# CHAPTER ONE

# INTRODUCTION AND JUSTIFICATION FOR THE STUDY

## 1.1 Background

Various arguments have been advanced in favour of trade liberalisation. The Heckscher-Ohlin theory maintains that free trade encourages specialisation in the production of goods in which a country has a comparative advantage. Specialisation in the production of goods in which a country has a comparative advantage promotes efficiency in the allocation and use of resources which in turn facilitates trade and improved welfare. Even factors of production used in the production of tradeable goods are said to benefit from trade through the equalisation of factor prices internationally (Samuelson, 1948).

The belief that an outward oriented trade policy is superior to an inward-looking or protectionist stance has been vociferously argued in the economic growth literature (Krueger, 1998; Dollar, 1992; Sachs and Warner, 1995). Wang and Winters (1998) argue that this is also the case for Africa. While the notion that export production is conducive for economic growth is well established, the path to export production has been contested in the economic literature. The East Asian experience has shown that the path to export production may indeed be via import substitution (Amsden, 1989; Wade, 1992; Ocampo and Taylor, 1998). Further, new trade theory with its emphasis on imperfect competition, economies of scale and more recently on geographic influences on trade patterns, has shown that comparative advantage may not be solely dependent on factor endowments. Strategic interventions may be required to secure comparative advantage in the production of certain goods and services. The belief that trade liberalisation is desirable is based on the notion that it promotes efficiency gains in the allocation and use of factor resources.

However, the link between trade liberalisation and economic growth has been questioned (Rodriguez and Rodrik, 1999; Hanson, 1998).[1] The consensus in the academic literature is that when protection is justified, empirical evidence (as in the case of the East Asian experience) and theoretical considerations (e.g. new trade theory) dictate the use of selective rather than “across the board” protection.[2] It could be argued that this is, and has always been the case in practice. The policy of protection is almost always selectively applied in the sense that differing rates or forms of protection are accorded to industries.[3]

Even, liberalisation within the context of the rules of the World Trade Organisation (WTO) is usually not uniform across industries or sectors, which in some sense, confirms the use of the selectivity criterion in the application of the policy of protection. If selective intervention has been the characteristic of trade policy then why has it not been successful? The answer lies in the selection of industries that are protected, the policy instruments used and the magnitude of the protective measures implemented. In addition the impact of policy depends on prevailing market conditions. Hence, it is imperative that the impact of policy is evaluated in order to ensure that the perceived benefits have been realised. This study attempts to do this. It analyses whether a specific objective of South Africa's trade liberalisation during the 1990s, namely, to promote competitiveness, has been realised.

## 1.2 The rationale for trade liberalisation in South Africa

Since the early 1970s there has been an emphasis on export-oriented industrialisation in South Africa. The policy during the 1970s and 1980s was to promote export production mainly through the granting of export incentives. The Reynders Commission, for example, while recommending a diversification of the export base away from gold exports did not view import liberalisation as a necessary condition for non-gold export production (Bell,

[1] However, the main critique rests on the tests undertaken in the study rather than on the proof that trade liberalisation does not lead to economic growth.
[2] Although, Krugman (1987) argues that free trade should be preferred as a rule of thumb since the scope for strategic policy is very limited.
[3] The issue boils down to getting the selection right, which is the crux of economic policy.

1996: 71). In 1972, a tax allowance for export marketing expenses was one of the first direct export incentives introduced by the government. This was followed by a new system of export incentives introduced in September 1980.

By the beginning of the 1990s, the official policy stance was one of export-oriented industrialisation. The General Export Incentive Scheme (GEIS) was introduced on 1 April 1990 with the objective of encouraging the production of value added exports. However, while export subsidies were used to reduce the anti export bias in the economy, the view that the path to export production should entail trade (and more specifically tariff) liberalisation began to gain ground. This is evident in the recommendations made by an official investigation into South Africa's tariff protection policy.

