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SOUTH AFRICA AT TWENTY

Where are we on the road to transformation, the view from abroad on SA's economy and what SA's business leaders believe will be a winning agenda to unlock growth, equity and jobs in South Africa

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Ladies and gentleman, thank you for giving me this opportunity to speak with you today.

As we approach South Africa's fifth democratic elections, as a nation we are all taking stock of what we have achieved – and what we need to do next. The world too has turned its gaze towards South Africa and asked the question: "what are we doing to advance President Nelson Mandela's legacy?"

The volatility of the Rand over the last few days and weeks has just given added impetuous to these questions.

In an Oped for Business Day, 5 November 2013, titled "***Take pride in what we have achieved - and raise the bar***", I argued ..."***when the US Federal Reserve tapers its bond purchase programme, developed markets' yields will rise and growth markets are likely to sell off. The anticipated tapering of quantitative easing means the time of easy money is over. SA must act fast to raise its game***."

As events in Davos concluded last week with the nasty shock of the capitulation and sell off of growth market currencies, particularly the Argentina Peso, and to a lesser extent Turkish Lira and the South African Rand, WEF delegates went home conscious of the arrival of a new phase of a re-pricing of growth market assets.

SO, WHERE ARE WE ON THE ROAD TO ECONOMIC TRANSFORMATION?

To recap, the Goldman Sachs Report *"Two Decades of Freedom - a 20 Year Review of SA"* identified key structural advances in our economy since April 1994:

- GDP almost tripled from \$136bn to \$400bn today;
- Inflation fell from a 1980-1994 average of 14% to an average of 6% from 1994-2012;
- Gross Gold and FX Reserves rose from \$3bn to a prudent \$50bn today;
- Tax receipts of R114bn from 1.7m people rose to R814bn from 13.7m people;

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- In the last decade a dramatic rise in the middle class with 4.5m consumers graduating upwards from the lower (1-4) Living Standards Measure (LSM) and in total 10m consumers added to the middle – higher LSMs (5-10); and

- Social grant beneficiaries rose from 2.4m to 16.1m people today.

The Report also highlights significant challenges including:

- Unemployment remains stagnant at 25% from the 23% inherited in 1994, concentrated amongst the youth;

- The majority of Africans remain in the lower income categories whilst the vast majority of white people remain in the middle to upper class categories;

- The current account deficit of now 6.8% is one of the highest amongst global peers, placing SA in the exposed company of other twin deficit countries;

- The contribution of mining and manufacturing to GDP has fallen to 23% now from 38% in 1986;

- Household debt to disposable income soared from 57% in 1994 to 76% now;

- Real wage inflation across the economy of 3% per annum was recorded over the two decades of democracy, whilst in the mining sector wage inflation in the decade 2001 -2011 was 11% per annum just as PGM productivity declined 4% per annum over the period; and

- The public sector, despite increasing to two million employees, and significantly increased spending has seen its contribution to GDP fall from 19% in 1994 to 15% today.

Interest in the Report has been widespread locally and abroad, and most recently at the World Economic Forum in Davos. The global demand for the Report has also been widespread amongst Goldman Sachs clients, both corporate and institutional.

THE VIEW OF SOUTH AFRICA FROM ABROAD

Seen from abroad many investors are positively surprised when reminded by the report of the progress recorded in the fiscal and monetary environment, the associated rise in the size, sophistication and depth of the economy and SA's capital markets, and the significant gains made both in the cash and non cash (free services) transfers for the poor and the rapid rise of the middle class. They are also encouraged by the adoption by the South African Government of the National Development Plan (NDP), and by the overall respect for the rule of law and the Constitution. And, the promise of a fast growing neighbourhood of Sub Saharan Africa is certainly catching attention.

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Yet many are equally concerned by the current twin deficit, the persistent labour strife exemplified by the platinum sector strike, a low growth environment with rising inflationary pressures, social service delivery protests, the inefficiencies and corruption in the public administration and instances of anti-competitive behaviour in the private sector. Many also suspect that the Government either lacks the political will to implement the NDP, or more likely lacks the skills and institutional capacity to execute on it. Some now even question South Africa's position as the best platform for investing in the African growth story.

SO, HOW DO THE OFFSHORE EQUITY INVESTORS CURRENTLY SEE SA?

- Growth / momentum institutional investors are currently the least persuaded by the South African story. This reflects both concerns at the weak and weakening Rand on the one hand, and on the other, the weak overall economic growth performance projected into a lacklustre corporate earnings outlook. This is not unique to South Africa. A similar slowdown in other growth markets such as Turkey is forecast as their Central Banks start to increase interest rates. Ultimately this is likely to result in an economic slowdown.

