South Africa suffers from low growth, high levels of unemployment and massive income disparities. The Trade & Industrial Policy Secretariat (TIPS) annual forum on 'Paths to Growth and Employment in South Africa' focused on a wide range of issues with a variety of interesting speakers. It is difficult to cover the breadth of issues in a short editorial and hence reference will be made to a few papers.

Having organised a major annual conference on the labour market in South Africa, I began on the assumption that the conference would be a polarization of economic debates in South Africa. I was surprised to discover, through the rich discussion at the conference, that there was remarkable consensus about some fundamental labour market issues.

Firstly, all agreed that the unemployment problem was not exclusively a macro-economic problem, or a trade policy problem or for that matter a labour market problem. Secondly, wages in and off themselves are not necessarily the sole explanatory factor behind the employment crisis. Thirdly, the changing demand for increasing skilled labour is the result of a complex array of factors and cannot simply be attributed to globalisation or trade liberalisation.

Recognition of these basic ground-rules presented an opportunity to get into the nuts and bolts of the unemployment crisis. However, as we moved on to specifics and detail, there was predictably much less consensus on many issues. For example, notwithstanding the argument that wages in themselves are not the main problem, there is some evidence to suggest...
that wages may deter employment in some sectors but not in others - that high wage rates matter for some sectors but not for others - or it may matter less for semi-skilled than for unskilled sectors.

There is, however, at the end of the day some trade-off between real wage growth and employment growth, argued University of Toronto based economist, Professor Dipak Mazumdar. It all depends on how the gains from real wages growth are shared. Moreover, the cost of firing is considered, in some cases, to be a more important reason why firms are reluctant to hire labour than wage rates themselves.

The second important issue in South Africa is the incidence of unemployment in South Africa. According to Gary Fields, Professor of economics at Cornell University, the problem in South Africa is as much an employment problem as it is an unemployment one - what this implies is that the problem of poverty stems not only from large masses of unemployed people with no income but also from people with low earnings below the poverty line. So the employment challenge is more daunting than we think - its about improving the earnings capacity of the under employed as well as creating decent earnings opportunities for the unemployed. However, the more formidable challenge is how do we create more employment for the unskilled labour force?

As Fields points out, South Africa has both an aggregate demand problem (low growth) as well as a skilled labour supply constraint. The obvious solution is high growth that is able to absorb masses of unskilled labour - but this is the million-dollar problem. How do you boost growth and to what extent will growth guarantee more employment? Indeed this is the area where most research is needed both at the macro-economic and micro-level. At the more micro level, there are many avenues for growth - these may be through land reform, small and medium enterprise sector (SME) development and others.

But even these micro issues are really complex. For example, as Albert Berry from the University of Toronto points out, we cannot expect SMEs to be a motor for growth since it relies on domestic demand for its growth impulses. As long as economic growth remains modest, SME growth will be modest unless an increasing number of them become more export-oriented.

Another way to increase the demand for labour is through more exports - but can we really increase exports at the rate necessary to absorb more labour? Similarly, there seems to be some consensus that macro-economic policy has been aimed at creating stability and often at the cost of growth. Once again, this is not a very clear-cut issue.

While there is consensus about the critical skills crises, there are some delicate issues to sort out.

The most difficult moral question facing government is how to effectively use its limited resources to address the skills problem. As Fields put, do we invest in training a new generation of youths or an aging unskilled labour force? This is where we need to focus our energies. According to John Knight and Geeta Kingdon from Oxford University, education may have an absolute effect as well as a redistributive effect. But, decisions about education should be taken on the basis of a proper cost-benefit analysis.

This issue of the Monitor homes in on a few articles by some of our international guests. However, there are many important and useful papers that were presented at the conference. These papers can be found on the TIPS website.

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To download the papers presented at the TIPS conference 2000, view the TIPS website - www.tips.org.za
The Employment Problem in South Africa

South Africa is experiencing a major employment problem that includes not only unemployment, but also low labour market earnings. In this article, Gary Fields discusses what can be done to alleviate South Africa's employment problem.

Introduction

That South Africa has an unemployment problem is unquestioned. By the narrow definition of unemployment (did not work in the last seven days but actively looked for work), the unemployment rate is 12-20% of the labour force. By a broader definition of unemployment, which includes the narrowly unemployed, plus those who were not working but would accept a suitable job if one were offered even though they are not now looking for work (and in some cases includes seasonal workers and contract workers as well), the unemployment rate rises to 27-34%.

As high as these numbers are, they capture only part of the problem. What South Africa has is an employment problem that includes not only the unemployed but also those with very low hourly wages, those with inadequate monthly or yearly work hours, and those who have to work too long just to be able to eke out a meager livelihood.

How large is South Africa's employment problem? Bhorat and Leibbrandt have estimated a low-earnings line, defined as the wage required to enable an average household to escape poverty, given the mean number of employed plus unemployed workers in a household. This amounts to R650 per month in 1995 rand. According to their calculations from October Household Survey data, 46% of the labour force - about seven million people - earn less than this amount. The unemployed, defined broadly, make up about half this group, and the working poor make up the other half.

Once the issue is defined as an employment problem - comprising not only those who are unemployed by standard international definitions but also those with low labour market earnings by South African standards - different policy analysis and prescriptions follow. The goal is no longer merely to create jobs. The goal is to create good jobs. It is as important to raise the earnings of the working poor as it is to get the poor working.

What, then, should be done to alleviate South Africa's employment problem? This article will examine a number of issues:

- Facing employment and wages simultaneously
- Increasing the derived demand for labour in a globalised world economy
- Confronting the structurally unemployed and underemployed; and
- Getting the right labour market model.

Wages and Employment: The Need to Confront Both

First-year economics students are taught that demand curves are downward-sloping but not vertical. In the labour market, this has two implications: other things equal, (1) higher wages lower employment and (2) lower wages raise employment. These are not easy choices to make, but then again, economics has been called "the dismal science" for good reason.

But in contemporary South Africa, there are those who say that there is no such tradeoff. I've heard at least three arguments to this effect.

The first concerns wage increases. It has been said that if wages are raised, firms will hire just as many workers as before, because employment is determined by other factors - perhaps by how much labour is required to support a unit of capital. Those who hold this view support wage increases and do not contend that employment will suffer.

The second argument goes in the opposite direction. Suppose that to try to create more jobs, wages were to be lowered. According to this argument, firms would not hire any more workers from the target group than before, because employment is determined by other factors - perhaps by how much labour is required to support a unit of capital. Those who hold this view support wage increases and do not contend that employment will suffer.

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The second argument goes in the opposite direction. Suppose that to try to create more jobs, wages were to be lowered. According to this argument, firms would not hire any more workers from the target group than before. Rather, they would hire those who are not part of the problem to begin with - namely, the skilled. By this line of thinking, the social challenge of employing the poor would remain unmet.
And third, one sometimes hears the macroeconomic argument that pushing wages up raises purchasing power and, through multiplier effects, leads to more jobs than are lost.

I have seen no evidence that supports these arguments. Several studies have estimated wage elasticities of demand for labour. These studies - by Bowles and Heintz, Fallon and Lucas, and Fields, Leibbrandt, and Wakeford - have derived estimates of -0.5 to -0.7. That is, each percentage point increase in wages would lead to a half-point reduction in employment or more. As with anything else, there is a confidence interval surrounding these point estimates. But what comes out of this literature is that nobody has found anything like a zero wage elasticity of employment, let alone a positive one. To maintain this in light of the evidence is wishful thinking.