> *"The reduction of import tariffs is therefore an integral part of a process of progress towards export orientation" (IDC, 1990: i–ii).*[4]

With the transition to democracy in South Africa, the policy of an export oriented trade strategy underpinned by tariff liberalisation was firmly entrenched. This is clearly borne out in the Growth, Employment and Redistribution (GEAR) strategy, which asserts that:

> *"…sustained growth on a higher plane requires a transformation towards a competitive outward-oriented economy" (*RSA, 1996: 3)*.*

South Africa's growth prospects depended on:

> *"…strengthening the competitive capacity of the economy in the long term"* (RSA, 1996: 7).

In this regard trade policy was important. More specifically, trade policy was to be characterised by:

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[4] The minister of trade, industry and tourism commissioned the Industrial Development Corporation, in collaboration with the Board of Trade and Industry, to *"…investigate the efficacy of the existing tariff protection policy" (IDC, 1990: ii).*

*"…a reduction in tariffs to contain input prices" (*RSA, 1996*: 4).*[5]

The stated intention of government's trade policy during the 1990s is elegantly summarised in a recent policy document in which it is asserted that:

> *"…significant trade reforms took place in order to open the economy and create opportunities for growth and improved competitiveness…In general, the tendency was towards a lowering and simplification of tariffs. This process took place from 1995 and was largely completed in 2002" (DTI, 2002: 11-12).*

From the above analysis, it is apparent that the justification for South Africa's liberalisation policy was based on the notion that protection (e.g. tariffs) resulted in price distorting effects, which adversely impact on competitiveness. Viewed in this way, tariff liberalisation is meant to ensure price or cost competitiveness. Given South Africa's re-entry into the global arena with the ending of sanctions in 1990 and the wide ranging tariff liberalisation programme agreed to under the WTO agreement, South Africa's liberalisation programme of the 1990s provide fertile ground for an analysis of whether tariff liberalisation did in fact result in improved competitiveness.

### 1.3 A brief review of the empirical work on the effects of tariff liberalisation during the 1990s

Historically, the development of the manufacturing sector was based on a policy of import-substitution for infant industry (Holden, 1992, 1995). Empirical evidence reveals that there has not always been a robust positive relationship between foreign trade and economic growth in South Africa (Strydom, 1995a).[6] This is especially the case for the period 1981-91 (Strydom and

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[5] It is interesting to note that the objective of striving for international competitiveness is not meant to be isolated from social objectives. In fact one of the stated intentions of economic policy is *"to support a competitive and more labour-intensive growth path"* (RSA, 1996: 7).

[6] For a review of South Africa's earlier trade policy stance see *inter-alia* Scheepers (1982); Holden (1992); Bell (1993, 1997) and Belli et al (1993).

Fiser, 1995) when South Africa's international competitiveness deteriorated quite significantly relative to earlier periods (Holden, 1993).

Trade liberalisation has been a characteristic of trade policy since the early 1970s with the reduction of quantitative restrictions being the main policy instrument as far as imports were concerned (Bell, 1997). By the early 1990s there was strong support for South Africa's industrial strategy being spearheaded by comprehensive tariff reductions (IDC, 1990; Levy, 1992). Bell (1993) contends that this support was motivated by political economy considerations given that it was a foregone conclusion that there was going to be a change in the political regime.[7] However, the extent to which political economy considerations influenced the tariff liberalisation process is difficult to determine given the strong presence of the African National Congress (ANC) within the National Economic Forum (NEF) which was tasked with determining the offer to the General Agreement on Tariff and Trade (GATT).

South Africa's tariff liberalisation began in earnest with the offer to the GATT in 1994 and implementation in 1995. In terms of this offer there was a concerted effort to rationalise the tariff schedule (IMF, 1998,) from one that was amongst the most complex in the world (Belli et al, 1993) to one that *"…substantially liberalized the economy through import tariff reform"* (Tsikata, 1999: 1). There was a firm belief that the GATT offer promoting import liberalisation through tariff reductions was conducive to the promotion of the manufacturing sector and the economy as an whole (Joffe et al 1995; DTI, 1995).

