

Economic Outlook

1. Introduction

The Western Cape economy grew by a respectable 3,2 per cent in 2003, albeit down on the buoyant growth of 4,6 per cent measured in calendar year 2002 in the wake of the rand exchange rate's depreciation. Economic growth slowed down in 2003 due to recessions in agriculture and manufacturing, which resulted from hostile climatic conditions as well as the strengthening rand exchange rate over this period (causing problems in the export and import-competing sectors). While the decline in real value-added in the regional agricultural and manufacturing sectors exceeded that of the national economy, overall growth in real Gross Domestic Product in the region (GDPR) still came in above the national average (that is, 2,8%) for 2003.

The Province's services industries compensated, growing by a strong 5,6 per cent in real terms, compared to the national average of 4,2 per cent. Real economic growth in the Western Cape Province averaged 3,9 per cent over the period 1999 to 2003, compared to 3,1 per cent nationally¹. It is estimated that real GDPR growth in the Western Cape economy again exceeded the national average in 2004; however, the manufacturing and agricultural sectors probably under-performed, with the overall out-performance explained by the region's services sector.

The Western Cape economy has therefore consistently out-performed the national economy over the past five years (this also applies over the 10-year period 1994 to 2003). Short-term economic prospects are favourable, as for the rest of the country. Whilst the sustained strength of the rand exchange rate inhibits growth and employment creation in the tradeable goods sectors (that is, goods that are exported and/or imported in

¹ Statistics South Africa revised the national accounts statistics, including the regional GDP data at the end of 2004 with its regular five-year rebasing and benchmarking exercise. Real GDPR growth for the Western Cape economy over the five-year period 1999 to 2003 was revised from 3,1% to 3,9%; the corresponding figures for the national economy are 2,7% and 3,1%.

international trade deals), business tends to adapt, and it is expected that the over-valuation of the exchange rate will ease over the short to medium term. Robust real economic growth is currently underway in the region as industry responds to the buoyancy in domestic spending, as well as a supportive world economy.

This chapter provides an analysis of the past performance and outlook for the Western Cape economy. As the Western Cape's prospects are closely linked to those of the South African economy, the first section provides an overview of the national economy's performance and outlook, discussing the global economic outlook, domestic economic growth, fixed investment, employment, inflation and interest rates, the balance of payments and the exchange rate.

The second section then provides a more in-depth discussion of the Western Cape economic performance and outlook. Both the past five years and the medium-term outlook (2005/06 – 2007/08) are assessed in respect of GDP growth, inflation, fixed investment, employment and exports.

2. Trends in the South African Economy

As mentioned, the Western Cape's economic fortunes are closely linked to those of the national economy. Following a decade of economic restructuring and prudent macroeconomic policies, the outlook for the South African economy is the best in years.

In this respect, the South African economy has matured appreciably over the past decade. Fiscal policy has become more supportive of growth, prospects for lower and more stable inflation and interest rates are real, tariff reductions have for the most part run its course, the political climate is the most stable in years, and business and consumer confidence are on historically high levels. This reflects an optimistic business mood intent on expanding production capacity. Exchange rate volatility remains a threat and currently places substantial pressure on the (higher value-added) export sectors, as well as import-competing sectors.

2.1. Global economic developments

World economic growth accelerated across a broad base during the second half of 2003 and early 2004. Initially growth was led by the United States (US) and the Chinese economies, but renewed vigour rapidly spread to Japan and the East Asian emerging economies, as well as the European, Latin American and African regions. The International Monetary Fund (IMF) estimates that the world economy expanded at an annualised rate of six per cent during the second half of 2003. This growth momentum continued during the first quarter of 2004. Some slowdown occurred during the middle quarters of the year as the headwinds from higher crude oil prices impacted and economic conditions weakened unexpectedly in Japan and the Euro area.

The current growth phase in the global economy reasserts the upswing phase of the global economic cycle that commenced around the end of 2001, when the US economy emerged from recession and the terrorist attacks in New York. However, subsequent wars in Afghanistan and Iraq introduced major uncertainty and higher oil prices, which led to temporary global economic weakness during the second half of 2002 and the first half of 2003. The Severe Acute Respiratory Syndrome (SARS) epidemic also impacted adversely on the Asian economies during the first half of 2003.

Deflation fears were the order of the day and globally, interest rates declined to historically low levels over this period. In addition, authorities in the US and Europe responded with expansionary fiscal policies. In the US, increased security and defence spending accounted for part of the fiscal stimulus. The US dollar also depreciated against the major global currencies as the strong capital inflows to that region over the 1996 to 2000 period decelerated, exposing the huge US current account deficit.

The macroeconomic stimulus, the end of the war in Iraq and the end of the SARS epidemic all contributed to the revival of global economic growth from the middle of 2003. Industrial commodity prices and precious metals prices rose strongly from the end of 2001; global industrial production growth has been exceptionally lively towards the end of 2003 and early 2004. These factors contribute towards driving global trade flows, expanding at year-on-year rates of 15 per cent to 20 per cent.

While this strong growth tapered off during the second half of 2004, the world economy registered the strongest real Gross Domestic Product (GDP) growth rate in 2004 since the four per cent expansion at the peak of the previous global economic cycle in 2000. This result is significant as the international upswing feeds strongly into national and regional economic performance and prospects.

While non-energy inflation rates are low globally, some acceleration occurred during 2004 (particularly in the US, China and the Euro area). Obviously, the sharp spike in international crude oil prices to above US\$50 a barrel played a role, and unexpected developments, in this regard continue to pose an inflationary risk. This has also been one of the major reasons for the slowdown in economic growth in the G3 (US, Japan and Germany) economies during the middle quarters of 2004.

The IMF estimates that a sustained US\$10 a barrel increase in the oil price leads to a 0,5 per cent reduction in the world real GDP growth rate in the subsequent 12 months. Oil prices declined towards the end of 2004, but spiked again early in 2005. The consensus view is that prices may subside following the Iraq election and stimulate global growth; however, this is no foregone conclusion. *Oil price volatility therefore remains a risk to the global, national and Western Cape economic outlook.*

The Federal Reserve (that is, the Reserve Bank of the US) has already commenced with increasing interest rates, following on similar moves by the Bank of England and the Reserve Banks of Australia and New Zealand. Interest rate levels in the major industrial countries are expected to normalise over the short term. This could have important implications for emerging market economies and currencies such as the South African rand. Higher interest rates abroad could stem the strong capital flows to emerging market countries currently in force due to a favourable interest rate differential.

Global economic growth should be relatively strong over the projection period. While the growth tempo has slowed closer to a trend rate (from the 5% to 6% pace registered during the early part of 2004), most analysts agree that growth will be sustained over the short term.

While the *US economy* is at risk to enter a sustained slowdown, renewed job growth could revive consumer spending in that economy (accounting for 70% of US GDP).

Following impressive levels of growth averaging 9,5 per cent during 2004, the Chinese economy is expected to experience a 'soft landing' as the authorities implement administrative interventions and monetary policy is tightened. A preview of this happened in 2004 (with real GDP growth coming in at 9,5% on average for the year).

In *Japan*, the domestic demand recovery disappointed in the latter part of 2004, but is still expected to replace export-led growth as the main driver of economic growth, which should render the Japanese economic recovery sustainable this time around. In fact, Japanese economic prospects are the brightest in a decade. Economic prospects in the region also remain the most robust in a global context.

Economic growth is lagging in the *Euro area* – South Africa's main trading partner – however, even there a steady economic recovery is underway.

The interconnectedness of global trade and capital markets has meant that improving growth in the major industrial countries and progress with internal macroeconomic policy reforms have also benefited the developing regions of the world.

Latin America has emerged from a deep recession and many *African* economies are benefiting from improved commodity prices. According to the IMF, the economic outlook for Sub-Saharan Africa (SSA) is the best in years, with real GDP growth estimated and projected to increase by five per cent to six per cent during both 2004 and 2005. However, progress across the developing world is uneven and often marred by socio-political instability (occurring, for example, in Venezuela and Central Africa). Table 1 shows more detailed projections in this regard.

Table 1 World economy real GDP growth outlook, 2004 – 2005

Country/ region	2003 (%)	2004F (%)	2005F (%)
US	3,0	4,3	3,5
Japan	2,5	4,4	2,3
Euro area	0,5	2,2	2,2
UK	2,2	3,4	2,5
China	9,1	9,0	7,5
Developing Asia ¹	5,1	5,6	5,5
Latin America	1,8	4,6	3,6
Africa	4,3	4,5	5,4
Sub-Saharan Africa	3,7	4,6	5,8
World	3,9	5,0	4,3

¹ Excluding China and India.

[Source: IMF World Economic Outlook, September 2004]

The main risk contained in the global outlook presented here is the possibility of the macroeconomic imbalances (*inter alia* reflected in the burgeoning US current account deficit, the sizeable G3-countries' growth differential, with sluggish domestic demand conditions in the Euro area and Japan comparing with the sustained buoyancy in the US) growing bigger and causing dislocations down the line.

The US dollar is particularly at risk of a more destabilising adjustment, including adverse implications for global interest rates and capital flows to developing countries. Furthermore, a volatile crude oil price remains a risk to the outlook, given the global economy's sensitivity in this regard.

South Africa's GDP revisions

Every five years, South Africa's GDP estimates are benchmarked and re-based. The latest revision of the GDP estimates involved the re-basing of the constant price series from 1995 to 2000, as well as new estimates for both the level of nominal GDP and the growth in real GDP. Statistics South Africa released the revised GDP estimates at the end of November 2004.

The level of nominal GDP was revised upwards for each calendar year from 1998 to 2003 by between 0,5 per cent and 3,9 per cent. The 2003 nominal GDP is currently estimated at R1 251-billion, that is 3,5 per cent (or R42-billion) higher than previously (R1 209-billion).

The six-year average real GDP growth rate has also been revised upwards, from 2,4 per cent to 2,7 per cent per annum over the period 1998 to 2003. Excluding 1998, real GDP growth averaged 3,1 per cent per annum over the past five years. This brings the average real GDP growth rate in the first decade of democracy closer to the three per cent level. The largest revisions were made to GDP growth in calendar years 2000 (3,6% to 4,2%) and 2003 (1,9% to 2,8%).

On a sectoral level, the largest upward revisions of the level of nominal GDP were made to mining (15,4% in 2000), internal trade (14,4%), manufacturing (5,9%), agriculture (5,3%) and personal services (4,9%). For two sectors – construction (11,5%) and financial & business services (2,9%) – the level of GDP was revised downwards.

In terms of real value-added growth (1998 to 2003), the largest revisions were made to the internal trade sector (including retail, wholesale, catering & accommodation, being revised from 2,1% to 4,6% per annum), manufacturing (from 1,8% to 2,3% per annum), mining (from -0,4% to 0,4% per annum) and personal services (from 2,6% to 4,1% per annum). In some sectors, the revisions have been quite radical, if not in terms of the level of growth then the pattern of growth.

On the demand side of the economy, the upward revision of overall GDP growth (from 2,4% to 2,7% per annum, 1998 – 2003) is explained by the upward revision of the growth in real domestic expenditure and a slightly higher contribution from net exports. The average annual growth (1998 – 2003) in real household consumption expenditure was revised from 2,6 per cent to three per cent per annum; real government consumption expenditure from 2,1 per cent to 2,5 per cent per annum and real gross fixed capital formation from 2,3 per cent to 2,9 per cent per annum. The growth in both real exports and imports was scaled down somewhat – for exports from 2,4 per cent to 2,2 per cent per annum and for imports from 2,4 per cent to 1,8 per cent per annum.

An important aspect of the revisions is the fact that the current growth tempo in the economy is significantly higher than previously estimated and anticipated by forecasters (including the Bureau for Economic Research, or BER). Real GDP growth could come in closer to four per cent in 2005 compared to a firm consensus earlier in the year that growth will struggle to reach three per cent. This is particularly true regarding consumption expenditure, both in respect of individuals and Government; the growth in real gross domestic fixed capital formation has in fact been revised downwards somewhat. This suggests a stronger consumption bias in the current economic growth performance than previously thought.

2.2. South Africa's economic growth: performance and outlook

South Africa's real economic growth performance has improved over the past decade. *Real GDP growth* averaged 2,9 per cent over the period 1994 to 2003 compared to 1,1 per cent over the preceding decade. A more revealing statistic may be the fact that real GDP *did not decline* in absolute terms in any of the calendar years since 1993. The growth performance has been more stable, and sound macroeconomic policies have contributed to sustainable growth. The current upswing phase of the business cycle, which commenced in September 1999, is the longest in the post-war history. Real GDP growth averaged 3,1 per cent over the five-year period since 1999.

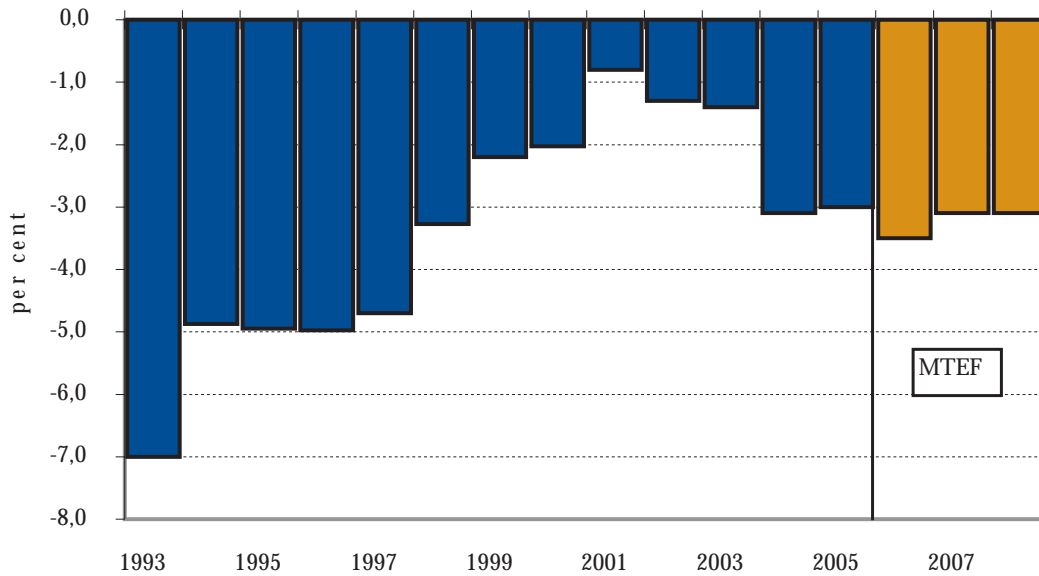
Both short- and long-term *nominal interest rates* have declined to 23-year lows on the back of lower inflation and lower inflation expectations. This is stimulating borrowing in the economy, particularly in respect of investment projects. Contrary to the 1970s and 1980s, real interest rates remain positive, rendering the current favourable monetary conditions sustainable.

While continued currency volatility represents some risk, chances are favourable that inflation expectations and actual inflation will become embedded well within the inflation targeting range. This, in turn, holds the promise of more accommodative monetary policy (that is, *lower real interest rates*), which should lift South Africa's fixed investment ratio further and stimulate employment growth.

Following some years of austerity between 1995 and 1999, *fiscal policy* has become more expansionary in recent years. A sound fiscal basis has been achieved upon which accelerated infrastructural development and social and welfare spending could be launched in a sustainable manner. The fiscal deficit widened to 2,3 per cent of GDP in the 2003/04 and 2004/5 fiscal years and is expected to deepen further to 3,1 per cent in 2005/06 before declining to 3,0 per cent in 2006/01 and further to 2,71 per cent in 2007/08 (*see Figure 1*). However, at these levels the budget balance remains consistent with prudent fiscal policies, which Government is determined to maintain over the next three to five years.

Business and consumer confidence are currently on historic highs. The swell in business and consumer confidence appears to be linked to fundamental economic factors – at this stage it is not a case of the 'over-optimism' that typically leads to over-investment and/or over-borrowing, spelling the final phases of an economic upswing. Overall household indebtedness is low, retail bad-debt problems are almost non-existent and South Africa's fixed investment ratio (16% of GDP in the second quarter of 2004) is increasing from a low base. These indicators suggest substantial further potential in the current historically long upswing phase of the South African business cycle.

Figure 1 General government budget deficit as % of GDP



[Source: SARB, Quarterly Bulletin, September 2004, Budget Review, 2005]

The demand side of the economy has responded strongly to the more stable financial conditions – real domestic expenditure accelerated to annualised growth of 6,5 per cent during the first half of 2004. While the growth tempo in real domestic expenditure slowed during the third quarter of last year, this slowdown is more technical than real, as real final demand continued to expand at a five per cent pace.