We come back now to the definition of the problem. If South Africa’s problem is conceived of as only an unemployment problem, then the implication of these employment elasticity estimates is clear: create more jobs by holding down real wages. But when one conceives of the problem as an employment problem, one is led to ask not only whether people are working but also how much they earn when they work. South Africa must choose carefully between policies aimed at raising the labour market earnings of the employed and policies that would raise employment by holding down the growth of real wages. Would it be socially desirable to have lower real wages but more jobs? What about higher real wages for those employed but fewer jobs? The answers can only be resolved through a continued society-wide debate.

The tripartite approach to social negotiations in South Africa, as in the rest of the world, leaves out a very important group: those workers who are not employed in the formal sector, who do not belong to trade unions, and who do not have representatives at the bargaining table. Extending collectively negotiated contracts is not helpful to the millions of South Africans who are out of work and the millions more who cannot possibly be covered because there is no employer who can be made to meet the agreed-upon terms. What promotes the interests of the unemployed and underemployed is shifting the demand for their labour, to which we now turn.

**Mitigating the Harsh Tradeoff: Increasing the Derived Demand for Labour in a Globalised World Economy**

The tradeoff posed in the last section can be softened, though not eliminated, by bringing another element into the discussion: the possibility of shifting the derived demand for labour curve so that more workers are demanded at any given wage than before. To see how this might be done, a look at some success cases in other parts of the world can be fruitful.

As is well-known, the so-called "East Asian Miracle" produced rapid economic growth, first in Japan, then in Hong Kong and Singapore, then in Korea and Taiwan. In each of these economies, real per capita Gross Domestic Product (GDP) grew at about a 7% annual rate for decades. Successfully penetrating world markets was a major contributing factor. No wonder these so-called "Asian Tigers" continue their export drive and that the "Asian Cubs" (Thailand, the Philippines, Indonesia, Malaysia, and, more recently, China) seek to become tigers themselves.

Much less-known is the labour market record that accompanied this growth. When the process first got started around 1960, real wages barely rose - wages in Taiwan were only 2% higher in real terms in 1970 than they had been in 1960. What did grow was employment. Thus, in the first phase of the Asian Tigers’ growth, the surplus labour with which they had begun came to be employed at virtually constant wage levels. But then, the labour surplus was exhausted and the labour market tightened to the point where employers needed to raise wages in order to retain existing workers and attract new ones. In each of the Asian Tigers, real wages grew apace of per capita GDP growth and unemployment rates of 2-4% were maintained throughout the decade of the 1970s.

During the epoch of rapid export-led growth in the early 1980s, East Asia experienced full employment, improved job mix, rapid real wage growth, low inequality, and falling poverty rates. Despite several objections, the argument I made then (and make now) is that the trade and industrialisation strategies they had followed had been good for workers and should be continued. Real exports from the East Asian and Pacific countries grew by 164% in the 1980s and by 187% in the first eight years of the 1990s, real GDP per capita continued to double in the 1980s and again in the 1990s, so too did real wages, and full employment was maintained except for crisis years at the end of the 1990s. (At the time of this writing, South Korea’s unemployment rate is back down to 3.6% and real wages are 11% higher than they were a year ago.)

Coming back to South Africa, what can work here is what worked in East Asia: producing things that those who have the purchasing power elsewhere in the world will want to buy. A fundamental truth is sometimes forgotten: if you're poor, you can't get rich by selling to yourself.

The challenge for South Africa is to find new niches in which South African producers can become world class, and thereby increase the derived demand for the nation’s labour. There is only so far you can go with metals, alloys, and precious stones.

The new niches need not be new products - did Japan invent anything other than the Walkman? They are likely instead to be existing products: footwear, furniture, ball-point pens, or whatever. Government cannot determine what these products are (or at least can do only a little of it) - the energies of South Africa’s private sector must be harnessed.

Take the example of computers. None of us demands an American-made computer or a Japanese-made computer or a South African-made computer. What we do demand is a computer with the right features, with high reliability, with good service facilities, and with a reasonable price for the features it has. Most of us will buy such a computer from wherever in the world it comes, and may perhaps not even know its origin when we buy it. And the computers themselves can be freely exported and freely imported,
subject only to relatively modest transportation costs and, in some countries, import duties. The people of East Asia benefited by manufacturing computers not because they could buy them cheaply when they produce them (Asians still find it cheaper to buy computers and other major electronics items in the United States and ship them home) but because they could use their wages from producing world class products to buy what they most wanted.

This model can work today. In fact, one may argue that for South Africa to prosper, such a model must work today. Why? Because the harsh fact is that the rest of the world does not need South Africa's working people, but South Africa's working people do need the rest of the world. There are 1,300 million Chinese and 1,000 million Indians compared with 40 million South Africans. These two Asian countries alone offer all the unskilled labour that anyone would want, plus a fair amount of skilled labour as well. If a business is thinking of producing someplace in the world, why would it not want to produce in China or India? Why should it want to produce in South Africa? Profit-maximising enterprises must want to employ South Africa's labour. This implies that if businesses are going to want to invest in the country, building factories and offices and creating jobs, they must find South Africa an attractive place in which to operate.

What promotes this? High productivity of workers, a cooperative work environment, the opportunity to make money. What impedes this? Excessively restrictive labour practices, the labour hassle factor, an unsafe living environment for the business executives and their families. According to research just now being completed by the Greater Johannesburg Metropolitan Council and the World Bank, corporate CEOs identify the leading constraints to business growth in South Africa as crime and violence, labour regulations, interest rates, exchange rates, corruption in government, skills shortage, and tax rates. The leading priorities for remediying this situation, according to these CEOs, are for the national government to promote an efficient and flexible wage policy in the labour market, maintain macroeconomic policy stability, and promote an efficient and flexible interest rate policy.

In Europe, they use the term "social partners" to describe the ways in which business, labour, and government get together to try to advance their common interests. South Africa has NEDLAC, workplace forums, sectoral bargaining councils, and skills training boards. Still, the overall attitude is conflictual and confrontational. "Partnership" is about the last word one would think to use to characterise South Africa.

Confronting Structural Unemployment and Underemployment

Clearly the South African labour market has a deficient-aggregate demand problem. But in addition, part of the problem in South Africa is structural unemployment: employers are demanding workers with certain types of high-level skills which the unemployed and the working poor do not possess.

Here is how one can tell what kind of unemployment problem exists. If you have 20 people seeking 10 new jobs and employment increases by 10, then you have a deficient aggregate demand problem. But if 20 people are seeking 10 new jobs and employment increases by 5, because the other 15 are deemed unqualified, then you also have a structural unemployment problem.

South Africa's structural unemployment problem is thought to be a skills problem. The nation can selectively aim to improve the quality of its human resources through a kind of Say's law: supply creates its own demand. Thus, if more highly-qualified people are educated and trained in the right kinds of areas, South African employers will want to hire them. People with computer skills, for example, are said to be in very short supply, and if there were more of them, one would expect that they would be employed.