- Cash flow oriented / Value investors continue to approach their South African investments with a deep fundamental approach and constructive outlook. Their concern over the macro conditions in the political economy has resulted in their applying a higher discount to their SA investment thesis and ultimately looking for cheaper valuations to increase investments. Liquid, well managed companies with well understood equity stories are at the top of the add - on list.

- Amongst certain mining investors, and many specialist Mining funds, South African Mining has become almost "untouchable" as a result of the persistent labour strife. Some deep value investors do however make the point that at some stage, should the labour issues be resolved, the Platinum Group Metals (PGM) sector may once again become an appealing investment sector.

- Lastly, hedge funds in particular continue to believe that the SA banks are broadly exposed to the unsecured lender credit pressures and that these pressures will contaminate their loan growth and Non-Performing Loan ratios and in turn their earnings and return outlook.

AND WHAT ABOUT THE RAND? HOW DO THE OFFSHORE INSTITUTIONS SEE OUR CURRENCY?

- Last year a lot of the outflow that pushed the Rand weaker was a combination of speculative interest in the context of a tapering environment, a reduction of overweight offshore bond positions, as well as active "overlay hedging" from real money investors that were long South African equities and bonds.

- 2014 has so far been somewhat different: portfolio flows in both bonds and equities have been very disappointing. Since the start of the year there have only been four days of positive inflow into the bond market, totalling R1.5 billion (vs bonds outflows of almost R7 billion). The equity

market is slightly better, but has still seen net outflow of around R1 billion for the year to date and only six positive days of inflow. Compare this with the anecdotal reports of corporate interest in the market which have been universally one way (buying USD) since the beginning of the year. In other words, what we are experiencing is the impact of a 6.8% current account deficit in the absence of portfolio inflows.

- Clearly the sentiment with respect to the US Dollar in an environment of tapering, expectations regarding the potential near term performance of growth markets generally, and more specifically concerns over the perpetual labour issues in SA, particularly in the mining sector, are all combining to produce a fragile sentiment with respect to emerging market assets generally and for South Africa. This means that the opportunistic inflows that we would have expected to come in and support the currency in the past, are simply not materialising.

Ultimately the "shorts" seems to be continuing to focus on those countries which maintain significant current account deficits and that were overly reliant on portfolio inflows as the primary source of their financing. The "early adopters" of a more hawkish monetary policy stance (Brazil, India, Indonesia) have seen their currencies stabilise in the last six weeks, whereas those viewed as continuing with real rates that are too low to attract or even keep hold of capital continue to weaken. Turkey and South Africa's interest rate actions this week places the spotlight further on the unfolding re-pricing of growth market assets and their relative attractiveness.

Unlike other key emerging markets (EM) the SARB established an Inflation Targeting (IT) framework in 2000. The framework has been effective in managing inflation (and deflationary) pressure, anchor inflation expectations and supporting growth in the past fourteen years. We expect the SARB to continue to maintain its measured approach to any future rate action and focus on the inflation and growth outlook consistently within its IT framework.

<u>SO WHAT OVERALL IS THE SCORECARD FROM ABROAD?</u>

The good

Quality of institutions - the trust and confidence from offshore investors, particularly in the South African Reserve Bank (SARB) and the Ministry of Finance, is probably greater than for any other emerging market. This makes investors more tolerant of volatility and short term negatives. Investors derive comfort from the transparency and integrity of policy makers, as well as their openness and accessibility.

The not so good

Skills shortages - this appears to be one of the most consistent issues preventing greater levels of Foreign Direct Investment (FDI). A lot of FDI that does come in, does not do so with a view to using SA as an export base. Unit labour costs are perceived to be too high compared to productivity. Put simply – SA could only afford higher wage growth in line with productivity improvements. We have lost competitiveness not only because the rand was too strong, but because there was an insufficient skilled

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labour. The link between productivity growth, improving education levels and better relations between labour and management is clear.

The could do better

Foreign investors want to see a labour legislation framework that gives workers and unions better representation, but at the same time prevents unions from crippling businesses or even industries. The fact that the same, extremely damaging, stand-off between the unions and the employers continues every year shows that this is an area that still requires attention and new policy initiatives. The government's own efforts to directly intervene in order to mediate are very welcome, but sadly cannot on their own address the fundamental structural fault lines in the labour law architecture.