Both household consumption expenditure and business fixed investment have picked up sharply, and domestic spending is augmented by Government’s social and welfare spending roll-out, as well as public sector fixed investment. Unfortunately the *over-valued* levels of the rand exchange rate have hampered the required supply response, particularly in terms of employment growth.

The strong appreciation of the rand exchange rate during 2003 and 2004 had a negative impact on South Africa’s economic growth, which decelerated to 2,8 per cent in 2003.

The strong rand impacted negatively on the international price competitiveness of particularly manufacturing firms, and exports slumped. Manufacturing exports contribute more than 50 per cent of total exports. In contrast, mining companies benefited from higher commodity prices in foreign currency terms, shielding the negative impact of the appreciating currency. The latter enabled South Africa’s commodity exports to recover strongly in 2004. However, simultaneously, imports accelerated sharply on the back of the strong currency and keen domestic spending, leading to deterioration on the trade account

of the balance of payments (that is, the balance between South Africa's earnings from the export of goods and its payments for imported goods).

While the manufacturing sector recovered firmly during the middle quarters of 2004, this occurred from a low base and appears to have run out of steam during the fourth quarter of 2004 and early 2005². While the private sector appears to be adjusting to the stronger level of the currency, reflected in high levels of business confidence, the manufacturing export and import-competing industries remain under pressure. The current account of the balance of payments (that is, the balance between South Africa's earnings from exports of goods and services and its payments for goods and services) deteriorated from a surplus in the first quarter of 2003 to a deficit measuring 2,7 per cent of GDP during the first half of 2004 (and 2,5% during the third quarter).

It is expected that the rand exchange rate will adjust to a 'fairer value' over the short term as interest rate levels in the major industrial countries normalise and the commodity cycle peaks. The progress South Africa has made in replenishing its balance of payments reserves and in generating greater domestic and foreign investor confidence should prevent a repeat of the 1998 and 2001 rand events. A healthier stock of foreign exchange reserves reduces South Africa's vulnerability to speculative currency attack, partly as it puts the South African Reserve Bank (SARB) in a stronger position to counter such an attack.

A contained depreciation of the currency (say to R7,00/US\$ by the end of 2005 and R7,50/US\$ by end-2006) should not destabilise the inflation and interest rate environments. Over the medium term, the policy of continued trade liberalisation, combined with a competitive exchange rate, should go a long way to nurture the required economic efficiencies to grow South Africa's exports off of a more diversified economic base, improve the balance of payments and render economic growth more sustainable.

It is expected that, overall, South African GDP growth will accelerate in the short term as the growth in real domestic expenditure is sustained and the rand exchange rate reverts to a 'fairer' value in 2006. Table 2 indicates that real GDP expanded by 3,7 per cent during 2004. Growth is projected to accelerate further to 4,1 per cent during calendar year 2005 and to slow marginally to 3,6 per cent in 2006 and 3,0 per cent in 2007 under the weight of higher interest rates.

²The Investec PMI declined from October 2004, falling to below the critical level of 50 in January 2005. This signals a mild contraction in manufacturing activity in January, the first such contraction in 15 months.

Table 2 South Africa real GDP growth outlook (expenditure components), 2004 – 2007³

%	Average 1999 – 2003	2003 actual	2004 estimate	2005F	2006F	2007F
Final household consumption	3,2	3,4	5,8	4,4	3,8	2,5
Government consumption	3,4	6,4	6,8	3,5	3,5	3,0
Gross fixed capital formation	2,6	9,0	8,0	9,2	8,8	4,3
Gross domestic expenditure	3,1	5,3	6,0	5,0	4,3	2,5
Exports	1,7	-2,3	4,9	5,9	5,8	5,4
Imports	1,7	7,3	13,5	9,2	7,9	3,3
Expenditure on GDP	3,1	2,8	3,7	4,1	3,6	3,0

[Source: BER, January 2005]

The baseline BER macroeconomic forecast adopted in this report is optimistic for the reasons explained above. In this regard, the BER does not deviate from the consensus view currently in force in South Africa (see the Reuters consensus forecasts in respect of real GDP growth in Table 3). However, as Table 3 also indicates, there is a significant outlook range, with some analysts being more pessimistic and others being even more optimistic. For the purpose of this report, it is important to be aware of the risks contained in the baseline outlook; these are highlighted throughout the report.

Table 3 Reuters consensus forecasts for South Africa, 2005 – 2007 (January 2005)

	2005	2006	2007
Real GDP growth (%)	4,0	3,6	4,0
Highest forecast	4,5	4,3	4,9
Lowest forecast	3,5	3,2	3,1

[Source: Reuters, January 2005]

It is important in this case to identify the *key risks* that are attached to the optimistic outlook adopted here. A particular risk concerns the *rand exchange rate*. The BER assumes some adjustment in the rand exchange rate to a more competitive level over the short term (see section 2.6 below). However, in the event of sustained currency strength, the outlook for economic growth may be notably different. The tradeable goods sectors (for example, mining and manufacturing) might be under greater pressure and South Africa's export performance might be weaker.

On the other hand, inflation and interest rates might be lower, fuelling the domestic boom further, without this benefiting domestic production to the desired extent. While growth could in the near term be higher in this scenario, it is also likely to be more unbalanced and less sustainable due to potential balance of payments problems.

³ The BER's macroeconomic forecasts do not necessarily agree with that of the National Treasury (see the Budget Review 2005, 23 February 2005, p. 50). The BER and the National Treasury use different econometric models and apply different assumptions. National Treasury upgraded its economic growth forecasts for the period 2005-07 compared to those contained in the 2004 Medium Term Budget Policy Statement (MTBPS) in respect of the period 2004-6. National Treasury's real GDP growth forecast for this period averages 4,2% compared to the BER's 3,6%. The BER anticipates a growth slowdown in 2006/07 due to higher interest rates in 2005/06, in turn related to business cycle pressures. The Treasury has slightly weaker growth in 2006 and a re-acceleration in 2007. The BER's economic forecast was also compiled before the release of the 2005 Budget, which is slightly more stimulatory to growth than expected. Regarding inflation, there is a greater correspondence between the BER's and the National Treasury's projections. The BER projects CPI inflation to average 4,9% over the 2005-07 period compared to the Treasury's 4,8%.

Another important risk concerns the *performance of the global economy*. In the event of a stronger global economic slowdown (driven by problems in China and/or the US, for instance), the outlook for the South Africa economy could also be affected. A sharper deterioration in international non-oil commodity prices (such as platinum and gold) could cause a deterioration of South Africa's terms of trade. Including weaker demand for exports, South Africa's growth outlook could also be worse. However, the rand is also likely to depreciate in such a scenario, which should mitigate much of the decline in the terms of trade.

The economy's potential GDP growth – that is, trend real GDP growth – is estimated around three per cent currently (IMF, June 2004), up from 1,2 per cent over the period 1980 to 1994. This improvement occurred mainly due to higher total factor productivity (TFP) growth, that is, real economic growth related to factors other than increased growth of the capital and labour inputs *per se*, such as increased production efficiencies and technological advances (*see Table 4*). The improved TFP growth occurred mainly due to the range and stance of economic policies that were implemented. For instance, the opening of the economy to international trade, which drove increased production efficiencies, as well as an increased role of the private sector in the economy, reflected in a significantly higher share of private fixed investment in total fixed investment in 2002 compared to 1995.

Table 4 South Africa sources of economic growth, 1980 – 2002

	1980 – 1994	1995 – 2002	1980 – 2002
Annual real GDP growth (%)	1,2	2,8	1,7
Labour (including informal sector)	0,7	0,7	0,7
Capital	0,9	0,6	0,8
Total factor productivity	-0,5	1,5	0,2

[Source: IMF Country Report No. 04/178, June 2004]

The economy's potential GDP growth rate should improve gradually over the medium to longer term as the capacity of the economy to absorb labour improves and the fixed investment rate picks up. However, the potential GDP growth rate is likely to remain constrained by two key factors – *skilled labour* and the impact of the *HIV/Aids epidemic*.

Taking a closer look at the *sectoral* contribution to economic growth over the past decade, there has been a clear shift away from the *secondary* to the *tertiary sector*, while the contribution of the *primary sector* remained more or less unchanged between 11 per cent and 12 per cent of aggregate GDP (at current prices).

In the secondary sector, the contribution of *manufacturing* declined from 20,9 per cent in 1994 to 19,6 per cent in 2003, that of *electricity & water* from 3,6 per cent to 2,4 per cent and *construction* from 3,1 per cent to 2,4 per cent over the corresponding period.

In the tertiary sector, the contribution of the *general government* declined from 16,2 per cent in 1994 to 14,7 per cent in 2003, under the impact of the more austere fiscal policies. However, the other tertiary sectors more than compensated for this declining importance – the contribution of the *financial & business services* sector increased strongly from 16,0 per cent to 20,1 per cent, while that of the *transport & communications* sector increased from 8,7 per cent in 1994 to 9,7 per cent in 2003.

The opening up of the South African economy and the liberalisation of exchange controls, which spurred renewed growth, drove the strong growth in the financial services sector. The growth of the transport & communications sector was driven by the expansion of the taxi industry, as well as the development of cellular communications in South Africa and Telkom's expanded roll-out over the 1990s.

Table 5 highlights the five-year (1999 – 2003) sectoral growth performance, as well as the outlook for 2005 to 2007.

Table 5 South Africa: Real GDP growth outlook (sectors), 2004 – 2007

	Average 1999 – 2003 (%)	2003 (%)	2004 estimate (%)	2005F (%)	2006F (%)	2007F (%)
Agriculture	1,6	-6,0	2,6	3,0	2,0	1,5
Mining	0,5	4,3	4,4	4,0	-1,0	-1,5
Manufacturing	2,8	-0,9	2,7	4,0	4,3	3,2
Electricity & water	-0,1	0,4	2,0	2,0	1,5	1,5
Construction	4,0	5,2	6,5	6,5	4,2	3,7
Internal trade & catering	5,3	6,7	6,5	5,4	4,2	3,2
Transport & communication	6,7	5,2	5,5	6,2	6,0	5,5
Financial & business services	5,4	4,1	3,7	4,9	5,1	4,5
CSP services	3,7	4,9	3,9	3,9	3,6	3,5
Government	-0,3	1,0	1,2	1,6	1,7	1,8
Total GDP	3,1	2,8	3,8	4,1	3,6	3,0

[Source: BER, January 2005]

2.3. Fixed investment: performance and outlook

Gross domestic fixed capital formation – that is, the total fixed investment spending by the private and public sectors – is currently expanding at a robust rate, both in the private and public sectors. Following growth of only 3,7 per cent in calendar year 2002, gross domestic fixed capital formation accelerated to growth of 9,0 per cent in 2003 and during the first half of 2004.

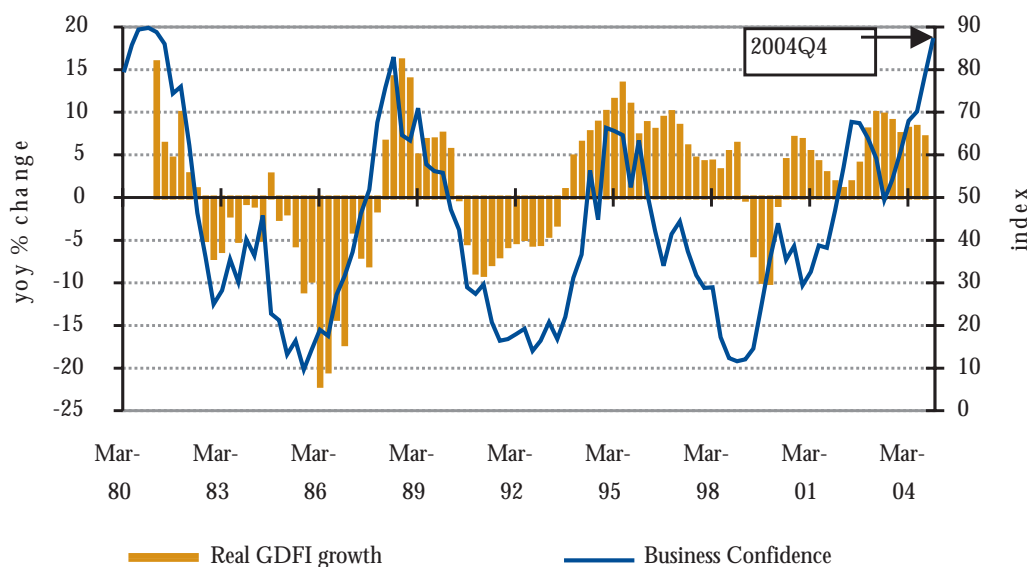
The recovery in fixed investment spending is broad-based. In the private sector, the momentum built gradually along with the general recovery in the economy since 1999. In

the public sector, calendar years 2002 and 2003 witnessed a reversal of the secular contraction in capital spending by the public corporations and government.

While the general fixed investment picture is decidedly bright at this stage, this does not conceal the more sombre fact that the fixed investment ratio only picked up to 16 per cent of GDP during the first half of 2004. This is well short of Government's 'unofficial' 25 per cent target and the historical picture of investment during the 1960s and 1970s.

The point about fixed investment, however, is that macroeconomic conditions – stable and lower inflation and interest rates – are favourable to nurture a higher fixed investment ratio over the medium to longer term on a sustainable basis. General socio-political stability is also a strong positive in this regard. While fixed investment has tended to be of the capital-deepening kind (substituting capital for labour) in recent years as firms rationalised and restructured to face fierce international competition, it is possible that job creation will become a stronger feature as firms contemplate expansion plans.

Figure 2 Business confidence versus fixed investment spending



[Source: SARB / BER]

It is important to note that the momentum in gross fixed capital formation *continued to strengthen* during 2002 and 2003 in the face of higher interest rates at the time and the volatility in the rand exchange rate. Firms appear to have taken a longer-term view in expanding production capacity because of the keen domestic demand conditions, the lower import costs (tied to the rand's appreciation) and what appeared to be a temporary hike in interest rates (in 2002).

Business confidence resumed an upward trend during the second half of 2003 as interest rates were lowered by a cumulative 5,5 per cent and a further 0,5 per cent in August 2004.

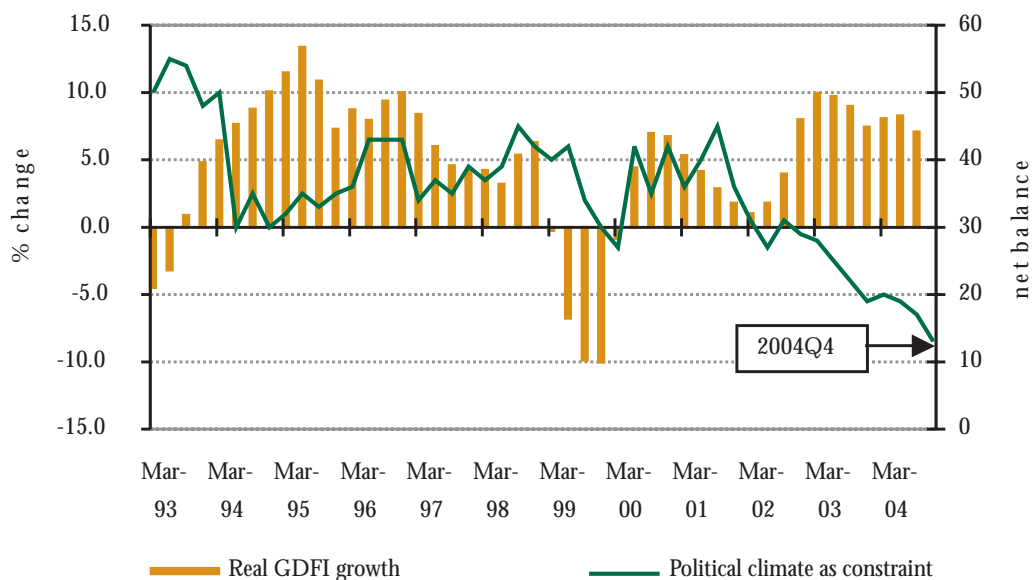
This reduces the cost of capital and boosts real domestic expenditure, both important drivers of business fixed investment. Business confidence reached a 23-year high during the fourth quarter of 2004. Figure 2 shows that a strong correlation exists between the levels of business confidence and changes in fixed investment spending.

The revised national accounts statistics show that private sector fixed investment remained strong during the first nine months of 2004 (growing by an annualised rate of 13% during the third quarter of 2004), despite the strength of the currency negatively impacting on mining and manufacturing firms' profitability.