The skills gap is vast, far exceeding the available resources, and difficult choices will have to be made. One particularly crucial choice is whether to focus on upgrading the skills of the currently unemployed and underemployed or, alternatively, emphasising the education of the next generation of workers. Too many budgetary allocations are based on the rule, "doing some of this and some of that is better than doing just one thing alone," and South Africa would do well to avoid such politically attractive but economically unwarranted kinds of decisions.

The basis for policy formation ought not to be, "It's good for the unemployed if . . . " The needs are too great and the resources too limited for that. Hard-headed decisions need to be made, confronting opportunity costs, fully recognising that to do more of one thing means to do less of another, and weighing the social and economic benefits and costs as carefully as possible.

Getting the Right Labour Market Model

A quite different need for South Africa is an analytical one. There does not yet seem to be a labour market model for South Africa that properly incorporates the main stylised facts. Clearly, the right model is not the competitive labour market model - wages are not set by supply and demand. Nor is it an integrated labour market model - the cities are not uniformly high-wage vis-à-vis the rural areas. The least bad fit comes from the crowding model - those who cannot get formal sector jobs crowd into the informal sector, depressing earnings levels there - but that does not fully fit either because of South Africa's large volume of open unemployment. Thus, an overall vision of how the South African labour market works and how the various components link together remains both a puzzle and a challenge.

Researchers always like to call for more research, but this is a case where it is really needed. Policies to combat South Africa's employment problem can be designed better once an overarching structure is in place. In East Africa, a new labour market model, coupled with policy experimentation, led to the conclusion that the solution to urban unemployment was rural development - hardly an obvious conclusion. Absent similar in-depth analysis in South Africa runs the risk of implementing an intervention appropriate in one labour market context that makes things worse in
another. For the poor and the unemployed in South Africa, that would be a great tragedy indeed.

**Conclusion**

The employment problem in South Africa faces five major challenges:

First, it is important to recognise that the problem goes far beyond the several million openly unemployed by broad definitions and includes also several million others who are employed by standard international definitions but are not earning enough by South African standards. Then formulate policies so that the number one goal is to improve the lives of as many of these people as possible through better earning opportunities.

Second, recognise that national policies to deal with the employment problem cannot be rationalised and designed well until choices are made about whom to try most to help. Decisions need to be made about whether the priority is to pursue higher wages for those employed or to seek fuller employment.

Third, recognise that alleviating South Africa's employment problem requires the involvement of the rest of the world. You can only get so far with products that your own businesspeople are able to produce and that your own consumers want and can afford to buy. South Africa has to be an attractive place for South African entrepreneurs to do business and for foreign firms to do business as well. Labour policies, human resource policies, and even cultural policies must be coordinated toward achieving this end. The road to success is to produce goods that those with the purchasing power in South Africa and in the rest of the world will want to buy. South African businesses and workers need to join forces to achieve this. Changing from a confrontational to a cooperative approach will not be easy.

Fourth, recognise that in addition to deficient aggregate demand for labour, South Africa also has a structural unemployment problem. Many if not most of the target workers do not possess the skills demanded by employers. Efficient ways of marshalling limited resources to educate the young and train the others need to be found. It would be helpful to pose the question of opportunity cost - if we do this, what can we not do? - in order to prioritise energies and budgets accordingly.

Finally, recognise that one barrier to formulating policies to combat the employment problem in South Africa is the lack of a guiding labour market model. It is therefore imperative to pull research findings and insights together in order to develop an overarching framework for labour market analysis in South Africa. This is the highest priority for researchers and policy-makers in the months and years ahead.

Meeting these challenges is of vital importance. The economic well-being of literally millions of South Africans hinges on the wisdom of these choices.

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**Endnote**

This article is based on a keynote address prepared for presentation at the TIPS Forum on "Paths to Growth and Employment in South Africa," Johannesburg, South Africa, September 18, 2000.

**Bibliographical Note**

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When and why does Globalisation increase rather than reduce Labour Market Inequalities in Developing Countries?

It is widely believed that globalisation can benefit developing countries by reducing wage inequality. Rising wage inequality in developing countries has, however, challenged this belief. In this article, Adrian Wood, looks at reasons why globalisation causes labour market inequalities to increase.

Introduction

Standard theory presupposes that globalisation reduces labour market inequalities in developing countries. The experience of East Asia in the 1960s and 1980s provides evidence that greater openness narrows wage differentials between skilled and unskilled workers. However, contradictory evidence exists in countries, such as Latin America, which experienced increased labour market inequality when trade barriers were reduced.

This article attempts to explain why globalisation increases labour market inequality, when theory predicts the opposite outcome. This article will also relate its findings to the South African context. The article is structured in three parts. The first section outlines the theory and empirical evidence of the effect of globalisation on wage inequality. The second part considers explanations of the conflict that exists between theory and evidence. The final part sums up findings and provides policy implications.

Standard theory

The belief that globalisation reduces wage inequality in developing countries rests on a widely used theory of trade - the Heckscher-Ohlin theory. According to the Heckscher-Ohlin theory, a country has a comparative advantage in the production of goods that are endowed with factors of production that are relatively abundant, because it can produce these goods cheaply. When trade barriers are reduced, the country exports goods that are intensive in its abundant factor and imports goods that use intensively factors that are relatively scarce. Thus, trade increases the demand for abundant factors because of the export expansion and effects corresponding factor prices. In developing countries, where unskilled labour is abundant, and skilled labour is scarce, the Heckscher-Ohlin theory predicts that trade liberalisation raises unskilled wages and lowers skilled wages thereby reducing wage inequality.

Mixed evidence

Evidence for the theory’s predictions of labour market inequality reduction is mixed:

- In East Asia in the 1960s and 1970s, wage inequalities went down when trade liberalisation occurred.
- In Latin America in the late 1980s and the early 1990s, increased openness had the opposite effect on wage inequalities. Wage inequalities in Latin America were increased by globalisation.

There is not a lot of very good research on other countries to draw on. A particular area that lacks research is one that disentangles the effects on wage inequality changes, of changes in openness and changes in other factors. Nevertheless, available evidence indicates that findings that support the predictions of the Heckscher-Ohlin theory for other countries are very mixed. There are probably more cases of increased wage inequality as a result of greater openness than there are of reduced wage inequality. On the other hand - and this is something of a paradox – there are probably more cases of increases in real wages than there are of reductions in real wages. There is thus a puzzling inconsistency between the standard theory and the available evidence.

Basically there are two different reasons why globalisation might cause labour market inequalities to increase in developing countries when theory predicts a decline. The first reason is related to the variation in resource endowments among developing countries. The second reason is related to the transfer of know-how into developing countries.
Differing resource endowments

Regional variation

Considerable differences in resource endowments exist among developing countries. Figure 1 presents regional resource combinations from 1960 to 1990 for the major developing regions. The diagram shows how resource endowments have evolved over the 30-year period. Looking at figure 1, it is apparent that the relative positions of the different regions vary a lot and have not changed very much over this thirty-year period. There were minor changes in their relative positions, but fundamentally the positions remain the same.

Corresponding to the differences in resource endowments are wide variations in the export composition of these regions. For example, African exports are concentrated in unprocessed primary products because the region has a high land to labour ratio and has low skill levels, whereas Latin America has far more processed products due to higher skill levels.

How do these variations in resource endowments bear on the question of how increased openness effects labour market inequalities? There are two reasons inequality might increase. The first reason is related to moderate skill to labour ratios; the second reason is related to high land to labour ratios.

