

**South Africa, as part of a difficult global environment, is confronted with policy choices to create higher sustainable economic growth. Policy makers are faced with a challenging economic environment and constrained by rising government debt as well as weak international demand for exports.**

## **SUGGESTIONS ON HOW TO PUT SOUTH AFRICA ONTO A HIGHER ECONOMIC GROWTH PATH**

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**[3821 words<sup>1</sup>]**

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<sup>1</sup> Excluding in-text references, figures and footnotes.

## 1. Introduction

This essay provides an in-depth discussion on how to put South Africa on a higher economic growth path. Section 2 provides an overview of South Africa's current economic environment as well as a review on the country's policy constraints. Section 3 critically outlines how South Africa can be put on a higher economic growth path given its constraints. The country's resource curse is identified as a major barrier to sustainable growth, thus, a pivotal international trade theory (the Heckscher-Ohlin model) is used as the foundation to create a growth model that will help South Africa overcome its resource curse. Before concluding in Section 5, a brief overview of China's successful policy choices and its relevance to South Africa is discussed in Section 4.

## 2. South Africa's Current Economic Environment and Constraints on Policy Choices

Former Minister of Finance, Pravin Gordhan, asserts that "the global financial and economic crises of six years ago might have ended, but the effects were still being felt" (Maswanganyi, 2014). Economies around the world have experienced a difficult global environment in the past six years and South Africa is no exception. South Africa is part of the 'Fragile Five'<sup>2</sup> – five emerging economies that all have high current account deficits and rely heavily on foreign capital inflows<sup>3</sup> (Colombo, 2014).

On 19 June 2013, the US federal chairman, Ben Bernanke, announced that the US would be tapering its Quantitative Easing (QE) programme (Priol, 2013). The QE programme involved the US central bank purchasing large amounts of financial assets from around the world to mitigate the adverse effects of the 2008 financial crisis (Zumbrun and Saraiva, 2013). Emerging economies (such as South Africa) have benefitted from the QE programme as it resulted in large financial inflows into the economies, thus, the tapering had brought on some concern about financial stability<sup>4</sup> (Jones, 2014). South Africa's largest trading partners have also faced a difficult economic environment, putting further pressure on South Africa's economic stability (Maswanganyi, 2014).

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<sup>2</sup> The countries that make up the Fragile Five include: Brazil, India, Indonesia, South Africa and Turkey (Colombo, 2014).

<sup>3</sup> Other common characteristics of the Fragile Five are high inflation and stagnant economic growth (Colombo, 2014).

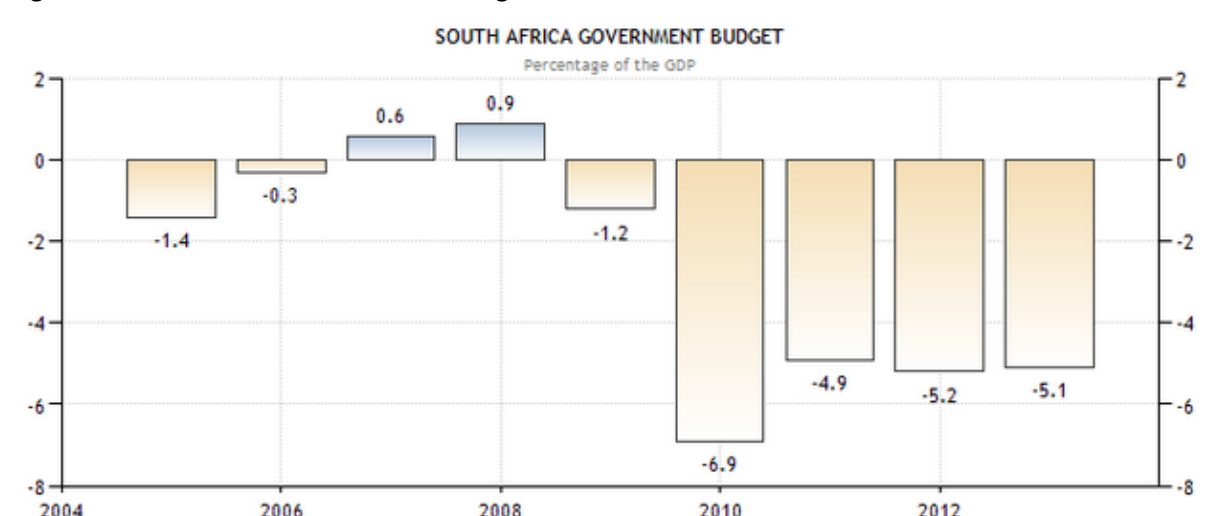
<sup>4</sup> South Africa experienced a R12 billion net outflow of capital in the first quarter of 2014 (Jones, 2014).