It would appear that exporting firms are adopting a longer-term view, announcing major investment projects recently (Nedbank Capital Expenditure Project Listing, August 2004). The automotive and chemical sectors are embarking on big investment projects, while fixed investment spending in the retail, real estate and tourism sectors also appear to be robust – the consumer boom is spurring the development of new shopping space.

Fixed investment spending has also been particularly strong in recent years in the platinum mining sector and in the telecommunications sector due to the roll-out of cellular phone infrastructure, whereas robust fixed investment spending on transport equipment has largely been driven by the improvement in general economic conditions, as well as the general shift from rail to road transport and transport companies upgrading their vehicle fleets.

Figure 3 Political climate constraint versus fixed investment



[Source: SARB / BER]

Public corporations' fixed investment has been boosted strongly by South African Airways' (SAA's) aircraft acquisition programme, the Coega harbour development and other general infrastructure development. Technical factors related to SAA's aircraft acquisition programme resulted in a sharp decline in public corporations' fixed investment during the third quarter of 2004; however, the capital spending trend in this sector is set to rise strongly in the next five years with the R165-billion planned upgrading of Eskom and Transnet's infrastructure.

Unfortunately the growth in the general government's fixed investment spending has remained subdued in view of ambitious budget plans. It is expected that these plans will come to fruition. While the fiscal commitments in terms of the government's accelerated roll-out of social and welfare payments are expected to absorb the bulk of additional state spending in the current and 2005/06 fiscal years, government fixed investment spending is targeted to increase more meaningfully from the 2006/07 fiscal year in terms of the Medium Term Expenditure Framework (MTEF).

2.4. Employment: performance and outlook

Employment creation remains the most important vehicle to reduce poverty levels in South Africa. While an analysis of employment trends in the South African economy is severely hampered by discontinuities in the data, available analyses tend to show that the economy created jobs on a net basis over the 1990s, contrary to popular belief. However, it would appear that the job growth occurred in the informal sector, as formal sector employment generally declined. This implies a shift from the formal to the informal sectors and/or indirect labour (that is, outsourcing, subcontracting and other atypical forms of employment).

According to the SARB, the mining sector shed around 250 000 jobs during the 1990s compared to the 1980s, the manufacturing sector around 102 000 and the construction sector 100 000 jobs (SARB Labour Market Frontiers, June 2004: 3).

Employment also shrunk sharply in the public sector, particularly since 1995. The share of government & community services (excluding domestic servants) in total employment declined from 23 per cent in 1995 to 18 per cent in 2002 (Bhorat, 2003: 9).

On the other hand, job opportunities grew in the stronger growing services sectors, such as financial & business services and internal trade (including retail, wholesale, catering and accommodation). The financial & business services sector added around 100 000 jobs over the period 1991 to 2001, compared to the 1980s (SARB LMF, June 2004: 4)⁴. The employment share of the internal trade sector (mainly retail trade) grew from 17 per cent in 1995 to 20 per cent in 2002; however, close to 40 per cent of the employment

⁴ However, restructuring and rationalisation in the financial services sector have led to job losses recently. Data from Statistics South Africa's Survey of Employment and Earnings indicate a 7,4 per cent year-on-year decline in employment in the finance, insurance, real estate and business services sector in the first quarter of 2004 (SARB AER, 2004: 19).

opportunities in this sector reside in the informal sector (Labour Force Survey, September 2003: vii). This sector is also one of the few sectors for which the unskilled component of its workforce increased over the period between 1995 and 2002 (Bhorat, 2003: 11).

The broader trend in the economy is a higher demand for skilled and semi-skilled workers and a reduced demand for unskilled workers. This reflects the impact of changes in technology in the global arena and locally the structural shift in the economy from the primary to the services sectors. The share of unskilled labour in agriculture declined from 77 per cent in 1995 to 43 per cent in 2002; in mining it declined from 19 per cent to seven per cent and in manufacturing from 19 per cent to 15 per cent (Bhorat, 2003: 11).

On the other hand, the share of skilled labour in the financial & business services sector increased from 17 per cent to 25 per cent; in manufacturing it increased from six per cent to 10 per cent and in transport & communication from 15 per cent to 22 per cent. Sectors that tended to shed jobs over the period 1995 to 2002 experienced a movement away from unskilled labour towards semi-skilled and/or skilled employment.

From a cyclical point of view, the wave of formal sector worker retrenchments reached a peak in 1998, that is, at the trough of the previous economic downswing and in the wake of the East-Asian financial crisis. Since 1999, that is, with the onset of the current upswing phase of the business cycle, the rate of retrenchments tapered off and in calendar year 2002 firm formal sector job growth of 2,0 per cent was registered.

Unfortunately this positive trend in formal sector job growth was interrupted by the impact of the strengthening rand exchange rate over the period 2003 and 2004. The manufacturing sector experienced a recession in 2003 and the rate of retrenchments increased again in this sector. Employment in the mining sectors also came under pressure; however, the increase in commodity prices assisted to limit the damage, particularly in the non-gold mining sectors.

National account statistics showed that the supply side of the economy responded to the buoyant demand conditions locally and abroad during calendar 2004, which led to faster job creation. Statistics South Africa's *Survey of Employment & Earnings* (SEE) indicated that non-agricultural formal sector employment expanded by 3,1 per cent in year-on-year terms during the second quarter of 2004. The employment component of the Investec Purchasing Managers Index (PMI) reverted to a positive trend since the beginning of 2004 and a number of sectors, including retail & wholesale and construction, reported improving employment growth.

Unfortunately this positive broader trend in formal employment creation was affected by the impact of the sustained strength of the currency on the manufacturing sector. Should the rand exchange rate adjust to a more competitive level over the short term, as is expected, production conditions in the manufacturing sector should recover and revive

employment growth in the sector. Outside of manufacturing, the employment-intensive construction sector is booming, both in the residential and non-residential sectors. Employment in the retail, wholesale, catering & accommodation sectors is also expected to continue improving. Therefore, from a cyclical point of view, chances are good that formal sector job growth continued during the second half of 2004 and should strengthen further into 2005 and 2006.

From a structural point of view, however, employment prospects for the economy may be less than robust. First, economic growth is projected to be in the order of 3,5 per cent on average over the next three to five years, which may be not sufficient to absorb the new entrants to the labour market. This is explained in greater detail in chapter 4. Unemployment is therefore expected to continue increasing over the medium term⁵.

Secondly, labour demand is likely to remain skills-biased, that is, a stronger demand exists for semi-skilled and skilled labour at the expense of unskilled labour. The National Public Works Programme and the improved cyclical demand for unskilled labour in the retail and tourism sectors have a role to play in alleviating this problem. However, over the longer term, a concerted effort is required to educate and train the employable part of South Africa's unskilled labour force. Education, skills upgrading and further training are therefore key to raising longer-term growth potential.

2.5. Inflation and interest rate: performance and outlook

The strengthening rand exchange rate has been a strong disinflationary force in the domestic economy during 2003 and 2004. Actual CPIX inflation – the all-items Consumer Price Index (CPI) inflation rate, excluding mortgage interest rates – surprised on the low side in 2004, coming in at 4,3 per cent on average. This is close to the mid-point of the inflation targeting range. The upper band of the inflation target is unlikely to be breached over the short term. Moreover, inflation is expected to decelerate again towards the middle of 2005 before demand-pull factors are expected to begin to impact. *Overall, CPIX inflation is projected to average 4,5 per cent during 2005, accelerating to 5,4 per cent on average during 2006.*

Domestic inflation is currently adjusting to a lower level in a structural sense. The inflation-targeting monetary policy is driving this adjustment, as well as the complementing macroeconomic policies, in particular fiscal and trade policies, which are expected to persist over the longer term. As the South African society's inflation expectations adjust in response to the observed lower levels of actual inflation currently in force, the actual inflation outcome is also likely to be positively influenced.

The rand exchange rate remains a potential destabilising factor. While another 'rand event' (*a la* 1998 or 2001) is not entirely precluded, chances are that the replenishment of South Africa's balance of payments reserves (to US\$29-billion at the end of September 2004) and

⁵ The HIV/Aids epidemic is obviously going to have an impact in this regard. The growth in the labour force is already tapering off sharply due to the impact of Aids mortality. Consequently, improved economic growth and labour absorption are likely to ameliorate the unemployment trend.

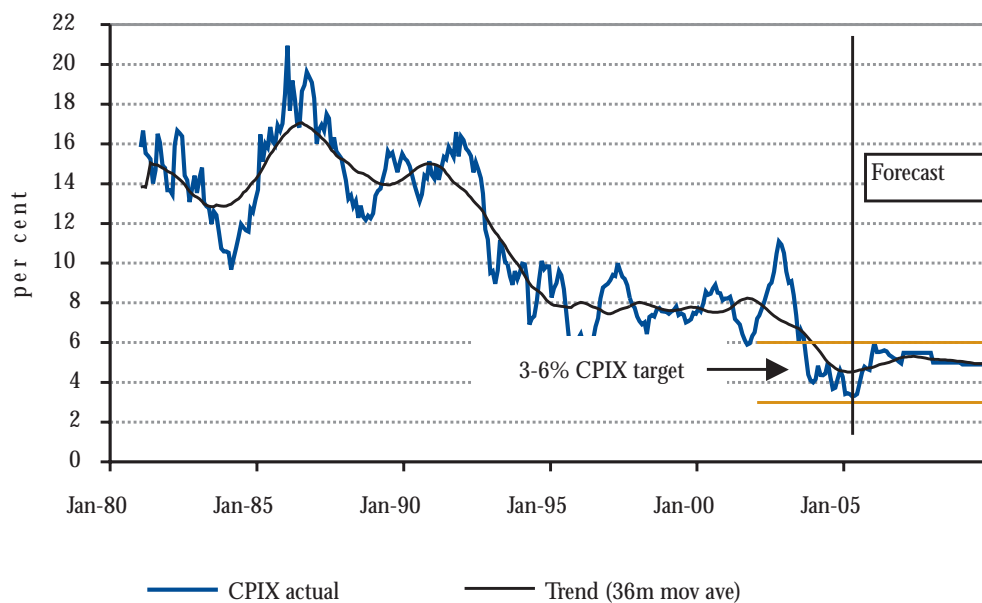
improved international investor sentiment could make a difference over the near term. The global inflation environment is also expected to be conducive to lower inflation in South Africa over the short to medium term, apart from the near-term oil price risk.

On a forward-looking basis, the SARB is not expected to tighten monetary policy well into 2005. In fact, the more benign inflation outlook allowed the SARB to cut interest rates in August 2004 (by 50 basis points or 0,5%) to counter the strength of the rand exchange rate; a similar cut is potentially possible later on in 2005, given the sustained strength of the rand.

However, the picture changes going into 2006 as the SARB becomes focused on inflation possibly accelerating towards the upper band of the inflation target in 2006 on the back of excess demand in the economy and a weaker currency. Interest rates are therefore expected to increase from the end of 2006. Bar unforeseen shocks, the total increase in interest rates could be on a limited scale in the current upward phase of the business cycle, should the favourable inflation outlook and the supporting sound economic fundamentals prevail.

Monetary policy will remain focused on driving inflation and inflation expectations lower until trend inflation stabilises within the target range. Once inflation has stabilised at these lower levels, there may be scope for a more accommodative monetary policy, which could increase trend growth and job creation in the economy.

Figure 4 CPIX inflation: the long-term trend



[Source: SARB / BER]

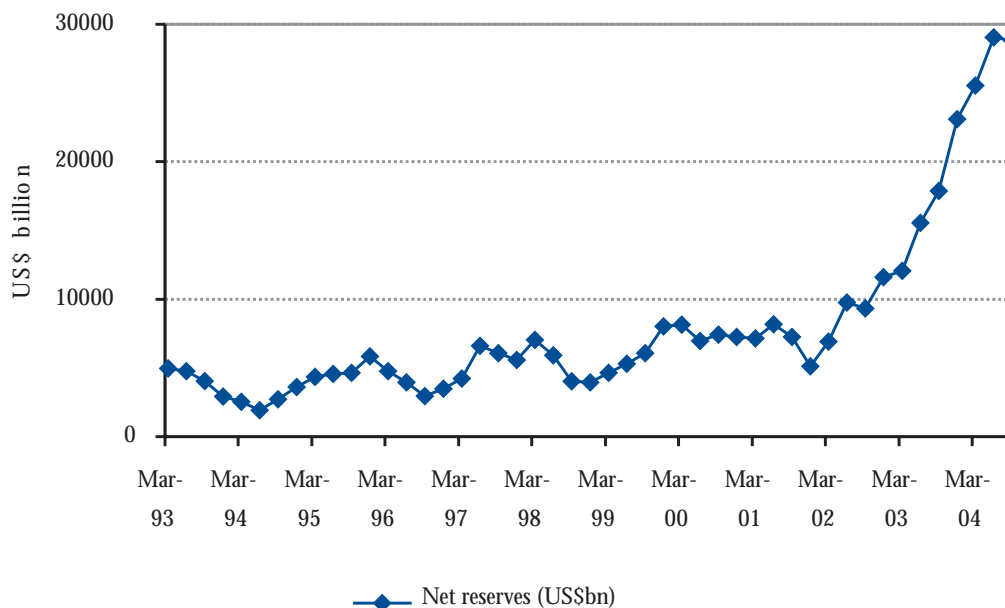
2.6. Balance of payments and the rand exchange rate: performance and outlook

Three key trends are discernable on the South African balance of payments since the end of 2001:

- *First*, the rising import to export ratio, which is closely correlated with the strengthening rand exchange rate. The result has been a deterioration of the trade balance into a deficit of R12-billion during calendar year 2004. The current account deficit measured 2,5 per cent of GDP during the third quarter of 2004, having been in a surplus during the first quarter of 2003.
- *Second*, the deterioration on the trade (and current) accounts was countered by the massive improvement in South Africa's terms of trade during 2003 and 2004. This resulted from the strong increase in international commodity prices over this period, exceeding the impact of higher crude oil and other import prices.
- *Third*, despite the deterioration in the trade balance (and the current account balance), net balance of payments reserves increased from around US\$5-billion at the end of 2001 to US\$29-billion at the end of September 2004 due to strong inflows on the financial account of the balance of payments (*see Figure 5*).

The higher level of reserves has been a direct result of the SARB's efforts to square off the open position of its forward book (that is, the balance between the SARB's forward foreign currency commitments and its forward currency receipts), which was achieved in February 2004. The subsequent replenishment of reserves, as well as the private banking sector's efforts to replenish foreign currency reserves to fulfil its role as the provider of forward exchange cover, have also been contributing factors.

Figure 5 Net balance of payments reserves (US\$-billion)



[Source: SARB]

While the global economy accelerated strongly since the middle of 2003, South Africa's export growth has been atypically subdued, largely as a result of reduced price competitiveness, as well as tepid growth in the economy of its largest trading partner, the Euro area. In particular, South Africa's manufactured exports came under pressure – the volume of manufacturing exports declined by 7,5 per cent in year-on-year terms during the first half of 2004 and manufacturers continued to report steep year-on-year declines in export volumes during the second half of 2004.

It is evident that the strong rand exchange rate is having a severe negative impact on South Africa's manufacturing exports and probably on export capacity. There is clear evidence that manufacturers are switching production to the lively local market. This is unfortunate in view of South Africa's longer-term export prospects and has negative implications for the balance of payments. The latter arises as South Africa's foreign currency earnings capacity could be compromised, in turn restraining real economic growth as higher rates of growth in domestic spending and import demand will not be sustainable.

South Africa's non-gold mining exports, in particular coal and platinum, fared better due to the strong increase in the dollar-based international prices – mining export volumes grew by 13 per cent year-on-year during the first half of 2004.

A broader recovery in exports is very dependent upon a more competitive currency. South Africa's export firms have improved production efficiencies during the 1990s; however, an overvalued currency could be very damaging to the country's export capacity. In South Africa's case, the overvalued status of the rand exchange rate is not sustainable and it is expected to adjust to a 'fairer value' over the short term.

Import demand, in turn, has accelerated strongly on the back of the strong currency and lively domestic spending on import-intensive consumer and capital goods. Import volumes grew by an average 14 per cent year-on-year during the first nine months of 2004. Imports were also boosted by special factors over this period, for example Government's acquisition of Navy corvettes, SAA's acquisition of new aircraft, and higher oil imports.