Moderate skill/labour ratios

Nearly all middle-income developing countries have moderate skill ratios. Moderate skill ratios are a weighted world average, but bear in mind that about half of the world labour force is in five low income Asian countries and more or less all other countries are above the world average skill to labour ratio. Most middle-income countries thus have ratios of skilled to unskilled workers that are above the global average, but below that of developed countries. The effect on relative wages in middle-income countries of globalisation is most likely to be a widening of the wage gap between skilled and unskilled workers. This is due to greater competition from other countries realising their own comparative advantages. Real wages for unskilled workers fall as the demand for cheaper labour-intensive imports rise. Real wages of skilled workers increase as the country attempts to establish a comparative advantage in high skill intensity production in the global market.

The coincidence in the late 1980s of expanding exports of low skill intensity from low-income Asia with greater opening of Latin American trade provides a possible reason for the increased wage inequality experienced in Latin America. East Asian competition in the market for goods of low skill intensity eroded Latin America’s comparative advantage in these goods. The comparative advantage of Latin America then shifted from goods of low skill intensity to goods of medium skill intensity. As a result, globalisation reduced the demand for unskilled workers by causing the low skilled sector to contract.

High land/labour ratios

The Heckscher-Ohlin theory asserts that if a country has high land to labour ratio, the abundant factor, which is going to gain from trade liberalisation, is land whereas the scarce factor, which is labour will lose. The real wage of labour will fall as a result of increased opening, in a land abundant region. Figure 1 illustrates that there are couple of regions that are land abundant developing regions, particularly Africa and Latin America, whereas both Asian regions are land scarce. As evidence highlighted earlier shows, East Asian trade liberalisation tended to cause the standard effect of a compression of wage inequality. In contrast, Latin America in the late 1980s and 1990s had above world average skill to labour ratio and it was a land abundant region. Landowners gained in real terms at the expense of labour, who tended to lose.

Now what about South Africa? Figure 1 shows that South Africa was virtually in the same place as Latin America in 1990 in terms of resource endowments. It is quite plausible to suppose that the tail of what happened to labour market inequalities in Latin America in the 1980s and early 1990s could very well be an important part of the explanation of what happened in South Africa in the 1990s.

Transfer of know-how

The second major reason why globalisation causes increased labour market inequalities in developing countries is related to the transfer of know-how. “Know-how” is a term used to describe tacit knowledge - the knowledge of how to do things that are in the minds of people. This type of explanation requires modifying the Heckscher-Ohlin assumption about technology, that is, all countries have access to the same technologies at all times, whether they are in autarky or whether they are open to trade. This is a very unrealistic assumption for most developing countries because developing countries in autarky are not able to produce the full range of goods that developed countries produce due to a lack of know-how.
Mobility of highly skilled labour

Countries acquire know-how through the mobility of highly skilled workers. Workers with know-how from other countries travel to a developing country and put advance production into operation. The main way in which this has occurred historically has been through permanent migration, which is how, for example, North America, the USA and Canada, were able to develop so rapidly. It is also of course how South Africa was able to develop so rapidly. Currently, the main means of mobility is not permanent migration, but business travel - short-term, intermittent, temporary movement of people.

Standard definitions of globalisation focus on reductions in the cost of moving commodities around the world. These definitions often ignore an important feature of globalisation which is the reduction in the cost of moving know-how around the world, and particularly the fact that international business travel and communication have become easier and cheaper. These cost reductions are attributed to technological and transport infrastructure, increased sophistication of trans-national companies, and policy changes. Thus, in addition to the reduction of transport costs on which Heckscher-Ohlin theory focuses, there has also been a reduction in co-operation costs.

Effects on real wages

The effect of a reduction in co-operation costs on real wages is going to be positive. Real wages rise, because the inflow of know-how improves a country’s technology and/or it adds to the stock of some complimentary factor of production. In the long term, this transfer of know-how is the main gain for increased openness.

Effects on wage inequalities

Studies investigating the effects of transfer of know-how on wage inequality have, in many instances, shown that wage inequality increases. This can be illustrated by a simple example:

Consider the effects of setting up an export processing zone that manufactures shirts or assembles radios in a poor, ill-educated agricultural developing country, where the population produces primary products, such as rice or baskets. Although the export-processing zone is not very skill intensive by world standards, it is more skill intensive than any other form of production in that developing country. The skill intensity of production in the developing country rises and pulls up relative wages of the more skilled workers. In this way, wage inequality in low-income developing countries increases.

Applying this explanation to South Africa’s trade environment in the 1990s is not very plausible. Firstly, South Africa is very unusual among developing countries – indeed in some ways one would not want to class South Africa as a developing country. South Africa already had a very large and diverse stock of know-how before opening occurred in the 1990s. South Africa was producing goods over the full range of skill intensities.

Secondly, there is no evidence that the type of transfer of know-how needed to bring about such effects in South Africa occurred. No export-processing zones were set up in very labour intensive activities or even in the more skill intensive activities in which South Africa’s comparative advantage probably lies.

However, perhaps a more subtle version of this process of transfer of know-how may be relevant to South Africa, because it seems that the ending of apartheid and the ending of sanctions did in fact increase flows of highly skilled people in and out of South Africa. There was thus an accelerated transfer of know-how from the rest of the world in a very wide range of sectors, including non-traded sectors as well as the traded ones on which the above explanation focuses. It is quite possible that the know-how and the associated new products and techniques that were transferred were, on average, more skill intensive than what was being produced in South Africa during that period.

Conclusion

Substantial evidence supports the theoretical contention that globalisation reduces wage inequalities. However, evidence also shows that globalisation can increase wage inequalities. This depends essentially on two factors: differences in resource endowments and transfer of know-how. These factors have implications for policy.

Firstly, the transfer of know-how is important for a country’s economic growth and development strategy and policy should be encouraging the inward mobility of highly skilled workers with know-how. Secondly, an important role of industrial policy is to indigenise this know-how, in other words to work on the much slower and more difficult process of transferring the know-how from foreign business minds to the minds of South African residents. Thirdly, policy needs to address distributional tradeoffs. There are some hard choices to be made between increased wage inequality and increased unemployment.

Finally, as the stock of skills in a country is shaped by not only the demand for skills, but also by the supply of skills, it is important to implement appropriate supply side actions. For South Africa, expanding the skills supply - particularly through the education system is an important globalisation strategy. Shifting the comparative advantage into increasingly higher skilled industries through education and training is vital for not only securing South Africa’s competitive position in global markets, but also for reducing current labour market inequalities.

Endnotes

This article is based on a keynote address given at the TIPS Conference, September 2000 and is a synthesis of various papers written by Adrian Wood.

1 The phrase ‘wage inequalities’ is used as shorthand for shifts in the demand for labour - wage inequalities also depend on the supply side of the labour market and labour market institutions.

Bibliographical Note

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The Role of the Small and Medium Enterprise Sector in Latin America: Implications for South Africa

Evidence from various countries suggests that considerable economic potential is present in small and medium enterprise (SME) sectors. In this article, Albert Berry, makes the case that the performance of SME sector will be pivotal to overall economic performance in Latin America over at least the next decade or two. Much of the argument appears to be transferable to the situation of South Africa.

Introduction

The current economic setting in most Latin American countries suggests that if the small and medium enterprise (SME) sector does not perform well during the next couple of decades, overall economic performance will also be unsatisfactory, especially in the areas of employment creation and income distribution. No other major sector has the potential to generate a large number of adequate-income jobs.

