was asked, I think we have always felt that there was an imbalance: we were getting all this portfolio investment which was keeping us going with the deficit,

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but we were not getting enough FDI , which is a much more stable form of investment. So I think one of the challenges facing the new government will be to create, or expand or maintain, an environment in which we will, once the present global crisis is over, be able to attract not only the requisite amount of portfolio investment but more particularly be more attractive as an investment destination for FDI. And that brings you back to certain structural aspects of this economy and the sort of signals you send out when you tackle those particular aspects, because FDI, in the nature of things, wants a long-term view, and it is based on that.

The other issue I would like to mention is that there is a proposal perhaps that the Reserve Bank mandate should be tweaked. To come back to my earlier point, it is always desirable to have a robust debate, but I do remain of the view that if you are going to retain an inflation-targeting regime then the only tool the Reserve Bank has got is interest rates. If you do not want to use that tool, then you have to think what other kinds of interventions the bank would then have to undertake. Would it have to look at liquidity requirements, cash requirements? Are there other ways in which it would be able to adjust its intervention in order to meet its inflation mandate?

PROF SIMKINS: I am encouraged by the fact that we changed the President of the Republic and markets did not pay any attention to it. So I think if we could do that, we can probably change Ministers of Finance and Governors of the Reserve Bank maybe with the same net effect on the market. That said, I think it is going to be important just what the ANC says in its election campaign. Jacob Zuma has already been out there, trying to combat the impression that the new leadership is economically unsophisticated. So depending on what it does during the election campaign we will get another set of readings, not only with him, but with all the other people who are involved in the campaign. That is the first, immediate test. Some damage could be done there to economic confidence if it is not handled carefully.

DR JAMMINE: What other methods can be used to reduce inflation? Yes, I believe that at source it is a monetary phenomenon, but the inflation target is set by the government itself. One cannot help feeling that far too much of the pressure of reducing inflation has been put on the monetary policy, and when one looks at alternative, clearly I come back to the skills base again. One of the reasons why you have got such high inflation is because the wage increases for people with skills has been soaring ahead at a rate way in excess of inflation and the ability to sustain that. There are all sorts of labour-market reforms that can be brought about, and all sorts of tax changes that can be brought about which can contribute towards lower inflation. But if you rely on the Reserve Bank alone to do the job, then it does not have all that many options other than using monetary policy to try to meet inflation targets.

PROF PARSONS: I think we have left out the question of administered prices, which play quite a big role in our economy. Those prices are set mainly by either parastatals or by the government, and seem to have a life of their own and to be based on a cost-plus basis. And obviously they have made the task of the Reserve Bank more difficult; it had to push a lot harder in order to do its job as a Reserve Bank. That was partly what I think lay behind the fight about the Eskom tariffs; and if they have been wrong for a long time it is very difficult to put them right overnight. I think a lot of the resistance to [the originally proposed Eskom tariffs] was partly on those grounds, also from the central bank, and partly because it was felt that why it was wanted was not being sufficiently investigated or perhaps interrogated, given the fact that you are dealing with a monopoly. So it is as well that the regulator is there, and that the regulator came up with a more reasonable proposal. That does not mean to say that the problem of financing Eskom has gone away, it has not. If anything it has got more acute. But there will be trade-offs and there will have to be tough choices made. If you devote R60 billion to finance Eskom to cushion the consumer, then presumably we are now getting, to come back to Johan's point, much more into a situation where if you do that, then you do not do something else. Up until recently you could almost do both — you could step up welfare payments, you could do this, that and anything — and you could still stay within broadly acceptable parameters. There are going to be a lot more tough choices in future. And that comes back to which of the parastatals or the administered prices are allowed to go their own way, or whether you are going to have some way in which you will have a protocol that fits the increases and the administrative prices into your broader anti-inflation stance.

Clearly there you need some kind of co-ordination if there are markets that are not competitive for whatever reason.

And I think I would just remind you of another point — it is not often that you can have a test-tube experiment in the view of economics: we had one on 23 September when for a few hours the world thought that Trevor Manuel had resigned. We will not get that opportunity again: a glimpse of what would happen if that is not handled properly. I come back to the point about succession planning. Yes, of course at some point there will have to be a change, but then how it is handled is much more important than who someone like Obama appoints as his Treasury Secretary. I think that is not going to make much difference. But who we appoint, if and when Trevor Manuel goes, given his track record, what he stands for — that will be important. So it is a question of how you manage the change. But we must understand it makes quite a big difference to us as an emerging market how these key appointments are handled. The signals they send out are very important to the future management of this economy and to the foreign perceptions of how we are running our affairs here.

SA in the dark: Daily power failures have disrupted the lives of South Africans and led to serious financial losses for businesses. Shop keepers in Rosebank Mall using gas lights.

Panel on Micro-Economic Reform:
Dr Neil Rankin,
Professor Steven Gelb,
Professor Johannes Fedderke

Dr NEIL RANKIN

I am going to take up a challenge [Prof Nick Benedell] put down this morning: can you come up with ten differences in the South African model from other countries? I failed, because I have only got six. But that is going to frame my discussion on microeconomic reform.

The first difference is that we have a government–big labour coalition, rather than the government–big business coalition that happened in the developmental states of East Asia. Related to that, especially now, is the uncertainty we see around policy. At the moment there is a lot of tension. We have seen a lot of squabbling, clearly because it matters who is in government. In a number of other developing stories there was one government, and we knew what they were going to do. In some cases, like Indonesia, we knew that they were going to steal, but that was clear and everyone's incentives were aligned.

The third difference in our model is that we are far away from the developed economies of Europe, North America and East Asia — we are far away from the large economies of China and India. Fuel prices are coming down, but transport costs, especially for the type of stuff that we produce which is big and bulky, are expensive.

The fourth difference is that if we think about some of the other countries that have managed to grow very rapidly, and I am thinking about Mauritius as one example, they grew through the export of textiles and garments, absorbing a lot of unskilled labour. Now we are a bit stuck because a lot of other countries have crowded into that type of space. So we need to think about what kind of space we can develop if we are going to get on to this high-growth path.

The fifth and the sixth points have been touched on at length this morning. One, we have a very poor education system that seems to be getting worse, and it is poor in maths and science; the second is that we have a low savings rate and a lot of short-term financial flows come into the country. So where does that put us?

I am going to be pessimistic and say that puts us in sort of a Nash-equilibrium development path. If you remember A Beautiful Mind, the story of John Nash, he is drinking in a bar with his grad school colleagues and he sees a beautiful woman, and they say let us go and chat her up. John Nash says no, hang on, if we all go and chat her up we are all going to be interfering and no-one is going to end up impressing her. That is the Nash equilibrium: we all act out our best intentions but somehow it ends up that things are not as good as they could have been. And I think that is where we are at the moment. There are other potentially more optimal growth paths we could be on, but because of the unique historic and political economic situation we find ourselves in, we are on this Nash-equilibrium growth path. It was ticking along at 5% and now it is ticking along at 3%. And it is going to be very difficult, especially in the next five years, for us to shift to a path that is different. And the path I think we need is labour-intensive, potentially export-driven industries that are going to enable us to grow.

Taking to the streets: Congress of South African Trade Unions march in Pretoria against rising prices.

So where are we going to be left? I think we are going to be left exactly where we are at the moment, where we have a smaller group of relatively successful firms. We tax the relatively small group and we buy off the discontents. We essentially buy off the unemployed youth through social spending, and that is done mostly through old-age pensions, because a lot of these people live with their grandparents.

That, I think, is what makes us different to everyone else, and that puts us in the context of thinking about what we need to reform. And I think there are two areas we need to think about: one is reforming processes and the other is thinking about reform is more difficult, but has an impact on choices that are made. I do not think anyone will disagree with reforming or making certain processes easier. In 2004/5 Small Business Project (SBP) did a study on cutting the cost of red tape. It was a study on regulation and how much it costs this economy. The figure comes up at about 6,5%. That is mostly an easy political reform to make. The main thing they said in that report was that compliance with tax regulations is very difficult. Let us make that easier. That is an easy policy reform that does not stand on anybody's toes.

Another thing is to think about labour regulations. People in the Department of Labour say they do not believe that these labour regulations are overly onerous. You speak to firms, and a large number of them say it is very costly for them to comply. There is a discord there, and if it is just an information thing, then dealing with getting better information to the firms is an easy political reform.

The more difficult reforms are going to be around issues where there are certain political ideologies or political constituencies, where we are going to tread on toes. One is obviously going to be labour regulations. One thing that is clear from the evidence when you look at the firm-level data is that many firms find that complying with many of these labour regulations is incredibly onerous, it places more costs on them than what would be normal, and that leads to various other outcomes. So they choose capital over labour, or they choose more skilled workers over the unskilled, or they choose to remain under a certain threshold. My argument here is not to do away with them all, but to think carefully about what the impact of regulations like that are.

The next area we need to think about is industrial policy, and with it the growing area of competition policy. We have a new industrial-policy framework which, from my reading, wants to be all things to everybody, and arising out of that is a more robust role for competition authorities. I think that is dealing with the symptoms rather than the cause, and this links back to our model. We are far away from potential suppliers, we have transport infrastructure that has severely let us down. People no longer use rail so everyone is on the road, and that increases costs. There is little competition — ports are run by the state through Portnet. These all lead to an outcome where we see markets with high mark-ups, so we have quite uncompetitive product markets. There are two things there: there is obviously the growth impact, and there is also the impact that has on consumers. It drives prices up and importantly, due to the transport infrastructure, the distance, tariff barriers, what that does is make our exports less competitive. And what we know is that most high-growth experiences are driven by the rapid growth of export. We are shooting ourselves in the foot, being so far away, having a costly transport system and keeping up high tariff barriers, because some of those tariffs are on inputs into goods that are then exported.

So we need to think about ways we can deal with those issues because any medium- or long-term growth strategy needs to think about how we can integrate ourselves more fully into the global economy, and this links exactly to what was said earlier about how our growth mirrors that of the world. So if I was making policy for the next three years, what would I do?

The easiest thing to do is to pick the low-hanging fruit — to deal with the bureaucratic processes, the discords in information, these types of things which are not going to affect any political constituencies. Reducing the cost of red tape, etc.

The next important thing, and again it picks up on what people said this morning, is to signal certainty, because uncertainty means that people do not engage in exporting, they do not engage in investment. If you are uncertain of where the rand is going to be in two or three years' time or even two or three weeks' time, you are not going to invest in an export contract or in a factory that is producing for export.

The third thing I think you would need to think about is the political capital that the current caretaker government has, and the incoming government in 2009 has. It is obvious, but often takes a while for people to learn, that you can only make reforms when you have political capital, and usually you have most of it at the beginning of your period of governance. So it will be interesting to see what the political capital that accrues with the change in government in 2009 can be used for, and whether we will have Zuma as our Lula or Zuma as our Chavez. Potentially we can be optimistic because sometimes the best game keepers are the poachers.

“… whether we will have Zuma as our Lula or Zuma as our Chavez. Potentially we can be optimistic because sometimes the best game keepers are the poachers.”

The last thing I would think about, given what we have seen in the past couple of weeks, our comparative advantage and some of my own research, is South Africa's role in Africa. It is likely that Africa is going to be less affected in the current global turmoil. Also, the types of goods that we send into Africa, the types of firms that engage in Africa, are much different to those who go internationally. The evidence is starting to show that actually, the firms that export into Africa are potentially those firms that are going to pick up the lower-paid, lower-skilled type of people. Now that seems to be in direct contradiction to the our thinking about comparative advantage. It is not, actually, because even our lower-skilled products within South Africa are actually more capital intensive when we look towards the rest of Africa. So that might be our path, or one of the paths that we might seek to look at in developing or implementing a growth strategy in the next couple of years.

Professor STEVEN GELB

I want to talk about three aspects of microeconomic reform, some of which touch on issues that Neil has already mentioned, but which I think need more focused attention in relation to economic growth. They are: inequality, BEE and FDI. Let me start off with inequality. As I think everybody here will know only too well, South Africa is one of the most unequal societies in the world. On a household basis, the official calculation from Stats SA of the Gini co-efficient, which is a standard measure of inequality, is 0,73, where 1 is a measure of complete inequality, and 0,73 would place South Africa probably at the very top — or perhaps bottom — of the international rankings. An even more telling piece of data, I think, than the Gini co-efficient, is that the average income from work and from social grants of those in the richest 10% in the South African population, in other words around the top 5 million, is 255 times as large as the average income those in the poorest 10% get from work and from social grants, and this of course excludes household income at the top from capital, in other words profits, interest and dividends. That shows a very extreme inequality.

I think it is important to emphasise constantly in South Africa that the conventional wisdom these days among development economists and the development-policy community, internationally backed up by considerable empirical evidence, is that poverty reduction in highly unequal societies depends not only on achieving economic growth, but also on simultaneous attention to addressing inequality. In other words, growth without moving towards a more equal society will not have anything like the same impact in terms of reducing poverty as growth combined with inequality reduction. So what is needed in an unequal society like South Africa is active policy to tackle inequality simultaneously with growth, rather than relying simply on the

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benefits of growth trickling down to the poor. In my view this has not happened in South Africa — certainly not before 1994, but even since then we have not really effectively addressed the degree of inequality, as this recent 2005/2006 data from Stats SA suggests. Instead what we have tried to do is to tackle poverty as an issue separate from inequality, and our main line of attack on poverty has been to throw money at the problem.

So we have in South Africa a very extensive grant system, probably the most extensive in developing countries around the world, and it is supplemented by in-kind transfers such as the free basic water allowance. Both the grants and transfers like the water allowance supplement the current income of the poor and support their consumption. In other words, they help them to survive, and in that way do alleviate or mitigate the effects of poverty. But it is quite evident, I think, that the grant system and the other transfers have not eliminated poverty, and they certainly have not addressed inequality.

In order to address inequality, again conventional wisdom around the world would suggest governments need to focus on asset transfers and asset-building programmes. In other words, programmes to transfer to poor people goods and services which will allow them to earn future income rather than simply enhancing their current income. And central in terms of asset-building and asset-transfer programmes are education and housing. These are both areas where the South African government has spent a lot of money, again ranking very high in terms of world tables for the proportion of GDP spent on these programmes, and even, in the case of housing particularly, delivered a very high volume of services. But the quality — I think we can agree, the quality of the services in both education and housing in South Africa is very, very low. In addition, complementary services have been absent. In the case of education, what I mean by complementary services are things like facilitation of job search, apprenticeship programmes. In other words, programmes that will assist people who get education to find jobs. And as a result the value of education and of housing as assets for the poor in South Africa is very, very low. I think this is the main reason why we have been so spectacularly unsuccessful in addressing inequality.

So if we wish to enhance growth, to go back to my earlier point, we need to address inequality and we need to do it by focusing much more centrally on issues like education reform and housing provision. We have to put these at the centre of our economic programme and our programme for growth. These programmes cannot be seen simply as social dimensions, nor can they be seen as issues which are important in the long run in order to sustain growth. They should

Courtesy of Samancor

be short-term priorities, and in fact I think should be at the heart of government's planning and resource-allocation processes, not just the allocation of government's financial resources, but even more crucially the allocation of government's human resources: in other words, the best people in government, and you know we know that there is not an over-supply of highly capable, highly skilled people within government. But some of the best need to be put into these programmes in order to address inequality if we are going to see reforms for growth going into the future. This has to be a short-term priority.

The second issue that I want to talk about is BEE, which follows in some ways very naturally from inequality because, after all, BEE is intended to address some of the aspects of apartheid's legacy of inequality, and indeed has in some ways succeeded in closing the inequality gap for some groups within the black population. Now there is a lot that one can saw about BEE and its relationship with economic growth, but I want to make just two points. The first is that it seems evident to me that we are in a very similar position in relation to BEE to that in which we were ten years ago. Some of you may remember that in 1998 a falling stock market began to create difficulties for many of the share-transfer plans and schemes which hundreds of companies had already adopted by then, and these share transfer schemes unwound as the JSE went into a decline. And that moment was the end of the first phase of BEE in South Africa post-1994, and ushered in a second phase which began with the constitution by the government of the BEE commission, and which recommended, which was broadly accepted by government, that there should be a lot more public intervention in the BEE process. As a result, over the past seven or eight years we have had a lot more government intervention, and a lot more general public intervention of the sort illustrated very well, I think, by the financial sector charter, which was a public process, if not led and initiated directly by government.

This second phase of BEE has led to major advances in the progress of the whole exercise, and I think to the country's benefit in many ways, but that process is now ending as the stock market goes into another serious decline, and again, many of the schemes which were established to transfer shares to black people are unwinding or in danger of unwinding.

I believe that we need to see the current situation not as a problem or as a threat to BEE, but as an opportunity. We need to see how we can build on it. In particular I think it is an opportunity substantially to downgrade and perhaps even eliminate the issues of ownership and the composition of boards of directors from the BEE process, in favour of promoting entrepreneurship on the one hand, and management by black people on the other, through greater emphasis on the composition of senior management in the big corporations, and greater emphasis on procurement from small and medium-size enterprise [SME] and start-up companies. And I think we can move in that direction, which I would see at this point as a very desirable thing to happen, while not abandoning the broad purpose of BEE in our economy and society.

This move would relate very closely to the second point about BEE which I want to make. I would suggest that the BEE programmes we have now, for all their necessity politically and for their economic value, have shifted the incentive structures in the labour market for talented and innovative young people, particularly for graduates, away from setting up companies, from entrepreneurial ventures, from start-up companies, particularly in labour-intensive sectors which might in the long run become job creators, towards the corporate world. The problem, of course, for the entrepreneur, for the start-up company, particularly where it is a company that needs to get into exports in labour-intensive sectors in order to promote job creation, is that it takes a long time to build such a company and establish it in the market place. And during that time the entrepreneur receives relatively low returns and runs a high risk. By contrast, moving into the corporate world, for which opportunities have opened up quite dramatically for young and talented black people, is a much less risky option

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and provides much less risk in terms of future earnings. But perhaps even more importantly it offers a much steeper upward trajectory of earnings in the short to medium term. And so the outcome, not surprisingly, is that most young black people faced with this choice have gone for the safer and more financially attractive option.

As a result, I think an unforeseen consequence of the way BEE has unfolded in South Africa is that we have a shortage of supply in relation to entrepreneurs, particularly those who can start small and growing firms which can then subsequently turn into medium-sized companies. I think this question of the supply of entrepreneurs is a big problem, and this brings me to my third issue, which is FDI.

If there is a shortage of domestic entrepreneurs then I think we need to make far more use than we do of foreign entrepreneurs, and encourage entry by them into our market in order to facilitate job creation. Commitment to foreign investment has been in some ways at the centre of economic policy in South Africa since 1994. If you think of the GEAR document, for example, it was very much the main purpose there. But I would say that this commitment to foreign investment has largely been rhetorical, or at best focused on the macroeconomic and financial aspects. In other words, FDI has been seen as a mechanism to fill the savings and/or foreign-exchange gaps which might otherwise retard fixed capital formation and investment. So we do not really have a policy concerned with promoting FDI in order to support the primary aims of overall economic policy, which are not growth for its own sake, but growth for employment creation, and growth that also improves productivity in the country and therefore sustains rising wealth for the country as a whole. This gap needs to be filled, as also I think does the gap reflected in the lack of a comprehensive policy in relation to outward FDI, which is very, very large in South Africa, but where a government policy really focuses only on the financial and macroeconomic dimensions. Policy towards outward investment basically consists of relaxed exchange-control provisions for certain types of investment into certain destinations, most predominantly in Africa. Whereas if you look at other developing countries, and not to mention developed countries, policy towards outward investment is focused much more directly on the productivity and domestic-employment impacts of outward investment — what does the home economy achieve through outward investments?