While these factors are expected to pass, the deteriorating trend on the current account of the balance of payments is unmistakable. As long as the wider current account deficit is financed by sufficient capital inflows, this should not present any problems; however, given South Africa's track record of volatile capital inflows, a large current account deficit is unsustainable in the event of a capital flow reversal. To restore balance on the current account, higher interest rates and/or a depreciation of the rand exchange rate will be required.

As noted, capital inflows on the financial account of the balance of payments have been sufficient to finance the current account deficit and a healthy increase in the balance of

payments reserves. Following a net inflow of R18,5-billion during the first half of 2003, the net inflow reached record proportions (an accumulated net inflow of R105,3-billion) during the subsequent 15 months. The bulk of these inflows were unrecorded transactions (one-third), other short-term investment inflows (47%) and portfolio investment inflows (one-quarter).

The stark reality is the fact that net direct investment has been negative during 2003 and the first half of 2004, that is, outward direct investment exceeded inward direct investment. Foreign direct investment (FDI) inflows are required to stabilise the capital inflow on the balance of payments to allow South Africa to sustain higher current account deficits which usually accompany higher real economic growth rates. Furthermore, increased inward FDI directly adds to domestic capital formation and employment generation, as well as facilitating the transfer of skills and technology, which all enhances South Africa's growth potential.

The recent portfolio inflows on the financial account of the balance of payments were very volatile, although the issuing of long-term debt abroad contributes to some stability. A large section of the other investment inflows appears to be related to trade financing, in turn related to the lower interest rates abroad and the strengthening rand exchange rate. These flows are sensitive to changing interest rates and movements in the exchange rate of the rand.

The rand exchange rate could therefore be vulnerable over the short term. The weak US dollar, the historical low interest rates abroad and the strong commodity cycle played a strong part in the rand's dramatic recovery during 2002 to 2004. The replenishment of South Africa's balance of payments reserves and increased foreign investor confidence reinforced the appreciating tendency of the rand.

However, as long as net FDI remains subdued, rand exchange rate volatility is likely to persist. At present the rand is particularly vulnerable to deterioration in South Africa's terms of trade (lower international commodity prices) and/or a reversal of short-term oriented capital inflows. Short-term investment capital inflows may be less forthcoming in an environment of higher interest rates abroad, a downturn in commodity prices and possibly a stronger US dollar.

3. The Western Cape Economy: Performance and Outlook, 2005 to 2007

In comparison to the other provinces of South Africa, the Western Cape regional economy displays a number of unique structural trends, giving rise to a dynamic process that has its own strengths and challenges for policy-makers.

Compared to the relatively small population share (10,2%), the Western Cape economy has an amazingly broad base with a multitude of sub-sectors or niches, many of which are growing well or have the potential to expand. With the exception of the mining sector, the Western Cape economy is well represented in each sector, with tourism as well as agriculture making up much of the mining deficit.

Table 6 Western Cape GDPR: Sectoral composition, 1999 – 2003

Sector	1999 %	2000 %	2001 %	2002 %	2003 %	Average 1999 – 2003 %
Primary sector	5,9	5,3	5,7	6,7	5,7	5,9
Agriculture	5,7	5,1	5,5	6,4	5,4	5,6
Mining	0,3	0,3	0,3	0,3	0,3	0,3
Secondary sector	25,7	25,6	24,4	25,6	24,8	25,2
Manufacturing	19,9	20,2	20,0	20,6	19,9	20,1
Electricity & water	1,9	1,8	1,7	1,6	1,7	1,7
Construction	4,0	3,6	2,8	3,4	3,2	3,4
Tertiary sector	68,3	69,1	69,8	67,8	69,5	68,9
Internal trade & catering	15,1	16,1	16,1	15,6	15,8	15,7
Transport & communication	10,0	10,2	10,2	10,1	10,3	10,1
Financial & business services	26,4	26,3	27,7	27,0	28,0	27,1
CSP services ¹	5,1	5,3	5,3	5,2	5,3	5,3
Government	11,8	11,0	10,6	10,0	10,1	10,7
Total GDPR (basic prices)	100	100	100	100	100	100

¹ Including 'Other producers' (mainly domestic servants).

[Source: Statistics South Africa: Statistical Release P0441, 28 November 2004]

Similar to the case nationally, the *tertiary sector* (comprising various services industries) produces the largest share of the GDPR, that is, *on average slightly more than two-thirds (68,9%) over the past five years (see Table 6)*. This is comparatively bigger than the tertiary sector's contribution to national GDP, which has been 64,3 per cent on average over the past five years.

The relative size of the *secondary sector* (manufacturing, electricity & water and construction) – 25 per cent of GDPR – is in line with the national situation, while the Western Cape has a much smaller *primary sector* (6% compared to 11,4% of national GDP, respectively) due to the absence of a meaningful mining industry in the Province.

Compared to the national economy and at a more disaggregated level, three sectors play a proportionately larger role in generating the regional GDP. These are:

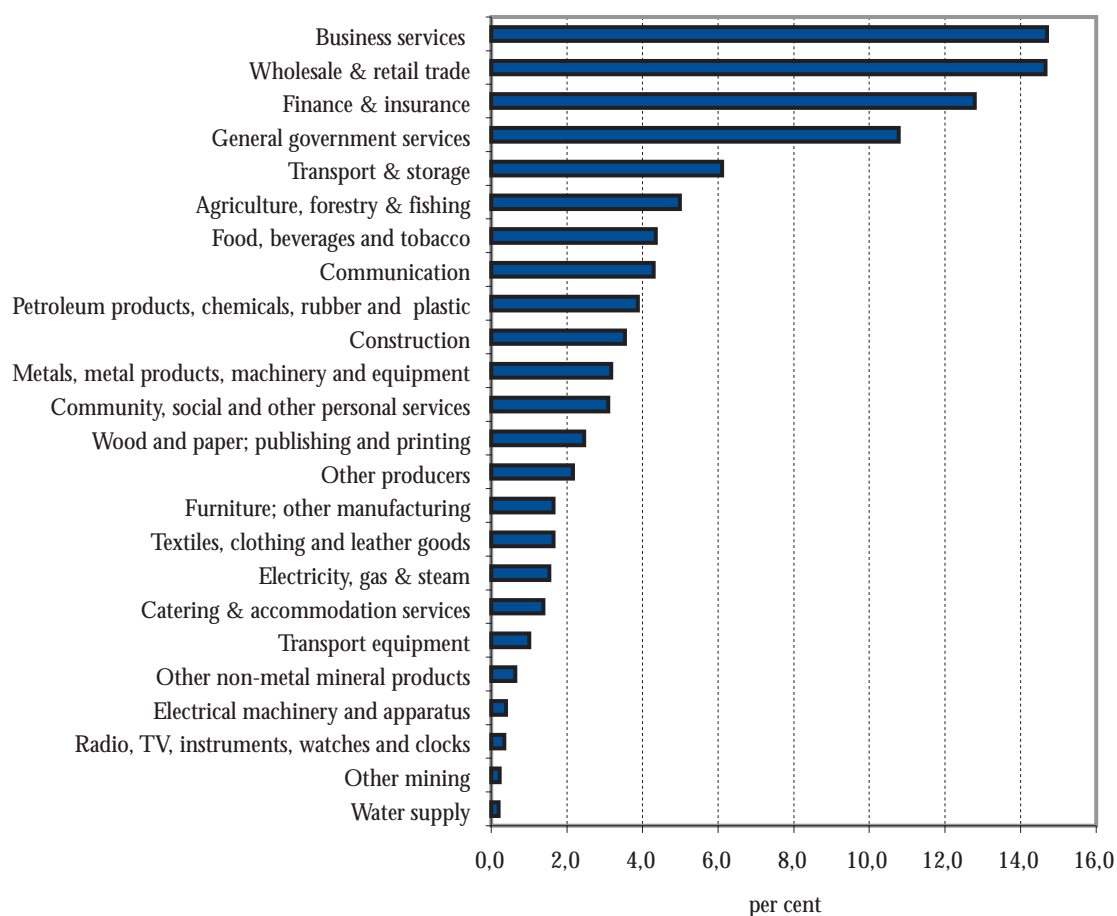
- *Financial & business services*, contributing 27,1 per cent of the GDPR on average over the five year period 1999 to 2003 compared to 19,2 per cent nationally. This sector

includes banking & insurance, real estate and business services, which in turn range from information and communication technology (ICT) services and engineering to accounting services, to name a few.

- *Agriculture*, contributing 5,6 per cent compared to 3,6 per cent nationally; and
- *Construction*, contributing 3,4 per cent compared to 2,5 per cent nationally.

These three broad sectors each accounts for around one-fifth of the respective national sectors.

Figure 6 Composition of the Western Cape GDP, 1999 – 2003



[Source: Quantec Research]

Contributions of the Province's *manufacturing* sector (20,1% of GDP on average over the period 1999 – 2003) and the *transport & communication* sector (10,1%) are very much in line with national contributions.

The Province's *internal trade sector* (including retail, wholesale, catering & accommodation) is larger in relation to GDP (15,7%) compared to the national situation (14%) due to the importance of the tourism industry in the Western Cape.

On the other hand, the Province has a number of smaller industries in a national perspective. The two that stand out most are:

- *Mining & quarrying* (contributing 0,3% of GDP compared to 7,8% nationally); and
- *General government* (10,7% compared to 15,5% nationally).

The Western Cape also has a relatively smaller *community & personal services* sector (5,3% compared to 6,2% nationally) and *electricity & water* sector (1,7% versus 2,6%, respectively).

The largest sectors of the Province are therefore:

- *Financial & business services* (banking & insurance 12,8% and real estate & business services 14,%) – 27% in total;
- *Manufacturing* (20%);
- *Internal trade & catering* (16%); and
- *Government* (11%).

These four broad sectors contribute more than 70 per cent of the regional GDP.

Within the manufacturing sector, *agro-processing* (food, beverages & tobacco), *metals processing & engineering*, *oil & petro-chemicals*, *clothing & textiles* and *furniture* are important activities.

In terms of GDP contribution, *transport & communication* (10%), *agriculture* (5,6%) and *construction* (3,4%) are also relatively large sectors in the Province.

However, conventional national accounts statistics do not always portray the growth of the more dynamic niche sectors. In this regard, an accurate representation of the tourism sector is a serious shortcoming in conventionally classified data. It is estimated that the tourism industry contributes between nine per cent and 10 per cent of national GDP, and the booming growth in the industry is reflected in the sharp growth in tourist arrivals in the Province (and nationally).

Within manufacturing and services, a diversity of growth niches is evident, which represent an important growth dynamic in the region. Included here are activities such as:

- *Mari- and aquaculture*;
- *Specialised agricultural niche products with a high value-added processing and marketing content*;
- *Boat building, repairs and upgrading*;
- *Commercial film production (particularly in the marketing sphere)*;
- *Specialised professional services*;
- *ICT services/software 'exports'*; and
- *The combination of health and tourism services*.

The Western Cape is also known for its booming 'retirement sector'. The proportionately larger presence of the financial & business services industry in the region is tied to the fact that these services are provided throughout South Africa (and even beyond the country's borders). The Western Cape clothing sector also services the higher end of the national clothing retail market and more manufacturing firms are moving this way. Apart from the local factors, national linkages are therefore an important aspect of the region's growth dynamic.

Regarding the structure of the region's economy, the picture is different from an employment perspective compared to a GDP perspective. The role of the more capital-intensive financial & business services sector (generating 10% of Western Cape employment in 2003) and transport & communications (5% to 7%) is reduced, while that of the more labour-intensive internal trade (20% when informal employment is included), agriculture (13% to 14%) and government (17%) sectors is increased.

The manufacturing sector's contribution to provincial employment (16% to 18%) is close to its GDP contribution (20%). Within the manufacturing sector, the clothing industry stands out as a labour-intensive industry, accounting for 25 per cent to 30 per cent of overall manufacturing employment in the Province.

From an employment perspective – and in order of importance – the government, internal trade & catering, manufacturing, agriculture and other producers (mainly domestic servants) are the most important sectors in the Province. Combined, these sectors account for more than 75 per cent of the total regional employment opportunities in the Western Cape⁶.

3.1. Western Cape Economic Growth (GDPR): Performance and Outlook

3.1.1. The past five years

Figure 7 shows that the Western Cape economy has out-performed the national economy over the past five years. Real GDPR growth for the Western Cape economy averaged 3,9 per cent over the period 1999 to 2003, compared to the national average of 3,1 per cent.

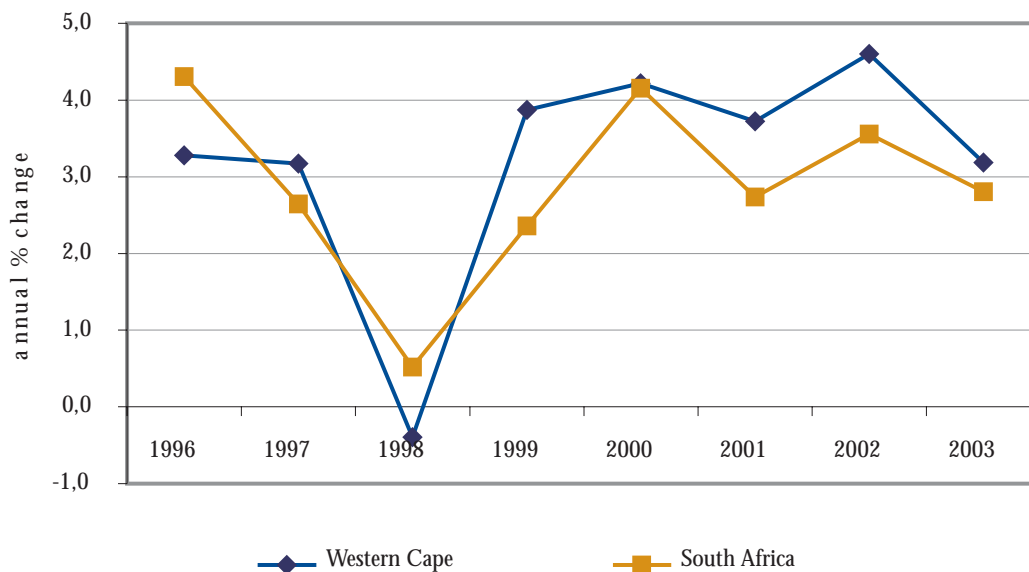
Even during 2003, when the appreciation of the rand exchange rate and the adverse climatic conditions had a proportionately larger negative impact on the regional agricultural and manufacturing sectors, the Western Cape real GDPR growth rate (3,2%) came in above the national real GDP growth rate (2,8%).

This performance is tied to robust growth in the region's services sectors, including a firm recovery in the financial sector. However, the recessions in agriculture and manufacturing

⁶ This is according to the Statistics South Africa September 2003 Labour Force Survey and Wesgro/Wolfgang Thomas' estimates of employment in the Western Cape in 2003.

caused a sharp deceleration in the region's real GDP growth rate from the buoyant 4,6 per cent registered in 2002 in the wake of the rand's sharp depreciation. It is estimated that regional growth again exceeded that of the rest of the country in 2004, albeit by a small margin due to the sustained strength of the rand and dry agricultural conditions. A number of the salient growth trends in the Western Cape economy are highlighted below.

Figure 7 Real GDP growth: Western Cape versus South Africa



[Source: Quantec Research]

The superior growth of the Western Cape economy over the past five years is largely due to the strong growth of the region's services industries, such as transport & communication, financial & business services and internal trade & catering. While these are nationally faster growing industries, Figure 8 shows that the Western Cape outperformed in these sectors, particularly in internal trade & catering (which grew by 6,6% per annum over the past five years compared to 5,3% nationally) and finance & business services (6,3% versus 5,4%).