Despite the challenging economic environment, Minister Gordhan believes inclusive growth models can be created to put South Africa on a higher economic growth path (Maswanganyi, 2014). This essay supports Minister Gordhan's notion and provides suggestions on creating a sustainable growth model for South Africa. However, before a growth model can be created, the current constraints policy makers face should be reviewed.

## Constraints on Fiscal Policy

Fiscal policy entails policy makers using tax policies and public expenditure to influence the economy (Salvatore, 2011, 45). Figure 1 illustrates that since the 2008 World Financial Crisis, South Africa has been experiencing a fiscal budget deficit. This implies that government is spending more than what it receives in tax revenue. Figure 2 further illustrates that South Africa's government debt-to-GDP ratio has severely increased since 2009. As a result, South Africa has become heavily reliant on foreign capital inflows to manage its balance of payments (Jones, 2014). During the 2014 Budget Speech, Pravin Gordhan announced that there would be limits on public expenditure to ease the budget deficit (Treasury, 2014). Moreover, there were no personal and corporate tax increases in the 2014 budget to increase government's revenue (Treasury, 2014). Bisseker (2014) explains that increase in taxes would have adverse effects as consumers have lower disposable incomes and less access to credit than in previous periods (Bisseker, 2014). Thus, policy makers are highly constrained in implementing fiscal policies to promote growth.

Figure 1: South Africa's Government Budget



Source: Colombo (2014)

Figure 2: South Africa's Debt-to-GDP ratio



## Constraints on Monetary Policy

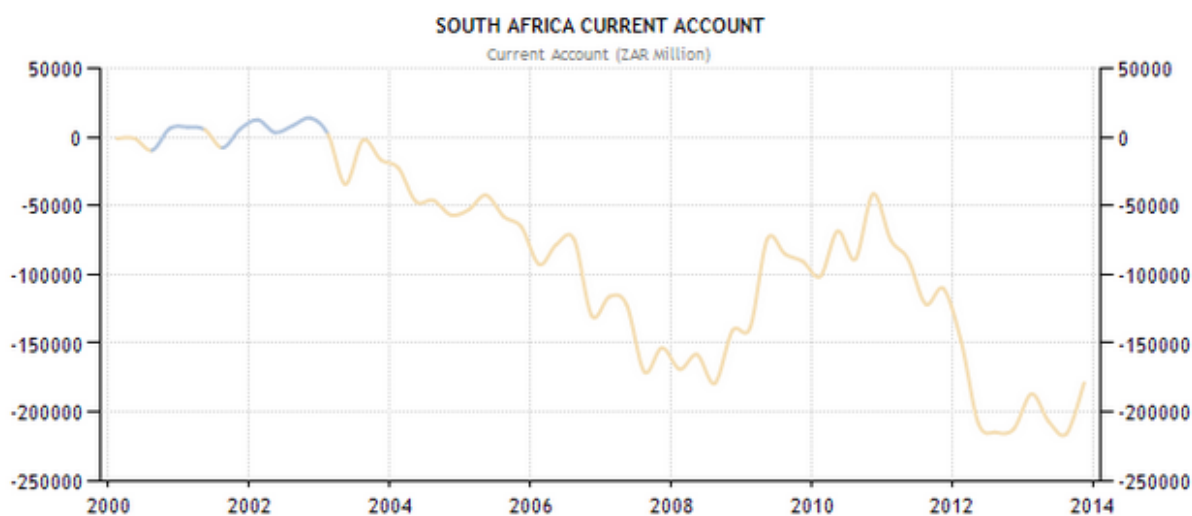
Monetary policy entails controlling and managing a country's interest rates and foreign reserves (Salvatore, 2011:58). Through monetary policy the South African Reserve Bank (SARB) can stabilise the country's currency and inflation rate (Salvatore, 2011:59). In response to the depreciating rand and inflationary pressures, the SARB increased South Africa's repo rate by 50 basis points to 5.5% on 29 January 2014. This increased the prime lending rate to 9%, the highest rate the country experienced in 5 years (Bisseker, 2014). Reuters (2014) reports that the SARB may have to further increase the interest rates either in mid-2014 or in 2015. However, Colombo (2014) advises that the SARB take careful consideration in increasing the interest rates further as South African consumers are highly reliant on credit due to the country's low savings rate. A further interest rate hike may lead to high defaults on debts, severe bank losses and a contraction in the economy (Colombo, 2014). Ensor (2013) asserts that the SARBs use of foreign reserves to stabilise the rand and put downward pressure on inflation is not sustainable either. This is due to South Africa's reserves being relatively low in comparison to other emerging countries<sup>5</sup>. Thus, a monetary intervention is also constrained in its ability to increase growth.