So I think we need to address FDI. It is a very important area of microeconomic reform. And in relying on foreign entrepreneurs to come into South Africa to fill the entrepreneurial gap, I would suggest further that we need to look not to the north, not to Europe, to the United States and the rest of the OECD, because this is not where we are going to find foreign investors who are likely to promote labour-intensive exporting sectors, whether in manufacturing or in services. We need to look at the south. We need to look at the global south, that is, perhaps geographically more to the east, to Asia, where you find an abundance of entrepreneurs who are focused on these sorts of sectors, and also, importantly, are willing to put the growth of their businesses ahead of their personal consumption levels in the medium term. And we really need to focus much more directly on attracting those sorts of investors into South Africa.

Let me say something about accelerating reforms. I think it is important to recognise the distinction between macro- and microeconomic reform. Macroeconomic reforms are relatively easy to implement even if their goals can be difficult to achieve, because they are what has been called stroke-of-the-pen reforms. In other words, the government can make a decision and put it into practice to introduce fiscal targeting or inflation targeting, or to adopt a floating exchange rate regime rather than a fixed exchange rate regime. Obviously there are often very complex politics involved after the reform is implemented if it is to achieve its goal. In other words, those politics kick in ex post once the reforms are in place, and

can make it difficult to achieve the outcome.

Now microeconomic reforms, on the other hand, are complicated to implement because they generally involve multiple groups of actors who need to be on board with the reforms in order for the implementation to happen in the first place. Think of education reforms, where you have to have the teachers, the parents, the department — the civil servants in the Department of Education, and so on — all agreeing to the reform process if it is going to be implemented. Think of industrial policy reform, where in order to introduce any sort of industrial policy there has to be support from business and at least acquiescence from the labour movement. So microeconomic reforms are much more complicated to put in place than macroeconomic reforms, and I raise this point because I want to strike a cautionary note about the possibility of accelerating microeconomic reform. We need to be aware of this distinction and the difficulties of actually achieving it. To accelerate such reforms is very difficult, and if they are put in place without going through an adequate process of consultation and bringing people on board, I think they are doomed to fail at the implementation stage. And indeed, to go back to where I started, failures in the school and education and housing programmes of this nature have a lot to do with the failure of the government to bring all the relevant stakeholders on board. And that is one reason why we still have such deep inequality which needs to be addressed.

Professor JOHANNES FEDDERKE

We have got a significant number of market distortions in the South African economy. We have got substantial market distortions in our output markets; we have significant degrees of pricing power that get manifested in very high mark-ups. We pay a very high growth price for these market distortions. That has been verified in a number of different ways and estimated in a number of different ways. We have very substantial distortions in the labour market, and we have talked about labour-market mispricing, the level of rigidities in the labour market, and the inappropriate types of regulation that we face in the labour market. Just about every single speaker today has emphasised the importance of education. The amazing thing about it is that this is not new. We have known since the late '90s that these are the constraints in the South African economy. The policy responses to them are not difficult, they are obvious, and we know this is not particularly contested terrain. You can quibble about what the magnitude of the wage elasticity in the labour market is and whether it is greater or less for skilled or unskilled workers, and in which particular sector it is at its largest. But that we have that responsiveness to labour-market mispricing and that there is a significant cost to inappropriate regulation is not contested. The same thing is true for education. We know what the problem is. It is not the access problem, it is the quality problem in the educational sector that is the difficulty, and we have known this for a substantial period of time. And with output markets we know that the response [should be an] aggressive competition policy which addresses the pricing questions. Trade liberalisation is another means of addressing this.

> "Perhaps it is conceivable that big business, big labour and big government are far more comfortable in bed with one another than one might imagine …"

And so I want to pose a puzzle to you. We have this very substantial set of evidence on labour markets, on output markets and on education, we can add health and any of number of other factors to that. The question is, so why does nothing happen? Why is there no movement on these issues? Reforming the educational sector and improving the quality of education should be a no-brainer. I am thinking simply of some of the people that work in my household. When I look at their particular expenditure patterns there is an extraordinary willingness to invest in education, an extraordinary recognition of the importance of human capital. So this is not a difficult political sell, that we need to do something about education, and yet nothing happens.

Perhaps what we face in the South African economy is yet another structural constraint, one that I quite like to call crony corporatism. Despite the nature of the public debate perhaps the interactions among the major interests groups within society are not quite as confrontational as we imagine them to be. Perhaps it is conceivable that big business, big labour and big government are far more comfortable in bed with one another than one might imagine given the nature of the rhetoric. And at the end of the day, the people who pay the price are the poor. It is a question. Maybe that is not the answer and I do not profess to have any evidence on that, but it is striking how, where we have had evidence for a decade or more, so little proactive policy intervention has occurred.

But here is another question. Think about infrastructure development in South Africa. We have identified it as a crucial area of constraint to the South African economy. How many of you have ever seen BMW advertise the need for you not to buy BMWs? And yet we have got one firm in South Africa that is constantly advertising that you should not use its product: Eskom. How many firms in the world actually have an active advertising campaign to suggest that you should at all costs not utilise their product? It points to the fact that we have had a under-provision of infrastructure, but how do we go about thinking about the solution to the infrastructure constraint? Again the approach is very, very old school. We do not take cognisance of international best evidence on how to approach this.

If you take a look at the way in which Brazil has approached infrastructure provision, it is far more open, far more market-based, with far greater emphasis on PPPs, rather than this very comfortable old reliance on state monopolies who are going to continue to provide the power. Everybody professes

> Everybody professes this great surprise at the fact that we have run out of electricity, but if you are an energy-poor country and combine that with the cheapest price of electricity in the world, you should not be surprised if you have got excess demand for that particular product.


Walter Knirr SA Tourism

this great surprise at the fact that we have run out of electricity, but if you are an energy-poor country and combine that with the cheapest price of electricity in the world, you should not be surprised if you have got excess demand for that particular product. It is Economics 101, first lecture, first principle. And the way in which we have approached the pricing issue, too, is very, very outmoded, and again, the international evidence and experience on this is something that we seem to be resolutely opposed to acknowledging. So there is no reason why these prices should not float more, and there are certainly market-design mechanisms that you can use in order to allow the price to float to reflect the scarcity. So rather than regulating it and telling the users who cannot use it at which point, allow the price, as in any efficient allocation of resources, to reflect the most valuable use of the resource in order to get an efficient allocation. It also has the rather fortunate side-effect that it becomes a lot easier to recapitalise the industry if it can price appropriately in order to reflect the true cost of provision. And yet once again, it is something that we do not want to particularly think about.

You could certainly extend that to other public utilities as well. What about Telkom? The fact that we are still mired in relative under-provision of telecommunications infrastructure despite the fact that modern economies are so intimately reliant on information flows is quite astonishing.

A very famous paper in the economics and growth literature by two very famous economists, Robert E Hall and Charles I Jones, published in 1999, looked at productivity differentials internationally across a very large number of countries and tried to attribute those differentials across physical capital, human capital and then productivity, which they attribute to something they called social infrastructure, and I will talk more about that. What they established is that in their sample the ratio of the richest to the poorest person is about 32 to 1. Physical capital differences between the poorest and the richest country will account for why the person in the richest country is approximately twice as rich as the poorest country. It is a minuscule proportion of the 32 to 1 ratio. Once you take a look at differences in education, and this has been a major subtext of today's discussion, that, too, accounts for a significant differential, but it only accounts for a ratio of 2,2 to 1. So, by taking into account collectively the differences in physical and human capital, you are only going to account for why the rich person is about four times as rich as the poor person. They then do a sophisticated piece of analysis where they look at the underlying social infrastructure which drives this productivity differential, and also has a direct impact on the extent to which investment in both physical and human capital is likely to take place. The net outcome is that an astonishing level of that differential between rich and poor is due to the quality of the underlying social infrastructure of rich and poor countries. A ratio of 25,2 to 1, of the 32 to 1, is accounted for by the social infrastructure.

So I want to return to an issue that kind of underlies development, often an implicit way, and is often not talked about. We talk about institutions and policy interventions as if they happen in a vacuum. They do not happen in a vacuum, they occur in the fundamental structure of institutional patterns which are more important than anything else. In our context these are things like the degree of political stability we maintain, maintaining the quality of the political transformation that we have seen; and the importance of a rights structure which guarantees the freedom of individuals to act in their own best interests. The functioning of markets depends fundamentally on the structure of property rights that you face, the ability to realise and then to enforce those property rights. The quality of your bureaucracy, the extent to which it is corrupted and, I think, particularly saliently in the South African context right now, the importance of a judiciary and its independence in order to be able to enforce the rights structure that underpins the stability of the political system — the rights that you have in property, and to fair process in encountering public servants and, indeed, the markets.

I do not know whether this is micro stuff, but without this the micro stuff will never fly. It is the fabric within which the microeconomic activity of the economic agents takes place and has to be realised. When it comes down to it, in a democracy we will see policy changes, and we face that right now. It is of the nature of democracy that the direction of economic policy will change. But the one thing that is non-negotiable for the purposes of development and growth is these fundamental aspects of social infrastructure which determine whether we will realise success or failure.

I want to add one additional nuance to an important point that Neil raised earlier: geography. Where we are in the world matters, whether we are close or far away from our main trading partners is an important characteristic. But we should also remember that, in a sense, who we are

Walter Knirr/Solly van Staden: City of Johannesburg

geographically also matters. Neil made the point that we are far away from our markets, but we face a double whammy effect. Our geographical structure of economic activity in South Africa is very unusual, because if you think about Singapore or Shanghai, Rio and Sao Paulo, all of these are characterised by the fact that they are located close to transportation opportunities, they are on the coastline. South Africa's main economic hub lies far away from the coastline. [A new study] looked at the geographical distribution of manufacturing activity in South Africa and what has happened to that from 1970 through to the 1990s. Unfortunately we stopped doing manufacturing censuses after 1996 so now we just do not know what is happening. But one of the really important features of the distribution of manufacturing activity is that over time many countries experience concentration of manufacturing activities in a couple of major economic centres. If you think about the United Kingdom, London is a major economic hub, with a very substantial proportion of its economic activity, together with Manchester, Liverpool and a couple of other centres. South Africa has become much more dispersed over time.

The paper analyses what frameworks might explain this, but notice that it carries additional implications for the way in which we think about micro policy. Because if it is true that the economic forces are such as to lead to a greater dispersion of economic activity, it carries significant implications for how and where you think about infrastructure provision. So it is not enough just to have the expenditure, the allocation to the power generation, it is also a question of distribution, and of where you need to get the power to and of how you need to get the power to it, and what consequences that will carry for the incentives for firms to locate within the geographical space. And that carries important implications for the cost structure that our firms face relative to their competitors elsewhere in the world, in terms of how easy it is to get into the major markets, and at what cost.

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PROF BINEDELL: Do we have any measures on social capital? By social capital I refer to the kind of work that Francis Fukuyama has done about the role that trust plays in entrepreneurship, which leads to co-operation, which leads to competitiveness. Is there some sort of overall measure, when you look at productivity and growth in a country like ours where social distances have been so high?

PROF PARSONS: I have three points. We have had a set of theories and empirical evidence on the one side, that is the one world, and the other is the policy and the action world. How do we build better bridges between the two? Perhaps to reduce it to a bottom-line question, what in the panel's view would be the biggest trade-offs that a new government would face if it heard what went on here today?

The second point just to put Johan right about the educational system and so-called big business, big government and big labour. I can assure you that when it comes to this issue of a better education system we are on the side of the angels. He need have no fear that there is a ganging up among those three constituencies against having a better educational system. If anything, the opposite has been the case, certainly from the business community, in insisting that as the system is operated it is not generating what we need.

And then, to the point Steven Gelb made, I suppose if I lived in a First World economy I would also say you can change the macro framework with a stroke of a pen, it is the micro that is difficult. Of course he is right if we were sitting in the United States or Germany. But as we have seen in South Africa, it is not easy to change the macro framework with the stroke of a pen without huge resistance, without a huge ideological battle, and without the threat of it being reversed. In other words, there is nothing about fundamentals of the macro framework that is not open to reversal. I think it is something we should bear in mind because we are facing that very debate here now.

MR SALIEM FAKIR: Macro economic policy and micro economics are interdependent, yet there is at a policy level a very clear disjuncture between what Treasury does and what the DTI [Department of Trade and Industry] does with industrial policy, and the separation of some of these functions between other different departments. It is not clear even in the new discussions, with Polokwane, how this matter is going to be resolved. Certainly in the economic summit there has been no clear vision on how you actually bridge the macroeconomic and microeconomic worlds and make them work in synergy with each other. Is it because different interests drive these two different policy worlds? Is that why we do not see an alignment between the two?

PROF FEDDERKE: Measures of social capital are not that easy to obtain for South Africa. There are two sources I am aware of. In the late 1990s there was a survey funded by the World Bank of households in Soweto which accessed social-capital measures, and which is the subject of a PhD dissertation which I think is about to be finalised at Wits [University of the Witwatersrand]. So there is a data set there which looks at very micro-level data on how individuals relate to different means of collective action, and what difference that might make for the economic activity and economic success. Other than that, some of my colleagues at UCT [University of Cape Town] are engaged in experimental work where the point of the exercise is that you place subjects into a situation where they have to make choices, and play a game of exchanges with one another. An explicit objective of the

From left: Prof Binedell, Prof Parsons and Mr Saliem Fakir addresses the panel.



investigation is the attempt to understand trust patterns between individuals, between members of different groups; how trust comes to be formulated and how it comes to manifest itself. And a lot of that evidence is very surprising; often, for me, quite counter-intuitive. So that begins to give you some sort of handle on that, the Fukuyama type of discussion of whether our trust patterns are kinship based, or whether they are more generalised and abstract of the sort that Fukuyama argues you have in the United States, Germany and Japan, say, in contrast to kinship-based trust structures. Other than that on a micro level I am not familiar with any other data.

PROF GELB: I know about a little bit of work that has been done in South Africa, but I think it is very important to just underline the complexity of the concept of social capital, which requires very different measurement and so on in relation to households trying to support consumption, as distinct from small firms trying to maintain their activities, as distinct from large firms and inside large firms, between larger firms, and so on. I do not think one World Bank survey can possibly begin to tell us more than a little bit about what social capital is between households. For businesses, I think it is very important, for example, to look at business associations and how they operate, how they are constructed, who they bring together, etc. I think that would be a very interesting study in the South African context, but to my knowledge it is not been done.

DR RANKIN: I also must profess my ignorance on this. I know the Centre for the Study of African Economies at the University of Oxford has done a lot of work on this in the rest of Africa, and the failure of the state to enforce trust or contracts — and arising out of that, the business networks among the ethnic Asians in East Asia and in East Africa, and the Lebanese in West Africa. Those are all mechanisms that arise to deal with the failure of clear property rights and that type of thing.

PROF FEDDERKE: On the relationship between theory and evidence and policy, I think the distinction is overdrawn, because good policy is informed by a sound analytical framework and sound evidence. I think to try to separate the two is dangerous. The best policy intervention relies on the best available evidence.

As to the main trade-offs we face, we have some immediate priorities. [One of these is] the intervention in the labour market to get people employed, based on the recognition that there is a fundamental cost distortion in our labour. That needs to be addressed, whether it be through the wage subsidy that has been proposed or by some other means. It is important and it is a priority to get people into jobs, and also to resolve thereby the human-capital imbalances of people who have never had access to the formal labour market.

I think addressing the problems in education — and I am focusing mainly on the microeconomic issues — addressing the problems of quality of education, and taking seriously the need to make sure that the people who have come through the schooling system can actually read, write and do some sums, that has to be prioritised. And that may mean very difficult decisions. It may mean that you have to be prepared to import your maths teachers from India and pay them appropriately to come to South Africa to solve the short-term constraints. It may mean that you have to accept that you have to incentivise teachers to do their job properly, and thereby pay them in line with their performance and how well their pupils do. I think an entire generation of kids have passed through our schooling system since the democratic transformation without anything being done about this fundamental issue of quality. It is enough already, and they deserve better, and I think it is high time that it gets addressed and the hard policy choices made. It will be difficult, including for the union, for that matter, and having to confront the fact that the members of the union are not necessarily best equipped in order to address this particular constraint.

And finally, liberalise, liberalise, liberalise to improve the competitiveness of the economy and the competitive pressure on the economy, in order to ensure that our producers become more competitive on the world stage, have less pricing power and therefore have to hunt for markets throughout the world in order to boost our export competitiveness.

PROF GELB: Let me start on the issue of bridges between evidence and policy. I think the real issue is what the role of economists is in actual policy making and in positions of political power and influence. I think that in the Anglo-Saxon world generally economists, for better or worse, are not very influential in the end, and for that reason economic analytical work does not have much impact on policy. Policy decisions tend to be made, I think, much more directly for political reasons than for good analytical reasons. In Latin America, in fact, economists have been much more active politically. Many of the presidents, ministers of finance and so on in countries like Brazil, Chile, Argentina have been very good, well-trained and well-published economists. And one could argue that at least in a country like Chile the economic policies have reflected that to their benefit most of the time over the past 20 years or so. I am not very optimistic that somehow the government in South Africa is going to suddenly start taking economic advice very seriously. That is the first thing.

I echo a lot of what Johan said about education. The public education system is a disaster and it is rather mystifying why, in 15 years, it has not begun to get better. I think one of the reasons is not that business has not been supporting a better education system. Everybody supports a better education system. The unions do, people in government do, the intelligentsia does. But I think there are many different ideas about what is needed to improve the education system, and how to get to the result that everybody thinks is desirable. One of the problems we face is that we have not been able to reach an effective political accommodation about how to improve the education system, which is true, of course, on a number of issues, such as the labour market, regulation, macroeconomics, etc. We have not been able to reach that political accommodation between these different interest groups, even though everybody would like to be at a better place. What we have to do is get out of this low-level equilibrium trap that we are in politically.

I found it very interesting, to digress, that the Minister of Finance recently said explicitly that he supports a new compact or even an old compact among business, government and labour, because that is not something that he has been very supportive of in the past. I think the fact that he has now moved to that position is very important.

To clarify the stroke-of-the-pen-issue, perhaps I did not communicate my point very clearly, but I was not suggesting that achieving the outcomes at a macroeconomic level is simply a matter of changing the policy. There is many a slip between the implementation of the policy and achieving those outcomes. However, introducing the policy itself, for example changing from the exchange rate regime, is something that is decided between Treasury and the central bank and is then done. Then the politics, as we have seen in South Africa, comes into play after the policy is implemented. To give two examples in South Africa, GEAR was written down on a piece of paper and implemented by government, at least in terms of its fiscal stance. Of course there was a huge amount of political conflict in the wake of that announcement, but actually deciding to move to that position was something that government just did. Similarly, the inflation-targeting regime: there is lots of debate about whether it is a good thing, but there was very little debate between interest groups prior to its implementation. That is what I meant by the stroke of the pen. On the other hand, we have not even got to first base on reforming education. Why? Because, as I said a minute ago, there are very different ideas about what is needed, and all of those ideas have to be somehow brought together simply to start moving forward. That is really the distinction I am trying to draw.