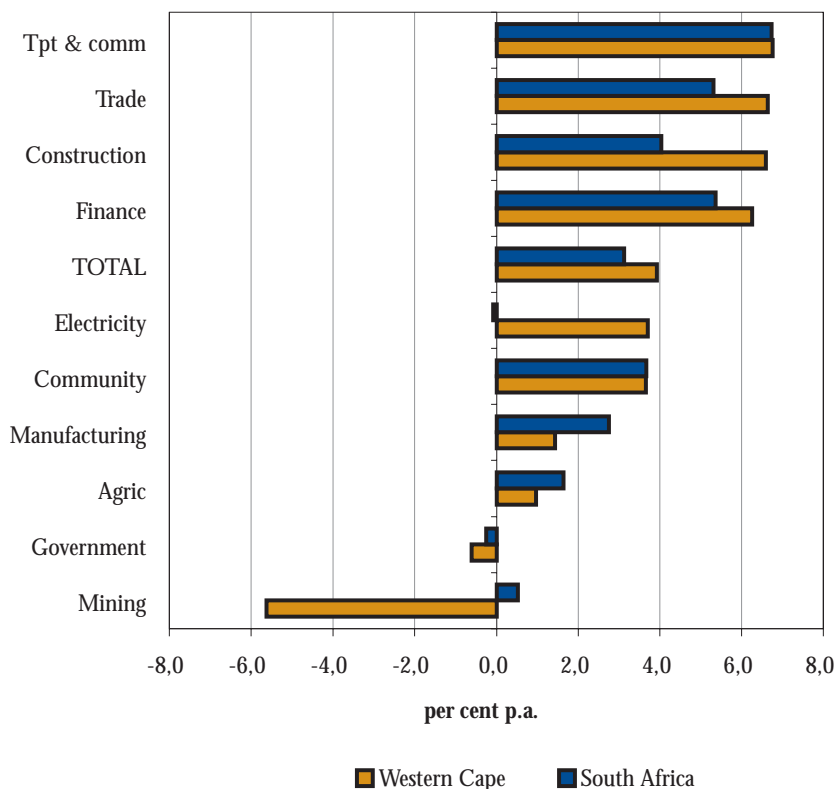
The internal trade & catering sector benefited from tourism, which has been a fast-growing sector in the Western Cape. The proportionately larger financial & business services sector in the Western Cape benefited from the property boom and the recovery in asset markets following the 2000 global meltdown in the ICT sector. The regional transport & communications sector kept up with the national growth tempo of this sector, growing by close to seven per cent per annum over the period 1999 to 2003. Therefore, the Western Cape economy is well represented in, and even outperforms, the faster growing national sectors.

Another sector well represented in the Western Cape (accounting for close to 20% of the national sector) and which outperformed the national sector, is the construction industry.

This sector grew by 6,6 per cent on average over the past five years compared to the national performance of only 4,0 per cent per annum.

This period witnessed the construction phases of a number of mega investment projects in the Western Cape, in particular the Century City shopping complex, the Grand West casino, the Cape Town International Convention Centre and Saldanha Steel, to name but a few. The hotel building boom of the mid-1990s in the Western Cape preceded these projects. The Western Cape construction industry shared in the general revival of the residential and non-residential building industries over the past five years.

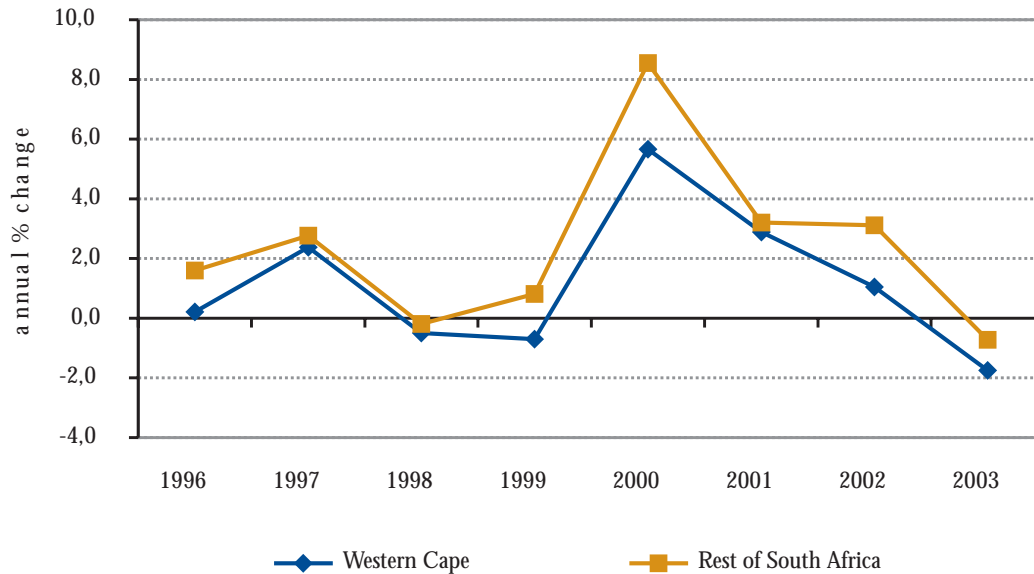
Figure 8 Average real GDP growth Western Cape versus South Africa (by sector), 1999 – 2003



[Source: Quantec Research]

In contrast, the growth of the Western Cape overall manufacturing industry has been disappointing. Real Western Cape manufacturing value-added grew at half the pace of the national average, or at 1,4 per cent per annum between 1999 and 2003 compared to 2,8 per cent nationally (see Figure 9). The share of manufacturing in the regional GDP declined from 23 per cent in 1995 to 19,9 per cent in 2003. The decline in the sector's formal employment contribution was worse, dropping from 21 per cent in 1995 to 16 per cent in 2003.

Figure 9 Manufacturing real value-added growth; Western Cape versus South Africa, 1996 – 2003



[Source: Quantec Research]

However, the sub-par growth performance of the Western Cape manufacturing industry needs to be put into perspective:

- The strong representation (35%) of the embattled national clothing & textile sector in the Western Cape has to explain an important part of the slow overall growth. Real value-added in this regional sector remained flat on average over the past five years, compared to marginal growth of 0,8 per cent per annum in the national sector outside of the Province.

This sector accounts for around 15 per cent of the Cape Metro's manufacturing Gross Geographic Product (GGP) and 25 per cent to 30 per cent of manufacturing employment (Barnes, 2004: 26)⁷. It contributes eight per cent of the Province's GDP. The number of clothing firms in the Province declined from more than 400 in 1995 to 324 in 2001 (Barnes, 2004: 15).

The shrinkage in the sector has been a result of restructuring, as clothing manufacturers have downsized to service the higher end of the clothing retail market in South Africa (Barnes, 2004: 16-17/ 27-28)⁸. Given this focus, the regional industry will be in a better position to withstand the expected increase in international competition in 2005 with the end of the Multi-Fibre Agreement. The latter restricted the major industrial countries' textile imports from countries such as China and India by way of import quotas.

However, the appreciation of the rand exchange rate during 2002 to 2004 has put substantial pressure on the sector and China remains a threat – witness the ratio of

⁷Quantec Research estimates that the clothing, textiles & leather sector contributes around 10 per cent to Western Cape real manufacturing value-added; however, the share is shrinking due to poor growth.

⁸The impact on employment may have been less serious as firms changed to indirect forms of labour (sub-contracting, etc.) and home industries developed in the wake of formal downsizing.

imports to exports in the clothing & textile sector in Figure 11. Business confidence is also currently measured at very low levels in this sector.

- The regional food processing and beverage sectors were also hard hit by the drought in agriculture in 2003 and 2004, adding to the exchange rate woes. However, it appears that food and beverage manufacturers are currently able to exploit the lively domestic market conditions to compensate for the decline in their exports; in fact, the sector has displayed remarkable resilience under the circumstances.

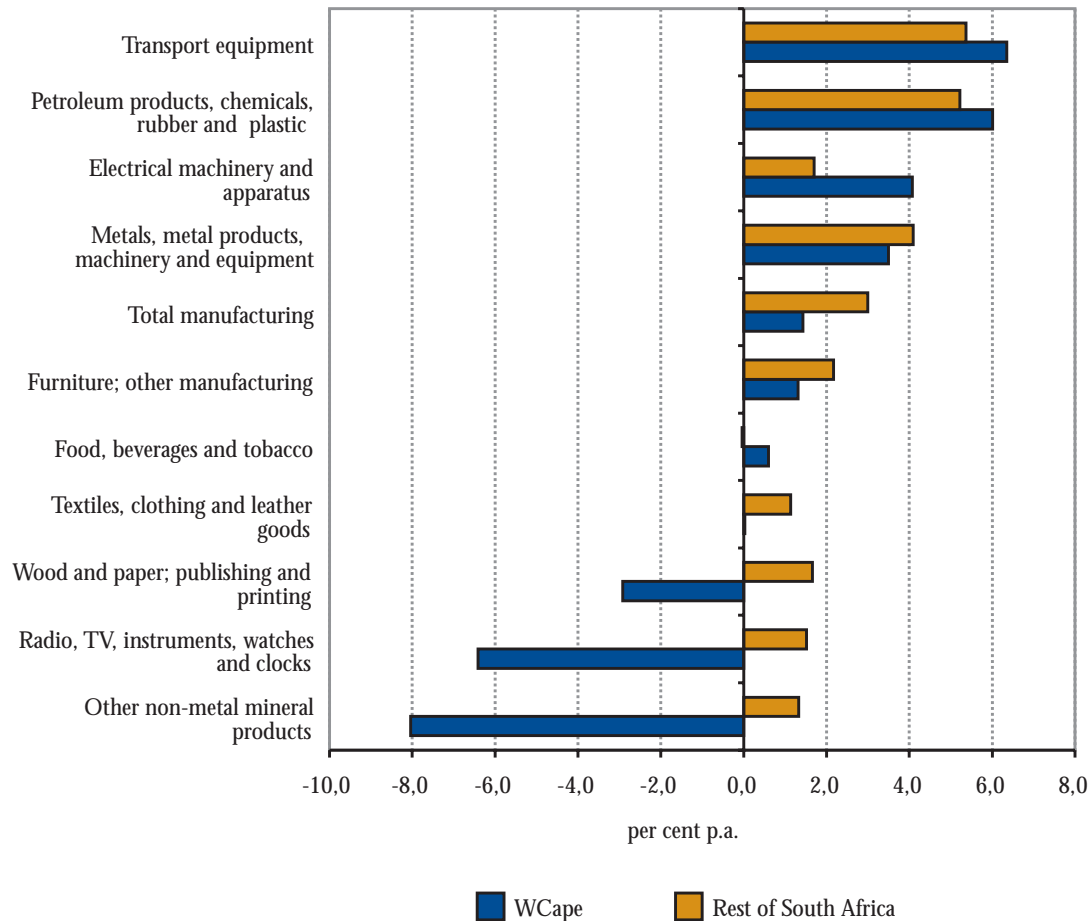
Real value-added in the food, beverages & tobacco sector tended to fluctuate around a flat trend over the past five years, both nationally and in the Western Cape. As this sector contributes 22 per cent to the Western Cape manufacturing real value-added (compared to 15% nationally), the lack of growth in this sector assists in explaining the sub-par growth performance of the Western Cape manufacturing sector.

- Other manufacturing sub-sectors showing weaker growth in a national context include wood & paper, printing & publishing, radio, television & instruments and non-metal minerals (*see Figure 10*). *These sectors tended to shrink in the Western Cape compared to positive growth in the rest of the country.*
- The Western Cape basic metals, metal products, machinery & equipment sector performed well (with real value-added growing by 3,5% per annum between 1999 and 2003); however, this was slightly below the performance of the same sector outside the Province, growing by an estimated four per cent per annum.
- The only manufacturing sub-sectors that outperformed their peers in the rest of the country are transport equipment (including automotive components and boat & ship building, with real value-added growing by 6,4% per annum over the period 1999 to 2003 compared to 5,4% nationally); electrical machinery (4,1% compared to 1,9%) and – to a lesser extent – petroleum products, chemicals, rubber & plastics (6% compared to 5,3%).
- Finally, the strong growth in some niche industries is not reflected in the aggregated statistics. As noted above, this represents an important aspect of the Western Cape's growth dynamic.

Real Western Cape manufacturing GDP declined by an estimated 1,7 per cent in 2003 compared to a one per cent decline nationally. A general recovery occurred in manufacturing since the end of 2003, driven mainly by keen domestic spending. Business is adjusting to the strong level of the exchange rate. However, in some sectors the pressure is immense, particularly the clothing & textile sector, as seen in Figure 11, due to the unrelenting strength of the rand.

The growth in the agriculture, forestry & fishing sector also fluctuated over the past five years, only growing by one per cent per annum in real terms compared to 1,6 per cent nationally. This is a labour-intensive sector, accounting for 13 per cent to 14 per cent of the Province's total employment. Production in this sector is very volatile, depending on climatic conditions. During 2003, real value-added in this sector declined by close to eight per cent due to the drought in the wheat- and fruit-producing areas. The 2004 wheat crop failed again. The wine industry is additionally struggling with global oversupply.

Figure 10 Western Cape manufacturing: real GDP growth, 1999 – 2003



[Source: Quantec Research]

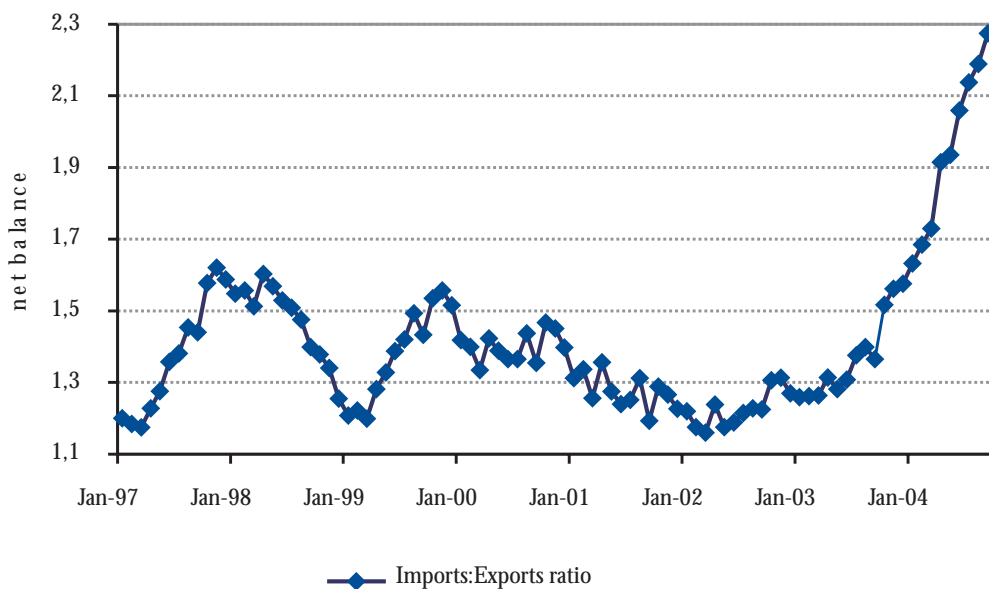
In all, the net result of these growth trends has been that the bulk of the growth in the Western Cape economy over the past five years (and the analysis does not change over a 10-year history) has been contributed by the tertiary sector, at more than 85 per cent. Close to half of this growth originated from the financial & business services sector (42%), while the trade & catering sector contributed 25 per cent and the transport & communications sector 17 per cent.

The *secondary sector* only contributed 13 per cent of the accumulated growth. Within this sector, the contribution of the manufacturing industry did not exceed that of the construction sector by a large margin (6,8% compared to 4,6%). This juxtaposes the comparatively weak performance of the regional manufacturing sector (which contributes 20% to GDP) with the comparatively strong performance of the regional construction sector (contributing only 3,4% of GDP). The disappointing contribution from the regional manufacturing sector becomes more apparent when it is compared to the national

situation, where manufacturing accounted for close to 15 per cent of GDP growth over the corresponding period.

Finally, the *primary sector* has only been adding marginally to GDP growth over the past five to 10 years (0,5%), declining in some years and growing in others, depending on the climatic conditions.

Figure 11 Clothing & textile sector: ratio of imports to exports



[Source: SARS]

3.1.2. A business cycle perspective

The national economy has been in an upswing phase of the business cycle from September 1999, and the Western Cape shared in this revival. National economic growth was hard hit during 1998 and 1999 when prime overdraft rates increased to a level of 25,5 per cent in the wake of the East Asian currency crisis and the SARB's efforts to protect the value of the rand.

Sustained growth in the Western Cape's services sectors and the construction phases of large retail shopping and tourism facilities in the Province countered the slowdown in manufacturing. The national economy registered a real GDP growth rate of 2,4 per cent in 1999, only emerging from the growth slowdown towards the end of 1999. This compared with the Western Cape's growth rate of 3,9 per cent for the same year.