## Constraints on Trade

<sup>5</sup> In comparison with Brazil's \$400 billion reserves, South Africa's current reserves are sitting at an estimated \$50 billion (Ensor, 2013).

Figure 3 illustrates the weak international demand for South African exports. As depicted, South Africa has been experiencing a persistent current account deficit since 2003. This deficit has been deteriorating significantly in the past three years. Colombo (2014) asserts that South Africa has been financing this deficit with R1.2 trillion in foreign net capital inflows, thus, creating high financial volatility in South Africa. Figure 4 further illustrates that South Africa has been experiencing a persistent current account deficit-to-GDP ratio since 2004. Currently, the country's current account deficit-to-GDP ratio is above 6%, a level Colombo (2014) indicates can lead to a currency crisis.

Figure 3: South Africa's Current Account



Source: Colombo (2014)

Figure 4: South Africa's Current Account-to-GDP Ratio



Source: Colombo (2014)

South Africa faces fiscal and monetary policy constraints, as well as constraints on international trade. Thus, policy makers are faced with a challenging economic environment. The flexibility in

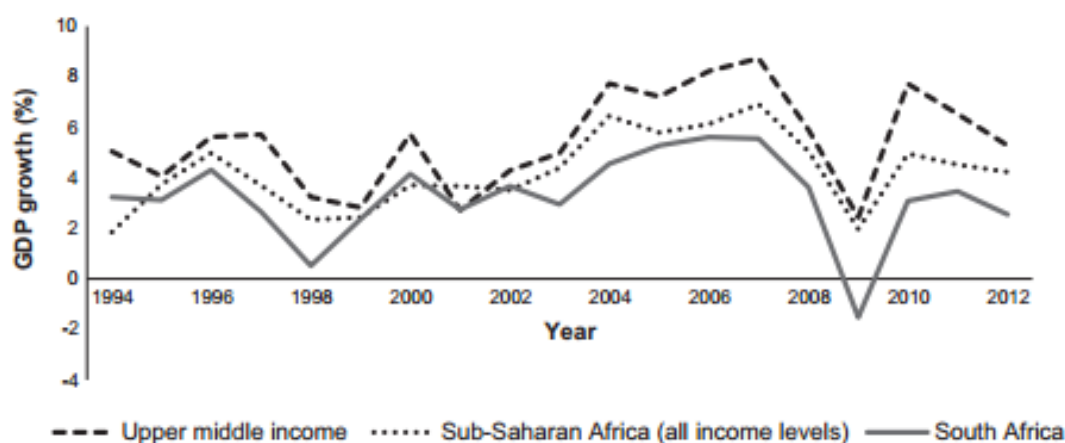
South Africa's fiscal and monetary policies are limited. Thus, this essay suggests that policy makes focus on overcoming South Africa's trade constraints. Improving South Africa's international trade position can lead to increase flexibility in the country's fiscal and monetary position. The rest of this essay will therefore focus on building a growth model to overcome South Africa's trade constraints.