DR RANKIN: The biggest realisation the new government is going to need is the degree of policy space it will have. These changes are happening at a very difficult time. Their list of feasible policy options is going

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to be very limited. I think this fits in exactly with what Johan and Steven have said: that we cannot throw more money at problems. We are going to have to look at making the educational system more productive — that is just one example. It is going to entail underlying structural change and political negotiation. There will obviously be trade-offs. If we are serious about reform there are going to be winners and losers, and how these are dealt with in the coming years is going to become quite important.

PROF FEDDERKE: It is difficult to know what to say about this except that you want a consistency and a coherence to policy across its different manifestations. How many political systems realise that? There are always tensions in any political system. I think what you have seen manifested in the South African instance is precisely that, and that explains why there is perhaps less co-ordination than would ideally be the case. How to arrive at it? I think it is a question for the political scientists to answer, not the economists, how you get everybody pointing in the same direction and singing off the same song sheet. I am not sure that economists are very good at realising that in any shape or form.

PROF GELB: In my view there has actually been quite a lot of coherence in policy in South Africa, because in effect I would say the Treasury, in some cases for better and others for worse, has been making all economic policy for the past ten or 12 years. It is true that the DTI has written down the industrial policy framework that Neil referred to, but it is just a piece of paper. As far as I can tell it does not mean anything and has not had any impact in the real world, and I do not see it as having much impact because the DTI does not have the capacity to make it happen, and business does not have the interest in making it happen. So, in effect, when Treasury makes decisions about whether or not to fund Eskom, whether or not to enable or to obstruct PPPs in the health sector and so on, it is in effect making industrial policy. For that matter, when the Department of Communications does not get its act together on addressing the problems in the telecom system it is making industrial policy: Treasury can act as a brake in some ways, but it cannot necessarily get the Department of Communication to improve its performance. So I think that maybe we need a shift, but it is not going to be a shift that necessarily is shown by a resolution of the rhetorical debate between those departments.

DR RANKIN: I think disjuncture exists because micro covers a whole lot of things, and as Steven says, it sits in a variety of different government departments, and the nature of the political process is that people have different visions for their different departments. So I would echo Steven's sentiments. If we want these to be all coherent, we just put them into one super ministry and call it the National Treasury. I think that is the way to go.

[News came through during a coffee break of yet another meltdown on the international markets, leading to a digression in the discussion]

DR JAMMINE: The bad news is that the JSE has fallen another 8% today, but it is not the only one. It has now fallen 14%-odd in rand terms, 57% in dollar terms since its peak. The extraordinary thing is that the rand/dollar exchange rate has not deteriorated, we are still at just over 11 to the dollar, and this is probably a carry-through effect of last night's threatened intervention by the IMF to protect the currencies of emerging markets and the announcement by the central bank of Brazil that it was indeed going to do so. Be that as it may, the other side of the coin is that the gold price initially fell to US$680 an ounce; it has recovered slightly, which is surprising. There is clearly a global meltdown: limits up, declines in US futures, which means they have stopped trading because of the rout that might come about, and the other side is the yen has risen dramatically, even against the strong US dollar. This is going to wipe out the Japanese economy in next to no time, let alone the US economy, which is becoming so uncompetitive. And it throws into question, in my view, whether or not we are seeing a major realignment of the global economy in favour of emerging markets who, because of their low exchange rates and the adjustment that is being incurred in their exchange rates, might weather the storm a little better than the likes of the United States and Japan right now. It might see the likes of South Africa and Brazil coming out somewhat stronger than our leading trading partners. It is a world that we have never encountered in our lifetimes and it could see in a major change in the way business is conducted, and in a manner that can affect all our lives in different ways in the future.

PROF PARSONS: I cannot add much to that interpretation. I certainly share it, and no doubt among the points that one has to bear in mind if one wants to be at least positive about some aspects of it, is that I think there are time lags before the steps that have been announced so far, whether by the United States or by Europe, can have an effect. That is the nature of the animal; the cheques have not gone out and it will take time for them to have effect. In the meantime, there are obviously serious adjustments taking place because the prospects that we will face a world recession are now beginning to click in before the cheques. I think to some extent it is an adjustment between, say, the United States economy and some of the other emerging economies. It is interesting that the gold price is not behaving as it normally does, which is to be some kind of haven, but that is simply because I think that, as Keynes would have put it, we are seeing a very high liquidity preference which even trumps gold. The only other point, in regard to any realignment, or the extent to which these emerging markets may come out of this better, is simply that it will also depend on their policy responses. And as we saw earlier, in this emerging-market club we have not done all that well. So clearly, the policy responses we devise or are seen to be following, or the extent to which we stick to those policies that are helping us to deal with our vulnerabilities, but are adaptable in those areas where we need to respond to what is a totally new situation, certainly present enormous challenges.

PROF FEDDERKE: I do not have the full information on today's developments, but I think the real consequences are going to be with us for some time, and the growth paths are going to be lower than we had been anticipating. On the other hand, I think that in the case of South Africa there are some strong positives that should insure us to some extent from the most egregious fall-out from the financial crisis. The first is that the quality of our banking system is such that we are likely to withstand the shocks slightly better than we might otherwise. Secondly, I think the quality of the macro policy environment has been such that we are in a slightly better position to weather the storms that we might otherwise have been. The difficulty really lies with the fact that we continue to be a very open small economy, so the world economy is going to impact us dramatically. I think the adjustment on the JSE that we are seeing now is a reflection of the lower growth prospects that are inevitably going to feed into our domestic economy, and we continue to face the core structural constraints that we have been highlighting all through the course of the day. In a tighter, more competitive international environment, those structural features are, if anything, going to assume an increased salience — the constraints that we have on the skills base of the economy, the lack of competitiveness in our output markets, in our labour markets, are going to become that much more important and raise the importance of very urgent and speedy addressing of these concerns in the policy framework.

As a result of delays with the link to Martin Wolf in London, Minister Manuel agreed to begin his address, and to be interrupted when the link was established.

Minister TREVOR MANUEL

This is like opening a pilot school on 9/11, it is that kind of timing. But it is an exceedingly difficult time to ask policy makers to take long views. If you look back to 1989 there was one day, 19 October, the day after [East German leader] Erich Honecker resigned, and then there was 10 November when the [Berlin] Wall came down. I have a sense that to some extent we are in a similar kind of period, but things are going the other way, and part of what we have to be able to get our heads around is what approaches we can take. There is an interesting view about part of what we are dealing with now, that these are exaggerated swings on both the equity markets and exchange rates. But part of what we need to do immediately is to unpack a slightly earlier period, and the day to go back to is 9 August 2007. That is the first date on which it was clear that central banks needed some co-ordinated action to pump liquidity into the market. We are looking at some 14 months, and it is quite important to try to detail what happened in that period and what that portends for the future. In many respects this is a cathartic moment in policy history, and I want to draw out some of the reasons in support of that.

I think Alan Greenspan's testimony to Congress yesterday is very important. It is quite unprecedented. We have witnessed the differences on derivatives between Warren Buffet and Alan Greenspan and I have been privileged to have participated in some pretty tight disagreements about the instruments, and I think he has articulated the view in his book that these are just bubbles in the steady stream. Do not worry about the bubbles, worry about the stream. The problem is that the bubbles became the stream, and part of the admission we had for the first time yesterday is in fact that — because the subtext of his representations to Congress yesterday was that financial markets need to be regulated, and that he had been wrong about it.

A second thematic is this notion that has now arisen very strongly, arguing for a Bretton Woods II conference. The first signals that the world had of that was a small Heads of State and Government meeting within the Commonwealth convened at Marlborough House in London in June, and when this Bretton Woods II conference was raised there, it did not find much attraction. By the time Gordon Brown put the same proposal to the European Union summit two weeks ago, suddenly people were sitting up listening.

The third reason I proffer for this being a decidedly different moment, is that there are some unusual actors behaving differently. One of the French newspapers, day before yesterday, carried a photograph of Nicolas Zarkosy paging through a copy of Das Kapital. This is Zarkosy. It is not your average French socialist. This is Zarkosy — and with all the showmanship that Zarkosy could muster, he says the answer is not in there, it is actually in Keynes. A few weeks ago he asked for a conference that deals with regulated capitalism. Zarkosy is your stock–in-trade Gaullist, who would tend towards the same kind of mindset that the Republicans and the Tories and so on would have, and that is an anti-government theme. I am saying that this is decidedly different. The FT Weekend last week, as Raenette reminded me during the week, ran a centrespread on Keynes, but they should have put it in their fashion supplement as well, because clearly Keynes is back in fashion.

The last of the reasons I would offer for this being a very different moment is [to do with the G20 meeting scheduled for 14–15 November]. The G20 has convened since the Asian crisis. It was not always G20, but since about 2001 we have been the G20. That is when Canada took hold and said we need the systemically significant countries together, and that is the composition: systemically significant countries. It has always been a gathering at the level of ministers of finance and central-bank governors. Paul Martin, when he was, first, Minister of Finance and then for a very short period Prime Minister in Canada, actually made the call for what he then dubbed the L20 — the G20 at leadership level. This call has been there, somewhat muffled at times, and just recently at the UN General Assembly the Australian Prime Minister Rudd based his entire speech on the issue of why the G20 must meet at leader level. The United States has been quite resistant. We were in the United States two weeks ago for the annual meetings with the World Bank and IMF, and on the Friday afternoon the G7 finance ministers met. Sometimes the G7 finance ministers are very kind to us. They invite us — India, China, Brazil, South Africa and Mexico — to breakfast. They even once invited us to lunch. But this time they did not even do that because they had all the answers, or perhaps they did not. But part of the arguments in the meetings was that the G7 has had its moment, it has outlived its usefulness.

I want to conclude at this point by saying that my submission would be that the agreement to move from a G7 to a G20 at Heads of State and Government level is significant, and it might portend something about formations for the future.

MARTIN WOLF

I would like to start with a couple of quotations which I think are very much to the point, particularly given what is going on in the markets today, which is pretty scary, to put it mildly. The first quotation is not from Alan Greenspan's testimony of yesterday, fascinating though it was, but from an article he wrote in the *Financial Times* in March, when he said: "The current financial crisis in the US is likely to be judged in retrospect as the most wrenching since the end of the Second World War."

> "The current financial crisis in the US is likely to be judged in retrospect as the most wrenching since the end of the Second World War."

And of course that particular forecast has proved unambiguously correct. There is no doubt this is the most significant global financial crisis since the 1930s. There is not the slightest doubt about that.

The second quotation, which I think is even more to the point, is from Paul Volker, his predecessor, of course, in a speech he gave at the Economic Club of New York on 8 April in which he said, and again I quote: "Simply stated, the bright new financial system for all its talented participants, for all its rich rewards, failed the test of the marketplace." And this, I think, is a background for our thinking about where we are.

What I would like to cover in my remarks is four main topics. Why did this happen? Why, broadly, are we seeing such a huge correction in world markets? Second: why is it so much worse than most, I mean even the relatively gloomy and worried people like me, expected? The third, I suspect is going to interest you most: what is going to happen now? Which of course is the thing we know least about, but I am going to discuss what I think about this now. And finally I would like to touch on some of the lessons, though I would like to stress that so much has happened and we have learnt so much as this has gone on, that any attempt to learn lessons can only be the most tentative exercise.

First of all, why did this happen? Why are we watching a shock on this scale? I would suggest we have had, though this may be seen as an excuse, something of what is now called the perfect storm. Four major background conditions came together in the past eight or nine years, to create these extraordinary conditions.

The first, which I know Trevor Manuel has commented upon, in fact, very recently, and it is of course a big theme of mine in my writing and in a recent book which I have just published, is the global imbalances and the associated savings gluts in very large parts of the world. We have lived now for a very long period in which the aggregate surpluses of the surplus-savings countries have been running at between US$1,5 and 2 trillion a year. That is an enormous part, well over a fifth, of their gross savings. And this, plus the extreme health of the profit situations of Western corporations, has meant a really global savings surplus with very low real interest rates at the long end. Perfect conditions for asset-price bubbles. And these global imbalances have, in practice, and I think probably inevitably, been largely offset by enormous spending by households in a limited number of developed countries, of which the most important by far were the United States, the United Kingdom, Spain and Australia, every one of which had particularly big housing bubbles.

The second background factor has been an environment of very low inflation for a whole host of reasons, but part of them the entry of China, in particular, into the world economy, and the combination of the savings surpluses. So low long-term real interest rates with low inflation have allowed a very easy monetary policy, and that was particularly true after the stock-market bubble, when you will remember interest rates in Japan were zero because of their own post-bubble shock, in the United States were 1% and in Europe, just 2%.

The third element has been a combination of deregulation and mal-regulation of the financial system. I could go into that in great depth, but I think both have been very, very important, not only the very extensive deregulation. I think the abolition of all the divisions between investment banking and banking, and the growth of the securities markets as the principal intermediation instrument, have been particularly important. But also important have been regulations of banks that encouraged them to go off balance sheet in a lot of their activities because it allowed them, apparently, to save on capital.

And the fourth element has been largely because of technology, but also because of intellectual "progress" — extraordinary financial innovation, even by the standards of the past with the explosion of derivatives markets and particularly securitisation.

These four things together have given us what we can now see, in retrospect, is an extreme Minsky cycle, and I am referring here to Hyman Minsky, the very famous anti-Chicago Chicago economist, who died about 10 years ago and whose work has certainly gained a great deal of currency recently in the Keynesian tradition. He described cycles that start with confidence, some sort of what he calls displacement, something that encourages an investment boom, in this case a housing investment boom. Then as asset prices rise, risky bets all come off, so everybody thinks they are really certain to make money. Helped by easy money, you move into euphoria and what he refers to as a Ponzi game, by which he simply means people buy assets with borrowed money expecting to pay back the money they borrowed, not out of income, but out of the appreciation of the assets. This is the final stage of the Ponzi game. At some point the asset prices start falling, people start making serious losses, people realise these losses are a threat and they start getting rid of assets in what is called the revulsion stage. As the asset prices are off-loaded, the intermediaries that have done much of the lending are quickly decapitalised because they are all very highly leveraged institutions. That is the nature of financial intermediaries. We are now in a very long — it has been going on for more than a year — revulsion stage. But in the last month or so it got very, very much worse, particularly after there seems to have been a trigger — I am not saying it is the cause: the decision to let Lehman Brothers fail. So that is, I think, broadly speaking why it happened.

At the moment as the enclosing continues the hedge funds are basically finding all their lines of credit withdrawn and their investors want out, and so they are off-loading a very large number of assets, and in particular the so-called carry-trades in which people borrowed in currencies with low interest rates to invest in currencies with higher interest rates, which seemed a very profitable activity for a long time. These carry-trades are all imploding, and that is why there is this tremendous flight from all high-return/high-risk assets, including of course, at the moment, the British pound.

The second section I wanted to cover is why is it so bad. And we have to remember that financial systems are inherently very fragile structures. The core institutions of all financial systems are banks and the essence of banks is that they have tremendous amounts of leverage. A bank, as an institution, promises to pay its depositors, in particular, their money back, often on demand, at par, so exactly equivalent to cash, but most of their assets are of course long term and very illiquid. So this is an inherently fragile system, and when confidence goes you are going to get tremendous problems, and that is why we have central banks and deposit-insurance guarantees. The question is, why was this not enough in this case to make people less nervous? And the answer obviously is that there was not enough capital given the losses, and there were a lot of creditors who felt that they are not adequately protected.

So why was there not enough capital? I think the core reasons are two. The first is these are absolutely enormous asset-price bubbles that occurred in these years, particularly in the property markets of the West. There are only three significant Western countries — well, two significant advanced countries, Japan and Germany — that have not had big housing bubbles in the past six or seven years. In Japan's case that is because they had one in the 1980s. Germany has avoided it. They had a big property boom after unification. Every other country has suffered a very sizeable housing bubble, and associated with that, particularly in the English-speaking countries, was an enormous, absolutely gigantic increase in household debt. And that is very closely related to the imbalances because most of the capital flowing into the United States and the United Kingdom essentially — through the intermediation process — ended up in household borrowing. In the case of the United States and United Kingdom, household debt now is between 160% and 180% of disposable income. This is roughly double what it was 15 years ago. It is really very scary.

> “But in the last month or so it got very, very much worse, particularly after there seems to have been a trigger — I am not saying it is the cause: the decision to let Lehman Brothers fail. So that is, I think, broadly speaking why it happened.”

The other factor, I think, is that risk, because

of the nature of the financial system, is not concentrated in institutions which hold loans long term, which you can identify and understand. It was dispersed by the securitisation process, the "originate and distribute" model, throughout the banking systems, at least, of the whole Western world. And one of the great shocks in this process was the very first discovery, in August 2007, that a lot of bad sub-prime mortgages were located in an obscure German bank nobody had even heard of. Since then we have discovered that close to half of the losses on sub-prime alone are actually concentrated in European banks, even though this is an American crisis. And that, of course, generated huge uncertainty among banks about where the losses were. They did not know how good their counter-parties were, and once a very major institution at the heart of all this, Lehman, went, their nervousness reached astronomical levels and spreads — Libor [London interbank offered rate] spreads, spreads in London interbank borrowing rates over forward official rates, ballooned out, in the case of the United States, to about 300 basis points, which is absolutely astonishing. Normally these spreads are very, very small.

But we have also realised, and this is clearly very important because of the first factor I mentioned, the scale of the housing bubbles, that the losses themselves are going to be very large on the basis of market estimates, which may or may not turn out to be an exaggeration. According to the IMF, the losses in US mortgages alone, plus consumer debt, will be US$1,4 trillion. This is "only 10% of US GDP" but it is a staggering sum and is certainly enough to de-capitalise the financial systems grossly. And that is why the panic reached such a stage that the Western world has had to re-capitalise its banks, and I fear they may have to re-capitalise them again.

There is an additional problem, however, in considering the capitalisation of the banking system, that a very large part of the intermediation — in the United States it seems to be close to half — occurs through the so-called shadow banking system; that is to say, outside the official banking system. And if the official banking system is under-capitalised, the shadow banking system is even more under-capitalised, and it does not have any of the guarantees on its liabilities that the banking system has. One of the things that seems to be happening at the moment, as I see it, is a run on the shadow banking system, which is leading to its implosion. I already commented on that briefly in the role of hedge funds. There is clearly also the extremely important role of derivatives, and particularly the credit default swop market which was supposed to insure institutions against the risks they were running in making risky loans. This seems, in fact, to have become a big source of difficulty because it has rendered a number of institutions very, very vulnerable to the crisis. So there are very special features of this in the nature of the system we are now running which, combined with the sheer scale of the bubbles, explain why it is now so bad.

Tourist take pictures in New York's Times Square as the days financial news is displayed on the ABC news ticker, Monday, Sept. 15, 2008. Lehman Brothers, burdened by $60 billion in soured real-estate holdings, filed a Chapter 11 bankruptcy petition in U.S. Bankruptcy Court after attempts to rescue the 158-year-old firm failed.

Now let me turn to the third section of what I want to talk about, which is what is going to happen now. Here I have to stress that these are historic times, certainly the biggest crisis by far I have seen in my lifetime, and I really do not know what is going to happen now. I think we can at least make some rough guesses, none of them, unfortunately, very cheering. I wish they were.