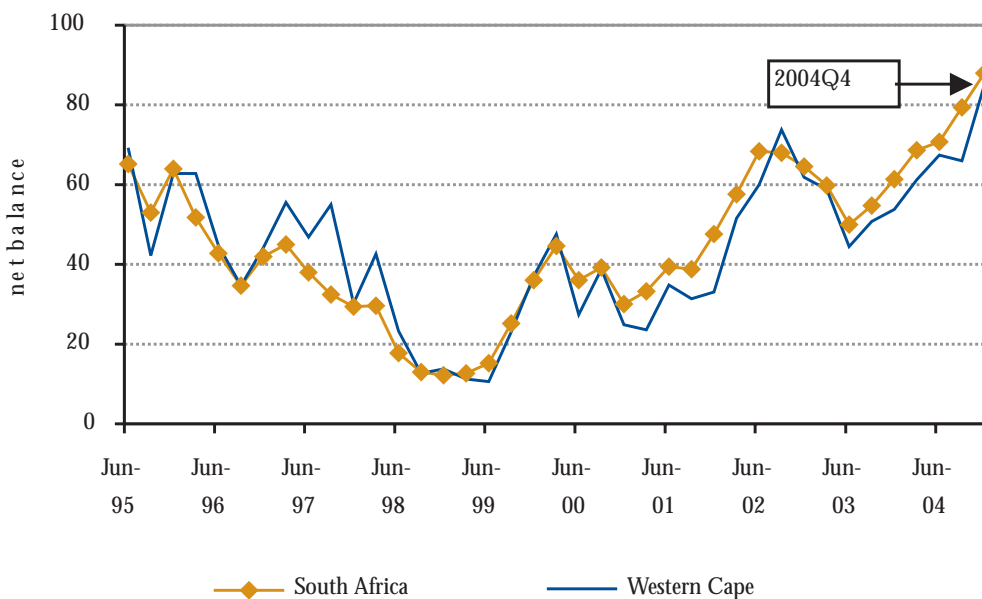
This economic revival has developed increased momentum over the past five years, despite heavy financial volatility. In 2001 and 2002, the economy weathered the sharp global

economic slowdown quite well as the sustained growth in real after-tax household incomes, improving employment conditions and higher consumer confidence levels fuelled a three per cent-odd sustained growth in final household consumption expenditure.

In this regard, the growth in the higher end of the retail market has been much healthier compared to the situation at the lower end of the income scale. Middle- to higher income earners benefited from tax cuts, lower interest rates, improving house prices, black economic empowerment (BEE) and more stable skilled employment conditions.

The more favourable growth of this market segment benefited the Western Cape retail sector. Exports also performed strongly on the back of the weaker currency (between 2000 and 2002). Real GDP growth averaged 4,2 per cent in 2000, both in the Western Cape and in South Africa. It accelerated further to 4,6 per cent in the Western Cape in 2002, while slowing nationally to 3,6 per cent. In calendar year 2002, positive formal sector employment growth was registered, both nationally and in the Western Cape (2,0% and 1,3% respectively).

Figure 12 Western Cape versus national business confidence (BER survey)



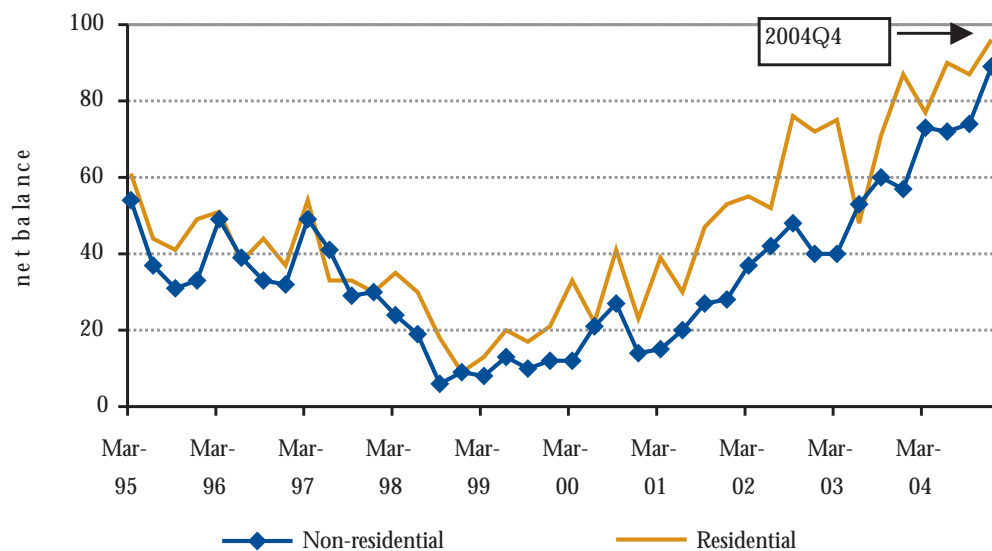
[Source: BER]

The combined impact of higher inflation and interest rates (2002/03), poor world economic growth and the strengthening of the rand exchange rate (between 2002 and 2004) was a significant deceleration in general economic growth to 2,8 per cent and 3,2 per cent nationally and in the Western Cape respectively during 2003. Manufacturing was particularly hard hit (clothing & textiles, food & beverages, metal products &

machinery, wood & paper and furniture). The adverse climatic conditions also had a negative impact on regional economic growth. The Western Cape employment situation deteriorated, reversing the improving tendency discernable since 2000.

In the first three quarters of 2004, Western Cape business confidence was measured on a lower level compared to the rest of South Africa (*see Figure 12*). Whereas around 80 per cent of the BER's respondents in the retail, wholesale, motor trade, manufacturing and building sectors reported satisfactory general business conditions nationally, only 61 per cent to 66 per cent did so in the Western Cape⁹. However, Western Cape business confidence recovered sharply during the fourth quarter of 2004, reverting to the historically close correlation in confidence trends between the region and nationally.

Figure 13 Building contractors' business confidence (BER survey)



[Source: BER]

Western Cape economic sectors that are fully sharing in the general improvement of economic activity in South Africa during 2004 include retail, wholesale and building & construction. National real retail sales grew at rate of close to 10 per cent year-on-year during the first 10 months of 2004. Consumer confidence was measured on a higher level during the second half of 2004 in the Western Cape compared to the other two large provinces in economic terms, Gauteng and KwaZulu-Natal.

Western Cape building contractors in both the residential and non-residential sectors also reported equally buoyant business conditions during the course of 2004 compared to the national situation. Building plans passed in the Western Cape, measured in square meters,

⁹ The BER measures business confidence nationally and on a geographical basis in the retail, wholesale, motor trade, manufacturing and building sectors. Whereas business confidence was measured on a higher level in the Western Cape compared to the whole country over the period 1995 to 1998/99, this has changed subsequently. Unfortunately, the BER's business confidence index does not include the rapidly growing services industries in the Western Cape (for example, financial services and transport & communication). This and the relative under-performance of the regional manufacturing industry probably explain the lower level of business confidence in the Western Cape compared to South Africa over the period 1999 to 2004.

are showing growth of 32 per cent year-on-year (for dwellings larger than 80 square metres); for flats and townhouses the growth is more than 100 per cent. Building plans for shopping space are also showing growth in excess of 100 per cent.

As seen in Figure 13, the BER's building business confidence index is currently on a 23-year high. The strong performance of the construction sector is likely to persist, boosted by the lively retailing conditions, the tourism industry and FDI.

The transport & communication sector is also likely to continue performing well, both in the region and nationally. Transport activity is closely driven by retail and manufacturing conditions, import and export activity, and tourism. The cell phone industry also remains in a strong growth phase as the number of mobile subscribers continues to grow.

In all, the current performance of the Western Cape economy is somewhat uneven, with real value-added growth not as strong in the agricultural and manufacturing sectors as in the services sectors.

Following the GDP revisions announced by Statistics South Africa at the end of 2004, it is estimated that real GDP growth came in close to the four per cent level in 2004, probably exceeding the national average by a small margin. The degree to which Western Cape economic growth exceeds that of the country may be a function of where the exchange rate is headed or, alternatively, how successful local business adapts to the changing macroeconomic parameters.

3.1.3. Economic growth outlook, 2005 to 2007

As seen above, the Western Cape economy's out-performance over the past five years has been tied to the strong presence of fast-growing services industries such as retail & wholesale trade, transport & communication and financial & business services in the Province. The flourishing tourism industry has been part and parcel of the growth story. Apart from these services industries, the construction sector also expanded strongly, although representing a relatively small part of the regional economy. Within manufacturing and services, a number of niche industries have also performed well and show promising potential.

However, the Western Cape agriculture and manufacturing sectors were hard hit in 2003 due to the negative impact of the strengthening rand exchange rate and adverse climatic conditions. The region's services sectors compensated, and growth came in above the national average. Indications are that the regional economy's relative out-performance continued during 2004, although the recoveries in the manufacturing and agricultural sectors probably lagged those in the rest of the country.

Considering the economic outlook for the region, the question is therefore whether the Western Cape will continue to out-perform in a national context.

From a domestic demand perspective, the short-term outlook for the Western Cape economy is decidedly favourable, similar to the national situation. As noted in the first section of the report, *inflation* and *interest rates* are likely to remain supportive to final consumer spending. *Consumer confidence* is *high* and rising and consumers' ability to spend is likely to continue to improve due to above-inflation wage settlements and improving employment conditions.

The improvement in *employment* in the Western Cape could *lag* that of the rest of the country due to the problems in the labour-intensive clothing industry, as well as the other major employers in the manufacturing sector, in particular food processing, wood products, printing & publishing. On the other hand, employment generation could be positive in the internal trade & catering, tourism and construction sectors.

Income growth is expected to continue improving and, combined with an increased propensity to utilise credit, consumer spending is expected to remain lively over the period 2005 to 2006. Western Cape industry is well positioned to service the strong-growing higher end of the retail market throughout the country, particularly should import competition be checked by some 'adjustment' in the rand exchange rate over the short term.

Export demand is also expected to be favourable over the projection period. While manufacturing exports are currently under pressure from the strong rand exchange rate, a more robust recovery should unfold once the rand depreciates, as is expected over the short term. Currently it is unknown to what extent export capacity has been affected more permanently by the exceptional strength of the rand. In a number of the smaller but faster-growing export categories over the past five years, volumes appear to have declined in 2003 and probably in 2004. Compensating for the decline in the region's manufacturing exports is the stable growth trend in the Province's agro-industrial exports and the favourable demand and prices for the Province's base metal exports.

Government is adding to the growth impetus via its accelerated roll-out of social welfare spending and infrastructure development, including the public works programme¹⁰.

Provided that the buoyancy in domestic demand is sustained and the more robust recovery anticipated in exports materialises, the lagging business confidence levels in the Western Cape should continue to catch up over the short term.

The outlook for *fixed investment* is promising. In this regard the regional situation corresponds to that in the rest of the country. Generally, firms appear to be adopting a long-term view and are increasingly embarking on expansion plans. Nationally, business confidence levels are on historical highs and the general political climate is rated as being the most stable in years.

¹⁰ The Western Cape's expanded public works programme aims to generate 120 000 jobs, and investment in infrastructure will be accelerated to 2,5 per cent of GDP (from one per cent currently) in terms of the agreements between government, business, labour and civil society reached at the Provincial Growth & Development Summit (November 2003).

Following a period of strenuous macroeconomic policies and restructuring in the domestic economy, we are entering an era of more supportive fiscal policy, gradually lower real interest rates and firms generally having adjusted to the lower level of import tariffs. Under these conditions, fixed investment spending can increasingly become of the capital-widening kind (being accompanied by expanding employment) rather than of the capital-deepening kind of the 1990s when formal employment contracted. That is the theory; however, there is already evidence that this is actually starting to happen.

Given these demand conditions, *real GDP growth* is expected to continue *accelerating* in 2005 and over the short term. The margin of growth above the national average may initially be relatively small due to the relatively weaker performing manufacturing and agricultural sectors. However, the internal trade & catering sector is projected to grow at a faster rate than nationally, being well positioned to service the fast-growing tourism sector and the higher end of the retail market. The growth in the financial & business services sector (including real estate) and in the transport & communication sector is also expected to keep up with the rest of the country, if not exceeding it. The construction sector should continue to benefit from the strong growth in both the residential and non-residential building sectors.

Identified growth sectors/opportunities in the Western Cape over the short to medium term include the following, to name only a few:

- The agriculture and food processing sector, including fishing & mariculture;
- Oil & gas developments, in particular the Kudu gas pipeline and downstream petrochemicals;
- The development of the downstream metals processing industry (Saldanha Steel/Duferco) linking into the Province's clothing/textile, food processing, beverages, automotive and fishing industries. Boat building & ship repair also show viable potential.
- High-value clothing, textiles and leather products (including the African Growth and Opportunity Act, or AGOA, opportunities), crafts and jewellery;
- Furniture – for household, office and industrial use;
- Tourism is expected to continue expanding in the Western Cape; the Provincial Government's own target is to increase the number of overseas tourists visiting the Western Cape from 790 000 in 1999 to four million by 2010. Domestic tourism is also targeted.
- The ICT sector is also earmarked for growth, particularly with the planned liberalisation of the communications market in 2005. ICT services show the strongest growth potential in the Province and also exhibit the strongest capabilities at this stage. Included here are call centres and business process outsourcing (BPO) centres.
- The film industry has also taken off in a big way and has growth potential, although this development is currently being constrained by the strength of the rand exchange rate.

In all, real GDP is projected to accelerate from growth of 3,3 per cent in fiscal year 2003/04 to 4,1 per cent and 4,3 per cent during fiscal years 2004/05 and 2005/06 respectively, exceeding the projected national growth rate by a small margin. In the outer years of the MTEF, real GDP growth is expected to decline slightly to 4,0 per cent and 3,9 per cent in fiscal years 2006/07 and 2007/08. These projections, however, remain above the national real GDP growth forecast of 3,9 per cent in 2005/06, 3,5 per cent in 2006/07 and 3,2 per cent in 2007/08.

The growth in the Province's services industries is projected to equal or exceed the national performance and a more competitive exchange rate (at around US\$7,00 to US\$7,50) should allow for a firmer recovery in the Province's embattled manufacturing sector, as well as the agricultural sector on the assumption of normal climatic conditions. *More detailed projections are provided in Table 7 and Table 8.*

Table 7 Western Cape macroeconomic outlook, 2004/05 – 2007/08¹

	2002/03	2003/04	2004/05F	2005/06F	2006/07F	2007/08F
GDPR (R-billion, current market prices)	168,8	185,4	203,0	222,5	244,4	263,4
Real GDPR growth (%)	4,3	3,3	4,1	4,3	4,0	3,9
GDPR inflation (%)	8,4	6,3	5,3	5,1	5,7	3,8
Western Cape CPI inflation (%)	9,0	4,6	2,3	4,5	5,5	3,7

¹ Fiscal years ending 31 March.

[Source: BER]

Table 8 Western Cape: Sectoral real GDP growth outlook, 2004/05 – 2007/08¹

Sector (SIC)	Average	2003/04	2004/05F	2005/06F	2006/07F	2007/08F
	1999–03					
	%	%	%	%	%	%
Agriculture	1,0	-6,4	1,7	2,4	2,4	1,8
Mining	-5,6	2,2	2,7	2,9	-1,5	-0,9
Manufacturing	1,4	-0,9	3,3	3,8	3,1	2,5
Electricity & water	3,7	7,5	-0,4	2,6	3,0	3,4
Construction	6,6	-0,3	8,3	8,5	6,6	6,4
Internal trade & catering	6,6	6,9	6,9	6,1	5,0	4,5
Transport & communication	6,8	7,6	5,3	6,0	5,6	5,3
Financial & business services	6,3	5,3	3,8	4,7	4,8	5,2
CSP services	3,7	4,8	3,9	3,8	3,6	3,5
Government	-0,6	1,2	1,3	1,6	1,7	1,8
Total GDP (market prices)	3,9	3,3	4,1	4,3	4,0	3,9

¹ Fiscal years ending 31 March.

[Source: Statistics South Africa / BER]

3.2. Western Cape inflation: performance and outlook

Figure 14 shows that price trends in the Western Cape economy correspond closely to those in the rest of the country. It follows that what has been said regarding inflation in the first section of the chapter also applies to the inflation performance of the Western Cape economy.