### 3. Putting South Africa on a Higher Economic Growth Path

#### Overcoming South Africa's Resource Curse

South Africa's trade constraints stems from a phenomenon known as a 'resource curse' (NDP, 2011:97). A resource curse occurs when a resource abundant country lags behind in growth relative to peer countries (Sachs and Warner, 1995). The National Development Plan (NDP) (2011:97) acknowledges that South Africa faces a resource curse and Ainsley (2013:552) empirically concluded that the country is indeed facing one - Figure 5 depicts Ainsley's (2013:552) findings. Figure 5 depicts the average GDP growth rate for South Africa, Sub-Saharan Africa, and all upper middle income countries for the period 1994-2012. As illustrated, South Africa's GDP growth rate has consistently been below average in Sub-Saharan Africa, as well as below average for an upper middle income country<sup>6</sup>, confirming the country's resource curse.

Figure 5: Average GDP Growth Rates



Source: Ainsley (2013:552)

<sup>6</sup> For the period 1994-2012, South Africa averaged a 3.26% GDP growth rate, while the average for Sub-Saharan Africa and all upper middle income countries were 4.72% and 4.18% respectively (World Bank, 2013).

South Africa faces a resource curse due to the country's high dependence on its natural resources for economic stability<sup>7</sup>. The country has invested a lot of resources in extracting and exporting its natural resources (Trading Economics, 2014); however, Ainsley (2013:550) asserts that these resources have not been efficiently managed. Colombo (2014) adds that the mining strikes in South Africa have reinforced the resource curse by further dampening the country's current account<sup>8</sup>.

The NDP (2011:93) highlights that in order to overcome the resource curse, South Africa needs to increase and diversify its export base. Increasing and diversifying the country's export base will lower its reliance on natural resources. In order to achieve this, South Africa needs to successfully promote international demand in other South African goods. However, South African firms have not been able to effectively take advantage of trade opportunities<sup>9</sup> (NDP, 2011:104). This essay turns to the Heckscher-Ohlin (HO) model, an international trade theory, to determine how South Africa can more effectively take advantage of trade opportunities.

## The Heckscher-Ohlin model and South Africa's Comparative Advantage

Baldwin (2008:160) refers to the Heckscher-Ohlin (HO) model as one of the pivotal theories of international trade. The HO model assumes a country has two main factor endowments, capital and labour<sup>10</sup>. Each country is relatively abundant in either capital or labour. According to the HO model, a capital-abundant country can gain a comparative advantage if it specialises in producing capital intensive goods. Similarly, a labour-abundant country can gain a comparative advantage if it specialises in producing labour intensive goods. All countries can benefit from international trade by exporting their factor-intensive goods and importing goods that are intensive in their scarce factor. Thus, a capital-abundant country can benefit by exporting capital-intensive goods and importing labour-intensive goods, whereas, a labour-abundant country can benefit by exporting labour-intensive goods and importing capital-intensive goods.