Firstly, I do believe that the determined action of governments has probably saved or will save the functioning of the core banking system. It is pretty clear they will do whatever is necessary to recapitalise the system and to guarantee their loans. And the one good thing so far is that in the generalised flight to safety, the liabilities of the major governments are seen as safe, and that is particularly important for the US dollar. That is one of the reasons the US dollar is going up so much now; it is the ultimate safe haven. So we do still have, and it is incredibly important in a crisis, creditworthy governments, and as long as we have creditworthy governments, we have some means of dealing with the crisis. A crisis becomes completely unmanageable for any country if not only the financial system, but the government itself, is not creditworthy. That is of course what happened to Argentina in 2001, and might, for all I know, happen to them again very soon. Nonetheless, despite having dealt with this problem in the banking system, the recessionary forces are now at work. I think they are really overwhelmingly powerful and they are going to create a very deep recession, quite possibly the deepest since the Second World War. There are at least four things which explain why I think it is likely now to be very deep.

The first is that despite saving the banking system, or the core of it, the credit markets are largely dysfunctional, the shadow banking system is imploding, and the banks are still trying to build up capital and trying to be incredibly risk averse. So they really do not want to lend to anybody if they can avoid it. In fact we have just had a discussion between our banks, after all largely government owned, and our government, in which the government wanted to persuade the banks to lend to small business, and it was pretty clear the banks did not want to do this.

The second thing that is happening is that the asset-price collapses in housing and equities, and also high-risk bonds, are pervasive and ongoing, they have not stopped. There is no sign of a bottom, even in US housing, which has been falling now for two years. In the case of the United Kingdom, Spain, Ireland and other such places, the housing markets fall has in my opinion only just begun.

The third element, as a result partly of the previous two, is that it is clear that the households of the major advanced countries affected by this crisis are going to save a lot more. And that really matters, because the consumption of the United States, the United Kingdom and a few other high-income countries has been an extremely important underlying growth engine for the whole world, and particularly their willingness to spend more than their income, and so run deficits that offset the saving surpluses of so much of the world. The US household sector has dramatically gone back into surplus in the second quarter of 2008, and I expect it to be further into surplus in the present quarter, and that means that much of this reduction in its deficit will be offset by both a fall in the external deficit of the United States with true recession, and a bigger fiscal deficit in the United States. That is going to explode outwards. But this engine of demand is going to go, and it seems to me extremely

> “According to the IMF, the losses in US mortgages alone, plus consumer debt, will be US$1,4 trillion. This is “only 10% of US GDP” but it is a staggering sum and is certainly enough to de-capitalise the financial systems grossly.”

unlikely in present circumstances that there is going to be anywhere else in the world that has the confidence, the will, to offset a reduction in its spending. Remember, very roughly speaking, the consumption of these countries that I have listed account for about a quarter of world demand. They are really big. Just on their own, they are four times bigger than China. So this is a really big factor, if I am right on this, and I believe I will be.

Finally, and of course everybody in the emerging world will have experienced this, but also many corporations, which are more risky, there is effectively a cut-off of funding to risky borrowers now. There is an enormous unwillingness in both bond and credit markets to fund risky borrowers of any kind, and you can see these cut-offs now affecting a long list of emerging countries which have been running current-account deficits and are now in very weak position. I notice today Belarus has been added to Ukraine. Turkey is probably a big question. Argentina is clearly a question. Pakistan is in very big difficulty. A lot of quite important emerging economies, as well as quite a lot of small ones, are all going to go to the IMF and the fund could run out of resources quite quickly.

So I expect, unfortunately, a very deep and possibly prolonged recession in the United States and Europe, and the difficulty here is that there is not an engine of world demand that can easily take off from them. After the Asian financial crisis, it was the United States particularly whose demand pulled the world through. There is not a locomotive big enough to pull the United States and Europe out. This is 60% of the world economy. There is not a locomotive strong enough to do it. The most likely one is going to be the fiscal sectors in these countries.

There is fortunately some good news here, in particular that the reduction in oil prices is going to allow lower interest rates throughout the world. The concern about inflation is gone. I expect interest rates in all the major countries to fall very rapidly. I would no longer be at all surprised if we actually saw zero rates in some major economies in the next few years, a quite astonishing situation rather like Japan's. And of course this will also tend to shift income to consumers and it will, with luck as we get through the shock, make them more willing to spend again. I do not expect a loss decade in the West like Japan's, but we have a big debt overhang and it is going to be a pretty tough period to get through.

Finally, what I think at this very preliminary stage might be lessons for the future — but I do think that almost everything I thought, and, really, everything the major institutions like the Financial Stability Forum and so forth have been thinking about this, is more or less irrelevant now. The crisis has turned out to be so much more severe than almost anybody except my dear friend Nouriel Rabini expected, so the gloomiest forecaster of all turned out to be, if anything, a bit optimistic. This is how serious it is. Well, the first thing I would say is to underline a theme that comes from my book: we are going to need a much bigger IMF with much more resources. The IMF's resources now are roughly US$300 billion, and that is simply not enough insurance to allow emerging economies to get through a shock like this, which is not of their making. I think it is to some extent of China's making, but it is not of most of the emerging economies' making. That is the first point. We really have to review the resources available for collective insurance in the global system.

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> There is fortunately some good news here, in particular that the reduction in oil prices is going to allow lower interest rates throughout the world. The concern about inflation is gone.

Secondly, we cannot run the world with the sorts of imbalances we have had in the past ten years. We need a much better balance in spending and investment across the world, and, particularly, large emerging economies with good investment opportunities like China and India, and which are relatively fundable, need larger current-account deficits if the whole system is going to be balanced.

Thirdly, it is clear we are going to need much better capitalised banks in future that stick to their core lending activities and have capital adequacy ratios that are strongly counter-cyclical. They should have been forced to raise their capital substantially in the boom years. They were not, and as a result they became decapitalised far too quickly in the bust years. And we also, and this is the fourth point, need a much more sophisticated management of liquidity in the financial system, not just capital, which is everything we focused on.

The fifth is that if the non-bank system is going to survive in any form, and I assume it will in some form, it really has to be brought into the whole net of capital requirements, liquidity requirements and a proper resolution regime. These non-bank institutions have turned out to be very significant. In the United States the investment banks have disappeared now, so maybe this will be less of a difficulty. Maybe they are all going to go, but if we have this sort of non-bank regime in the future, we cannot let it run wild as it did in the past.

And finally, it is pretty obvious that derivative trading has to be much more carefully regulated. The introduction of derivatives has to be assessed because they have such huge implications and, in principle, derivative trading should be conducted on exchanges, which gives you the transparency and the management of counter-party risk that would not otherwise occur.

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QUESTIONS & COMMENTS

MINISTER MANUEL: Have you given any thought to the institutional arrangements? Clearly it is not a one-country issue, so how does this get taken forward? I mean you are correct, the IMF needs a lot more capital, but part of what I believe to be necessary is that the moment for multilateralism is back, so what are the institutional arrangements? Because neither the IMF nor the World Bank nor the WTO [World Trade Organisation] are anywhere near centre stage.

MR WOLF: It is a subject I have been thinking about recently, and I know others have been thinking about because I was in Washington at the time of the annual meetings — I assume you were there too — and there has been a lot of talk about this. Our own Prime Minister Gordon Brown has of course been arguing along these lines. It is very, very clear that this is a multilateral moment in the very simple sense that it has turned out pretty brutally, in that everybody is sinking in the same boat, and that is what I think of as a multilateral moment. The question, however, is what precisely the institutional form for renewed multilateral co-operation should be.

The issue is pretty clear. It seems to be in two dimensions. The greatest focus must be on the financial sector and the financial system. I will come to monetary macro-policy in a moment. And it is also completely clear that the financial system is a global system, or at least it is now, whether it will be in two or three years from now will be an interesting question. And actions taken by the financial system have profound cross-border effects, while of course they are regulated and ultimately underpinned by national governments. And we have seen even in the rescues that everybody is doing something slightly different. It is difficult to see how far we can get in co-ordinating this. I cannot believe with the present level of global co-operation and the vastly divergent resources of nations around the world, that we are going to get a single global regulator with a single global fiscal authority behind that regulator. Ultimately, as we have seen so clearly, a regulator and a central bank need a fiscal authority or authorities behind them. Even within the euro zone, which shares one currency, it was quite an effort to agree on a fiscal package, and they are all somewhat different. So I do not think we can actually have the single regulator and single system.

What we do need is an institutional arrangement more effective than the one we have today, which ensures that the regulations applied across the different countries are compatible with one another, and the emergency actions taken by countries are compatible with one another, and they take into account the cross-border effects of what they do. And that has been a very big issue. That probably means some sort of radical enhancement and rethinking of the VIS-type Basel so-called rules for banking, and a very substantial beefing up of the Financial Stability Forum in these dimensions. This is a co-ordination function at the highest level, but I think it will remain a co-ordination function. I think the same applies to monetary and macroeconomic policies, including current-account imbalances. This is a surveillance function of the IMF. The problem is that, of course, the fund has no teeth.

I like to joke that there are two classes of countries over which the IMF has never had any influence whatsoever from its inception. The first contains one member, and that is the United States, and the other is creditor nations. The problem of global imbalances is that it was a problem that concerned, essentially, the United States, over which the fund has no influence, and the creditor nations, over which of course it has no influence because they do not need its money. So while we can see that there is an aim here to make it stronger, to make it speak out more strongly, to make its surveillance more effective, I really cannot imagine that we will be able to do it.

When all the dust is settled, if we still have a global system, and globalisation still survives, which I hope it will, we are going to have to review these matters. But I do not think we should be too naive about it. We are not going to fix these problems globally, but we might be able to fix them nationally within the context of compatible policy regimes. And the big problem we have had here is that in very important dimensions, particularly on the global macroeconomic imbalances and monetary policy, and also on the handling of the financial system, policies have not been globally compatible. Whether we can improve that I do not know, but it is clearly an essential task for the future.

“We are not going to fix these problems globally, but we might be able to fix them nationally within the context of compatible policy regimes.”

PROF GELB: What do you think is going to happen in the world trading system and its relationship to the world financial system, because if in the financial system you have got what you call a multilateral moment, that seems to be on the retreat in the trading system, and I think recession is likely to accelerate that process. So what do you think the interaction is going to be between those two processes?

MR WOLF: That is a very important question. There are two ways that I can see that what is happening in the financial crisis has very significant implications for trade. The first is that it will simply call into question the whole legitimacy of market processes as a way of deciding how economies are managed and run. The argument, quite understandable actually, though I think wrong, will be that since the financial markets are such an unbelievable mess, why should we trust markets in goods and services either? So that will be a sort of a general de-legitimising of the market as a system.

The second, more directly relevant issue, is the scale of the recession we may now have. It is clearly obvious already, and in times like this people get frightened for their jobs and their futures and their security and the security of their children, and in this situation they turn inwards and look for the one institution that they normally expect to help them in a crisis, and that is their government. Indeed, I think one of the main functions of governments is to provide that sort of insurance. In a world where governments find it difficult to co-operate, they could easily start acting against one another and the most obvious way to do this is to go for protection. And that is, of course, famously what happened in the 1930s. I am modestly optimistic, and I would stress modestly and optimistic, that we will avoid the worst. Firstly, our governments, particularly in the West, are very used to co-operating with one another in this way, which is quite different from the 1930s. It is institutionalised, not perfectly, but it is institutionalised, including the WTO, and they are well aware how dependent they all are on trade, and that includes even the United States. If Mr Obama wins, as I expect, though he has certainly given some protectionist rhetoric, there is nothing to suggest he is a serious protectionist. So it may be protectionism at the margin, provided they hold on to things. I was also encouraged that the euro zone did finally manage a co-ordinated package on bank intervention. So I think that co-operation among governments will apply. But if we end up with a really deep recession, with enormously high unemployment and negative growth for long periods, it is going to be quite difficult to hold the line, and though I am moderately optimistic, I am not so in all circumstances.

DR JAMMINE: With the huge downward adjustment in emerging-market currencies, are we possibly seeing this as a method or a manner in which the world markets are switching the locus of economic power gradually away from the Western industrialised countries towards emerging markets? Because clearly these currency declines will act as shock absorbers, and conversely American and Japanese production are going to be very adversely affected.

MR WOLF: Yes, it is certainly going to reverse what I thought at one stage was the rather beneficial development of the reduction of the US deficits through export-led growth, and indeed it is very significant for the United States, because if you look at US figures carefully, you will discover that over the past year or so basically all the growth in the US economy was export led. So it has relied on a weak dollar and quite strong growth in the rest of the world for such growth as it has had, and this is one of the reasons — the combination of weakening growth in the rest of the world and the loss of competitiveness — why one can now expect quite a serious recession in the United States.

For the oil-importing emerging economies, now that oil export prices are falling, the weakening of their currencies is helpful, with two very important qualifications —

Nasdaq Marketplace: stocks continue to suffer in the United States and internationally in spite of efforts by the Federal Reserve to stop a deepening crisis.

and they are very important. It is helpful if they do not lead to very rapid increases in domestic interest rates because of either inflationary concerns or simply difficulties in funding national and corporate debt, and this is largely a by-product of a funding strike. So you are not much helped, it seems to me, if with weakening currencies you get massive rises in interest rates, and that combination is certain in much of the world.

The second issue, which I simply do not know enough about, is how far countries have managed to avoid the currency mismatches that were such a monstrous problem in the Asian financial crisis. Because if it turns out that many countries have large foreign-currency liabilities and limited foreign-currency assets, then their governments will be in terrible trouble. So it is a shock absorber only if the currency mismatch problem is not too severe. But in the end, I think the really striking thing about this crisis is that it has demonstrated in the most horribly negative way that the United States is still the centre of the global universe. If the United States gets ill, everybody gets close to terminal.

MS TALJAARD: Could we ask your thoughts on the meeting scheduled for 15 November, in conclusion?

MR WOLF: I am afraid the meeting you are referring to is one I am not as aware of as I obviously should be. But my view, generally, at the moment, is that the American administration is no longer really relevant to anything that is going to happen, beyond whatever [Treasury Secretary Henry] Paulson can do on the bail-out. We are going to have to wait for a new administration — unfortunately, because it means waiting for more than two months, really, before any significant further action is going to happen. But let me just say that I believe that what we are going have to rely on very heavily in the world now, to get through this, is fiscal policy, so there is no way we are going to get away from huge fiscal deficits. We are going to need enormous reductions in monetary policy and monetary-policy easing, and we are going to need, as I stressed in my column this week, very massive increases in assistance for vulnerable emerging economies. I do not know whether these three things will be forthcoming, but they are the necessary conditions for ensuring that this is simply a recession and not worse than that. The fact that we are in an interregnum period in the United States, with a very, very weak president with virtually no authority, is of course a very unfortunate accident from the world's point of view, because we may not have these two or three months of stability. Indeed all the signs are that we will not. But it seems to me the sorts of actions I just indicated are really all we can do now to get through this.

Minister
TREVOR MANUEL

[Resuming his address] I was at the point of talking about this G20 meeting. Clearly, this is being interpreted differently in different parts of the world. I think it is important to recognise that the norm is that the finance ministers and central bank governors have an annual meeting. We had an extraordinary meeting in Washington two weeks ago. President George Bush came in for a while. But the one big challenge is obviously trying to respond to the challenge of leadership. Who leads? At the moment you have absolutely no co-ordination between governments and markets. I will come back to that in a moment.

The other point I wanted to make, just by way of introduction, is that in most parts of the world policy makers are trying to think through what the challenges are, which is why this picture of Zarkosy with Das Kapital is so wonderful. But in God's own country, people do not treat life like this. I was watching one of the presidential campaign rallies where Senator McCain said that Senator Obama wants to take taxes, and wants to raise the taxes for some people in the United States, and that is socialism. It is a swear word, and in a way I think that portends poorly for the kind of thinking that we need right now.

I think the fundamental question alluded to by Martin is what policy makers do now, and the key issue has to be co-ordinated action. We have seen this twice now. We have seen it in the differences between the UK package, which has obviously been quite forward looking, and the US package, which has been kind of not quite there. I think it is also important to recognise that in the United States there have been a series of different announcements and initiatives. One has to be worried about the quality of information that regulators have. In about June, Secretary Paulson went to Congress and asked for support for what looked like a problem coming with Fanny Mae and Freddy Mac, and they agreed to a US$20 billion package. When these entities went to the wall and there was an agreement struck, it was a US$200 billion package. It is very significant. Ken Rogoff, one of the economics professors at Harvard, argues that the United States, in taking on Fanny Mae and Freddy Mac, have taken an additional US$1,6 trillion on to the national debt. So the numbers are quite staggering. There is the 700 billion, which is most well known, but I think you also have to add in the fiscal stimulus that preceded that. I forget what the number was. Chairman Ben Bernanke called for a second stimulus package this week. He spoke about a fiscal stimulus and interest charges. And outside of that there was a report later, and it is not connected to anything, but it is clear that some of the mutual funds are going to the wall, and this would be a variety of collective investment schemes, including presumably retirement funds. And the number of US$540 billion has been mentioned. So the numbers are staggering, but they do not sit in one place. But you have had the difference between the 400 billion package and that, and I think across Europe, as individual countries announced depositors' insurance as an urgent measure, you also saw money moving around as that was being tested. Hence the need to organise co-ordination, and the point that Martin raised is that the best co-ordination has to happen through a new multilateral format, recognising that what we have is seriously flawed.

The interesting option that the G20 presents is that it gets you over that hump of creditors and debtors, because it is a mixed bag of countries. And so it might offer us the best format for now.

I do not want to cover a lot of ground on what has gone before, but I think that a key determinant [of the current situation] was the way in which credit was extended in the United States through the housing market — in Greenspan's book he talked about unwelcome "froth" in the US housing market — and the other issue is, of course, the credit default swops [CDSs]. In 1994 a group of young bankers from JP Morgan got together, brainstormed, and came up with the idea. By 2000 the CDS market had grown to US$100 billion, and by the end of last year it was US$62 trillion. Now I think the fundamental question is where were the regulators, how come they did not know this? When anything grows at that rate there has to be something wrong. So the position of regulators across the sector, across all of the financial sectors, is very important. Go to Greenspan's book, look at page 371, and you will see that he actually welcomes the CDS as a vehicle for transferring risk away from these highly leveraged originators. So I think that his *mea culpa* yesterday is very, very important. The total derivatives at this stage are valued at about US$600 trillion, or about 11 times world GDP.

> "The three great forces that rule the world are stupidity, fear and greed."

Now I cannot begin to think how you unwind some of those positions, and I cannot begin to think of what kind of damage you do. But I think the oscillations that we are seeing today and have been seeing would clearly be a part of it, because you know, if we look at the G7 markets, US$16,4 trillion has been written down. Our losses are very significant on the JSE, but they pale into nothingness when you look at the grander scheme of things. I came across this wonderful quotation. The author insists that she can attribute it to Einstein: "The three great forces that rule the world are stupidity, fear and greed." I hope Einstein said it, but if he did not, then I think that we must attribute this to the author, Julia Collier. Clearly that is part of what we are trying to deal with, and part of the huge dumping that we are seeing is hedge funds moving. The huge oscillations speak to fundamental problems.

One of the difficulties that we are living through as policy makers is at what point you have sufficient information to take a decision. I am not saying we do not know what is going on, but today trade on the New York Stock Exchange frequently moves between two points of as much as a thousand. A thousand points in a single trading day is quite unheard of. A lot of the trades have tended to happen in the last hour of trade as well. It is suggestive of hedge-fund activity and I think it is very important to understand that as they have to close out positions, there is going to be this kind of blood that we are witnessing on the JSE and on markets across the world today.