This article makes the case that the performance of the small and medium enterprise sector will be pivotal to overall economic performance in Latin America over at least the next decade or two. Given its similarities with the economic structure of Latin countries, much of the argument appears to be transferable to South Africa.

Importance of the SME sector

The main reasons for the importance of the SME sector in Latin America and South Africa are found in a set of economic conditions that characterise both countries (see Table 1 for a comparison between Latin America and South Africa, 1970 to 2000):

- The high level of income inequality
- A recent period of slow economic growth since about 1980
- A shift towards greater openness
- Higher level of fiscal prudence than previously

These economic conditions make the performance of the SME sector more important than it would otherwise have been.

Table 1: A Comparison Between Latin America and South Africa, 1970-2000

<table>
<thead>
<tr>
<th></th>
<th>Latin America</th>
<th></th>
<th></th>
<th>South Africa</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP Growth</td>
<td>5.7</td>
<td>1.7</td>
<td>3.2</td>
<td>3.6</td>
<td>1.3</td>
<td>1.6</td>
</tr>
<tr>
<td>Population Growth</td>
<td>2.5</td>
<td>2.0</td>
<td>1.9</td>
<td>2.8</td>
<td>2.4</td>
<td>2.3</td>
</tr>
<tr>
<td>Per Capita Income Growth</td>
<td>3.1</td>
<td>-0.3</td>
<td>1.3</td>
<td>0.8</td>
<td>-1.1</td>
<td>-1.3</td>
</tr>
<tr>
<td>Gross Capital formation as Percent of GDP</td>
<td>23.7a</td>
<td>18.6a</td>
<td>21.6</td>
<td>19.9b mostly .50-.63</td>
<td>29.9</td>
<td>21.8</td>
</tr>
<tr>
<td>Gini Coefficient</td>
<td>mostly</td>
<td>.50-.63</td>
<td>.583c</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Notes:
- a) Gross fixed investment.
- b) Approximation.
- c) Refers to the distribution of expenditures among persons ranked by per capita family expenditure (World Development Report 1997, p. 223)
Role of the SME sector

To understand the important role that SME plays in today's Latin American economies, it is useful to distinguish the labour demand associated with each separate sector of the economy.

Table 2 compares sources of net new employment between 1970 and 1990 in Latin America. The table clearly shows a decline in the source of new jobs for the agricultural, large-scale private and public sectors. These sectors will continue to lose relative importance as a source of employment. The public sector is in most countries under a fiscal constraint, which impedes employment expansion.

The large-scale private sector producing tradables might generate significant employment growth in a few countries, but downsizing has been the more normal accompaniment of liberalisation thus far.

The rest of the private sector can be disaggregated into the SME segment and the very small firm (microenterprise) segment. Microenterprise plays the very important insurance role of guaranteeing a minimum, albeit quite low, level of income to many people, but it does not have the capacity to generate moderate to high incomes for a large number of people.

This leaves SME as the sector which does not require very large amounts of capital to grow and which, also, should be able to produce good levels of income for many people.

The Key Question-How Important a Role Can SME Play?

The SME sector's contribution to economic performance could in principle be improved either by raising the internal efficiency of the resources already employed within it or by changing the share of the economy's resources employed by it. If too few resources are directed this way, potential growth will be lost, but if too many are then the payoff to the marginal resources allocated to it will be small and again growth will be lost since those resources would have paid off better in some other use.

Viewing the trade-off between use of resources in SME and in other ways gives a static perspective on that sector's role. But dynamics are equally or more important, including both the implications of the size of the SME sector for savings, investment and technological change - what we may call the growth implications, and also the dynamics of adjustment when an attempt is made to reshuffle the structure of the economy (by size in this case) with a view to raising its efficiency. In the latter case, the question of path dependency may become important; though the role of SME might, for example, have been a large one had a path conducive to that outcome been followed, if the opposite path was pursued for too long, the option may have been squandered.

Static Efficiency of SME

Total factor productivity (TFP) analyses have been carried out with some frequency in Latin America and elsewhere, both to assess the relative efficiency of different branches of industry, different sizes, etc., and to measure the change in such efficiency over time. However, the literature on size and TFP does not point to any consensus conclusions on the relationship between size and productivity.

The Dynamic Efficiency of SMEs

A number of recent studies of SMES have highlighted the fact that many smaller firms are also young ones and that in assessing the economic potential and contribution of SME it is important to be aware of firms' life trajectories, not just their point of time status. Rates of entry and exit are higher for smaller establishments than for larger ones, so in this respect, SME is the middle of the spectrum between microenterprise and large enterprise.

In an overall assessment of the role of SME in an economy, the considerable rate of turnover which characterises even the small-medium sized firms in most economies does not appear to have any clear-cut implications for the sector's usefulness to the economy.

The Overall Contribution of SMEs and its Potential under Liberalised Trade

Recent literature from virtually all parts of the world emphasises the important contribution which SMEs can make to an economy's strong overall performance. It has been recognised that some of the world's best performing economies, notably outward-oriented East Asian countries, are very heavily based on small enterprises.

These countries have been very successful at hooking the SMEs into the export process, through some combination of direct exporting by smaller firms (often through relatively small intermediary agents, as in the case of Taiwan) or through subcontracting by SMEs with bigger firms, as in Japan over a long period and Korea with increasing intensity since the mid-1970s. This record of achievement under export orientation is particularly attractive to the countries of Latin America and to South Africa at present, given the challenge to succeed in a more open context and to do so on both the growth and the distribution fronts.

Table 2: Source of Net New Jobs in Latin America, by Sector: 1970s and 1990s

<table>
<thead>
<tr>
<th>Source (Sector)</th>
<th>1970s</th>
<th>1990s</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture</td>
<td>10</td>
<td>0-5</td>
</tr>
<tr>
<td>Public Sector</td>
<td>20</td>
<td>0-5</td>
</tr>
<tr>
<td>Large private firms, Non-Agriculture</td>
<td>25</td>
<td>5</td>
</tr>
<tr>
<td>Microenterprise (non-agriculture)</td>
<td>25</td>
<td>60</td>
</tr>
<tr>
<td>Small and medium enterprise (non-agriculture)</td>
<td>20</td>
<td>30</td>
</tr>
</tbody>
</table>

Source: Based on data from PREALC, International Labour Office.
The Economic Context of SMEs

Before considering how public policy may encourage a strong performance from SMEs, it is necessary to have a reasonable understanding of their setting and hence of their problems and needs.

One can distinguish three broad groups of SMEs according to the nature of their relationships with other firms, those which are:

- **subcontractors** (usually but not always for larger firms);
- **members of "clusters"** made up mainly of small firms; and
- more or less **independent**, in that they fall in neither of the above two categories.

**The need for economic efficiency**

Many needs are common regardless of setting. Firms must achieve a certain level of efficiency either to have success as independents or to qualify as candidates for either of the other two arrangements. Contractors are not willing to invest their time or efforts with subcontractors which are not close to being efficient producers. And a cluster must have a high level of collective efficiency if it is to compete in world markets, as many of the most effective clusters do.

**The need for competitive capability**

Regardless of the context in which an SME finds itself, its success will depend on ability to participate effectively in international trade, either as direct or indirect exporter or as successful competitor with imports. It is thus important to consider what policies help SMEs to achieve success of this sort.