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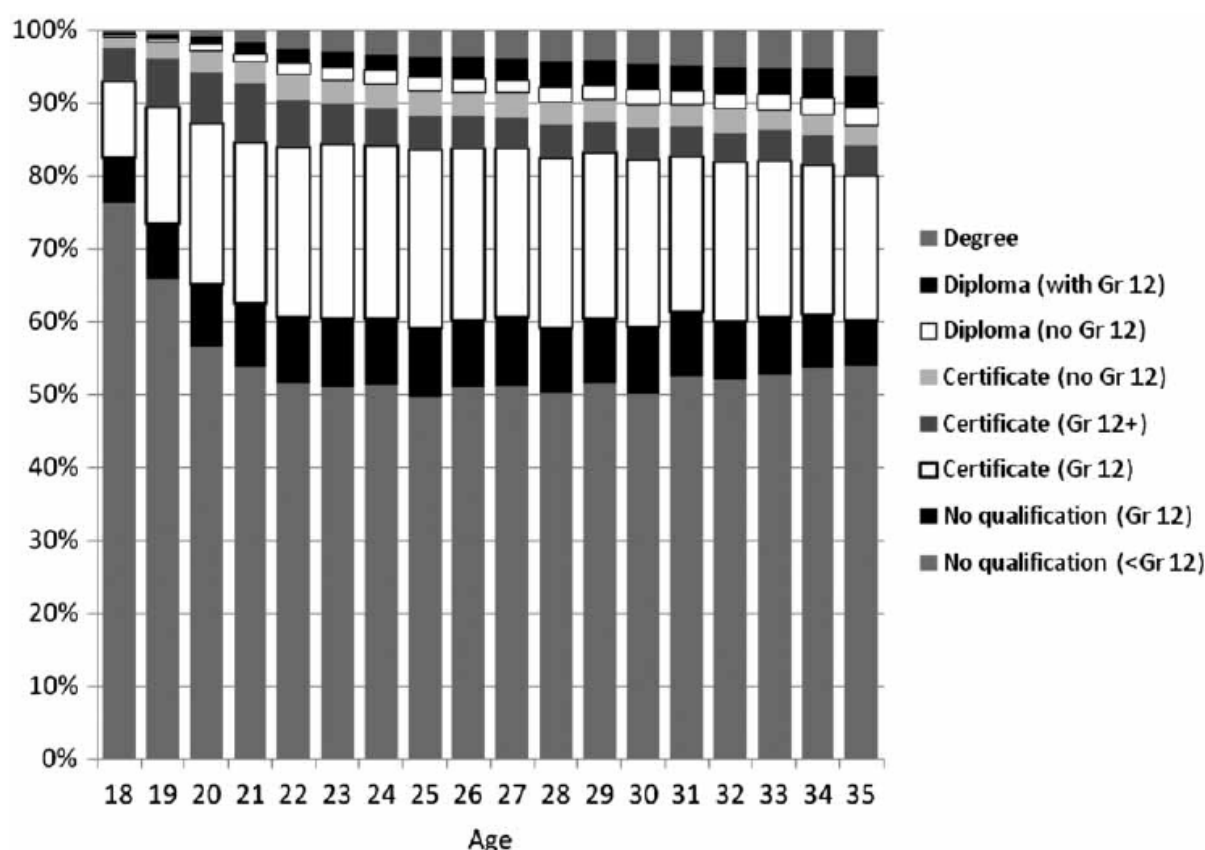
<sup>7</sup> Almost one-third of South Africa's exports comprise of natural resources, these include; gold (8% of total exports), chromium and platinum (8%), iron ores (7%) and coal (6%) (Trading Economics, 2014).

<sup>8</sup> Since the 2008 World Financial Crisis, South Africa has experienced its first period of negative growth in the first quarter of 2014 in light of the mining strikes that started in early 2014 (Destiny, 2014).

<sup>9</sup> Despite the rand depreciating by 36% between the end of 2010 and 2013, South Africa's exports remained low (Bisseker, 2014).

<sup>10</sup> Capital abundant countries are assumed to have an abundance of high-skilled labour, whereas, labour abundant countries are assumed to have an abundance of unskilled labour (Baldwin, 2008:160). Similarly, capital intensive goods/firms are assumed to be high-skilled labour intensive, whereas, labour intensive goods/firms are assumed to be unskilled labour intensive (Baldwin, 2008:160). This essay uses the terms 'unskilled' labour and 'low-skilled' labour interchangeably.

Figure 6: Skills Level in South Africa



Note:

'Certificate (Gr 12+)' = Grade 12 Senior Certificate with a University entrance level.

'No Qualification (Gr 12)' = Attended but did not pass grade 12.

'No Qualification (<Gr 12)' = Did not attend grade 12.

Source: Gustafsson and Mabogang (2012:354)

Figure 6 depicts the skills level in South Africa for different age groups. As illustrated, approximately 60% of the population between 18 and 35 have no qualifications. Thus, in accordance with the HO model, South Africa can be seen as a country that has an abundance of low-skilled labour. South Africa can therefore gain a comparative advantage by producing low-skilled labour intensive goods. However, the country is experiencing a shift in structural employment; labour intensive firms (such as low-cost manufacturing firms) are employing fewer workers, while capital intensive firms (such as telecommunication and financial industries) are employing more workers (NDP, 2011:99). Altman (2006:2) believes that South Africa's focus in becoming a technological driven country (which requires high-skilled labour) has adverse effects for the country's low-skilled workers. Tsikata (1999) as well as Lewis (2001) contend that South Africa has failed to make effective use of its comparative



advantage in low-skilled labour. This is reflected by Deloitte's (2013:2) estimation that South Africa's manufacturing competitiveness will remain weak and stagnant over the next few years<sup>11</sup>.