The can't do much about

Current macroeconomic mix: high and growing twin deficits, high inflation and dependency on portfolio inflows. These are partly the result of external drivers and partly the result of past policies. But either way, there is little that policy makers are perceived to be able to do to alleviate the issues in the short term.

Domestic macro mix: The sustainability of a ~ 7% current account deficit and a ~5% fiscal deficit with unemployment at ~25% and growth at ~ 2% is questioned. While at the same time inflation is at risk of piercing the upper end of the targeting band in a global environment of rapidly declining portfolio flows into emerging markets. Policy makers at both treasury and the Reserve Bank are therefore limited in the responses that they can adopt to turn the tide in the short term.

A WINNING TEN POINT AGENDA: VIEWS FROM DOMESTIC BUSINESS LEADERS

To recap, our *"Two Decades of Freedom"* report pointed to the following key issues for SA to address:

Driving economic growth through:

- Revitalising the mining and manufacturing sectors, and driving new frontiers for growth;
- Building economic linkages with Africa, and creating visible economic wins from BRICS;
- Driving investor confidence and targeting $5-10bn in FDI per annum;
- Driving innovation via increased spend on R&D and investing in expanding technology;
- A common effort to protect the rate & cost of capital and SA's credit rating; and
- Defending the rise of the African Middle Class

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Labour Pact for

- Sustainable growth and Employment; and
- Balancing wage inflation with productivity growth.

Public sector

- Creating fiscal space by optimising state assets, particularly focused on SOEs;
- Productivity: "bang for buck" especially in the areas of health and education outputs;
- Exercising good management practices and professionalizing the public administration to meet its performance requirements;
- Education fit for employment;
- Special focus on unemployed/ unemployable youth; and
- Leadership driving a culture of accountability and teamwork.

In anticipation of the President's State of the Nation speech on the 13th of February, closely followed by the Finance Minister's Budget Speech, I asked 15 CEO's from JSE top 40 companies what initiatives they would like to see launched in 2014. In particular what do they believe would unlock earnings growth, investment and jobs in their businesses and in turn lift the performance of SA Inc. as a whole.

In aggregate our discussion with the CEOs produced a ***ten point agenda for unlocking earnings growth, job creation and capital investment.***

1. *A complete overhaul of SA's labour relations architecture*. Universally, the view amongst these business leaders is the current system, built on the Western European model, is "just not working for South Africa" and is proving destructive to job creation and productivity. The dysfunctional conflicts within the union movement aside, the effect of the current labour relations system is higher real wages for fewer workers, lower productivity and job losses for more and lower exports. Overall this is an unsustainable recipe for the country.

A less restrictive, more responsive labour system with a partnership approach between business, government and labour designed to avoid strikes, drive job creation, attract investment and skill both the workforce and the feedstock for the workforce is needed. Business can support and help resource training, artisanship's and apprenticeships to develop skills for work, and work closely with schools and FET colleges. When strikes do occur they should require secret strike ballots and be a last, not a first, resort.

Wage inflation should increasingly be tied to productivity gains and incentives aligned. A conversation between unions and managers on sharing both the costs of production and the profits should be encouraged so that all the stakeholders drive shared interests to grow their companies.

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Some believe that this requires a New Labour Commission, while others believe we cannot afford the time and need an immediate action orientated initiative to implement the required changes.

2*. Lifting the administrative burdens on business*: "Bureaucratic Overload!" is the battle-cry. Business feels stifled by the degree of regulation and the exhaustive procedures of the regulatory authorities. Amongst an already stretched agenda the transformed public administration has to review, and business has to comply with, onerous license regimes, empowerment requirements, complex planning consents, customs clearing procedures and immigration procedures for hiring skilled expats. And amongst those procedures lurks the shadowy threat of the long arm of corruption. The simplification of these procedures and the "professionalization" of the public administration would lower the costs and increase the speed of doing business in South Africa.

One example is to "make it easy" for expats to move into South Africa or other African countries to perform work. "If we run South Africa like we are hosting the World Cup every day, not just for a fortnight once every hundred years, it would make us a winning nation".

3. *A flexible and responsive Trade Policy*: an example is the clothing industry in which one company said would create around 10,000 new jobs if the Government scrapped the import duties on the textile industry which it could do at the stroke of a pen. The current duties protect fewer people's jobs, all of whom in this case, the company would guarantee a job in the new local clothing manufacturing facility. This company could also create jobs in this sector in the form of small business facilitation. This is but one example where a more partnership approach between government and business can unlock jobs and growth through a dynamic trade policy.