**Policy vs Exogenous Factors in the Performance of SMEs**

Evidence from East Asian countries suggests that the SME sector can loom large and important in an economy and that when it does so both the growth and the income distribution performances can benefit greatly. There remains, however, the biggest question of all: To what extent does such impressive success owe itself to exogenous factors like a wealth of entrepreneurial talent, a culture which favours the business characteristics that are friendly to the development of SMEs, a topography conducive to a dense network of small firms, or a history which did not produce a lot of large firms?

Although scepticism over Latin America's potential success with SME development should be taken seriously, it should not be overdrawn. As of the early 1970s Korea's industrial structure was more similar to that of Latin countries like Brazil and Mexico than to that of Taiwan.

Korea was dominated by large, vertically integrated firms which did relatively little subcontracting, and the SME sector was accordingly much less important than in Taiwan or Japan. Since that time however, SME output and employment has increased enormously in Korea. At the same time the level of inequality in the country has diminished.

Most of the SME growth in Korea has been due to the following factors:

- a rapid increase in the density of subcontracting
- an increase in competitive pressures
- public policy efforts to expand the role of SMEs.

This experience is relevant to the Latin American and South African contexts: in an East Asian country with considerable structural similarities to the traditional Latin pattern, a rapid increase in the role of SME can be achieved when conditions are right.

**Which Polices Help the Most to Induce a Strong Performance from SMEs?**

The SME sector is a very heterogenous one, so it should not be expected that the same policy package would be optimal across all branches, across countries at different levels of development, between SMEs which are subcontractors and those which are part of clusters, producers of tradables versus producers of non-tradables, etc. It must also be recognised that in some areas our understanding of what good policy may be remains incomplete for lack of policy experiments and careful analysis. These caveats aside, a number of important conclusions are now possible.

**SME support policies**

SME development requires solid support systems. At the national level, those in charge of the main levers of policy are often unfamiliar with the varying situations and needs of specific groups of firms defined by sector or, as in the case of SMEs, by size. For informed, effective policy at the national level this hurdle must somehow be overcome by, for example:

- providing more complete knowledge for the decision makers
- including representatives of the SME sector at the policy-making table.

One of the challenges to effective support policy is recognising the difference between the success and failure involved in integrating SMEs into the world economy. Potential failure is implicit in the fact that integration can decimate some SME sectors, especially when the real exchange rate is allowed to fluctuate, creating periodic waves of imports. But success has been achieved both by whole countries like those mentioned from East Asia and by specific sectors within some Latin American countries.

**Exchange rate management**

Although SMEs show various types of flexibility and agility—they can be quite vulnerable to certain types of external shocks. In the present era, with its inflows and outflows of hot money putting pressure (in one direction or the other) on the exchange rate, the risk of damage or death to essentially healthy SMEs (healthy in the sense of their having the potential to be economically productive over a lengthy period) is high.

**Supportive microeconomic policy**

Policies of a microeconomic nature should aim to assist firms in becoming more efficient and competitive. Many
simultaneously increase a firm's performance capability and also increase the likelihood that it will be able to enter a useful subcontracting relationship with a large firm or be a productive member of a cluster. Large firms are only interested in subcontracting work out to smaller firms at or above a minimum performance level.

**Marketing support**

Marketing success constitutes one of the key challenges for many SMEs. Governments' institutional capability to deliver marketing support is weak in most developing countries. Strategies for providing marketing support include:

- providing firms with the wherewithal to find buyers for themselves, rather than attempting to substitute for efforts by putative exporters.
- decentralising export marketing support so as to be able to respond to the enormous diversity of players and market mechanisms across subsectors.

**Technology upgrading**

Technology upgrading is key to the continuing success of SMEs, especially those which produce tradables. The challenge of technological acquisition requires activist strategies at both the firm and collective levels. Collective technical support can be "broad-based" and can

- enhance the overall availability of usable information by sponsoring courses on specialized topics; facilitating the use of specialised consultants to a range of firms; and promoting information-sharing among firms
- promote "high-intensity" technological learning by supplying technical inputs directly to firms.

Broad-based collective support has been most effectively delivered by decentralised institutions, either by industry associations, by independent non-governmental organisations, or by local governments in specialized industrial districts.

**Access to credit**

There is little doubt that many SMEs could grow more efficiently with better access to credit, but it is less clear what are the limits to the likely performance of a financial system in terms of allocating such credit to the "right" borrowers. Perhaps the only valid generalisation is that a financial system will work better when it has better designed rules to guide lending to SMEs and more SME-specific personal expertise, that is, more people who have enough feel for the context of SMEs to be discerning lenders. Not too many institutions in Latin America or elsewhere in the developing world have performed impressively in this regard.

**Education and training**

SMEs do not and cannot be expected to supply most of the needed learning in-house, both for lack of resources and out of fear of "poaching" by other firms. Several types of support are directed to improving inter-firm cooperation involving SMEs:

- support for relevant business associations - sometimes umbrella SME associations, sometimes industry-specific ones, often local ones;
- practically oriented support for large-small linkages, e.g. along the lines of the SEBRAE programme in Brazil (Marx, 1993, cited by Humphrey and Schmitz, 1995, 19).
- SME network support programmes, of which the Danish Network Cooperation Programme and Chile's PROFOs are good examples (Berry 1997);
- subcontracting exchanges; though it is not clear whether they will often have a large payoff, their modest costs makes them a logical component.

**Conclusion**

With respect to how to carry out SME support policies, three points deserve comment.

- First, support should be provided on a group basis where feasible, in order to increase the chances of inter-firm cooperation.
- Second, the modus operandi of support systems and their components should usually be one-shot or time-limited when possible in order to avoid the creation of permanent bureaucracies, at least until the benefits have been shown to be clearly satisfactory.
- Finally, it must be recognised that no simple formula has been found to energise the SME sector. Although a good credit system is no doubt part of an effective policy package, it is by no means enough. The record with industrial estates, incubators and like ventures is by now long and for the most part unhappy; in some situations these mechanisms can help some firms, but there is no empirical basis for believing that they will be a significant part of a good support system and there is all too much evidence that scarce resources can be wasted on them.

Experience of other countries has proven that the SME sector can play a central contributing role under proper conditions and with adequate support. But both experience elsewhere and economic logic imply that a strong and coherent support system will be necessary if that potential is to be reasonably fully reaped. The marked parallels between the economy of South Africa and those of many Latin American countries, both in economic structure, recent growth performance and level of inequality, suggest that many of the conclusions applicable to Latin America are likely to be relevant to South Africa as well.

**Endnote**

This article is a shortened version of a conference paper presented by Albert Berry at the TIPS Annual Forum on 20 September 2000. The full version of the paper can be downloaded from the TIPS website (www.tips.org.za).

**Bibliographic Note**

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South Africa's International Competitiveness: The Role of Labour Costs

International competitiveness can contribute to the reduction of unemployment and the creation of sustainable economic growth. In this article, Stephen Golub assesses South Africa's international competitiveness, by analysing international differences in labour costs and labour productivity.

Introduction

East Asian and other successful emerging economies such as Chile and Mauritius have demonstrated that export growth can contribute to economic development, employment creation, and poverty reduction. Looking to emulate these experiences, the South African government has broken with the inward-looking policies of the Apartheid era, and seeks fuller integration into the world economy.