Trying to understand the problem, I came across an interesting paper by somebody called John Billaway, who quotes James Tobin from 1984. I think this begins to bring us closer to some of the positions we need to take on this. Tobin writes:

I confess to an uneasy physiocratic suspicion that we are throwing more and more of our resources into financial activities remote from the production of goods and services, into activities that generate high private rewards disproportionate to their social productivity. I suspect that the immense power of the computer is being harnessed to this paper economy, not to do the same transactions more economically, but to balloon the quantity and variety of financial exchanges. For this reason perhaps high technology has so far yielded disappointing results in economy-wide productivity. I fear that as Keynes saw even in his day, the advantages of the liquidity and negotiability of financial instruments come at the cost of facilitating nth-degree speculation which is sort-sighted and inefficient. I suspect that Keynes was right to suggest that we should provide greater deterrents to transient holdings of financial instruments, and larger rewards for long-term investors.

Twenty-four years ago, I think Tobin provided us with the answer that we need today, because I think that this is what the next wave will be about. Perhaps somebody will say that the three great forces in the world are fear, greed and suspicion — perhaps we can get some of this behind us and try now to have rationality as a force. And this will mean that approaches to super-leveraging are going to be different. Governments have to take stock and, as Martin said, governments in the main have to ensure that the financial sector is adequately capitalised. And this will leave countries with huge deficits. I know that when I announced a deficit of 1,6% for next year — shock and awe, "marching to the tune of Blade Nzimande". I do not know whose tune the Irish are marching to, but they have had to move from a surplus, where they have been for about seven years, and it looks like their deficit is going to be 6%. You can look at a series of countries. From the Prime Minister's questions earlier this week in the House of Commons, there is a claim that the deficit is going to balloon to a level last seen 60 years ago.

If that is what happens in the world, then a series of other challenges begin to arise. Firstly, if co-ordinated action results in a series of co-ordinated deficits, then what happens in capital markets becomes exceedingly important. Firstly, capital can be fairly lazy. It does not have to take any risks, it can just be lazy and wait for governments to borrow and be guaranteed fixed returns. And secondly, because there is such an appetite, it is clear that spreads are going to widen and be very highly differentiated, which means that debt into perpetuity presents its own series of problems. Firstly, how much of the financial sector needs to be capitalised and re-capitalised, because without it there is going to be nothing? Secondly, how do you deal with the provision of a series of public services? And thirdly, how do you, in the classic Keynesian way, kick-start economic activity in the real economy if too much capital is used in financing the financial sector? I think that the scale of the challenges that confront policy makers is now enormous.

In one of the other debates in the United States, James K Galbraith was taking on a series of other people in the American Enterprise Institute and elsewhere about the nature of the response, and he argues that a sustained fiscal expansion will be essential if the financial rescue first undertaken is to succeed. It cannot succeed on its own. It will be necessary to stabilise the housing sector. It will be necessary to stabilise state and local government spending, undercut by falling property taxes. It will be necessary to stabilise the incomes and expenditures in the aggregate of the elderly. It will be necessary to finance new capital spending at federal, state and local levels. I am not quite sure how all of that is going to be financed. I am also not sure, if the United States is in the market for all of this, to balloon their deficit even further, what happens to other countries. One of the other contributors to the debate has to be Joseph Stiglitz, of course. It is wonderful, he says, that today everyone, even the president, accepts him for microeconomic policy — for government to try to maintain the economy at near full employment. And then in exploring the micro policy options says :

Lowering interest rates will not stimulate the economy much — banks are not going to be willing to lend to strapped consumers,

> and consumers are not going to be willing to borrow as they see housing prices continue to fall. And raising interest rates, to combat inflation, won't have the desired impact either, because the prices that are the main sources of our inflation — for food and energy — are determined in international markets ...

And then he makes a very strong case for a fiscal policy response that is different from a monetary response, exploring options in respect of both tax and spend.

The question is, where are we? I will go back to a very important subtext in the Martin Wolf piece earlier this week when he said the world wakes up to the wish-dream of decoupling. There is going to be no decoupling. Part of our responses are going to have to be co-ordinated. But part of it, I think, is about thinking ahead of where the rest of the world is and then trying to work through. So for us the G20 is going to be very important. Also important is something we said in Washington two weeks ago, that the IMF needs to be brought back into the centre stage. It is completely marginal at the moment. It should not be, because buried in the organisation is actually an enormous intellectual capacity. But it is not being used, it is not being called upon. And here I think that it is worth repeating that our banking system — or, in fact, our financial system — is sound. The banking sector is very sound. The non-banks are just a bit more complex to supervise, because there are 14 000 pension funds. But I think that we can be pretty satisfied that those who operate in South Africa are soundly supervised and well capitalised.

The other issue we need to bear in mind is that the extent to which we are feeling this in South Africa is important. Ken Rogoff did a study while he was chief economist at the IMF, and one of the conclusions is that of all of the emerging markets, South Africa is one of the least dollarised economies. You cannot go into a store in this country with dollars and spend them. And he argued then, and I think correctly so, that the cushion of having a currency that is domestic and, in fact, regional, that is as extensively traded as the rand is, is going to prove itself to be a remarkable strength in the future. I think we are starting to see that right now.

“And here I think that it is worth repeating that our banking system — or, in fact, our financial system — is sound.”

Let me conclude by saying that a lot of work needs to be done in the world on regulation. Again, it is not something we have ever stood back from. What was released just this week is a financial-sector assessment programme [FSAP] which the World Bank and the IMF have undertaken together, and it confirms all of our own observations and feelings about the financial sector in South Africa. An interesting observation is that the United States has never accepted an FSAP until now. The advantages of having an outside look into what you are doing and making observations are very important. I think that the other issues that are going to be important in this very uncertain period that we enter are the approach we take to further relaxations of the capital account versus that endeavour to explore the options for stable de-planned, diversified trade ties.

But fundamentally we are looking at a world beyond this. It is going to be very different from what we have known before. After the Great Depression there was a search for solutions, assisted by proposals that Keynes developed; the Bretton Woods conference of 1944 allowed leaders to sit while a war was being fought and try to plan for the world ahead. The world ahead was a world of Cold War, which actually constructed differences, but an amazing equilibrium at the same time. That lasted until November 1989. Now we have had the excesses of the past 19 or 20 years, completely unregulated parts of the markets. I think that there is a basis for quite a different future. I think we are going to come back to that fundamental argument from Tobin about the production of goods and services whose value is judged relative to their social productivity. I cannot see anything else emerging from this period, and I suppose that is what is going to challenge, certainly, the microeconomic paradigms, but I think it will talk directly into microeconomic reforms that countries like South Africa need to deal with.

QUESTIONS & COMMENTS

[UNIDINTIFIED SPEAKER]: Mr Minister, the one thing that worries me a lot about our position is our current-account deficit. That has always been the Achilles heel of this country, and we are at a record situation now. How are we going to cope with the situation?

PROF PARSONS: Just a point about the issue of confidence, and by this I do not mean confidence in the banking system, but general confidence out there in South Africa. At a time when there are all types of analyses and with the very traumatic events that are taking place, it seems to me that one has to make special efforts to maintain that confidence lest there be any misunderstanding about what is happening. And although there are formal speeches given and there are presentations made, it seems to me this may not be enough. And I am just wondering whether, after the meetings in the first half of November, one could not contemplate some kind of report-back or feedback before the year is out, just to send a message back to the South African nation as to where we stand and give us all balance. I think that the confidence factor is really quite important.

PROF FEDDERKE: I must say I was beginning to feel incredibly nostalgic through all these presentations. I mean, the last time I wrote about Minsky cycles I think was in 1988 as a graduate student, immediately after the '87 financial crisis on world markets — and similarly the Tobin argument that the Minister alluded to. I was very pleased to hear that, because it actually does take us back into the long run, and the Tobin argument was originally formulated in the context of a growth model. And I think it is worth bearing in mind, though with one important qualifier. I think the Tobin argument is true, provided that the liquidity does not serve as a factor of production in its own right. And I think in our context it is vitally important to bear in mind that liquidity and monetary instruments, particularly in developing countries such as ours, actually do serve a crucial function within markets as factors of production. But it has to be a nuanced picture of managing it just right, of not allowing the excesses, but at the same time allowing the innovation of the financial system to intermediate in order to raise the liquidity of the system, in order to be able to grow faster. And I think in part in South Africa our balance has not been too bad. We have not been struck quite as badly by the financial innovation that we have seen in the First World, and the consequences that have followed from that. The question that comes to us, and I confess I do not fully understand this yet, is how we are going to deal with this. Is it to strike that right balance between allowing the innovation of the financial system to improve the intermediation between deficit and surplus units in the economy, while keeping pace with it in regulatory terms? Greenspan just two years ago was one of the great paragons of central banking. Now the reputation looks tarnished. And it is a question of how we, as regulators, can actually keep pace with the rate of innovation within the financial sector, and I think this is going to be with us for a considerable time into the future. I do not know what the answer to that is, but it is clearly the significant challenge.

[UNIDENTIFIED SPEAKER]: We have heard on radio and television that the Troika has talked about creating 5 million jobs Given the financial scenario just painted and the situation that we have in South Africa today, and the uncertainty of the market, as you have just pointed out, would it not be over-simplistic or maybe too hopeful for us to talk about that, and maybe dangerous?

[UNIDENTIFIED SPEAKER]: Building on the first and the last questions and the current-account deficit, are there any specific steps that you believe you and your cabinet should be taking to correct that current-account deficit? And linking into it, without debating which is the real unemployment rate, are there any more specifics on job creation beyond what you said on Tuesday?

QUESTIONS & COMMENTS

MINISTER MANUEL: One of the issues that would have to be worked through is that we need to examine the global imbalance as a fundamental problem, and ask questions about how you can maintain it in better equilibrium. That I think is a starting point. I do not think we can walk away from it. You have seen the most unbelievable spikes in all of the commodity prices. It does not feel like it, but many of the commodities that we produce are still at levels higher than what they were at the end of 2007. But the global imbalances have to be dealt with. I mean, for instance, Saudi Arabia has a current-account surplus of 30-something percent of GDP.

And I think that as those issues are dealt with there are two aspects that have to be important. The first is that there is going to be, in the fullness of time, a greater dispersal closer to the mean as opposed to the real outliers. There still will be outliers. And secondly, to some extent, different tolerances, because if you have a highly globalised financial system and you have the current accounts that in many respects still reflect a different paradigm — because it comes from before, you have not quite developed the alignment — and I think that this is one of the challenges that we have to work through. I don't think any of the kind of stopgaps that people would like to see are going to be appropriate. I mean, how would you deal with the current-account deficit in the old way? You would raise tariffs, you would impose exchange controls to try to seal yourself off from the world. None of those kinds of things are going to find resonance. So part of what we I think need to do is to fold away the textbooks that have been current and think about these issues. And this is why it does mean that you do not have any immediate stock answers to many of the questions, because the environment that we are dealing in is so fundamentally new.

Sometimes the Australians' approach to life works. The former governor of the Australian Reserve Bank said they used to be very concerned about the current account because they have had a deficit of more than 5% for a very long time. And every time either the Treasurer, that is the Minister of Finance, or he would appear before the press, obviously that question would be asked. Whenever they spoke, obviously they had to talk about the current-account deficit. And then they got together and said, "Let us not talk about it any more," and the press stopped writing about it, so perhaps nobody has noticed that they actually have a current-account deficit. Just recently when the Aussie dollar took a big smack a few weeks ago, people noticed that it was there again. But I think that there is sufficient goodwill to want to work through these issues quite differently.

The confidence issue is obviously correct. I think that if you aggregate the global business confidence index now, you would be far in deficit compared to any earlier period. Perhaps we need to go outside of Nedlac [National Economic Development and Labour Council]. Perhaps it is too much of a negotiating forum. If you are reporting back, you do not want to negotiate. You want to say these are the issues, let us go away and work at it. There are some things that are actually just empirically based, and you need to deal with them for what they are, understand risk for what it is, put it on the table, put a proposal on the table and then work through it. But this does not suggest that we should not have big report-backs where South Africans begin to understand, feel engaged, take ownership of the challenges, take ownership of the solutions and then begin the processes that work through them.

Jan, your question is obviously correct, but I think it is necessary, going back to Tobin, to distinguish between a financial banking sector that operates a bit like ours, well regulated, well capitalised — we went for Basle II and it was right. Effectively you do not have too many of these non-bank,

unregulated originators of debt. I think that has been the fundamental problem, and I think that the terms of what is accepted as collateral at the window at the Reserve Bank are clearly understood. Please do not bring your bicycle or anything like that, it will not be accepted as collateral at the window. The rules are abundantly clear and I think if the rules are that clear they work, and perhaps they work better in a small market like ours.

But the idea cannot be to deal with intermediation into factors of production and try to stall that. It cannot be. You have to understand, arising from the experiences we are just living through now, what levels of froth you have to risk. Sure, we want markets to innovate. I think it is finding that balance between regulation and innovation, and I think you need a fairly open discourse about some of these kinds of issues. Do we have it? I think we do better than most.

The question of 5 million jobs. We undertook a process of working with a number of economists, domestic and foreign. Some people chose to call it the Harvard Group, but the correct name was the International Growth Advisory Panel [IGAP]. Their observations are in published documents, no secrets. One of the first problems identified is that for a country of around 48 or so million people, using rough rule of thumb, equivalent to our peers, we should have about 18 or so million people in employ. We are 5 million short. That is a gap we have got to try and fill. So it is not something that has been toyi-toyi-ed about. It has come out of this process.

Where are those people? Who are those people? There has been some disaggregation of the unemployed by age, race, geography, schooling. So it is obvious that the bulk of people are young, black South Africans who have about 14 years of education or less. Less than a degree or a college diploma. Incomplete degrees or diplomas — frequently people leave school at Grade 12. One of the challenges is obviously that you need to focus on how to smooth the school-to-work transition. You must analyse labour-market trends, understand what the impediments are, and drive the change. You need a series of proposals related to that. So I think [the figure of 5 million] would accord with a lot of the research done. I do not think it exists as a demand. I think it exists as a broad objective that we should strive towards.

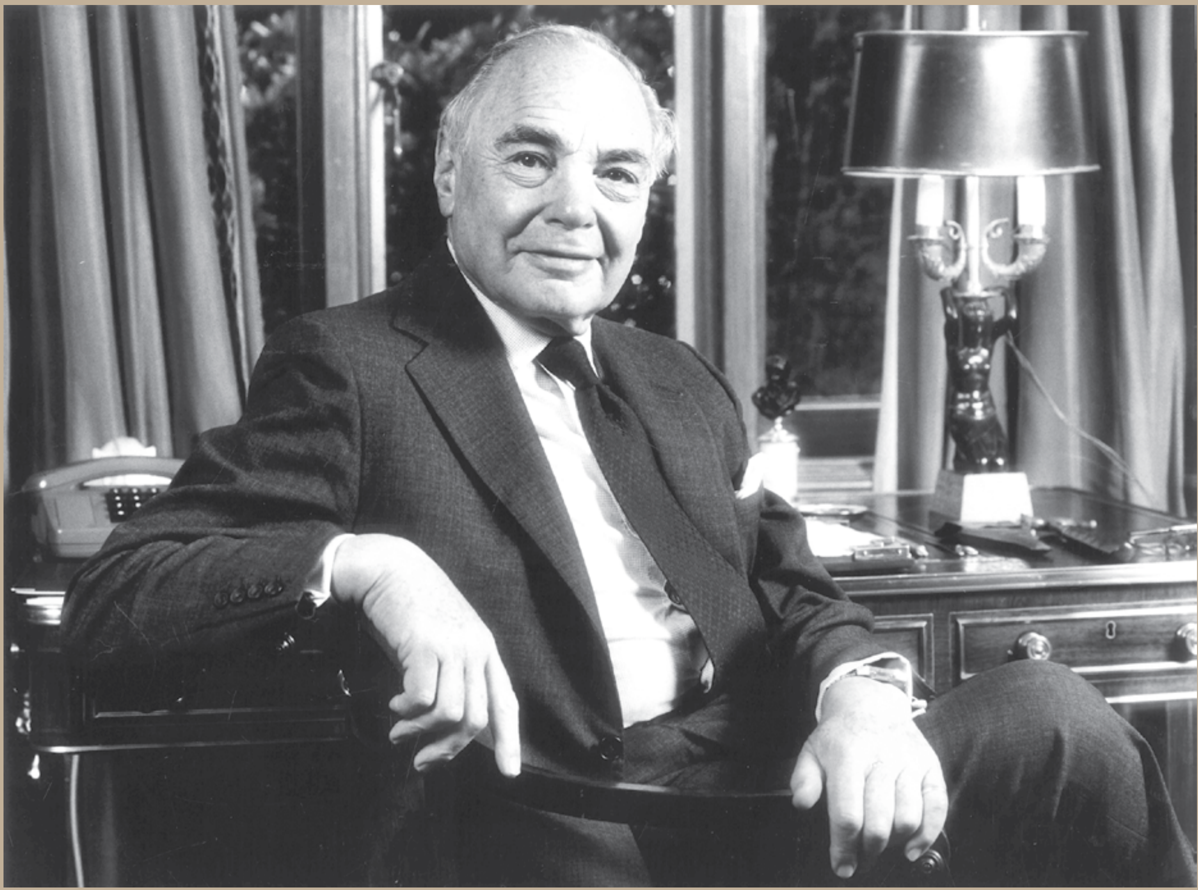
As we deal with those kinds of issues, clearly some things must be overhauled. Our trading system will probably need to be overhauled. The division of spending between new entrants to the labour market and people who are in employ needs to be overhauled, and you probably need to get better bang for the buck through the SETAs. The schooling system upstream would need to be overhauled, and I think we need to look at the sectors into which the people could be absorbed, because while expanded public-works programmes and so on help, they are not going to be the same as private-sector jobs. They are job opportunities that tend to be of short duration. When all of that is done, you have to implement it, but part of implementing it is that some things have to change. It is a tough call, but I think it is a call that is in the IGAP reports. It is also supported by the OECD reports on South Africa. I do not think that we should actually go to war about the number, or feel a sense of failure, or feel that we have to disagree because [the ANC's] alliance partners said it. I think we can examine the issues for what they are, and understand that if we could raise the number of employed people by an additional 5 million, there are 5 million more pay packets, the market grows by 5 million, a lot of families are lifted out of poverty and I think it is an objective worth striving for.

Your question was partly about the current account, partly about the 5 million jobs. I am saying that you need to take that into a deeper discussion about all of the microeconomic reforms that must be undertaken. Because optimally you want to get back to the point raised by Tobin about the link between finance and production. And so some of the industrial policy issues clearly need to be overhauled, some of them need to be approached differently. The expansion of SME development is a very important part of that. The labour markets issue. Some of the trade issues. Even, in some respects, I think that you need to understand that the trade negotiations, now stalled, are part hard economic negotiations, hard economic fact, but there is also a fair amount of diplomacy, and there are foreign-relationship questions that you need to answer as you construct, because you are going to win those things on the basis of the alliances that you strike. So there is a smorgasbord of work that we have to undertake. We should not shy away from it, but I think that we must understand that in this new period there is going to be no easy ride for anybody.