In order to increase and diversify South Africa's exports, policy makers should adopt the principles of the HO model and view South Africa's abundance of low-skilled labour as a comparative advantage. Focus should therefore be on exporting low-skilled labour intensive goods. Petzer (2014) supports the international promoting of low-skilled labour intensive goods, however, Saunders (2013) highlights that the majority of low-skilled workers in South Africa are unemployed<sup>12</sup>, thus, before being able to benefit from this comparative advantage, policy makers should identify key industries that are able to absorb low-skilled labour.

### Focusing on Key Industries

In identifying the key industries South Africa can realise its comparative advantage in, this essay looks at the country's top five labour intensive industries as well as its top 10 trading partners. Altman (2006:16) identifies the top five semi- to low-skilled labour intensive industries in South Africa as: Agriculture, manufacturing, mining, construction and transport. Figure 7 depicts the employment levels in each of these industries. As illustrated, all five industries employ over half a million workers each, with the manufacturing industry employing the highest amount of 1.75 million workers. Given that South Africa's resource curse stems from its focus on natural resources, this essay suggests that greater focus be put on promoting the other four industries identified. South Africa's ten largest trading partners determined by Trading economics (2014) are: Brazil, China, Germany, India, Japan, Nigeria, Spain, United Kingdom, US and Zimbabwe.

Figure 7: Employment Levels of Labour Intensive Industries

Industry	Employment '000'
Agriculture and forestry	739*
Construction	1020*
Manufacturing	1753**
Mining and quarrying	519*
Transport	813*

\*Source: StatsSA (2013)

\*\*Source: StatsSA(2012)

<sup>11</sup> In 2013, South Africa was ranked 24<sup>th</sup> out of 38 countries in terms of manufacturing competitiveness, whereas, it is predicted that South Africa will drop to 25<sup>th</sup> place within 5 years (Deloitte, 2013:2).

<sup>12</sup> Only 28.9% of low-skilled workers were employed in 2012, thus, 71.1% of low-skilled workers are unemployed (Saunders, 2013).

Policy makers should review the key industries and trading partners identified to determine the most appropriate trade composition for South Africa. Mittner (2013) views the QE tapering as a signal that the US and other developed economies are recovering, thus, reflecting a positive outlook for South African trade. If South Africa is able to stimulate an increase in demand for low-skilled labour-intensive goods, the country could see an improvement in its trade balance in light of Mittner's (2013) view.

Before being able to increase international demand for low-skilled labour-intensive goods, the key industries need to absorb the country's unemployed low-skilled workers. While supporting the notion that more jobs need to be created for low-skilled workers in the South Africa, Ramutloa (2013) notes that one of the major challenges low-cost manufacturing firms face is reducing costs to remain competitive. Hodge (2012:15) empirically concluded that labour costs have had a significantly negative impact on growth of manufacturing firms (the highest employer of low-skilled labour) in South Africa. Due to strict labour laws, manufacturing firms have been forced to increase real wages<sup>13</sup> without receiving any increase in labour productivity. This has undermined South Africa's competitiveness in the manufacturing sector, thereby resulting in a fall in output (Hodge, 2012:15). Dorn (2013) supports this claim by asserting that wages for low-skilled workers are too high for low-skilled labour intensive industries in South Africa to remain competitive. Thus, policy makers should consider policies that reduce the costs of hiring low-skilled labour.

### Reducing costs of Hiring Low Skilled Labour

As mentioned earlier, the majority of low-skilled workers in South Africa are unemployed (Saunders, 2013). In accordance with Classical economics theory, a high unemployment rate should cause downward pressure on wages (Hodge, 2012:15). The lower wages will allow firms to hire more labour, thereby increasing employment (Hodge, 2012:15). However, the presence of a minimum wage in South Africa limits the downward pressure of wages, thereby, preventing the employment rate from increasing. Gorman (2013) further adds that the minimum wage for low-skilled workers in South Africa is set above the equilibrium wage rate<sup>14</sup>. Thus, low-skilled labour intensive firms cannot afford to absorb excess low-skilled labour due to the above equilibrium wages.