4. *Free movement of capital*: the continued existence of the architecture of exchange controls continues to restrict the movement of capital for businesses, and adds uncertainty for companies in competing globally for assets including with the use of their shares as acquisition currency. The funding of offshore and onshore balance sheets remains regulated and complex, and adds risk to the overall management of the firms. Whilst liberalisation has occurred, the complete removal of the exchange controls architecture would be perceived as a progressive step in supporting corporate South Africa's global competitiveness. Some believe such a move would also be supportive for the currency.

5. *Administrative excellence*: whilst the broad public policy approach and regime of the current administration is perceived positively the quality of implementation is perceived to have deteriorated. The deployment of capable administrators into the public service to provide the best of breed leadership and "best people for the right seats" in SOEs and Ministries / departments of state is seen as a top priority for the 5th State administration.

6. *Prosecuting corrupt officials*: ensure prosecution with full enforcement of sentences for corrupt government officials. The introduction of a State Tender Board is seen as a positive in this regard. Strict compliance with the adopted anti-corruption measures is required.

7. *Regional integration*: Improving African regional trade and market viability, including improving cross-border logistics and substantially reduced waiting time at border posts. If South Africa is to take

advantage of its position as a "gateway to Africa" we must work hard to open the doors for business on the continent and simplify if not in some cases eradicate the visa, permitting, logistical bottle necks and other impediments to doing business. Improving regional infrastructure such as power, road and rail will go a long way to unlocking inter regional trade.

8. ***Unlocking cheap, clean energy in Africa***: Africa has been fortunate to discover significant oil and gas reserves and is blessed with some of the best hydroelectric resources in the world. The South African government should work with business to explore and unlock alternative energy options and enablers, including:

- Accessing viable gas resources in the region (including, exploring for and exploiting shale gas);
- Considering Liquid Natural Gas (LNG) imports; and
- Collaborating on gas-to-power plants.

The above should aim to bring down the cost of power for inter-alia the mining and manufacturing sectors in South Africa. Significant private capital and job creation awaits.

9. ***Advancing the provision of infrastructure***: the long term stability, availability and affordability of power and other infrastructure e.g. water and transport is essential to inter-alia the mining industry. Eskom needs special focus and also linked to exploring alternative regional sources of energy. Given the liability profiles of pension funds and long term savings vehicles in SA, there is a natural and significant appetite for infrastructure assets. SA has over R4.5 trillion assets under management in pension funds and others forms of long -term savings in SA. Government and the savings industry need to accelerate work in developing the right framework and risk sharing to tap into more of these savings to fund the infrastructure necessary to drive growth and job creation. The SOEs policy, governance and management and the role of the shareholder as owner needs to be clarified. Efficiency, reliability and productivity, and pricing impacts should be foremost in the minds of the SOEs.

10. ***Certainty of operating environment***: "No moving the goal posts". Whether the financial, health or mining industry the cry is the same: set the rules and don't change them. Whether it is the rules governing affordability of household insurance policies, mining licenses and the broader regulatory regime covering strategic minerals, the role of the private sector hospitals, medical aids and so on relative to the NHI - the private sector needs certainty for long term investments and job creation. Large scale investment decisions and associated jobs in the hundreds of thousands depend on it.

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CONCLUSION

South Africa, as it approaches the 5th democratic elections in its 20th year of democracy appears to be at a crossroads. The world has become tougher for all growth markets. We need to raise our game. We need to get the basics right. Much has been achieved but to overcome structural inequality, unemployment and low growth SA needs to get to work. This is the job of all South Africans. It is the job of business to invest, to train, to hire and to drive earnings. It is the job of the unions to organise, to unlock productivity, to widen access to the work force and to add to the sustainability of industry. It is the job of the Government to create policy and deploy the best people to a professional and efficient administration. It should also cut the cost of doing business, open doors for trade and investment, pull down barriers to growth, spend tax payers' money effectively, to get "bang for the buck", protect the poor and the vulnerable and work with its social partners to take extraordinary measures to get all South Africans in to work.

It is all our "jobs" to work together to build a prosperous South Africa. The *"Two Decades of Freedom"* report suggest that in the next 20 years South Africa should aim to raise its GDP annual growth rate (from the past 20 years' average of 3.3%) to 5% thereby growing the size of the economy to $1trn by around 2030. Such growth, if attained, would cut both the unemployment rate and Debt / GDP % in half, and see GDP per capita double.

This vision is within our grasp. Team South Africa: its all to play for!

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