In the period of excess that we have just lived through you had this neat arrangement with Chinese workshops manufacturing for entities like Wall Mart; Americans buying, happy; costs reduced; inflation down. But if those families are out of their homes and they do not have money and they feel under huge stress, then China is either going to close down those factories or they are going to be aggressively marketing around the world. They are not going to say to South Africans, "We are comrades, it is okay, we are going to spare you." I think we must understand that this world is going to be a very different one. One of the difficulties is that we are living through a period where there is, they say, "a flight of quality". They did not say what kind of quality, good quality, bad quality, but people are dumping money into the dollar market and then into short-dated treasuries in the United States. What that is doing is appreciating the dollar relative to everything else, and so the [US] manufacturers are going to be less competitive. Try to understand what is happening to General Motors: it announced the closure of five plants, right on the eve of an election. Hewlett Packard announced, was it 28 000 layoffs? The largest single layoff by a company. GE is facing its own share of troubles. There are going to be enormous difficulties like that. But they are not going to sit around and allow their markets to remain open. The risk of protectionism in these times is, of course, very great. The pity is that we have not concluded the Dohar Round. And I think many of the old Western European economies are fearful of the new accession countries from the East. But that I were a researcher ... it is going to be exciting for researchers, it is going to be hell for the rest of us.

> "… it is clear we are going to need much better capitalised banks in future that stick to their core lending activities and have capital adequacy ratios that are strongly counter-cyclical."

This new period we are going into needs to be thought about quite differently, because it is going to be as integrated as this globalised world that we have come out of. There is going to be no decoupling. The trends are going to be different. There is going to be a greater focus on the real economy, and we may not have used all of our time advisedly in getting up to speed in a lot of these issues, so your question about the 5 million is important. We cannot sit around waiting and debating this thing endlessly. We have got to be taking decisions and moving ahead.



Harry Oppenheimer.

Bobby Godsell, on behalf of the Harry Oppenheimer Memorial Trust

Today's lecture commemorates the lives of two great sons of Africa.

Sir Ernest Oppenheimer established one South African company and transformed another, making Anglo American and De Beers absolute world leaders in their fields.

His son, Harry Oppenheimer, in turn transformed the world diamond industry and built Anglo American and De Beers into the African continent's most successful multi-national corporations. Both Ernest and Harry were business statesmen, each spending more than a decade of their lives in elected public office. Each understood that just as it was impossible to have a good society without successful business, so too was it impossible to have a successful business without a good society.

How appropriate then that our guest speaker today is a great son of Latin America and Brazil. A sociologist by training, the leading exponent of dependency theory, a key figure in Brazil's return to democracy, President Cardoso led his country's fight against the surge of four digit inflation and economic, social and political instability which are its inevitable consequence. He built an architecture of macro economic stability that has not only endured his own two terms as President (1995 to 2002), but which has continued to serve his country into the second term of his successor, Labour Party leader, President Luiz Inacio Lula da Silva.

What better person, then, to continue the Oppenheimer tradition of patriotic enterprise than President Cardoso?

Former Brazalian President: FERNANDO HENRIQUE CARDOSO

Fernando Henrique Cardoso.

When I accepted this invitation, the idea was to share something of my own experience as a President facing an inflation crisis, and then subsequently preparing for a major political transition. However, the current global economic crisis is so overwhelming that it is probably more interesting and inescapable to talk about present-day conditions. I have more questions than answers. We face an unprecedented situation. South Africa and Brazil have much to share and much to contribute in terms of this crisis. We face plenty of risks, much uncertainty and hard decisions ahead, but depending on how we react not all is negative. Unusual circumstances tend to create rare opportunities.

I wish therefore to focus this presentation on the challenges facing emerging countries like ours in the new era of globalisation that is upon us. Each day reinforces the notion that we are confronted with more than a financial collapse.

The "boom, bubble and burst" of reckless lending have evolved into a systemic crisis. George Soros, in a book published last May, insisted that we are approaching the end of an era. The political consequences of this crisis are unpredictable. Will it lead to a resurgence of nationalism and xenophobia, like in the 1930s? Or will the multilateral institutions of global cooperation be reinforced or reinvented?

This is one of the questions to be raised.

The political consequences of the depression of 1929 were terrible. Fascism was the long-term consequence. Yet this is not the necessary consequence of today's crisis. It will depend on how you and I react. We could as well reinforce the multi national institutions that try to enhance global cooperation. Perhaps reinvent these institutions to enable them to deal with the global situation we now face.

We should humbly admit that we do not have an answer to this question yet. The crisis is still unfolding. Its ripple effects in the real economy, in peoples' lives, are still expanding. Who can tell how far the downward spiral will go? We can see what is occurring in the United States in terms of employment and this is becoming a tremendous problem. I suspect that in the coming months we will face difficult situations in Brazil. Given the interconnectedness of the global economy, nobody can predict the intensity and duration of the recession.

In the beginning we tried to avoid the use of the term "crisis". Then we said it is "a crisis" but not a recession. Now we agree a recession is here. I hope that we will not be forced to speak about "a depression".

We have seen the evolution from a crisis of liquidity to a crisis of trust. When nobody trusts anybody, investment and lending freeze. Fear replaces greed. Credit evaporates. The collapse of virtual capital markets has drained money from the real economy making it much more difficult for companies to invest and consumers to spend.

In 1995 and 1996 Brazil reorganised its banking system. 30 banks, mostly state banks, were closed. By executive order I established the rules in terms of which banks could be supported by the central bank. The then owners and executive management had their personal belongings frozen until we were clear to what extent they were responsible for the banks' failures. In my case this was dramatic as my son was married to the daughter of the owner of one of these banks. But we did it! Today the banking system of Brazil is very healthy. Yet suddenly there is no credit. Yet US$1.7 trillion has been pumped into the world's banking system. And still the banks are saying: "Can we trust them?" "Will you pay me back?" To make liquidity available is one thing; to restore trust is much more difficult. And so the productive economy is being hit everywhere by the restrictions of credit and the contraction of demand.

> "One positive sign is that for the first time — and this may well go down in history as a landmark event — a global crisis is being dealt with through global concerted action."

The crisis of the unregulated and opaque global financial markets seems irreversible. One positive sign is that for the first time — and this may well go down in history as a landmark event — a global crisis is being dealt with through global concerted action. The Americans started by focusing on a national solution to their predicament. Soon enough they were forced to take into account what the Europeans were proposing.

Initially in Europe, each country's government decided on a course of action. In the end they realised that it would be impossible to go it alone and that they would need some form of cooperation.

Other key countries — like China, India, Russia, Brazil, South Africa and Mexico and so on and so forth — have still to play their hand.

The way forward in terms of global collaboration will be erratic. To build a new global financial architecture will take time. It will require leadership. But, constrained by the global nature of the crisis, the issue has come to stay. And the crisis may well provide the leadership that normal times were not able to provide.

I think that this is a crucial question. Do we need more active leadership? And when I refer to leadership I am not just looking north. Countries like South Africa, Russia, Brazil, China, Indonesia and Mexico have to ask for participation in the decision-making process. I remember when President Clinton was in office he use to speak about a new financial architecture for the world. This is not a novelty. Every time we faced a crisis in Brazil, I sent letters to Heads of States, urging for concerted action. Brazil has suffered several crises, as you know. In 1994, we had the so-called Mexican crisis, nicknamed "the Tequila crisis". I was elected President in October1994 after first serving as Foreign Minister and then Finance Minister. When I was about to go into the Presidency, the Brazilian currency *Real* was trading at .82 to the dollar. That was disastrous for our exports.

We had more or less lost control of interest rates. When the Mexican crisis occurred it was impossible for us to take any dramatic action. When the first G7 meeting took place, I wrote to the Heads of States. Before I went to Chile I gave a speech about the economic situation in Latin America. I argued that we have to devote ourselves to the new realities of globalisation, and to the new regulation this globalisation made necessary. We needed to re-consider the roles of the both the IMF and the World Bank. My letters were answered very politely but absolutely no action was forthcoming. In 1997 the global economy experienced the Asian crisis. Brazil's US$ 70 billion in reserves evaporated in three weeks. Again I wrote some letters. In 1998 came the Russian crisis. This was followed by the crisis of American financial institutions (savings and loans). In 1999 we had our own crisis. The market attacked the *Real* and we decided to abandon a floating currency. It was a consequence of this crisis that the *Real* started floating. By April of that year everything had been solved. Then came Argentina's crisis — one of their many. And then the year 2000 was just wonderful: nobody had a crisis. GDP rose by around 4 or 5%. Wonderful! Blue skies!

2001 saw 9/11 and the global economic crisis this precipitated. In 2002 President Lula was a candidate and the Workers' Party supported him. They proposed a dramatic rupture with both Brazilian and global economic policies. Politicians do not pay much attention to the markets but the markets pay attention to politicians. The markets believed that Lula was going to change everything. The value of the *Real* against the US$ declined from 1.8 to 3. A tragedy, so again, the IMF.

Through all of these crises, not just myself, but several Presidents tried to convince the owners of the world that something was wrong. We thought the idea was not so difficult to understand. Global markets needed global rules. Political decision-making stood outside global economic markets. As a consequence, globalised financial markets evolved rapidly and radically. Nation-based financial regulation could not keep pace. During my tenure as President, people cried that the IMF was imposing rules on Brazil. Poor IMF! They had no money to impose any rules on anybody. They are very good at preparing statements and giving advice to others, but when it came to taking decisions, they had neither the power, nor the funds to act decisively. We had to turn to the President and Secretary of the Treasury of the United States for decisive action. I would ask "Please Bill, help". Together with President Lagos from Chile, I later appealed to President Bush to assist Argentina. There was no response and Argentina collapsed. Our Bretton Woods institutions are too weak to be able to take care of a globalised world. They have neither the will, nor the power, nor the money to act effectively.

This applies equally to the World Bank. The Brazilian Bank for Development has twice the resources of the World Bank. The Bank for International Settlements is good at giving advice, but has no power to act effectively. Countries like Brazil and South Africa need to be part of the reform of the present global financial architecture.

Former President Cardoso, Bobby Godsell and Nicky Oppenheimer at the Brenthurst Library.

In the same way that globalisation did not herald the "end of history" as some feared and others anticipated, the present crisis will not mean the end of globalisation. In my view, it will lead to a new age of globalisation driven by a stronger interplay between politics, economics and culture. This is a challenge of great magnitude given the absence of appropriate institutions and the lack of serious debate about viable alternatives.

A new world is emerging where the United States will be one great power among others, all of them seeking to shape an uncertain future. I believe that the United States will remain the leading global player but its influence will be felt in a radically new political landscape. Profound changes in the production process and the investment of capital in emerging countries are reshaping the international economic scene. From 1990 to 2005, China was responsible for 28% of global growth, Latin America for 7% (which is equal to the total of Asian countries, except Korea and Japan) and India for 9%. So these emerging market countries produced 44% of global growth. We are fast reaching a turning point where about one-half of global GDP, measured in terms of purchasing power parity, comes from emerging countries.

This power shift from the North to the East and the South represents a sweeping rearrangement of the economic world order. Will it translate into a new political world order? This depends on our actions. In my view the economic crisis will accelerate the transition to a multi-polar and multicultural world.

The age of American unilateralism has come to an end. The strength of Obama´s candidacy is a clear sign of this. Europe is well positioned, together with emerging countries, to bring a new, more flexible approach to deal with a whole array of global threats, ranging from climate change, nuclear proliferation, to fighting epidemics, terrorism and transnational crime.

I think that the experience of emerging market countries, with the addition of European experience, can provide the world with a better approach to these different issues. A more peaceful world. A more responsive world. I am not just referring to the epidemics, but also to climate change, the problems of energy, and of water. These are the real problems that the world faces.

"Worldwide there is an enormous effort to discover new energy resources. These efforts must take into account the environment."

Look at the problem of energy and Brazil's experience. In Brazil, every car is run on a blend of gasoline and ethanol. Some have been concerned at the possible damage ethanol production would do to the Amazon. However ethanol production is not profitable beyond the 17th parallel. There is therefore no possibility of using the Amazon to produce sugar cane. Here in Africa — in Angola, Mozambique and in South Africa for example — you have lots of good soil for sugar cane. Just recently the Brazilian company, Petrobras, in association with a Portuguese and Spanish company, found oil in the sea at a depth of 6000 meters. It seems as if this will at least double the Brazilian reserves. Worldwide there is an enormous effort to discover new energy resources. These efforts must take into account the environment.

All of these changes point towards the rise of an international order driven by regulatory mechanisms and a decision-making process that will be more broadly shared. That is the key question. We need new regulatory instruments. The debate between the roles of the state and markets is ridiculous. History shows that markets need regulation. Well-regulated markets support an efficient and equitable state.

But who should make the rules? That is the political question. It is not a technical issue. Global markets need global regulation. In such a context, the correction of economic and financial asymmetries will hopefully gain prominence in the global agenda. This may finally lead to concerted action to fight extreme poverty in long neglected areas such as Sub-Saharan Africa.

All of this can be summed-up in the vision of a new global contract that cannot be imposed by force. It can only be negotiated by a variety of states and non-state actors and must be based both on the safeguard of human rights as universal value and on the respect for diversity. Countries like Brazil and South Africa are well positioned to participate in and influence this process that includes the reform of the global financial architecture but also goes beyond it. Both are multi-ethnic societies, with an immensely rich history and culture. Both have dynamic private sectors and vibrant civil societies.

Much has been accomplished in Brazil since the restoration of democracy, as in South Africa since the end of apartheid. Given, however, the magnitude of repressed needs and expectations, the pressure on our governments for delivering quick, far-reaching change is enormous. Many of our young people live in despair, with no sense of future. We all know that no one lives forever on unfulfilled promises. This perception is compounded by problems like corruption and the rising levels of criminal violence, especially in our large cities.

Impunity and insecurity combined with the persistence of poverty and inequality explain the disconnection between peoples' aspirations and the capacity of political institutions to respond to the demands of society. Democracy must be made to work or apathy, cynicism and disaffection will prevail.

Our common challenge is combine economic stability and better quality of life for all. If we do not reinforce the values of democracy we can prepare for a disaster. Democracy is

From left: Jonathan and Nicky Oppenheimer with Mr Cardoso.

not just a set of institutions. Democracy must also shape the lives of ordinary citizens. Both Brazil and South Africa have very high levels of inequality. Brazil and other Latin American countries are now making an enormous effort to address this inequality.

In Mexico between 1994 to 2008 poverty has reduced from 40% around 22%. In contrast, in Peru, rapid economic growth of 5% has seen no poverty reduction.

There can be no separation between economics and politics. World leaders need to engage in a joint effort to have better markets, and to build better societies.

The way forward lies in strengthening the partnerships between government, the private sector and civil society. Over the last thirty years, the primacy of the market has prevailed in most countries over the need for government regulation. With the onslaught of the crisis the pendulum is shifting in the opposite direction. A new balance is needed among the three sectors of society.

An interesting experience to be shared from Brazil is the growing commitment by major corporations to participate in and influence the improvement of public policies in crucial areas such as education, health care and public safety. In some cases, more important than financial support, is the mobilisation of the core assets of the corporations — their human resources and management expertise — in partnership with local governments and civic organisations. Private action for the public good complements and sustains government's responsibility in the provision of public services.

This is an area in which Brazil and South Africa have much to share and learn from each other. My wife made an enormous effort in Brazil to remold the idea of how to go ahead with social policies. The key question is to provoke the participation of civil society. Business can often do this more effectively than government.

I think it is time to conclude.

We live in momentous times, fraught with risks but also with great opportunities.
One of the most far-reaching consequences of the financial crisis will be a major shift from the virtual to the real economy. Willing or unwilling, we may well be forced to go back to the age-old ethics of hard work and saving, transparency and trust as the foundation of economy and prosperity. In reaction to out-of-control borrowing and spending, it is high time to revisit the notion that innovation, productivity and competitiveness are the pathways to wealth and job creation.

We may be at the threshold of what some have called "a new age of frugality" in contrast with the follies of recent years. We may be driven by less consumption due to the shortage of credit, more hard work and innovation to increase earnings and productivity, more efficient control of the market by the state and society.

I wish to conclude with one last comment. The crisis has demonstrated the overwhelming cost of greed.

The hour is now for re-opening the debate about a number of questions about the kind of societies we want to live in — questions that have been side-stepped in the times of easy money. The reckless pursuit of profit has brought us to a dead-end. Financial laissez-faire has imploded. The days of risk-taking and high living are over. Real needs and the public good are bound to take precedence over outright consumerism.

It is time to ask ourselves what are the real foundations of our societies. What is "quality of life" and what are the values that should orient our collective behaviour?

The future is not a point in time waiting for us to get there. It depends on and is shaped by the decisions that we take today. I trust that our two societies, Brazil and South Africa, countries that have achieved so much in such a short period of time, often against tremendous odds, and which have amazing reserves of cultural and social wealth, can play a leading role in the global reshaping of the world we live in.

Even at the heart of the nightmare, let us not forsake the dreams that inspired our countries in the quest for freedom and dignity.

Thank you very much.

Declaration of the Summit on Financial Markets and the World Economy

THE WHITE HOUSE
PRESIDENT
GEORGE W. BUSH

We, the Leaders of the Group of Twenty, held an initial meeting in Washington on November 15, 2008, amid serious challenges to the world economy and financial markets. We are determined to enhance our cooperation and work together to restore global growth and achieve needed reforms in the world's financial systems.

Over the past months our countries have taken urgent and exceptional measures to support the global economy and stabilize financial markets. These efforts must continue. At the same time, we must lay the foundation for reform to help to ensure that a global crisis, such as this one, does not happen again. Our work will be guided by a shared belief that market principles, open trade and investment regimes, and effectively regulated financial markets foster the dynamism, innovation, and entrepreneurship that are essential for economic growth, employment, and poverty reduction.

Root Causes of the Current Crisis

During a period of strong global growth, growing capital flows, and prolonged stability earlier this decade, market participants sought higher yields without an adequate appreciation of the risks and failed to exercise proper due diligence. At the same time, weak underwriting standards, unsound risk management practices, increasingly complex and opaque financial products, and consequent excessive leverage combined to create vulnerabilities in the system. Policy-makers, regulators and supervisors, in some advanced countries, did not adequately appreciate and address the risks building up in financial markets, keep pace with financial innovation, or take into account the systemic ramifications of domestic regulatory actions.

Major underlying factors to the current situation were, among others, inconsistent and insufficiently coordinated macroeconomic policies, inadequate structural reforms, which led to unsustainable global macroeconomic outcomes. These developments, together, contributed to excesses and ultimately resulted in severe market disruption.

Actions Taken and to Be Taken

We have taken strong and significant actions to date to stimulate our economies, provide liquidity, strengthen the capital of financial institutions, protect savings and deposits, address regulatory deficiencies, unfreeze credit markets, and are working to ensure that international financial institutions (IFIs) can provide critical support for the global economy.

But more needs to be done to stabilize financial markets and support economic growth. Economic momentum is slowing substantially in major economies and the global outlook has weakened. Many emerging market economies, which helped sustain the world economy this decade, are still experiencing good growth but increasingly are being adversely impacted by the worldwide slowdown.

Against this background of deteriorating economic conditions worldwide, we agreed that a broader policy response is needed, based on closer macroeconomic cooperation, to restore growth, avoid negative spillovers and support emerging market economies and developing countries. As immediate steps to achieve these objectives, as well as to address longer-term challenges, we will:

- Continue our vigorous efforts and take whatever actions are necessary to stabilize the financial system.
- Recognize the importance of monetary policy support, as deemed appropriate to domestic -term liquidity facility, and urge the ongoing review of its instruments and facilities to ensure flexibility.
- Encourage the World Bank and other multilateral development banks (MDBs) to use their full capacity in support of their development agenda, and we welcome the recent introduction of new facilities by the World Bank in the areas of infrastructure and trade finance.
- Ensure that the IMF, World Bank and other MDBs have sufficient resources to continue playing their role in overcoming the crisis.

