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Good case for keeping foot gently on pedal of support

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IN TERMS of output, employment and
exports the automotive industry is one of SA's largest and most dynamic manufacturing sectors. However, it has also been one of the largest recipients of state support. The cornerstone of this support — tariffs on built-up vehicles — will continue to decline from 29% now to 25% in 2012. But under the recently announced Automotive Production and Development Programme (APDP), tariffs will then remain fixed at that level until 2020.

Given the importance of the industry to the economy, should tariffs and industry support in general continue to decline and, if so, to what level? Is there a rationale for maintaining support?

The simple answer may depend on whether one works in the vehicle assembly and components manufacturing industry or is in the market to buy a new (or used) car at the lowest possible price.

Standard economic theory predicts that lower tariffs and the liberalisation of imports of used vehicles should bring down prices. So what is the rationale to provide continuing support to this industry, which appears to be taking a long time to become competitive. Or to phrase the question differently: is SA a good place to make cars? And if it is not, might it become one in the future?

The first point is that support for the industry has already been very sharply reduced.

Tariffs have declined from 110% in the late 1980s to 65% at the start of the Motor Industry Development Programme (MIDP) in 1995 to the current 29%. Furthermore, it is important to remember that under the MIDP, and in respect of the future APDP, these duties can be rebated. This has the effect of lowering protection still further.

Also, in terms of the European Union (EU) Free Trade Agreement, imports from the EU are subject to an even lower import duty. The result of lower tariffs has been a steady decline in the share of the domestic market supplied by local production. Consumers have benefited from falling prices in real terms and much expanded choice.

Our analysis suggests that the industry is not far from the tipping point at which further liberalisation would place major local assembly plants and their suppliers at risk. Apart from the employment losses associated with such an eventuality, in this highly scale-intensive industry, increased import penetration could lead to reduced output volumes in assembly and component production and therefore to higher unit production costs.

Nevertheless, the existence of painful adjustment costs does not on its own constitute an argument for continuing support unless it can be demonstrated that the industry can be sustainable at lower levels of support in the future.

This is a complicated question. Domestic vehicle assemblers are all foreign-owned and compete with other subsidiaries of the multinational parent companies .

So the future of the domestic industry depends on whether it can enhance its position within these global networks.

On the one hand, the structure of the South African industry is much more efficient than what developed in the import-substitution phase. The scale of production is higher, both in assembly and components production, and in-plant production costs have therefore been reduced. But production volumes remain below world scale. And the fact remains that the more dynamic emerging automotive producing countries, such as China, India, Mexico and Thailand, have been making even more rapid progress.

Further liberalisation would lead to greater import penetration, but some argue that growing import competition would push firms to export more. This seems unlikely as the industry is already quite export-oriented. In fact, given the export-import complementation structure of the MIDP, and the production-import complementation of the APDP, further liberalisation is likely to have a damping effect on exports.

When multinational car makers decide on the production of a new model, locations are selected according to several criteria.

One of these is naturally the size of the home market and the level of protection afforded to assemblers competing in that market. The main substantive argument for continuing support beyond temporary adjustment assistance arises out of the possibility that some dynamic comparative advantage exists.

Higher volumes and a correspondingly higher level of economic localisation of the supply chain would significantly improve competitiveness. Volkswagen's recent announcement that it will reduce the number of model platforms while raising volumes and local content is a case in point.

A problem is that SA is geographically remote from major markets. Neither SA nor the southern African region constitutes a viable "automotive space". The regional market is very small and, apart from SA , is divided into several tiny economies, for which the cheapest sources of supply are used vehicles from countries such as Japan. Multinational firms do not see SA as a prime export base except to the extent that exporting facilitates access to the domestic market via the MIDP, and helps them achieve the volumes required for efficiency. Relative remoteness implies significant logistics costs. The main problem for vehicle producers is inbound logistics, a problem compounded by low levels of localisation of components. In-plant production costs in SA are in fact very competitive with traditional production centres such as Germany.

However, there are considerations that ameliorate the position to a degree. Widely dispersed global markets mean that risk is reduced, while trade arrangements with the EU and the US have been advantageous and SA remains an important supplier to several niche markets, which collectively are very important.

Closer trade ties with large and growing proximate markets such as India and

Brazil would probably be sensible.

The domestic market in SA is among the top 25 in the world and, the current downturn aside, has been growing rapidly. The regional market is very small but has the potential to become significant in the longer term. Africa’s population of 995-million is projected to grow to 1,9-billion by 2050, and with regional gross domestic products growth rates of, say, 6%, vehicle market expansion will be very rapid off a low base. One multinational vehicle producer forecasts that Nigeria will be the largest vehicle market in Africa by 2025. Assuming that other countries in sub-Saharan Africa achieve similar growth rates, Africa will by then constitute a significant market. On these grounds, a clear case can be made for a degree of continuing support as the regional market expands to a size sufficient to support a more competitive South African industry.

The importance of the recent announcement of the introduction of the APDP in 2013 cannot therefore be overstated. Its architecture is based on incentivising automotive-related production, investment, and large-scale vehicle assembly, albeit at lower tariffs and support levels than currently apply. These measures should ensure that SA remains on the global map in respect of vehicle production, and is also positioned to play a leading role in the future growth of the African market.

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