So far, however, the growth rates of exports and of foreign direct investment, while improved, have been less than policymakers had hoped for. Exports have increased but not by enough to generate an export-led growth boom similar to that of East Asia and a few other dynamic emerging economies. Figure 1 shows South African growth of exports of goods and services, in constant $US, in comparison with other "emerging market economies" and the world as a whole, for various periods. Prior to 1995, South Africa's trade grew much more slowly than the rest of the world. In the 1980s and early 1990s, South Africa's exports in constant dollars increased by 1-2 % annually, while world trade was increasing by about 5%. Some emerging countries had export volume growth rates of 10% or more during part or all of this period. From 1995-98, South Africa's annual export growth rate jumped to about 7%, but this is still well below many of the other emerging economies.

Some analysts believe that labour market rigidities hamper South African international competitiveness (for example the World Economic Forum's competitiveness rankings). Economic theory suggests that trade liberalisation can increase unemployment if labour markets are inflexible. Indeed, South African manufactured exports are relatively capital intensive and imports of manufactured goods have increased markedly. Unemployment has worsened from already high levels. Real wages have continued to rise in the face of this very high unemployment. Consequently, the purpose of this article is to assess South Africa's international price and cost competitiveness, particularly with regard to labour costs, and to examine the quantitative relationships between South African cost competitiveness and trade flows.

International Competitiveness

"International competitiveness" is a much-used phrase whose meaning is not always clear. Paul Krugman goes so far as to claim that competitiveness is a dangerous obsession when applied to countries, as opposed to companies. Krugman correctly points out that countries are not in direct competition with each other in the way that Coca Cola and Pepsi Cola are, and international trade is not a zero-sum game. Nevertheless, meaningful use of the term competitiveness is possible. In the larger sense, competitiveness can
be defined as a favorable business climate, sometimes measured by a composite score of a series of indicators: structural and macroeconomic policies, basic infrastructure, education, labour market rigidities, etc. This is the approach of the World Economic Forum’s competitiveness rankings. While these rankings are somewhat arbitrary, they do often capture features of the broad business climate.

One can define competitiveness more narrowly as international cost and price competitiveness, which is measured by comparisons of prices or costs across countries in a common currency. We will focus on this narrower definition of competitiveness, particularly relative unit labour costs, which reflects international differences in labour costs and labour productivity. There are some connections between this narrow conception of competitiveness and the broader notion of the overall business climate, since the latter will impinge on productivity.

South African international competitiveness "improves" when the South African real exchange rate depreciates, that is South African prices or costs fall relative to those of its competitors, thus raising the demand for South African products in world markets. In the literature on international competitiveness, various indicators of relative prices have been used. In an environment of increasing "globalisation", in the sense of greater global mobility of production, relative unit labour costs are a particularly useful indicator of competitiveness. Footloose industries will tend to locate where unit costs of non-tradeable inputs, particularly labour, are low. Costs of tradeable inputs, such as raw materials and capital, are likely to be approximately equalized internationally. The costs of non-tradeable inputs, however, may differ between countries. The most important non-tradeable input is labour. Thus, unit labour cost, that is the labour cost per unit of output, or equivalently wages divided by labour productivity, could be an important determinant of the location of production. Also, other factors such as the quality of infrastructure, level of education, the availability of social and physical capital etc., are captured indirectly in the unit labour cost measure through their effects on labour productivity.

South African Wages, Productivity, and Unit Labour Costs in Manufacturing

In this section, South African levels and rates of change of labour productivity and wages in aggregate manufacturing are compared to other countries. Productivity is calculated as real value added per employee, using the manufacturing value added deflator to deflate nominal value added, which is then converted to rands using a measure of the equilibrium or purchasing-power-parity exchange rate. Wages are defined here as total remuneration of labour, inclusive of non-cash fringe benefits, divided by number of employees. Wages are converted to rands using the market exchange rate.

Figure 2 compares South African wages and productivity to those of the major industrial countries in 1990 and 1998. Figure 3 presents similar data for a number of developing countries. Some clear patterns emerge.

- In the 1990s South African labour was quite competitive vis-à-vis labour in industrial countries. South African productivity was well below that of industrial countries, but in most cases, relative South African wages were even lower. That is, South African unit labour costs, the ratio of wages to productivity, were generally close to or below those of industrial countries both in 1990 and 1998. In the case of the United States, for example, South African wages and productivity were both around 25 per cent the

*1997 for Chile, Hungary and India; 1996 for Indonesia, Malaysia, Mauritius, and Zimbabwe; 1995 for Mexico, Thailand, Brazil and Poland.
U.S. level in 1990, meaning that South African unit labour costs were almost equal to those of the United States.

- Vis-à-vis developing countries that are major exporters of manufactures, however, South African unit labour costs were generally high, that is relative South African wages exceeded South African productivity (see Figure 3). Note that there is very large variation in South Africa’s overall level of wages and productivity vis-à-vis other developing countries. South African manufacturing productivity is two to four times greater than that of India, Indonesia, and Thailand, but is lower than Korean and Chilean productivity. Regardless of this variation in productivity differentials, South African relative wages exceed South African relative productivity in all cases in 1990 and all but one in the later 1990s, implying that South African unit labour costs are high relative to other developing countries.

- South African labour competitiveness improved against most countries during the 1990s as relative wages generally declined. There are, however, some exceptions among the developing countries (India and Mexico). The large depreciations in Asia and Latin America in the aftermath of the 1997-98 Asian crisis undoubtedly substantially deteriorated South Africa’s competitiveness.

Competitiveness and Exports

To assess the effect of competitiveness on exports, real effective exchange rates based on unit labour costs (REER-ULC) and other price indexes were calculated. Real effective exchange rates are weighted averages of bilateral real exchange rates, with the weights based on South Africa’s trading pattern. REERs were calculated for a wide range of alternative weights and price series, but this had little effect on the results.

Figure 4 plots South African real manufactured exports divided by real Gross Domestic Product (GDP) against the South African REER-ULC, inverted for ease of visual inspection (so that an increase in the REER index represents a real depreciation of the rand, that is an improvement in South African competitiveness). The REER shows that South African competitiveness worsened in the early 1980s then improved dramatically in the mid-1980s. There was then another period of real appreciation in 1992.

The rest of the 1990s have witnessed a substantial real depreciation, roughly returning real exchange rates to their late 1980s levels.

Figure 4 shows a strikingly close correlation between real exports and relative unit labour costs. The only apparent anomaly is that manufactured exports have grown more rapidly in the 1990s than competitiveness alone would justify. This is readily explicable in terms of a combination of the ending of sanctions associated with Apartheid and the adoption of more outward oriented economic policies. Regression analysis confirms the visual correlations of Figure 4. The strong effect of competitiveness on exports is robust with respect to variations in the way the real exchange rate is calculated, and to the specification of the regression equations. However, the effects of competitiveness on manufactured imports and foreign direct investment (FDI) were inconclusive. Other factors may have swamped the effect of competitiveness on FDI into South Africa in recent years, in particular, the sanctions under the Apartheid era, and the lifting of these sanctions with the demise of Apartheid. Also, FDI inflows are likely to be very sensitive to less quantifiable aspects of the business environment. The high crime rate in South Africa in particular could have a large deterrent effect on FDI.