Lowering the minimum wage rate to the equilibrium wage rate will allow manufacturing firms to absorb more low-skilled workers. However, Saunders (2013) contests that lowering the minimum wage will further increase inequality in the country. The NDP (2011:90) aims to ensure every family

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<sup>13</sup> "Unit labour costs in manufacturing rose more than 17-fold in South Africa between 1980 and 2010" (Hodge, 2012:8).

<sup>14</sup> The equilibrium wage rate is at "the point at which the marginal cost of labour equals its value of marginal product" (Hodge, 2012:15).

has a standard of living which is sufficient and acceptable. Thus, it will not be desirable to lower the disposable income of a minimum wage rate worker. As a result, this essay suggests granting a minimum wage subsidy to key firms hiring low-skilled workers.

Subsidies are granted when the social benefit of an activity is greater than the private benefit (Black, Calitz and Steenekamp, 2012:131). With regards to low skilled labour, the social benefit (reduced unemployment) is greater than the private benefit (marginal product of low-skilled labour). Thus, policy makers should consider the social benefit of granting a wage subsidy that will be used to maintain the minimum wage rate for low-skilled workers while allowing firms to pay their marginal product of labour. The subsidy will split low-skilled workers wages into two components: the equilibrium wage paid by the firm and the subsidy provided by government. This is expressed in equation (1) as follows:

$$\text{Workers minimum wage} = \text{firms equilibrium wage rate} + \text{minimum wage subsidy} \quad (1)$$

Policy makers should allow low-cost manufacturing firms to pay low-skilled workers the wage they would pay at equilibrium<sup>15</sup>. The subsidy granted to firms will be used to supplement the low-skilled workers wage to ensure they still receive the minimum wage. The value of the subsidy should therefore be the difference between the minimum wage rate and the equilibrium wage rate for firm. The minimum wage subsidy is determined by rearranging equation (1):

$$\text{Minimum wage subsidy} = \text{workers minimum wage} - \text{firms equilibrium wage rate} \quad (2)$$

The subsidy will give low-skilled labour absorbing firms a cost advantage and will enable them to hire more labour. An increase in employment for labour-intensive firms will enable South Africa to increase production in labour-intensive goods, whereas, the cost advantage will increase the firms international competitiveness. This competitive advantage will help the NDP (2011:93) achieve its goal of diversifying and increasing exports, thereby helping South Africa overcome its resource curse. By overcoming the resource curse, South Africa can be put on a higher economic growth path.

### Financing of Minimum Wage Subsidies in Key Industries

South Africa is currently face a rising budget deficit, thus, addressing how policy makers will provide adequate funding for the minimum wage subsidy is a key issue. Ray (1999:387) provides a policy strategy that will allow the wage subsidy to be “self-financing”. The wage subsidy will equate a firm’s marginal cost of labour to its marginal product of labour, thereby, enabling the firm to maximising labour productivity. According to Hodge (2012:15), this increase in productivity will increase the

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<sup>15</sup> The marginal cost and marginal value of labour can be determined using advanced econometric techniques.

firms output as well as profits. Policy makers can create a 'self-financing' policy by increasing the profit tax on key firms and returning the increment tax proceeds in the form of the wage subsidies (Ray, 1999:387). Ray (1999:387) explains that the profit tax and wage subsidy should be conditioned on two measures of the firm's performance: employment and profits. If the firm experiences an increase in profits, but does not absorb more low-skilled labour, it will end up paying a higher net-tax. Thus, the firm will be incentivised to increase employment in low-skilled labour as this will allow the firm to receive a net subsidy; thereby lowering its net tax (Ray, 1999:387).