Common Principles for Reform of Financial Markets

In addition to the actions taken above, we will implement reforms that will strengthen financial markets and regulatory regimes so as to avoid future crises. Regulation is first and foremost the responsibility of national regulators who constitute the first line of defense against market instability. However, our financial markets are global in scope, therefore, intensified international cooperation among regulators and strengthening of international standards, where necessary, and their consistent implementation is necessary to protect against adverse cross-border, regional and global developments affecting international financial stability. Regulators must ensure that their actions support market discipline, avoid potentially adverse impacts on other countries, including regulatory arbitrage, and support competition, dynamism and innovation in the marketplace. Financial institutions must also bear their responsibility for the turmoil and should do their part to overcome it including by recognizing losses, improving disclosure and strengthening their governance and risk management practices.

We commit to implementing policies consistent with the following common principles for reform.

- Strengthening Transparency and Accountability: We will strengthen financial market transparency, including by enhancing required disclosure on complex financial products and ensuring complete and accurate disclosure by firms of their financial conditions. Incentives should be aligned to avoid excessive risk-taking.
- Enhancing Sound Regulation: We pledge to strengthen our regulatory regimes, prudential oversight, and risk management, and ensure that all financial markets, products and participants are regulated or subject to oversight, as appropriate to their circumstances. We will exercise strong oversight over credit rating agencies, consistent with the agreed and strengthened international code of conduct. We will also make regulatory regimes more effective over the economic cycle, while ensuring that regulation is efficient, does not stifle innovation, and encourages expanded trade in financial products and services. We commit to transparent assessments of our national regulatory systems.
- Promoting Integrity in Financial Markets: We commit to protect the integrity of the world's financial markets by bolstering investor and consumer protection, avoiding conflicts of interest, preventing illegal market manipulation, fraudulent activities and abuse, and protecting against illicit finance risks arising from non-cooperative jurisdictions. We will also promote information sharing, including with respect to jurisdictions that have yet to commit to international standards with respect to bank secrecy and transparency.
- Reinforcing International Cooperation: We call upon our national and regional regulators to formulate their regulations and other measures in a consistent manner. Regulators should enhance their coordination and cooperation across all segments of financial markets, including with respect to cross-border capital flows. Regulators and other relevant authorities as a matter of priority should strengthen cooperation on crisis prevention, management, and resolution.
- Reforming International Financial Institutions: We are committed to advancing the reform of the Bretton Woods Institutions so that they can more adequately reflect changing economic weights in the world economy in order to increase their legitimacy and effectiveness. In this respect, emerging and developing economies, including the poorest countries, should have greater voice and representation. The Financial Stability Forum (FSF) must expand urgently to a broader membership of emerging economies, and other major standard setting bodies should promptly review their membership. The IMF, in collaboration with the expanded FSF and other bodies, should work to better identify vulnerabilities, anticipate potential stresses, and act swiftly to play a key role in crisis response.

Tasking of Ministers and Experts

We are committed to taking rapid action to implement these principles. We instruct our Finance Ministers, as coordinated by their 2009 G-20 leadership (Brazil, UK, Republic of Korea), to initiate processes and a timeline to do so. An initial list of specific measures is set forth in the attached Action Plan, including high priority actions to be completed prior to March 31, 2009.

In consultation with other economies and existing bodies, drawing upon the recommendations of such eminent independent experts as they may appoint, we request our Finance Ministers to formulate additional recommendations, including in the following specific areas:

- Mitigating against pro-cyclicality in regulatory policy;
- Reviewing and aligning global accounting standards, particularly for complex securities in times of stress;
- Strengthening the resilience and transparency of credit derivatives markets and reducing their systemic risks, including by improving the infrastructure of over-the-counter markets;
- Reviewing compensation practices as they relate to incentives for risk taking and innovation;
- Reviewing the mandates, governance, and resource requirements of the IFIs; and
- Defining the scope of systemically important institutions and determining their appropriate regulation or oversight.

In view of the role of the G-20 in financial systems reform, we will meet again by April 30, 2009, to review the implementation of the principles and decisions agreed today.

Commitment to an Open Global Economy

We recognize that these reforms will only be successful if grounded in a commitment to free market principles, including the rule of law, respect for private property, open trade and investment, competitive markets, and efficient, effectively regulated financial systems. These principles are essential to economic growth and prosperity and have lifted millions out of poverty, and have significantly raised the global standard of living. Recognizing the necessity to improve financial sector regulation, we must avoid over-regulation that would hamper economic growth and exacerbate the contraction of capital flows, including to developing countries.

We underscore the critical importance of rejecting protectionism and not turning inward in times of financial uncertainty. In this regard, within the next 12 months, we will refrain from raising new barriers to investment or to trade in goods and services, imposing new export restrictions, or implementing World Trade Organization (WTO) inconsistent measures to stimulate exports. Further, we shall strive to reach agreement this year on modalities that leads to a successful conclusion to the WTO's Doha Development Agenda with an ambitious and balanced outcome. We instruct our Trade Ministers to achieve this objective and stand ready to assist directly, as necessary. We also agree that our countries have the largest stake in the global trading system and therefore each must make the positive contributions necessary to achieve such an outcome.

We are mindful of the impact of the current crisis on developing countries, particularly the most vulnerable. We reaffirm the importance of the Millennium Development Goals, the development assistance commitments we have made, and urge both developed and emerging economies to undertake commitments consistent with their capacities and roles in the global economy. In this regard, we reaffirm the development principles agreed at the 2002 United Nations Conference on Financing for Development in Monterrey, Mexico, which emphasized country ownership and mobilizing all sources of financing for development.

We remain committed to addressing other critical challenges such as energy security and climate change, food security, the rule of law, and the fight against terrorism, poverty and disease.

As we move forward, we are confident that through continued partnership, cooperation, and multilateralism, we will overcome the challenges before us and restore stability and prosperity to the world economy.

Action Plan to Implement Principles for Reform

This Action Plan sets forth a comprehensive work plan to implement the five agreed principles for reform. Our finance ministers will work to ensure that the taskings set forth in this Action Plan are fully and vigorously implemented. They are responsible for the development and implementation of these recommendations drawing on the ongoing work of relevant bodies, including the International Monetary Fund (IMF), an expanded Financial Stability Forum (FSF), and standard setting bodies.

Strengthening Transparency and Accountability

Immediate Actions by March 31, 2009

- The key global accounting standards bodies should work to enhance guidance for valuation of securities, also taking into account the valuation of complex, illiquid products, especially during times of stress.
- Accounting standard setters should significantly advance their work to address weaknesses in accounting and disclosure standards for off-balance sheet vehicles.
- Regulators and accounting standard setters should enhance the required disclosure of complex financial instruments by firms to market participants.
- With a view toward promoting financial stability, the governance of the international accounting standard setting body should be further enhanced, including by undertaking a review of its membership, in particular in order to ensure transparency, accountability, and an appropriate relationship between this independent body and the relevant authorities.
- Private sector bodies that have already developed best practices for private pools of capital and/or hedge funds should bring forward proposals for a set of unified best practices. Finance Ministers should assess the adequacy of these proposals, drawing upon the analysis of regulators, the expanded FSF, and other relevant bodies.

Medium-term actions

- The key global accounting standards bodies should work intensively toward the objective of creating a single high-quality global standard.
- Regulators, supervisors, and accounting standard setters, as appropriate, should work with each other and the private sector on an ongoing basis to ensure consistent application and enforcement of high-quality accounting standards.
- Financial institutions should provide enhanced risk disclosures in their reporting and disclose all losses on an ongoing basis, consistent with international best practice, as appropriate. Regulators should work to ensure that a financial institution' financial statements include a complete, accurate, and timely picture of the firm's activities (including off-balance sheet activities) and are reported on a consistent and regular basis.

Enhancing Sound Regulation

Regulatory Regimes

Immediate Actions by March 31, 2009

The IMF, expanded FSF, and other regulators and bodies should develop recommendations to mitigate pro-cyclicality, including the review of how valuation and leverage, bank capital, executive compensation, and provisioning practices may exacerbate cyclical trends.

Medium-term actions

- To the extent countries or regions have not already done so, each country or region pledges to review and report on the structure and principles of its regulatory system to ensure it is compatible with a modern and increasingly globalized financial system. To this end, all G-20 members commit to undertake a Financial Sector Assessment Program (FSAP) report and support the transparent assessments of countries' national regulatory systems.

- The appropriate bodies should review the differentiated nature of regulation in the banking, securities, and insurance sectors and provide a report outlining the issue and making recommendations on needed improvements. A review of the scope of financial regulation, with a special emphasis on institutions, instruments, and markets that are currently unregulated, along with ensuring that all systemically-important institutions are appropriately regulated, should also be undertaken.
- National and regional authorities should review resolution regimes and bankruptcy laws in light of recent experience to ensure that they permit an orderly wind-down of large complex cross-border financial institutions.
- Definitions of capital should be harmonized in order to achieve consistent measures of capital and capital adequacy.

Prudential Oversight

Immediate Actions by March 31, 2009

- Regulators should take steps to ensure that credit rating agencies meet the highest standards of the international organization of securities regulators and that they avoid conflicts of interest, provide greater disclosure to investors and to issuers, and differentiate ratings for complex products. This will help ensure that credit rating agencies have the right incentives and appropriate oversight to enable them to perform their important role in providing unbiased information and assessments to markets.
- The international organization of securities regulators should review credit rating agencies' adoption of the standards and mechanisms for monitoring compliance.
- Authorities should ensure that financial institutions maintain adequate capital in amounts necessary to sustain confidence. International standard setters should set out strengthened capital requirements for banks' structured credit and securitization activities.
- Supervisors and regulators, building on the imminent launch of central counterparty services for credit default swaps (CDS) in some countries, should: speed efforts to reduce the systemic risks of CDS and over-the-counter (OTC) derivatives transactions; insist that market participants support exchange traded or electronic trading platforms for CDS contracts; expand OTC derivatives market transparency; and ensure that the infrastructure for OTC derivatives can support growing volumes.

Medium-term

- Credit Ratings Agencies that provide public should be registered.
- Supervisors and central banks should develop robust and internationally consistent approaches for liquidity supervision of, and central bank liquidity operations for, cross-border banks.

Risk Management

Immediate Actions by March 31, 2009

- Regulators should develop enhanced guidance to strengthen banks' risk management practices, in line with international best practices, and should encourage financial firms to reexamine their internal controls and implement strengthened policies for sound risk management.
- Regulators should develop and implement procedures to ensure that financial firms implement policies to better manage liquidity risk, including by creating strong liquidity cushions.
- Supervisors should ensure that financial firms develop processes that provide for timely and comprehensive measurement of risk concentrations and large counterparty risk positions across products and geographies.
- Firms should reassess their risk management models to guard against stress and report to supervisors on their efforts.
- The Basel Committee should study the need for and help develop firms' new stress testing models, as appropriate.
- Financial institutions should have clear internal incentives to promote stability, and action needs to be taken, through voluntary effort or regulatory action, to avoid compensation schemes which reward excessive short-term returns or risk taking.
- Banks should exercise effective risk management and due diligence over structured products and securitization.

Medium -term actions

- International standard setting bodies, working with a broad range of economies and other appropriate bodies, should ensure that regulatory policy makers are aware and able to respond rapidly to evolution and innovation in financial markets and products.
- Authorities should monitor substantial changes in asset prices and their implications for the macroeconomy and the financial system.

Promoting Integrity in Financial Markets

Immediate Actions by March 31, 2009

- Our national and regional authorities should work together to enhance regulatory cooperation between jurisdictions on a regional and international level.
- National and regional authorities should work to promote information sharing about domestic and cross-border threats to market stability and ensure that national

(or regional, where applicable) legal provisions are adequate to address these threats.
- National and regional authorities should also review business conduct rules to protect markets and investors, especially against market manipulation and fraud and strengthen their cross-border cooperation to protect the international financial system from illicit actors. In case of misconduct, there should be an appropriate sanctions regime.

Medium -term actions
- National and regional authorities should implement national and international measures that protect the global financial system from uncooperative and non-transparent jurisdictions that pose risks of illicit financial activity.
- The Financial Action Task Force should continue its important work against money laundering and terrorist financing, and we support the efforts of the World Bank — UN Stolen Asset Recovery (StAR) Initiative.
- Tax authorities, drawing upon the work of relevant bodies such as the Organization for Economic Cooperation and Development (OECD), should continue efforts to promote tax information exchange. Lack of transparency and a failure to exchange tax information should be vigorously addressed.

Reinforcing International Cooperation

Immediate Actions by March 31, 2009
- Supervisors should collaborate to establish supervisory colleges for all major cross-border financial institutions, as part of efforts to strengthen the surveillance of cross-border firms. Major global banks should meet regularly with their supervisory college for comprehensive discussions of the firm's activities and assessment of the risks it faces.
- Regulators should take all steps necessary to strengthen cross-border crisis management arrangements, including on cooperation and communication with each other and with appropriate authorities, and develop comprehensive contact lists and conduct simulation exercises, as appropriate.

Medium -term actions
- Authorities, drawing especially on the work of regulators, should collect information on areas where convergence in regulatory practices such as accounting standards, auditing, and deposit insurance is making progress, is in need of accelerated progress, or where there may be potential for progress.
- Authorities should ensure that temporary measures to restore stability and confidence have minimal distortions and are unwound in a timely, well-sequenced and coordinated manner.

Reforming International Financial Institutions

Immediate Actions by March 31, 2009
- The FSF should expand to a broader membership of emerging economies.
- The IMF, with its focus on surveillance, and the expanded FSF, with its focus on standard setting, should strengthen their collaboration, enhancing efforts to better integrate regulatory and supervisory responses into the macro-prudential policy framework and conduct early warning exercises.
- The IMF, given its universal membership and core macro-financial expertise, should, in close coordination with the FSF and others, take a leading role in drawing lessons from the current crisis, consistent with its mandate.
- We should review the adequacy of the resources of the IMF, the World Bank Group and other multilateral development banks and stand ready to increase them where necessary. The IFIs should also continue to review and adapt their lending instruments to adequately meet their members' needs and revise their lending role in the light of the ongoing financial crisis.
- We should explore ways to restore emerging and developing countries' access to credit and resume private capital flows which are critical for sustainable growth and development, including ongoing infrastructure investment.
- In cases where severe market disruptions have limited access to the necessary financing for counter-cyclical fiscal policies, multilateral development banks must ensure arrangements are in place to support, as needed, those countries with a good track record and sound policies.

Medium-term actions
- We underscored that the Bretton Woods Institutions must be comprehensively reformed so that they can more adequately reflect changing economic weights in the world economy and be more responsive to future challenges. Emerging and developing economies should have greater voice and representation in these institutions.
- The IMF should conduct vigorous and even-handed surveillance reviews of all countries, as well as giving greater attention to their financial sectors and better integrating the reviews with the joint IMF/World Bank financial sector assessment programs. On this basis, the role of the IMF in providing macro-financial policy advice would be strengthened.
- Advanced economies, the IMF, and other international organizations should provide capacity-building programs for emerging market economies and developing countries on the formulation and the implementation of new major regulations, consistent with international standards.

Trevor A. Manuel, MP Minister of Finance Republic of South Africa 18 November 2008

Colleagues,

The global economy is presently living through its deepest crisis since the Great Depression of 1929. Around the world, people's representatives like ourselves are engaging with the impact of this crisis on their respective mandates. I want to express sincere appreciation for this opportunity to address the National Assembly on what we know about this crisis. Earlier today we had an opportunity to discuss these matters in great detail with the members of the Portfolio Committee on Finance. Important as those discussions were found to be, we recognise that the challenges before us cannot be confined to one or other portfolio committee — the nature of the challenges is such that they affect the very fundamentals of all of our work — the crisis gnaws at the contract that we have with the people of South Africa; indeed it compels us all to ask about our ability to contribute to a deep and durable democracy that will lift millions of our people out of a life of grinding poverty.

First and foremost, this is a crisis of the developed world. Loose credit extension in the years since the dot-com bubble burst in 2001 and large fiscal deficits in the US have increased the debt of households and governments alike. These debt levels have become unsustainable. The popping of these bubbles has had and will continue to have a large global impact.

Many countries not at the centre of the current turmoil will suffer terribly and tragically. As firms in developed countries strive to repair their balance sheets, they tend to sell everything and repatriate resources back to their home base. This has implications for us as it has for many emerging economies, despite the fact that the epicentre of the crisis does not lie on our shores. The depreciation of our currency, the rand, in line with many other emerging market currencies is testimony to these developments.

Of particular concern is Africa. Strong rates of growth in recent years are at risk as commodity prices fall and countries are forced to pay back capital. These fears pose the risk that there will be greater demands for protection from fearful populations and, less benignly, cynical adventurers. This is the state of the world, and it cannot be allowed to continue.

Recent events

The causes of all this can only be paraphrased here today. Over the years, banks purchased vast quantities of loans used for house purchases in the United States. As interest rates were increased in 2006 and 2007 in that country, many of those debtors began to default, putting at risk the value of all the housing loans. This uncertainty has resulted in the share prices of financial and nonfinancial companies falling, affecting lending operations between the banks.

Financial institutions involved in property, such as Northern Rock, failed, while other institutions experienced increasingly large losses on their investments in the housing markets. Losses of $200bn were predicted in the early days of the crisis. Estimated losses now stand at an estimated US$1.4 trillion, according to the IMF.

Central banks in advanced economies responded by announcing coordinated action to address short term funding markets, establishing temporary currency swap arrangements, and injecting liquidity into the markets. Sovereign wealth funds were tapped for funding for UBS, Morgan Stanley and Merrill Lynch. Interest rates have been cut sharply.

These actions did little to stem the tide however. Investment banks in the US failed (Lehman Brothers), were bought for a song (Bear Stearns), or changed their regulatory stripes to access a deposit base (Goldman Sachs and Morgan Stanley). The US Federal Reserve provided AIG, a large insurance company, with support of approximately US$150 billion, made up of an initial equity stake of US$40 billion and the difference in various liquidity support measures.

Governments have committed about $4 trillion to support financial systems around the world. About US$661 billion of write-downs and losses have been acknowledged so far.[1]

The signs of spreading economic malaise are abundant:

- In the quarter to September 2007, Volvo sold about 42 000 trucks. In the same

[1] And concentrated in the United States and Europe:
US = US$410 billion, Europe = US$224 billion.

Wachovia	US$97 billion
Citigroup	US$68 billion
Merrill Lynch	US$58 billion
Washington Mutual	US$46 billion
UBS	US$44 billion

period this year, they sold just 175.

- The cost of dry bulk shipping charter rates (as per the Baltic Index) plunged 71.9 per cent in October.
- General Motor's share price has fallen 88 percent this year, to US$3, its lowest price since 1946.
- GM, Chrysler and Ford have requested a US$ 25 billion bailout as car sales in the US dropped 32 percent last month compared to a year earlier.

The world's equity markets have declined precipitously. Since October 1, 2008, the US Dow Jones Industrial Average has fallen by about 36 percent. Brazil's Bovespa has dropped by 45 percent. Russia's RTS has declined by 71 percent. Our JSE All Share Index has fallen by roughly 30 percent.