It has been argued that despite a large increase in import penetration with trade liberalisation there is no evidence of de-industrialisation (Fedderke and Vaze, 2001; Tsikata, 1999). Trade liberalisation is also credited with having promoted efficiency in the manufacturing sector production (IMF, 1998: 48). However the IMF study acknowledges that while there exists a strong positive

[7] Bell (1993) cites Michaely et al (1991) who found that a trade liberalisation programme is usually implemented with a change in political regime in developing countries.

correlation between trade openness and productivity growth in South Africa, total factor productivity of the manufacturing sector has lagged behind that for the economy as a whole, mainly due to the high levels of effective protection in the manufacturing sector (IMF, 1998: 50). Tsikata (1999: 19) asserts that trade liberalisation caused a shift in relative prices and incentives with a result that "…exports of manufactures have expanded rapidly and become more diversified".[8]

It has also been found that export oriented sectors have achieved higher levels of output and productivity gains than import-competing sectors, thus suggesting that tariff liberalisation was beneficial (ILO, 1998). This study also claims that since employment was in decline before 1995, employment losses cannot be mainly attributed to trade liberalisation. Using firm level data on applications made to the Board on Tariffs and Trade (BTT), Holden and Casale (2000) find that the BTT, in granting protection during the period 1990-98, was sensitive to the adverse effects of the tariff liberalisation process, particularly with regard to employment considerations.

However, the benefits of tariff liberalisation have been contested. Roberts (2000) argues that tariff liberalisation failed to promote economic growth, improve trade performance and create employment. Although export-oriented companies have increased their investment rates, the contribution of rising exports to the growth trajectory during the 1990s, particularly in terms of output and employment, has been disappointing (Holden, 2001b). The government (DTI, 2002: 24) has also confirmed that the industrial policies have not had the desired impact on the growth rate and employment creation. From 1990 to 2000, manufacturing value added (MVA) increased at an average rate of 1.5 percent, significantly lower than the overall economy (2.2 percent) and the services sector (2.8 percent) (TIPS, 2002). MVA remained fairly constant for this period, while there was a steady increase for the services sector since 1995. In addition, contrary to expectations, exports were

[8] Tsikata (1999: iv) cites that the food, textiles, clothing and footwear were the exceptions. These sectors experienced declines in exports.

not unskilled labour intensive (Tsikata, 1999; Lewis, 2001). This is taken to mean that *"South Africa is not taking full advantage of its comparatively abundant labour supply"* (Tsikata, 1999: v). However, if a distinction is drawn between South African trade flows to developed and developing or emerging countries, then this contradiction does not exist. Exports are unskilled labour intensive to developed countries, but skill intensive to developing or emerging countries (IMF, 2000). In addition, the limited employment creation that has resulted during the 1990s, has been biased towards skilled workers, suggesting that the full potential from expanding trade has not been realized (Lewis, 2001).[9] Fedderke (2001) and Edwards (2001) argue that trade has had a positive impact on employment creation, but technological factors have offset some of the gains from trade.

Analysis of changes in South Africa's competitiveness has been done on the basis of international cost and price comparisons. The empirical work has concentrated on international competitiveness by analysing movements in the real effective exchange rate (REER) or labour cost comparisons. Declines in the REER have served to increase the competitiveness of South African exports (Fallon and De Silva,1994; Tsikata, 1999; Golub, 2000).[10] Unit labour cost (ULC) comparisons show that South African labour costs are competitive relative to developed countries, but uncompetitive relative to developing countries (Golub, 2000).[11] In addition, cost competitiveness is found to be a strong determinant of manufacturing export volumes (Golub and Ceglowski, 2002). While relative unit labour cost and REER comparisons are common in the analysis of competitiveness, it is important to realise that they are highly sensitive to exchange rate changes and as such may mask the effects of trade policy on competitiveness. Also, an aggregate competitiveness indicator (like the REER and ULC) may not accurately depict competitiveness at the sectoral level, particularly for countries like South Africa where production

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[9] Bhorat (2000) has found similar results for the period 1970-1995.

[10] For a review of the methodological issues relating to the calculation of the REER for South Africa see (Kahn, 1998; Walters and de Beer, 1999).

[11] The study found that while South Africa's labour productivity was lower than that of developed countries, the labour costs were relatively much lower with a result that South African labour costs were competitive *vis-à-vis* developed countries.

may be commodity intensive (Wood, 1995; Bell et al, 1999). The empirical analysis to date on the South African economy has also not specifically analysed the impact of trade liberalisation on the REER and ULC.