Additionally, if the wage subsidy allows South Africa to make effective use of its comparative advantage, firms will be in a better position to take advantage of international trade opportunities. The NDP (2011:94) acknowledges that if it can sustain an increase in exports, the increase in foreign revenue can be used for further economic development. It can be argued that the minimum wage subsidy will promote further economic development. Government will receive the increase in foreign revenue through increased tax revenues from exporting firms. Thus, using the increase in foreign revenue to fund the wage subsidy is in line with Ray's (1999:387) self-financing policy as well as the NDP's (2011:94) development objective.

#### 4. Learning from China

Although China and South Africa are two different economies, South Africa's current economy shares some similarities with China's economy in 1979. Prior to 1979, China had experienced high unemployment and stagnant growth due to inefficient utilisation of resources (Morrison, 2014:1). In 1979, China embarked on several economic reforms that resulted in the country becoming the second largest economy in the world 30 years later (Morrison, 2014:2). The suggestions mentioned in this essay were inspired by China's economic reform. Much can be learned from China's success, thus, South Africa's policy makers should critically review China's policy choices.

In the late 1970's China embarked on an international trade reform by liberalising trade and investing in promoting exports in its manufacturing sector (Morrison, 2014:8). The two major contributing factors to China's manufacturing success were a rapid increase in productivity and relatively low wage rates (Morrison, 2014:5-9). China had a high unemployment rate, thus, it followed a Classical economics approach in setting low wage rates (Morrison, 2014:9). The low

wages gave China's exporting sectors an international competitive advantage<sup>16</sup> that resulted in it becoming the world's largest manufacturing exporter (Morrison, 2014:3). Wages were low during China's rapid growth period, however, real wages started to increase once China reached a level of sustainable growth (Morrison, 2014:9). The NDP (2011:102) acknowledges that achieving growth and employment requires wages to be low for a period of time. It is estimated that wages will only start to increase 2-5 years after a country achieves a level of sustained growth (NDP, 2011:104). Learning from China's success will help policy makers to create an inclusive growth model that will put South Africa on a higher economic growth path. Thus, South African policy makers can learn from some of the policy measures undertaken by China that turned it into a manufacturing and exporting powerhouse.

## 5. Conclusion

The aftermath of the 2008 World Financial Crisis creates a challenging environment for South Africa. The QE policy has raised concerns about South Africa's financial stability. These concerns are justified, as a review of the country's policy constraints reveals that policy makers are restricted in their ability to steer the economy to higher growth. This essay maintains that by improving South Africa's international trade position, the country's fiscal and monetary position will improve too. South Africa is facing a resource curse that is causing the country's growth rate to lag its peers. The NDP acknowledges that South Africa can overcome the resource curse by increasing and diversifying exports, however, South African firms have not been able to effectively take advantage of trade opportunities. The HO model is used as a foundation to create a growth model that will enable South Africa to overcome the resource curse. In accordance with the HO model, South Africa has a comparative advantage in low-skilled labour that it is failing to take advantage of. This essay suggests that South Africa focus on expanding its labour-intensive industries and exporting labour-intensive goods. The country's five largest labour intensive industries are identified as key industries that should be promoted. It is identified that marginal costs of hiring low-skilled labour is greater than the marginal product from labour, thus, dampening productivity levels in the labour-intensive industries. This undermines the international competitiveness of the key industries identified. To overcome this competitive barrier, this essay suggests lowering the minimum wage firms pay to low-skilled workers. Firms should be allowed to pay low-skilled workers their marginal product of labour, thereby, enabling these firms to absorb more labour and increase production. It is not socially

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<sup>16</sup> It must be noted that China's competitive advantage started to deteriorate in the early 2000s due to a drastic rise in real wages (Morrison, 2014:9).

desirable to lower the disposable income of minimum wage workers, thus, policy makers should realise the social benefit of providing a wage subsidy to the identified key industries. The subsidies will be used to ensure the disposable income of a minimum wage worker is not reduced. These subsidies will be financed through Ray's (1999) self-financing subsidy policy. It is noted that China faced a similar economic environment prior 1979 that South Africa faces today. The suggestions mentioned in this essay were inspired by China's successful economic reform. Today China is the World's second largest economy, and the World's largest trading partner, thus, much can be learned from China's success. South Africa's policy makers should therefore critically review this essays suggestions as well as China's policy choices, as it can help create a growth model that will put South Africa on a higher growth path.

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