THE CURRENT STATE AND SHORT-TERM PROSPECTS FOR THE SOUTH AFRICAN & WESTERN CAPE ECONOMIES

A report prepared for Western Cape Department of Economic Development & Tourism by the Bureau for Economic Research, University of Stellenbosch

30 November 2005

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Global economy

- Recent international economic indicators have tended to confirm the expectation of "trend growth or better" in the global economy following the slowdown during the second half of last year and early this year. The OECD G7 country composite leading indicator increased for five consecutive months from April this year.
- Likewise, both the OECD EU15 and Japanese composite leading indicators increased for the past four months consecutively. The evidence is stronger that Japanese domestic demand is picking up in a sustainable manner on the back of improved employment and income growth. In the Euro area growth still remains largely driven by exports; however, the more upbeat assessment of economic conditions in the region is a significant recent development.
- Chinese real GDP growth continues to proceed at an 8.5-9% pace, including evidence of better balance between retail and investment demand. The Asian region will be an important source of global economic growth over the short term.
- Although US economic growth has come in stronger than expected during calendar 2005, the expectation is for some slowdown in this economy over the short term.
- The economic outlook for developing countries remains positive as industrial commodity prices remain well supported. A number of developing country economies in Europe, Asia, Africa and Latin America are also benefiting from more stable macro-economic environments and micro-economic reforms.
- International crude oil prices have moderated significantly. This could be due to a combination of more price sensitive demand, mild winter weather in the Northern Hemisphere, and increased OPEC supply. Depending on the climatic conditions in the US and Europe, the oil price could continue to moderate over the short term; however, it is unlikely to settle at much lower level. Currently the risk remains for it to spike upwards in the event of hostile climatic conditions and/or supply problems.
- Global inflation has accelerated in response to the high international crude oil price and increases in industrial raw material prices – the all commodities global PPI inflation index increased by 7% (annualised) over the past six months and this is expected to feed into higher CPI inflation. However, this pass through has been below expectation and could be limited by stiff international competition (led by China). CPI inflation is projected to peak around 2.5% in the major industrial countries before subsiding again.
- Global short-term interest rates are on the way up: the Fed Funds interest rate is heading for 5%; the ECB is likely to announce an interest rate hike and the end of the zero interest rate policy in Japan is likely. While interest rate hikes should remain contained given the relatively benign inflation outlook, the normalisation of interest rate levels has important implications for capital flows to emerging market economies during 2006.
- The current strength of the US dollar is not sustainable and the dollar is expected to depreciate again over the near term. We still expect dollar depreciation could be stronger against the Asian currencies compared to the euro going forward.

South African economy

- All indications are that the historically strong domestic economic performance continued during the second half of 2005. Both business and consumer confidence moved to a higher level during the third quarter compared to the second quarter; business confidence remained on this level during the fourth quarter of the year. Current forecasts call for a 4.3% real GDP growth rate during calendar 2005; this could be higher depending on national accounts statistics revisions.
- Real GDP growth re-accelerated from 3.5% (annualised) in the first quarter to close to 5% in the second quarter, with the manufacturing sector recovering strongly (7.3%). Growth is broad-based, accelerating at a 5.4% pace in the primary sector and 4.9% in the tertiary sector (excluding government). The growth in the manufacturing sector is still strongly influenced by developments on the exchange rate front. While it appears that manufacturers are more successful in regaining market share in the buoyant domestic market at the stronger levels of the rand, there appears to be little reprieve on the export side; BER manufacturing respondents continue to report steep year-on-year declines in export volumes.
- Business confidence is highest in the non-tradable goods sectors, such as retail and motor trade, construction and a number of services sectors. While manufacturing business confidence did recover from the lower 60s to 68 during the second half of the year, it clearly lags that of construction (92), new vehicle dealers (92), wholesale (90), retail (82) and services (82).
- These sectors are currently creating employment. While manufacturing employment is under pressure, it needs to be emphasised that, overall, the SA economy is generating jobs at present, with the official statistics showing growth of 1.7% in formal non-agricultural sector employment (i.e. 111 000 jobs on a net basis) in the year to March 2005. The BER's business surveys in the construction, internal trade and other services sectors indicate that the rate of employment growth in these sectors picked up during the second half of the year.
- The domestic market continues to boom. This is reflected in sustained high confidence levels in the retail sector, unprecedented unit car sales (expected to grow by around 25% this year) and keen overall credit demand. Consumer spending remains strong, driven by real income growth on the back of improved employment conditions, low interest rates, social transfer payments from government, lower effective personal tax rates and high consumer confidence. While household debt levels are increasing, households' effective interest burden have tended to shrink due to the lower level of interest rates.
- Fixed investment spending also remains strong, with accelerating public sector fixed investment compensating for a somewhat slower momentum in the private sector during the first half of the year. However, buoyant building & construction conditions and a re-acceleration in manufacturing fixed investment during the second half of the year (according to the BER business surveys) point to sustained momentum in private sector fixed investment. Public sector fixed investment spending is projected to become an important source of growth over the short to medium term. While SA's fixed investment rate remains low (17% of GDP) by international standards, this has increased from 14% and is destined to rise further. The combination of keen domestic demand conditions, the improved outlook for real economic growth and sustainable low inflation and interest rates augurs well for SA's fixed

investment rate over the medium term. Foreign direct investment is also contributing more meaningfully.