To date the empirical work on South African trade policy has produced mixed results. Hence *"…the impact of trade policy reform on the South African economy remains a contentious issue"* (TIPS, 2002: 55). Against this background, empirical work on the effects of trade policy reform will be of particular relevance for policy makers and academics in the foreseeable future.

## 1.4 The main and sub hypotheses of the study

As highlighted above, significant trade (tariff) liberalisation has been undertaken during the 1990s in order to promote competitiveness. However, the role of tariff liberalisation in promoting competitiveness has not been explicitly analysed. In fact, government has recently stated that:

> *"…there is a need for a thorough review of the role of tariffs in competitiveness"* (DTI, 2002: 33).

This study attempts to do just that. The main hypothesis that will be analysed in this study is:

> South Africa's tariff liberalisation policy in the 1990s has contributed to improved competitiveness of the South African manufacturing sector.

This will be accomplished through a critical appraisal of the following sub-hypotheses:

- The trade incentives of the 1990s created a significant anti-export bias in manufacturing production.
- Tariff liberalisation gave rise to the anticipated price effects as measured by the real exchange rate (RER).

- Tariff liberalisation had a significant positive impact on price competitiveness in South Africa.

## 1.5 Research Methodology

The methodological and analytical basis for this study is drawn from the empirical literature focusing on trade liberalization and economic growth. An extensive review of the theoretical and empirical literature underpins the analysis for the South African manufacturing sector. Descriptive statistics and econometric techniques are used to derive the results in this study. An econometric model is constructed which forms the basis of the test of the main hypothesis. The methods and analytical techniques employed in the study are highlighted in each of the chapters in which they are used and their limitations are also clearly spelt out. Graphic illustrations and tables also support the results obtained in this study. The policy implications of the results and areas that warrant further research are highlighted in the last chapter.

## 1.6 Structure of the study

The study is structured as follows:

- Chapter 2 undertakes an analysis of trade theory and it's implications for competitiveness. This chapter highlights the policy implications for competitiveness of the different trade theories.

- Chapter 3 provides a critical appraisal of the theory of protection and it's implication for competitiveness. This chapter considers the empirical evidence on the links between tariff liberalisation and competitiveness and also provides a definition of the concept of competitiveness that underpins the empirical analysis in this study.

- Theory stipulates that the extent of tariff liberalisation will influence competitiveness. Recently it has been asserted that *"…more of South Africa's output is protected by tariffs in 1998 than in 1988"* (Fedderke and Vaze, 2001:447). Chapter 4 critically analyses the extent of tariff liberalisation during the 1990s in the light of this assertion.

- Within a two sector model (tradables and non tradables) the price raising effects of import protection serve as a disincentive to export (anti-export bias). Chapter 5 evaluates the conventional measure of anti-export bias within a three sector model (importables, exportables and non-tradables) for South Africa during 1990s. In this chapter a test of the hypothesis of whether the trade incentives of the 1990s created a significant anti-export bias in manufacturing production is undertaken.

- Chapter 6 considers whether tariff liberalisation effects have fed through to the prices of domestic producers. The hypothesis that tariff liberalisation gave rise to the anticipated price effects as measured by the real exchange rate (RER) is tested in this chapter. The results of this chapter provide the first tentative indications of the impact of tariff liberalisation on price competitiveness.

- Chapter 7 extends the analysis of the previous chapter by considering a more rigorous econometric analysis of the impact of tariff liberalisation on prices and competitiveness. Panel data evidence for the manufacturing sector for the 1990s is considered. The methodology employed incorporates recent developments in the application of unit roots and cointegration in panel data estimation. This chapter tests the hypothesis that tariff liberalisation had a significant positive impact on price competitiveness in South Africa.

- Improved competitiveness could entail a change in the composition of products produced (e.g. production of higher technology or higher value added products). Chapter 8 attempts to ascertain if the production of the trade liberalising sectors displays any characteristics of improved competitiveness.

- Finally, some conclusions and policy recommendations are made in chapter 9.