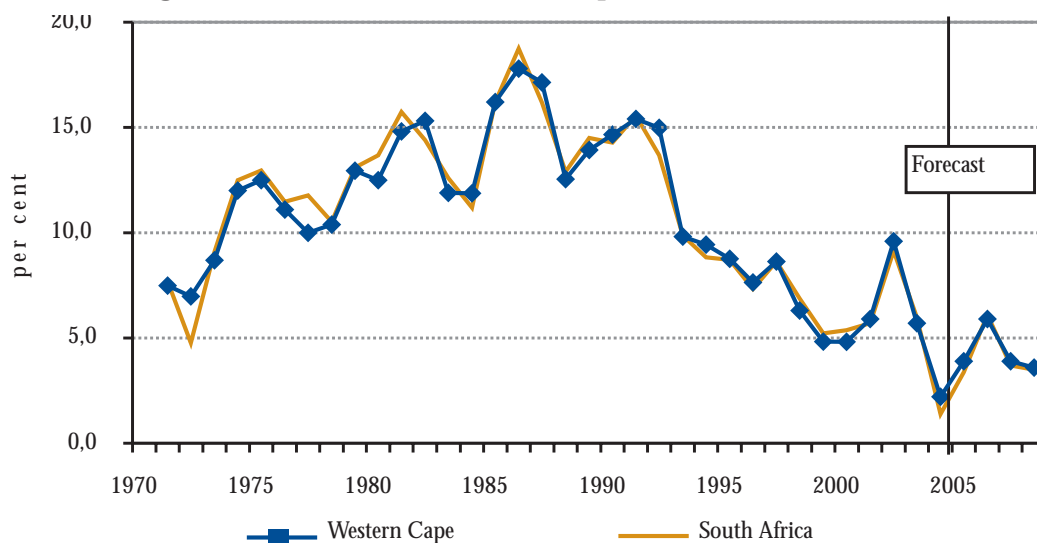
Inflation is currently well under control, benefiting from the strength of the rand as well as a structural adjustment in inflation expectations, which are responding to Government's inflation-targeting monetary policy framework. Food price inflation is also at exceptionally low levels, partly related to currency strength. CPIX inflation could come in below the four per cent level during the early months of 2005.

Having said that, ordinary cyclical forces and possibly the currency are likely to cause acceleration in domestic inflation over the short term. It is expected that surplus production capacity will disappear over the short term as the general economic growth momentum gathers steam; the production side of the economy has already responded to the lively domestic demand conditions.

Should the rand depreciate in addition, we could be faced with both demand-pull and cost-push inflationary forces later in the year. CPIX inflation is therefore projected to accelerate to between five per cent and six per cent during 2005/06.

It is expected that the lower level of inflation expectations and the maturing anti-inflation process in South Africa will curtail the price and wage responses in the private sector and keep inflation within the target range. Furthermore, with Government's renewed efforts to curtail administrative price adjustments, positive surprises in this regard could impact favourably.

Figure 14 CPI inflation: Western Cape versus South Africa, 1970 – 2008



[Source: Statistics South Africa / BER]

3.3. Western Cape fixed investment: performance and outlook

3.3.1. The past five years

As noted in the first section of the report, *gross fixed capital formation* is currently expanding at a rapid rate throughout South Africa. The growth is broad-based, involving both the private and public sectors. The Western Cape economy is sharing in the growth of fixed investment, although less robustly during 2003 and probably 2004.

Figure 15 reveals that the growth in fixed investment spending in the Western Cape has been more stable over the past number of years compared to the rest of the country. The more stable trend is linked to the fact that the less cyclical services industries contributed the bulk of the fixed investment growth over the past five to 10 years.

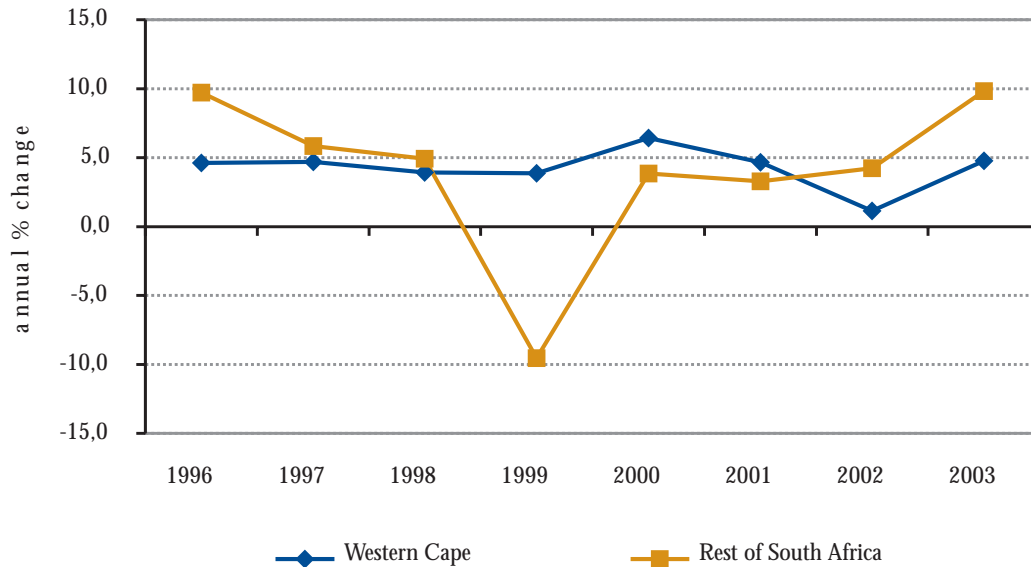
The general revival in fixed investment spending since 2000 is rooted in a gradual strengthening of domestic demand conditions over the past five years, lower and more stable interest rates, higher business confidence levels and a more favourable real economic growth outlook. It would appear that the stronger level of the exchange rate has stimulated capital expenditure further in 2003 and 2004, as firms exploit the opportunity to replace worn-out machinery and equipment and in some areas add to production capacity at the lower import costs.

Total gross domestic capital formation expanded at an annualised rate of nine per cent during the first half of 2004, similar to the growth rate registered in 2003. This could also be an indication that firms are taking a long-term view, and are not being discouraged by the deleterious effect the strong rand exchange rate has on profitability and export volumes.

Real fixed investment spending in the Western Cape grew by an average rate of 4,2 per cent per annum over the period 1999 to 2003, similar to the rate of expansion over the period 1995 to 2003. This compares favourably with the growth of only 2,3 per cent in the rest of the country over the corresponding period. However, the national five-year average is distorted by the sharp (9,5%) decline in 1999 outside the Western Cape. Fixed investment spending declined sharply in the wake of the spike in interest rates to 25 per cent in 1998.

In the Western Cape, strong investment spending at the time in the retail and tourism sectors, as well as the transport & communication and financial services sectors, countered the general cyclical decline in capital spending. Excluding 1999, real growth in gross fixed capital formation has averaged 5,1 per cent nationally since 2000 – slightly higher than the Western Cape's 4,2 per cent. However, the average growth rates over the whole period from 1995 to 2003 are similar around four per cent.

Figure 15 Fixed investment: Western Cape versus the rest of South Africa, 1996 – 2003



[Source: Quantec Research]

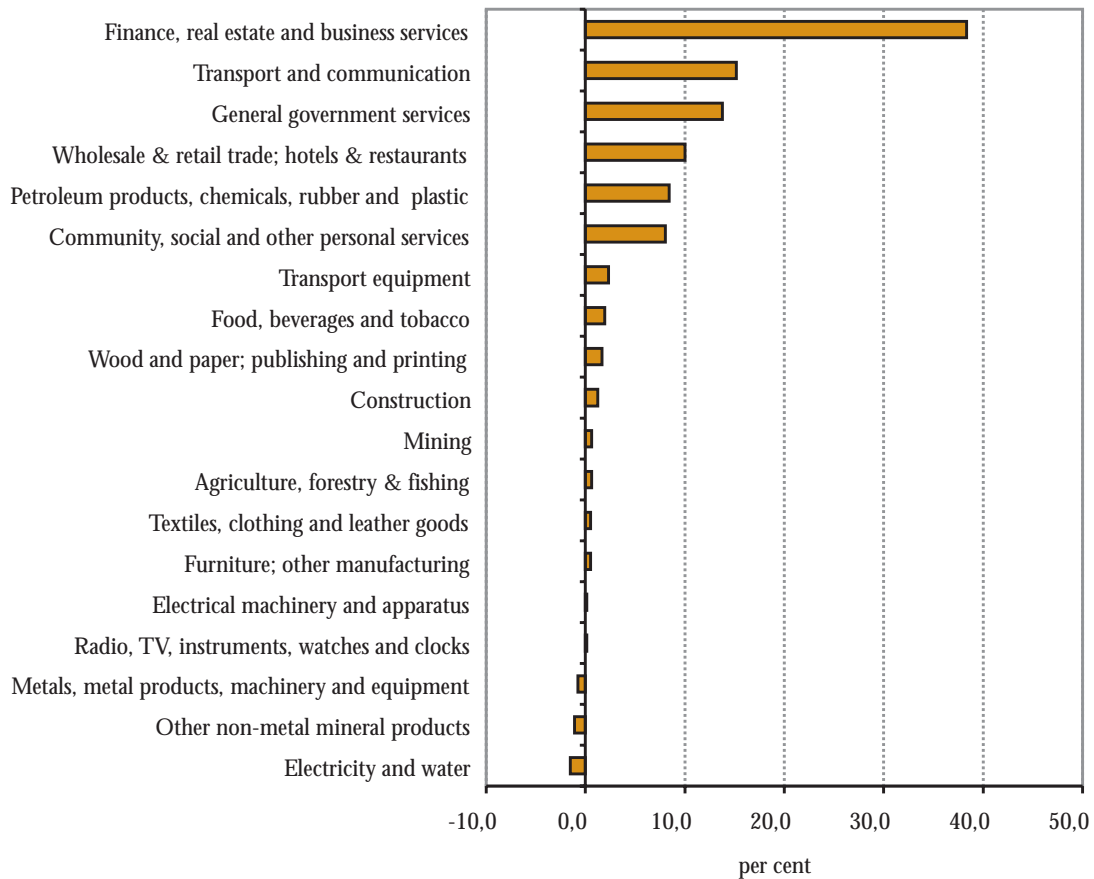
Considering the *sectoral contribution to the growth in fixed investment spending* in the Province, Figure 16 shows that the financial & business services sector has by far been the largest contributor. This sector accounted for close to 40 per cent of the growth in regional fixed investment spending over the past five years. Other sectors that contributed substantially to the growth in fixed investment spending include transport & communication (15%), the regional government (14%), internal trade & catering (10%) and the petro-chemical sector (8,4%). The community, social & personal services sector contributed eight per cent, while food & beverages and transport equipment contributed around two per cent each. Apart from wood & paper and printing & publishing, the other sectors contributed little to the real growth in fixed investment spending in the Province.

The strong fixed investment spending in the financial services (banking & insurance), transport & communication and the petro-chemical sectors was *not accompanied by net job growth* in these sectors, suggesting that *capital deepening* occurred.

This also appears to be the case in a number of manufacturing sub-sectors. Only the transport equipment sub-sector created meaningful employment over the past five years while contributing to fixed investment.

The strong fixed investment spending in the internal trade & catering and business services sectors was also accompanied by net job growth. These sectors are, however, the exception to the rule. In all, regional fixed investment spending increased by 4,2 per cent per annum over the past five years while formal sector employment *declined* by 0,4 per cent per annum over the corresponding period. The decline in formal sector employment is discussed in section 3.4.

Figure 16 Western Cape fixed investment growth: weighted sectoral contribution, 1999 – 2003



[Source: Quantec Research]

The Western Cape succeeded in attracting 17 per cent of national FDI inflows over the past decade (1994 to 2003) (Wesgro, 2004: 9) – the third-largest share of all nine provinces. The European Union (EU) and the US accounted for the bulk (84%) of FDI into the Province. While FDI inflows declined in the wake of the global economic slowdown in 2000 and 2001, it is expected to recover again over the short term. Intensifying global competition for lower-cost destinations, regional integration and improved and more open business environments in developing countries should be supportive of FDI flows.

3.3.2. Outlook, 2005 to 2007

Stability has been a hallmark of the Western Cape’s fixed investment growth track record over the past decade. The strong investment by the less cyclical services industries contributed to this result, as well as large retail and tourism infrastructure developments at the time of the previous trough in the national fixed investment cycle – 1999 in particular.

The outlook for the financial & business service sector, transport & communication and retail, wholesale & catering is favourable, and these sectors have been the largest contributors to fixed investment spending in the Province over the past five years. The petroleum refineries are also expected to invest substantial amounts in new technology to comply with Government's new fuel emissions standards to be phased in from 2006. Furthermore, general prospects for the property development sector remain bullish, both in the residential and non-residential sectors.

Manufacturing fixed investment is lagging the tertiary sectors and needs to improve the labour absorption capacity of the regional economy. In this regard, new investment in the Province's more labour-intensive metals-processing industries shows promising potential, provided the required policy environment is created. The fixed investment rates in the food processing, clothing & textiles, furniture and a number of niche industries are also likely to be stepped up over the projection period.

3.4. Western Cape employment: performance and outlook

3.4.1. The past five years

Estimates of the Western Cape's labour force in 2003 vary from 1,9-million to 2,2-million, with 1,5-million to 1,7-million people in employment and 39 000 to 450 000 unemployed. Adding discouraged work seekers, the number of unemployed increases. While the Western Cape has the lowest official unemployment rate in the country (20% on the narrow, official definition), regional unemployment appears to be growing more rapidly. This could be due to a combination of relatively weaker employment absorption and a large migration influx of workers into the region and into the labour force*. The Quantec Research provincial database shows that the Western Cape's formal sector employment creation has been worse than that of the rest of South Africa over the period 1999 to 2003**.

** For the purpose of this report, the Quantec Research provincial database was used to deduct trends in regional and sectoral employment. Reference is also made to the results from the Statistics South Africa Labour Force Survey where useful.*

*** This is contradicted by the analysis in chapter 4 of this report. According to the Labour Force Survey, six out of every 10 job seekers in the province managed to find work over the period 2000 to 2003, which is much better than the national labour absorption rate of around 30 per cent. However, the regional employment performance over the recent past may be overstated in the Survey due to an improvement in the successive Labour Force Surveys, with the later Surveys more accurately measuring employment compared to the first 2000 Survey.*

According to this database, Western Cape formal sector employment (including domestic servants) showed an average annual decline measuring 0,4 per cent over the five-year period 1999 to 2003¹¹. Table 9 shows that in almost all the sectors, formal employment declined. Net job growth only occurred in the automotive sector, retail & wholesale trade,

¹¹ Excluding "other producers" (mainly domestic servants), the average annual contraction in formal sector employment amounts to 0,9 per cent.

business services, community, social & personal (CSP) services (including domestic servants) and in mining. Informal sector employment expanded by 3,5 per cent per annum over the corresponding period, resulting in a flat overall employment trend in the region.

The employment trend suggested by the Quantec Research database corresponds to the national picture highlighted in the first section of the report, that is, that a shift occurred from the formal sector of the economy to the informal sector and indirect forms of labour. It is possible that the jobs lost in the formal sector according to the Quantec database, at least to some degree, reflect the transition to indirect forms of labour, captured in the 'informal' component of overall job growth. This is also what Wesgro research indicates has occurred in some sectors (Barnes, 2004).

Quantec Research employment time series data

Any employment estimates in South Africa are fraught with difficulties and should be used with care. This is even more so at the regional level, and stems largely from the historical lack of consistent and comprehensive surveys based on both the enterprise and household populations. Quantec Research constructed an employment database with sectoral and provincial employment time series data (1970 – 2003) using the following sources:

Regional Statistics

- Labour Force Survey (LFS) (2000 – 2003) – Statistics South Africa
- October Household Survey/General Household Survey (OHS/GHS) (1995 – 2003) – Statistics South Africa
- Population Censuses (1970-2001) – Statistics South Africa
- Industry Censuses (various) – Statistics South Africa
- EasyData Standardised Provincial Demographic Database (1970 – 2003) – Quantec Research

National Statistics

- Survey of Employment and Earnings (SEE) (1972 – 2004) – Statistics South Africa
- Development Bank of South Africa (DBSA) Standardised Employment Series – DBSA (discontinued during the late 1990s)
- Manpower Survey – Statistics South Africa and Department of Labour (discontinued in 1996)
- South African Labour Statistics – Statistics South Africa (last published in 1996)
- EasyData Standardised Industry Database – Quantec Research (1970 – 2003)

Statistics South Africa's OHS (annually, 1995 – 1999), the LFS (replacing the OHS and surveyed bi-annually since 2000) and the GHS (replacing the OHS and surveyed annually, 2002 – 2003) are household-based surveys. The current LFS sample size is approximately 30 000 households (0,3% of all households). The actual households included in the samples change over time. The LFS and GHS are therefore not well suited for industry and/or provincial dissemination of employment data with any high degree of confidence. However, it is good at estimating overall employment and unemployment. The LFS and GHS also split employment between formal and informal employment, although the formal and informal employment and unemployment estimates vary considerably over time. Definitional changes also played a role in this.