- The October 2005 inflation statistics surprised on the low side, with CPIX inflation coming in at 4.4%, i.e. well below market expectations (4.7%); PPI inflation also came in lower than expected at 4.2%. The BER retail and manufacturing respondents also revealed lower selling price expectations during the fourth quarter of 2005. The inflation outlook has therefore improved and currently it is not at all certain that interest rates will be hiked anytime soon. Oil prices remain a wild card.
- While SA's current account deficit is projected to widen further (to above 4% of GDP), the quality of capital inflows to finance this deficit is improving, i.e. more meaningful inward FDI and investment on the JSE tied to the improving domestic economic prospects. This should counter undue pressure on the currency in the event of short-term capital outflows in a more hostile external financing environment next year.
- Compared to previous expectations of a significant slowdown in the economy during 2006/7, we are currently more convinced of a sustainable 4% real GDP growth performance over the short term – *see Table 1 below for more detailed macro economic forecasts.*

Table 1: Macro-economic outlook for South Africa: 2005 to 2007

	Ave 1999-2004	**2004**	**2005F**	**2006F**	**2007F**
Expenditure on GDP (real % change):					
Household consumption	3.7	6.1	5.7	3.9	3.3
Fixed investment	3.7	9.4	7.9	7.9	9.2
Gross domestic expenditure (GDE)	**3.6**	**6.3**	**4.4**	**4.6**	**4.4**
Exports	2.3	2.9	6.0	6.1	5.5
Gross Domestic Product (GDP)	**3.2**	**3.7**	**4.3**	**4.1**	**3.9**
Inflation, interest & exchange rates					
CPIX inflation	6.9%	4.3	4.1	5.0	4.7
PPI inflation	6.7%	0.7	3.1	5.2	4.9
Prime overdraft interest rate (eop)	14.71%	11.00	10.50	11.50	10.50
R/$ exchange rate (eop)	7.70	5.66	6.60	7.15	7.70
R/euro exchange rate (eop)	7.85	7.53	7.85	8.94	9.39

Source: Bureau for Economic Research

Western Cape economy

- At the previous economic briefing (5 September 2005) an optimistic picture was presented of the Western Cape economy. The second half of 2005 economic indicators confirmed this underlying positive picture. While shortcomings remain, the current economic performance has solid foundations and the potential to move to a higher plane.

- Western Cape business confidence increased noticeably between the second and third quarters, with the BER business confidence index for the region moving from 76 to 86 and remaining at that level – in line with the national average – during the fourth quarter. Business confidence recovered particularly strongly in the regional retail sector, while the high business confidence levels were sustained in the construction and services sectors. It would appear as if the strong momentum in the region's tertiary sectors continued during the second half of the year; both residential and non-residential construction also continued to expand.

- The Achilles heel of the regional economic performance remains manufacturing. The regional manufacturers are less optimistic compared to their national counterparts. The less than robust business conditions in the regional manufacturing sector have adverse implications for regional employment creation. Whilst employment creation in the retail and construction sectors is buoyant, BER manufacturing respondents indicate the net retrenchment of workers occurring. Sustained rand strength appears to be taking a disproportionate toll on regional manufacturing.

- At a sectoral level, the food and beverages sectors appear to benefit from the keen domestic spending and experience less pressure from import competition. However, production is switched from exports to serve the rapidly growing domestic market and in this way employment levels are sustained. The clothing and textile sector, on the other hand, suffers in addition from severe import competition, reporting both poor domestic sales as well as poor export sale. As a result these sectors are shedding labour. While the effective re-introduction of quotas in respect of Chinese textile and clothing exports to the USA and the EU may bring some relief, third country markets face the potential dumping of Chinese production during the interim.

- The robust business conditions in the property development and construction sectors continued during the second half of 2005. However, BER respondents tend to be pessimistic that the growth in building activity will continue during the first quarter of 2006. This may be in anticipation of interest rate hikes, the probability of which has been substantially reduced following the October 2005 inflation statistics releases. The buoyancy in this sector could therefore last longer, particularly in the non-residential sector where leading indicators are moving in favourable directions. On the other hand, the building and construction sector reports serious skilled labour shortages, which may act as an important constraint on activity.

- The favourable conditions in the financial services sector were also sustained during the third quarter of 2005. The sustained high growth in this sector is exposed to the interest rate cycle. However, given the more benign inflation and interest rate outlook, the previously foreseen "cyclical slowdown" could be less severe during 2006/7. This also applies to the general economic picture. We currently foresee less of a cyclical slowdown in the national and regional economies over the short term. In fact, some softening in the currency could go a long way to strengthen the regional manufacturing conditions next year.

- Regional real GDP growth is estimated to come in at 5% during calendar 2005, up from an estimated 4.1% last year. Growth is then projected to soften somewhat to 4.5% during 2006 and further to 3.9% during 2007.

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30 November 2005