One of the great sources of ballast in the world economy has been the rapid economic growth of China, which has contributed on average 20 percent of world growth in the last 5 years. With a gigantic population and rapid economic growth, China has been both a great importer of raw materials and commodities from the rest of the world and a great exporter too. China's demand for commodities contributed to the commodity price boom the world experienced over the past 6 years.

But growth in China has begun to moderate, resulting in lower imports and putting downward pressure on commodity prices. Chinese GDP growth slowed to 9.0 percent in the 3rd quarter 2008 from 11.9 percent in 2007 and 11.6 percent in 2006. The IMF forecasts Chinese growth of 8.3 percent in 2009.

Commodity prices have responded quickly. The price of platinum has dropped 47 percent since January 1. Gold prices have fallen by over 13 percent. And oil prices have dropped by 31 percent. Coal prices remain 40 percent higher than they were in January, but have declined by 31 percent since October 1.[2]

Falling prices for oil and other commodities and the major outflows of capital from emerging markets in the middle of October signaled that we have entered a new phase of the crisis. Economic conditions have deteriorated worldwide. Despite this, the global economy will continue to grow in 2009, with all of the growth deriving from developing economies.

- World output to fall from 5.0% in 2007 to 3.7% in 2008 to 2.2% in 2009.
- Advanced economies GDP growth at 1.4% in 2008 and -0.3% in 2009.
- African growth expected at 5.2% for 2008 and 4.7% for 2009.

Impact of the international environment on South Africa

Commodity price changes alone have ambiguous effects on South Africa, but we should be under no illusions about the fact that our economy will suffer along with the rest of the world. The financial crisis is giving way to a real economy slowdown. Some countries will bear the full brunt of both the financial crisis — lending and borrowing has come to a halt — and the economic crisis — exports and imports will fall.

In South Africa we have experienced at least part of the financial shock. Our exchange rate has depreciated sharply and the prices of our equities and bonds have fallen far. Yet our sound and well-regulated banking system is not dependent on foreign lines of credit and our exposure to toxic assets has been nearly non-existent. Some firms with extensive international operations have seen losses, but even these have been small. Our public debt levels are low and our level of foreign currency debt is even lower. This helps to lower our vulnerability to financial shocks.
Global economic weakness in trade and investment however will have more farreaching effects. Declining commodity prices and lower growth in major trading partners will lower demand for South African exports and reduce the income we derive from them.

Only one part of our challenge is to ensure an appropriate short-term response. In the long-term, we need to ensure that our firms and our people are more proadverb, more export-oriented, and have higher saving and investment rates. We need to be able to achieve much higher economic growth rates with a sustainable current account.

It is becoming clear, however, that at least in the medium-term, our aspirations for more rapid economic growth and our capacity do not match.

[2] IMF food price index peaked in May 2008, 50% higher than a year earlier. Since May, food prices have declined by 14%.

Union Buildings, Pretoria

Walter Knirr/Solly van Staden: City of Johannesburg

Our policies have been appropriate to our macroeconomic challenges in recent years. We have set a monetary framework that targets a low and stable rate of inflation over the long-term. As a small economy we can expect that inflation will sometimes fall outside the target, and we have experienced such an occurrence this year and last from sharply rising food and oil prices. We are not alone in this — nearly all countries have missed their implicit or explicit inflation targets over this period. What matters is that we have a framework that is flexible enough to ensure that we re-achieve low inflation over time and with due regard for economic growth. The economic and social costs of a prolonged period of high inflation or deflation caused by wayward or ill-conceived monetary policies cannot and should not be tolerated by a democratic society.

On the fiscal side, we have endeavored since 2005 to raise saving in the economy and create fiscal space. We did this for two reasons. One was to offset the negative effects of rapidly-growing domestic demand on inflation and the competitiveness of the economy. The other was to create financial savings to expand demand should economic growth fall sharply.[3]

At this point in time, we can prudently maintain a healthy growth rate in government spending while keeping public borrowing modest and sustaining low long-term interest rates. As growth slows, however, it is likely to become more difficult to maintain a positive government saving rate. Continuing to focus spending on capital and public infrastructure helps to keep saving up, and so we have opted to continue to emphasise our public infrastructure commitments — the expansion of our energy production capability and to ensure readiness for the World Cup, among others.

Our good track record in financing investment in human capital — in health, education and skills development — will also be maintained. These commitments will help to raise the economy's growth rate in the present as investment spending is maintained, and in the future contribute to rising potential growth of the economy.

To close the gap between the 6 percent economic growth rates we aspire to and the realities of slower growth we are now experiencing requires a renewed effort to reform our economy.

Reform is needed to propel investment. Purchases of South African bonds and equities by foreigners accounted for almost half of South Africa's financing needs between 2002 and 2007. About US$20 billion per year is needed to finance the current account deficit. Continuing to attract foreign investment implies the need to maintain confidence in our macroeconomic policies and raise the growth rate of the economy.

Our dependence on foreign savings can be reduced over the long-term, but the only way to do this sustainably is to export more — to produce goods and services more productively and at lower cost than before and sell them abroad. This is where economic reform needs serious engagement by South Africans to make good long-term decisions.

There is no shortage of good and bad ideas. Our task is to find the good ones and move forward with policy articulation and implementation. Raising the cost of economic activity and restricting our ability to trade is not the right path for

[3] That is below the rate of growth that provokes inflation or an unsustainable current account deficit.

South Africa. We live in a world where our domestic industries, such as the domestic auto or metals industries, are intimately and irrevocably linked to the rest of the world. The indiscriminate dispensing of cash to firms that lobby for help will also not raise incomes and create jobs. We have made financing available for industrial policy — it is time that economically-sensible plans are articulated for public review and support.

Our focus on government's contribution to reducing the costs of economic activity and expanding infrastructure needs to be matched by investment and productivity growth in the private sector.

There is room for policy adjustment in a range of sectors to facilitate investment in new businesses and growth in employment, particularly in network industries. New power generation, greater responsiveness to environmental needs, expanding our access to advanced telecommunications, the redevelopment of water and transport infrastructure, among others, imply fertile ground for private and public partnership and new economic activity.

Let us be clear — the global crisis enjoins us to take forward our efforts if we intend to permanently reduce unemployment, increase incomes, and lower poverty. Our macroeconomic policies are sufficiently flexible to address a prolonged economic downturn, as demonstrated in the shift to a fiscal deficit in the MTBPS. We have a good understanding of what the international community is doing to combat economic weakness, and we understand the need to address our local economic challenges.

Reform of our international institutions

Our domestic efforts to address the global economic crisis need to find external resonance in the reform of the international financial architecture, in the reform of our multilateral institutions, and in the renewal of global commitment to mutual accountability. A coordinated international approach to the financial sector is also needed.

The international financial and economic crisis is in large part about the failures of national and cross-border regulatory regimes in assessing and managing the risks building up in financial institutions and systems. In Sao Paolo and Washington, at the G20, we discussed how to address these problems in a durable and credible way in coming months. On a national basis, it was noted that policy frameworks need to maintain fiscal sustainability — there is little gain to be had from a new massive build-up of imbalances. We cannot allow a crisis caused by a rise in debt and cheap credit to be followed in 10 years time with another crisis caused by the same thing.

To make headway, Ministers of Finance and Central Bank Governors have been asked to look at a range of issues in the financial markets, with deadlines set for next year. Particular attention needs to be placed on sound regulatory policies and the application of standards for accounting, auditing and transparency.

Each country will therefore have to develop its national plan, based on the common principles for reform. We will each have to assess to what extent both our fiscal and monetary policies support the internationally agreed principles. More importantly, we will need to ensure better co-ordination and co-operation not only between our own financial regulators, but between our regulators and those of other countries, particularly in regulating financial institutions that operate in more than one country. I will be convening a meeting of all our financial regulators, as well as the SA Reserve Bank and National Treasury, to ensure that as South Africa we give effect to the common principles for reform, and to facilitate our full participation in global standard-setting institutions and the Financial Stability Forum.

Colleagues, allow me to conclude. We have the good fortune of being able to stand on the shoulders of those who preceded us, and so we understand much about what has gone wrong in the world economy and what is required to deal with it. The effects however will be with us for the foreseeable future, and so we need to think carefully about how we reach our own domestic economic goals in this new environment. Our macroeconomic framework is sound and because of the choices we have made in the past, we have the resources and policy space to set an appropriate response to the evolving economic downturn.

We need however to address the microeconomic and regulatory constraints to more rapid economic growth. This implies a renewed social dialogue, one part of which will be the development of a national approach to financial markets regulation and reform. But addressing our long-term growth and employment challenges requires a broadening of that dialogue. Much needs to be done to achieve our aspirations of a country without poverty.

Global turmoil, local growth: sailing in unchartered waters

By: Raenette Taljaard

This week saw Trevor Manuel, the finance minister, pilot the fiscal ship of state through potentially uncharted waters with talk of a global recession looming, despite various bail-out efforts, as well as the prospect of an urgently convened summit of the world's top 20 economies on November 15 in Washington.

These events are developing in the dying days of the Bush administration and amid the United States presidential campaign and, domestically, within the dying days of the interim Motlanthe administration as we approach the 2009 poll.

There is uncertainty about who will be the new US treasury secretary, just as there is uncertainty about who will fill Manuel's shoes when the term of the current government expires.

A clear acknowledgement that we have not seen the end of the crisis has echoed across the influential opinion pages of the Financial Times in recent weeks.

Martin Wolf, a respected FT columnist and author, captured it perfectly on Wednesday: "Enough has now been done to prevent a meltdown of the financial systems of several advanced countries. More must be done, if necessary. But a long and deep global slowdown is still likely.

"Determined action is needed to limit these effects."

These are truly unprecedented global events to which we need to adjust, as Manuel reminded us this week when he tabled the medium-term budget policy statement.

Our currency's free-fall, along with those of other developing countries, has dramatically underscored our emerging-market status as well as our current account Achilles heel, which a recent International Monetary Fund (IMF) Article IV country report on South Africa has forecast to be as high as 9,6 percent of gross domestic product by 2009 and hovering above 9 percent until 2013.

As the IMF notes in its report: "In the near term, it will be critical to preserve macroeconomic stability by containing higher inflation and addressing external vulnerabilities so that the push to accelerate growth and spur job creation will not be derailed. More fundamentally, higher output and employment growth are needed to reduce still high unemployment and inequality."

We must ask ourselves crucial questions. What strategy can we adopt for a more labour-intensive growth path that will not be fiscally unsustainable or create warped industrialisation incentives that could create new sector-dependent growth that fails to adapt when new competitive sectors emerge globally? How do we even contemplate a labour-intensive growth path when we do not know the depth of what could turn into a global recession?

How do we meet the escalating and legitimate expectations of South Africans for improved standards of living without losing sight of the ongoing need to enhance, build and expand our country's reputation for prudent fiscal management given the role this reputation will play in securing any capital inflows at all at a time of growing emerging-market risk aversion?

Jacob Zuma, the ANC president, told the council on foreign relations in Washington that: "Our top priorities are to improve health and education, drastically reduce crime, maintain financial and macroeconomic stability, substantially improve efficiency in the public service by instilling discipline and accountability, and work with business and labour to create jobs in the private and public sectors."

Although much has been done to table various lists of priorities — both at Polokwane and at the Tripartite Alliance's recent economic summit — the difficult challenge of balancing needs and wants in the policy space that is again shrinking because of global forces will be formidable indeed for any post-2009 administration.

The IMF's recent Article IV country report on South Africa and a paper focusing on selected issues points to a host of factors that have been the main constraints to growth in our country over the past decade. These include our low investment rate, insufficient labour productivity gains, reduced openness to trade and slower technical progress.

In addition, the paper asks the crucial political question: can fiscal policy boost growth and employment in South Africa and result in a deficit-neutral compromise that does not distort macroeconomic stability?

The paper sketches two scenarios of policy initiatives. The first includes a package of reforms that cuts corporate income taxes by 2 percent; raises public investment by 1 percent of GDP and raises revenue to plug the resultant revenue gap by raising one percentage point of GDP via a mining royalty and also slowing the growth of government consumption expenditure.

The second takes the same steps and, in addition, cuts the average effective personal income tax rate by 1 percentage point to boost the supply of labour by income-tax paying workers. To maximise the labour supply effect, the cut can target the middle of the income tax scale, thereby lowering the marginal tax rate of sought-after skilled workers and small and medium-sized enterprises. This scenario introduces a 10 percent wage subsidy for low-skilled, lower-income workers.

The IMF stresses that the two policies are not substitutes as they target one of two household groups.

In addition to various other reports that the national treasury bequeaths a new post-2009 administration, these scenarios certainly create a solid basis for an informed discussion about how to go for growth and employment without harming macroeconomic stability.

With Parliament set to play an ever-increasing role in budgeting and policy debates, one can but hope that our public representatives will be up to the task of managing these various choices cautiously in a potentially altered global marketplace, where the developed world and emerging markets' destinies remain closely woven together and are not "decoupling" as some analysis has suggested.

Published on the web by Sunday Independent on October 27, 2008.

BUSINESSREPORT
NOVEMBER 19 2008

Steady as she goes, says Captain Manuel to Good Ship SA

Donwald Pressly
Cape Town

While South Africa is being flooded with ideas about how to handle the global financial crisis, finance minister Trevor Manuel sent a message to the nation yesterday that current fiscal and monetary policies are correct, and indeed have been protecting the nation against the "biggest crisis since 1929".

His key messages were that South Africans needed to become even more productive. They needed to save more and export more competitively, while the state needed to ensure borrowing was limited.

Speaking in the national assembly, Manuel said there was no shortage of good and bad ideas. "Our task is to find the good ones and move forward with policy articulation and implementation. Raising the cost of economic activity and restricting our ability to trade is not the right path for South Africa. We live in a world where our ... domestic auto or metals industries are intimately and irrevocably linked to the rest of the world."

Manuel said the "indiscriminate dispensing of cash" to firms that lobby for help would not raise incomes and create jobs. "We have made financing available for industrial policy – it is time that economically sensible plans are articulated for public review and support."

He said current policies had been appropriate to South Africa's macroeconomic challenges in recent years. "We have set a monetary framework that targets a low and stable rate of inflation over the long term." As a small economy, he said, "we can expect that inflation will sometimes fall outside the target. We are not alone in this."

He said South Africa had experienced "at least part of the financial shock". This included a sharp depreciation in the rand exchange rate and the plunging prices of equities and bonds.

Earlier in the day, Manuel had told members of the finance portfolio committee that his office had been inundated with requests from countries that wanted to study the national credit legislation.

While local household debt levels were not nearly as bad as in the UK and the US, he was concerned about conspicuous consumption, which led people to purchase, for instance, a R1 million car "to be somebody".

He said the Germans had the right attitude: they had learnt from the crisis of the 1930s to save in order to spend. He suggested that perhaps the Chinese had gone overboard with the principle of "save to save".

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Trevor Manuel, the minister of finance, says current policies have shielded the country from the worst of the storm PHOTO: BLOOMBERG

Treasury sticks with 3.7% growth

The treasury reiterated its October 21 forecast that the economy would grow about 3.7 percent this year, even as the global financial crisis deepened.

"The projection is that we will come in at 3.7 percent or 3.8 percent growth this year," Lesetja Kganyago, the treasury's director-general, told parliament's finance committee yesterday. "A gap is emerging between what we need and what we are likely to achieve. In the long term, we need to be more productive, more export-oriented," he added.

While South African banks have emerged relatively unscathed from the crisis, the rand and stock prices have fallen as investors shun riskier emerging markets.

While the weaker rand would bolster the competitiveness of exports, it would also partially offset the benefits that lower oil and food prices had on inflation, said Kganyago.

It said fiscal policy should be used to offset short-term economic slowdown, while the government should cut the cost of doing business though investing in infrastructure.

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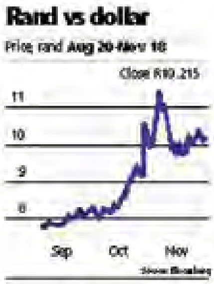

BUSINESSDAY
NOVEMBER 19 2008

Manuel warns of danger of leftward policy shift

With harsh steps 'we won't get the money we need for growth'

Linda Ensor
Political Correspondent

CAPE TOWN — Finance Minister Trevor Manuel yesterday added his voice to warnings that the ruling African National Congress's (ANC's) leftist allies risked damaging the national economy by pressing for policies that would dampen growth and drive away desperately needed foreign investment.

These policy proposals relate to the reintroduction of foreign exchange controls, harsh measures against foreigners, the abolition of inflation targeting and others that would increase the cost of doing business.

Treasury director-general Lesetja Kganyago also stressed the need for prudence in the context of a global economic slowdown when he told Parliament's finance committee that "it will not serve anyone any purpose to be adventurous with macroeconomic policy".

Their comments endorsed the view of several economists that the left-wing fiscal and economic views expressed by ANC politicians and trade unionists were causing uncertainty among foreign investors, and would harm SA's growth.

Uncertainty over future policies has resulted in the recent downgrading of SA's credit rating by two rating agencies, though the treasury has rejected their reasons.

Foreign inflows are critical to finance the deficit on the current account of the balance of payments, which will be under increasing pressure as commodity prices and exports slump on sluggish world demand.

"About $20bn per year is needed to finance the current account deficit. Continuing to attract foreign investment implies the need to maintain confidence in our macroeconomic policies and raise the growth rate of the economy," Manuel said in a speech on the global crisis.

Earlier, he warned committee members that if "people make calls for foreign exchange controls, and if we impose harsh measures on foreigners, we won't get the money we need for economic growth".

Calls for inflation targeting to be abandoned to make cheap credit available would result in the same crisis as in the US, which had its origin in copious amounts of cheap credit being made available relative to savings, Manuel said.

"The economic and social costs of a prolonged period of high inflation or deflation

US Treasury Secretary Henry Paulson testifies at the financial services committee hearing on Capitol Hill in Washington yesterday. Paulson said the unpredictable nature of the financial crisis meant it was necessary to ensure that financial bail-out money was not diverted to other uses. The Troubled Assets Relief Programme was designed to stabilise financial markets and the flow of credit, and 'is not a panacea for all our economic difficulties', he said. See Page 10 Picture: REUTERS

Profit warnings put damper on global markets

Stephen Gunnion
Markets Editor

CONCERN about the effect of the deepening recession on corporate profits sent stock markets reeling again yesterday as Japan warned its economy would retreat next year and inflation eased more than expected in the UK and the US.

Banking shares bore the brunt of the negative sentiment in Europe and Asia after Monday's announcement of large-scale staff cuts at Citigroup.

Resources shares dragged the JSE lower on worries that the global downturn would weigh on demand for the foreseeable future.

However, markets staged a last-minute turnaround after the US market opened higher on better than expected results from computer maker Hewlett-Packard and home improvement chain Home Depot. Comments by US Federal Reserve chairman Ben Bernanke also helped comfort investors.

In another volatile day:

- Share prices around the world fell on mounting prospects of recession;
- Japan warned its economy might contract in fiscal 2009-10;
- The US Federal Reserve chairman said the US credit market was improving;
- Barclays said its top executives would forgo annual bonuses;
- Japan's Nikkei average slipped 2,3%; and
- JSE-listed resources stocks tumbled 4%.

Bernanke told the House of Representatives financial services committee there were signs that credit markets, while still strained, were improving. "Overall, credit conditions are still far from normal."

UK and US inflation figures worried investors.