Conclusions and Policy Implications

A mixed picture of South Africa’s competitiveness emerges from the analysis of this article. There has been a sizeable real depreciation in the last few years, but the recent depreciation has only returned the real exchange rate to the level of the mid-1980s. In absolute terms, South African wage levels appear to be reasonably competitive against developed countries when productivity differences are allowed for. However, it is probably more appropriate to compare South Africa to other emerging economies.

An increasing share of South Africa’s exports goes to developing countries, particularly Africa and Asia. A case can also be made that South Africa’s main competitors in developed country markets are other developing country exporters of manufactures. On this basis, South Africa appears to have a serious labour cost problem. South African unit labour costs (wages adjusted for productivity differences
across countries), are higher than almost all developing countries, ranging from low-wage countries like India and Indonesia, to higher wage countries like Brazil and Korea. At the very least, these results suggest that there is no room to increase real wages faster than productivity. On the contrary, wage moderation and/or continued real rand depreciation are necessary to gain competitiveness vis-à-vis other emerging markets and to foster the continued growth of exports and foreign direct investment.

While macroeconomic cost competitiveness is very important, by itself, it is not sufficient to resolve the unemployment problem and to create the foundations for lasting growth. Labour market rigidities, inadequate education, and crime are often-noted structural problems that must be tackled directly.

References


Endnotes

This paper is based on a longer paper, "South African International Cost Competitiveness" prepared for the South African Finance Department as part of the USAID/Nathan Associates SEGA Project. All the views expressed are strictly personal and do not represent the South African Finance Department, Nathan Associates or USAID.


Bibliographical Note

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Focus on Facts

Wage Premia and Wage Differentials in South Africa

This wage inequality analysis focuses on examining inequality measures for 9 main sectors and 10 manufacturing sub-sectors of the South African labour market.

Table 1 provides the wage differentials at the main sector level. The 90-10 differentials indicate that the highest levels of wage inequality are found in the Financial services sector (3.91), followed by Electricity (3.76). The lowest levels of inequality are in Community Services and Agriculture, with the latter yielding the lowest 90-10 differential. Note however, that when using the Gini which weights the entire distribution of earnings, Agriculture is the most unequal sector (0.79), and Electricity the least unequal (0.41).

The 90-50 differentials are greater than the 50-10 differentials for all main sectors. The percentile differentials indicate that sectors with high-skill factor proportions, such as Financial services and Electricity are rewarding top-end employees far more than skilled workers in other sectors. This reflects the extreme shortages in the labour market for these skill types, which are manifest then in significant wage premia. In the same vein, the suite of skilled workers demanded by Agriculture and Community services, for example, do not represent supply shortages of the same magnitude. In this case, the wage premia are much lower, and may in fact not exist.

Table 2 calculates wage inequality measures for 10 manufacturing sub-sectors. The highest 90-10 differentials are in capital-intensive industries, namely Radio, Television & Communication and Chemical & Petroleum industries. In contrast, it is two labour-intensive industries, Food, Beverages & Tobacco and Textile, Clothing & Leather, which yield the lowest 90-10 percentile differences - 3.59 and 3.32 respectively. If we do not split the sample of earners at points in the distribution, and take the overall Gini measure, the Radio, Television & Communication sector is still the most unequal, with an extremely high Gini of 0.78 and the Textile, Clothing and Leather sectors are the least unequal, with a Gini of 0.41.

In terms of the percentile differentials, the data suggests that within the manufacturing industry, wage differentials and wage premia are linked to technology mixes within each of the sub-sectors. Capital-intensive industries engender a demand for high-end workers with very specific skills. The shortage that exists for this labour in turn results in high wage premia, so ensuring that relatively higher levels of wage inequality within these industries. In contrast, labour-intensive industries yield a lower demand for high-end workers, and perhaps even have more of a requirement for general skills at the top-end. The shortages for these worker types are not as significant, meaning that the wage premia are lower, leading to a more truncated wage distribution.

Ultimately then, technology choices within the sector are inextricably linked to the wage inequality outcomes observed in each of these sectoral labour markets. The data also suggests that much detail concerning sectoral differences and factor proportions are hidden if we focus solely on aggregate measures of wage inequality.

The Development Policy Research Unit (DPRU) is part of the School of Economics at the University of Cape Town. The DPRU was formed in 1990 to undertake economic policy-oriented research, and is supported financially by a range of local and international agencies.

DPRU Research Activities

The DPRU coordinates research activities in the fields of
• labour markets and poverty
• regulatory reform
• regional integration

DPRU Research Projects

• Labour demand and labour supply in South Africa
• Regional Industrial Strategy Project
• An evaluation of the success indicators of the Skills Development Programme for the Department of Labour
• Employment trends in the Sector, Education and Training Authorities for the Department of Labour
• An analysis of the Youth Labour Markets for the National Youth Commission
• Subsistence Fisheries Research Project for the Department of Environmental Affairs and Tourism
• Competition in the Water Industry for the Competition Commission

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DPRU Workshops

Labour Market Policy in South Africa

The DPRU hosted a workshop in conjunction with Friedrich Ebert Stiftung (FES) on 23rd November 2000 on Hiddingh Campus in Cape Town. The aim of the workshop was to focus on policy issues related to South African labour markets. Presenters at the workshop covered the following topics:

- Ulrich Walwei - Trends in the EU Labour Market and Implications for SA
- Len van Niekerk - Employment trends in the SA Labour Market
- Lawrence Edwards - Trade Liberalisation and Employment
- Ian Macun - The Role of the National Skills Development Programme in the South African Labour Market
- Labour Market Policy Panel:
  Neil Coleman, Iraj Abedian, Murray Leibbrandt, Jeremy Baskin - “The role of government intervention in determining employment, poverty, equity and efficiency outcomes”

SADC Industrial Development through Regional Cooperation and Integration

The DPRU convened its second research-in-progress workshop on 29-30 September 2000 at the Safari Court Hotel in Windhoek, Namibia. These annual workshops are related to the DPRU’s research for the Industrial Strategy Project. The aim of this project is to identify the policies, programmes and processes that will contribute to the regional integration and industrialisation of the Southern African Development Community (SADC). The following topics were covered by presenters at the workshop:

- Rashad Cassim - The Determinants of Intra-Regional Trade in SADC
- Geoffrey Du Mhango - The Clothing and Textile Sector: Malawi
- Dirk Hansohn - Economic integration in Southern Africa. A view from a small country
- Paul Kalenga - Emerging trends and patterns of foreign direct investment (FDI) in Southern Africa
- Faith Kolala - South African Retail Firms in Zambia
- Monysha Jhamna - Restructuring of the Mauritian Clothing Industry in the light of New Trade Agreements
- Michael Masebula - Key issues facing sugar industries in the Southern African Development Community
- Thapelo Matsheka - Towards Financial Market Integration in SADC
- Regional Integration and the Automotive Industry in Southern Africa
- Martine Visser - Inter- and intra-industry trade flows between SADC and SACU: Key Policy Issues
- Owen Sichone - A Political Economy Perspective on the Prospects for SADC
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Bhorat, H. “Brain drain hits the labour market”. Business Day. 7 September 2000.

Bhorat, H. “Some people are more jobless than others”. Sunday Independent. 5 November 2000.

Conference papers


Kalenga, P. 2000. What are the critical issues arising from the SADC trade integration process? DPRU Policy Brief 00/P3.

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