In contrast to the LFS, the SEE is a quarterly enterprise-based survey covering a sample of approximately 10 200 employers, being both private sector companies and public institutions in the formal non-agricultural sector. Only national employment and earnings statistics are estimated from the survey information. The survey gives a good indication of formal employment by sector. The SEE was revamped during 2002 to cover the service industries comprehensively. The sample for the SEE is designed and drawn from Statistics South Africa's re-engineered Business Sample Frame (BSF), which excludes non-value-added tax (VAT) paying businesses (firms with a turnover smaller than R300 000 per annum and/or unregistered).

Two main shortcomings of the SEE therefore are:

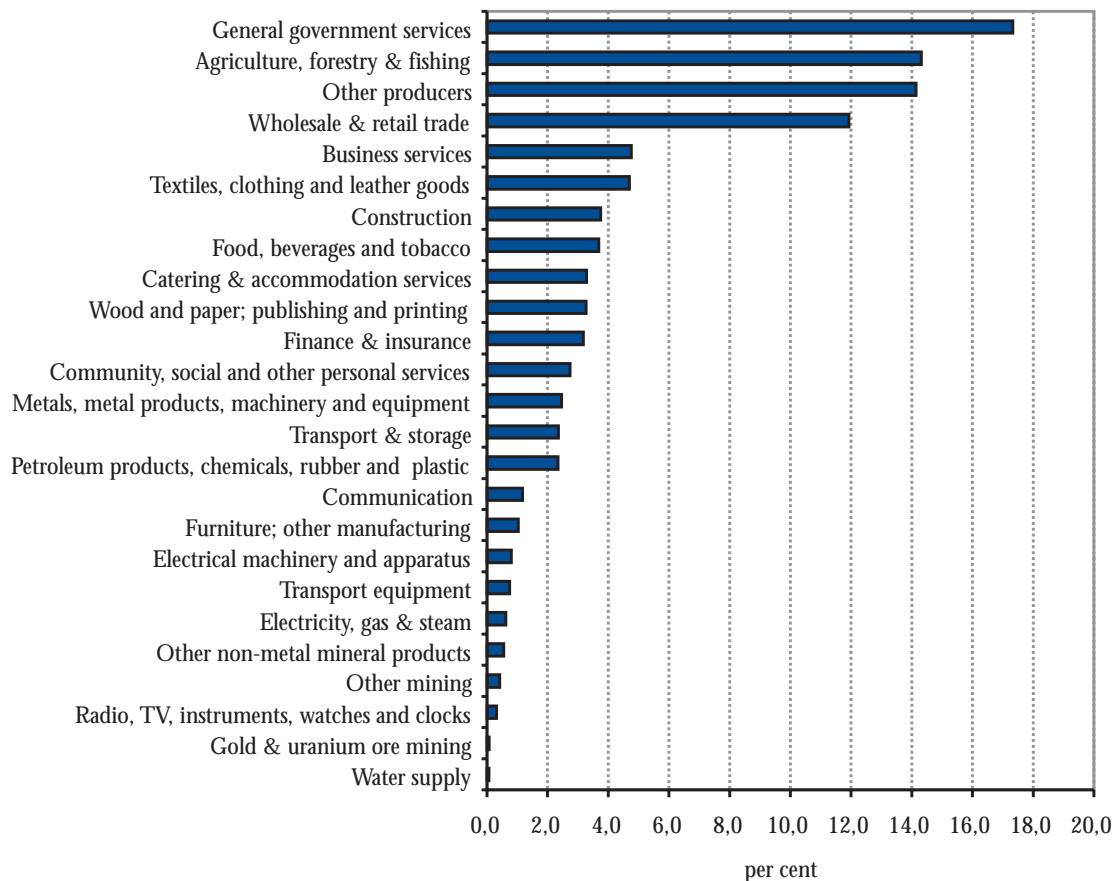
- First, the SEE's coverage is not comprehensive; both the agricultural and informal sectors are not surveyed. In addition, the coverage of the SMME sector is problematic due to the exclusion of non-VAT paying firms. In September 2003, for instance, the gap between the SEE number for formal non-agricultural employment (6,4-million) and the LFS overall employment (11,6-million) is explained by 1,2-million workers in agriculture, one million in domestic service, 1,9-million in the informal sector and 1,1-million employed in sectors/firms not covered by the SEE (SARB Quarterly Bulletin, June 2004, p.13).
- Secondly, major discontinuities exist in the SEE as certain sectors were alternately included and excluded from the survey's coverage. For instance, data before and from the first quarter of 1998 and data before and from the third quarter of 2002 are strictly not comparable. It is possible to circumvent this problem by statistically linking the time series in order to provide continuous (albeit imperfect) employment time series.

Quantec Research attempts to overcome these shortcomings by relying on most of the above sources to estimate regional employment for 26 industries. The various population censuses provide a benchmarking basis for estimating employment, unemployment and the labour force on a regional basis. The regional estimates are benchmarked on the national estimates from the EasyData Standardised Industry Database, which are compatible with the labour remuneration statistics in the national accounts. Regarding the discontinuities in the SEE, Quantec linked the new and old SEE (before the services industries were comprehensively covered) by phasing in the new SEE from 1985 onwards. Previously, the DBSA Standardised Employment Series was used as the basis to give estimates of the service industries.

Regional estimates of industry employment (formal and informal) as well as unemployment should be used as medium-term indicators. Short-term results from the LFS are problematic because of the high levels of variation caused by the sample size and definitional issues (the Western Cape LFS sample is normally based on approximately 4 000 households or 8 000 workers). The analysis regarding employment trends in the accompanying section relied upon the Quantec Research database.

While the data sources tend to be contradictory, it appears that employment growth in the Western Cape occurred in the fast-growing and more skills-intensive services industries and niche manufacturing sectors. In this respect, the Western Cape appears to share the national trend of skills-biased employment creation (Western Cape SER, 2003: 24). Even in the more unskilled and informal labour-intensive internal trade & catering sector (employing one-fifth of the Province's workforce), the share of unskilled workers has tended to decline over the past five years. Nonetheless, the strong growth in the retail and tourism sectors added to job growth in the region and probably softens the skills bias of employment creation in the region.

Figure 17 Sectoral composition of the Western Cape employment, 1999 – 2003



[Source: Quantec Research]

According to the Quantec database, many formal sector jobs were lost in the Western Cape manufacturing sector over the past five years, with jobs contracting at an average annual rate of 3,2 per cent as seen in Figure 17. This compares with an average annual decline in manufacturing employment outside of the Western Cape of only 0,8 per cent per annum. In almost all of the sub-sectors in Western Cape manufacturing, jobs were shed over the past five years.

A particular worrying trend is the large-scale retrenchment that occurred in the Province's largest manufacturing employment sectors, specifically food & beverages (employing around 19% of the regional manufacturing workforce), clothing & textiles (24%) and wood products, printing & publishing (14%)¹². It is possible that these jobs – or at least some of them – were replaced by informal jobs and home industries, such as the case appears to have been in the clothing sector (Barnes, 2004)¹³.

¹²The Quantec database shows that 26 000 jobs were lost in these three sectors over the past five years, or 12,5 per cent of the Western Cape manufacturing workforce.

¹³The Labour Force Survey shows net job growth in the manufacturing sector over the period 2000 to 2003, albeit less robust compared to the other sectors in the Western Cape.

As these three sectors employed 56 per cent of the regional manufacturing workforce in 2003, the employment trend here is likely to have a major bearing on the regional factory employment prospects. This may also help to explain why the region's employment creation has been weaker than nationally, despite the fact that the regional economy grew faster. Furthermore, the region's fast-growing services industries did not create many formal jobs in the process, with the exception of the retail & wholesale and business services sectors.

Table 9 Western Cape: Formal sector employment growth, 1999 – 2003

Sector	1999	2000	2001	2002	2003	Average
	%	%	%	%	%	1999 – 2003 %
Primary sectors	-1,5	-1,8	-1,9	-3,8	-1,7	-2,1
Agriculture	-1,5	-1,8	-2,0	-4,1	-1,8	-2,2
Mining	-2,8	0,0	1,2	4,2	2,0	0,9
Secondary sectors	-5,8	-3,3	-3,1	-0,9	-2,8	-3,2
Manufacturing	-3,6	-3,9	-4,7	-1,3	-2,3	-3,2
Electricity & water	-0,1	-8,7	-3,6	-4,0	-4,5	-4,2
Construction	-13,0	-0,7	2,4	0,7	-4,3	-3,0
Tertiary sectors	0,8	-0,8	1,4	3,4	1,2	1,2
Internal trade & catering	5,6	-1,3	0,6	0,2	2,0	1,4
.....Retail & wholesale trade	11,3	0,1	2,1	1,0	1,7	3,2
Transport & communication	-2,4	-4,4	-5,5	0,9	-2,4	-2,7
Financial & business services	-0,5	0,6	5,7	10,2	0,8	3,4
.....Business services	1,6	2,0	8,8	16,5	0,2	5,8
CSP services ¹	4,0	4,1	4,0	4,9	1,9	3,8
Government	-4,5	-5,0	-2,9	-0,8	0,4	-2,6
Total formal employment	-1,2	-1,6	-0,2	1,3	-0,1	-0,4
Informal sector	5,3	3,2	2,1	3,5	3,4	3,5
Total employment	-0,6	-1,1	0,1	1,6	0,2	0,0

¹ Including domestic servants.

[Source: Quantec Research]

The Quantec database also shows strong employment losses in the Province's rapidly growing construction sector, which could also be a case of indirect forms of labour and/or home industries replacing formal employment. The BER's survey evidence in the Western Cape building & construction sector, on the other hand, indicates healthy employment growth in this labour-intensive sector at present.

3.4.2. Outlook, 2005 to 2007

Taking into account the negative trend in formal employment in the Western Cape economy in recent years, the outlook could be viewed as less than promising. The uncertain outlook for the clothing & textile sector is a negative for the Province's employment outlook. Considering the broader negative currency-induced tendency in the Province's manufacturing exports of late, manufacturing job growth could be under pressure. The positive employment trend in the automotive sector (mainly automotive components) is, for instance, at risk.

On the other hand, some sectors appear to be switching production for exports to the local market that is benefiting from the robust domestic spending¹⁷. Export-induced job losses in the food, beverage, furniture and wood products sectors may be limited in this way. These sectors also appear to be better able to stand up to import competition compared to the clothing & textile sector.

The BER's survey evidence in the national manufacturing sector indicates positive growth in factory employment in the food, wood and furniture sectors at present. Should the currency bring some relief, the current positive employment tendency in these industries should strengthen further over the short term¹⁸. The Western Cape is likely to share in this improvement as these industries have a strong presence in the Province. The same goes for the labour-intensive construction sector, which is booming currently and creating jobs (contrary to what the official data indicates).

Furthermore, the outlook for consumer spending is very favourable, and combined with a positive trend in tourist arrivals, the net job growth recorded in the retail & wholesale trade over recent years is likely to strengthen.

There appears to be a clear negative trend in agricultural employment in the Western Cape (as well as nationally), which is likely to persist. Furthermore, adverse climatic conditions have shattered earlier hopes of a better wheat crop in the Western Cape. Employment conditions may be better in the fruit-producing areas, where sustained export growth is proving an important support.

In all, the employment outlook for the Western Cape economy is mixed. Anecdotal (and survey-based) evidence of improvements in some sectors, combined with the favourable general economic outlook, contrasts with the adverse formal sector employment trend over the past number of years. Industry is currently adjusting to the new macroeconomic parameters, more specifically a stronger currency, a lively domestic market and lower and more stable inflation and interest rates.

¹⁴ Firms producing tradeable goods and able to do so (depending on the type of product involved) also switch production to the non-durable goods sector.

¹⁵ Data limitations make it difficult to say whether this represents a turnaround in the adverse structural trend in employment in these industries over recent years.

On balance, prospects may be favourable that the adverse employment trend of recent years will be arrested over the projection period, particularly should fixed investment grow as projected and change from a capital-deepening to the capital-widening kind.

3.5. Western Cape exports: performance and outlook

3.5.1. The past five years

The Western Cape export sector is well diversified, although the agriculture & fishing sector has a disproportionate share (close to one-third) in total exports¹⁶. When food-processing exports are added, this amounted to more than half of total Western Cape exports in 2003. The most important export products within this category are fruit (including processed) at 26 per cent of the total, wine, beer & spirits (13%) and fish (9%).

The Province's mining sector only contributes three per cent to four per cent of total exports. However, when iron & steel exports¹⁷, which have grown rapidly since the advent of Saldanha Steel, are added, the contribution of basic commodities increases to around 12 per cent.

The manufacturing sector accounts for the remainder of total exports. In fact, as food processing and basic metals are officially classified as manufacturing, this sector contributes close to two-thirds of total Western Cape exports. Excluding food processing and basic metals, manufactured exports amounted to 35 per cent of total exports in 2003.

The important manufacturing export products from the region are clothing & textiles (7% of total exports), machinery & equipment (including electrical & telecommunications equipment) (6%), precious & semi-precious stones & jewellery (3,5%), plastic products (2,2%), chemical products (including cosmetics) (2,1%), wood products (1,6%), and hides & leather products (1,4%).

Table 10 shows the 10 largest export products from the Western Cape in 2003, as well as the growth trends. The 10 listed product categories accounted for 75 per cent of total Western Cape exports in 2003, up from 65 per cent in 1996 to 1998, suggesting that the Province's largest export products have been growing at above-average rates.

The growth in the value of total Western Cape exports (excluding services exports and mineral fuels) averaged close to 19 per cent per annum over the period 1996 to 2003. Applying the SARB's non-gold export price deflator, this translates to eight per cent to nine per cent real export growth per annum over the past six to seven years¹⁸.

¹⁶ It needs to be pointed out that excluded from the export statistics discussed here is the foreign exchange earning contribution from services, including tourism, and the exports of engineering and financial services. Furthermore, due to the distorting effect of mineral fuel exports, this product category is also excluded from the analysis.

¹⁷ In terms of the Standard Industrial Classification (SIC), basic metals (including iron & steel) are classified in the manufacturing sector.

¹⁸ Quantec Research estimates a real growth rate of 11,4 per cent per annum over the period 1996 to 2003.

On the same basis, the growth of the 'core' export products listed in Table 10 amounted to 11 per cent per annum. Within this group, the Province's beverage, fish, iron & steel, clothing & textiles, precious stones & jewellery and plastic products exports performed particularly well, growing by more than 10 per cent per annum in real terms. This compares favourably to the real growth of South Africa's total goods exports measuring around five per cent per annum over the corresponding period.

Table 10 Western Cape exports, 1996 – 2003¹

Top 10 Product Categories	1996 Rm	2003 Rm	% Share		% Change			
			1996	2003	1996 – 2003		2002 – 2003	
					nominal	real	nominal	real
1 Fruit & veg (incl. processed)	2 690,0	6 852,7	28,0	25,7	16,9	6,6	8,1	18,5
2 Wine, beer & spirits	752,1	3 333,0	7,8	12,5	28,2	16,9	4,6	14,6
3 Iron & steel and minerals	546,7	2 635,5	5,7	9,9	30,0	18,6	10,7	21,3
4 Fish	697,8	2 311,9	7,3	8,7	22,1	11,4	-4,4	4,7
5 Machinery & appliances	406,5	1 090,3	4,2	4,1	17,9	7,6	-16,8	-8,9
6 Textile products	298,5	1 021,0	3,1	3,8	22,7	12,0	-16,0	-8,0
7 Precious & semi-precious stones & jewellery	228,6	943,8	2,4	3,5	26,7	15,6	-19,3	-11,6
8 Clothing	238,4	768,3	2,5	2,9	21,5	10,9	1,6	11,4
9 Plastic products	170,4	576,2	1,8	2,2	22,5	11,8	-15,6	-7,5
10 Electrical & telecom. machinery & equipment	226,7	564,3	2,4	2,1	16,4	6,2	-5,1	4,0
Total Exports	9 602,4	26 638,9	100,0	100,0	18,5	8,2	-5,8	3,2
..... Total above	6 255,7	20 097,0	65,1	75,4	21,5	10,8	0,2	9,8
..... Total 'non-core'	3 346,7	6 541,8	34,9	24,6	11,8	2,0	-20,6	-13,0

¹ Excluded from the statistics are mineral fuel & armaments exports.

[Source: Wesgro]

Wesgro points out that there are a number of 'non-core' export categories that also grew sharply from a low base in recent years, in particular ships & boats, furniture, chemical products (including cosmetics), wood products, automotive components, tobacco products and paper (Wesgro, 2003: 6).

However, closer inspection of the 2003 export statistics from the region indicates that the export performance deteriorated substantially, as particularly manufacturing exports, including a number of the 'non-core' export categories, came under pressure. The deterioration can be linked to poor world economic growth during the 12 months up to the middle of 2003, as well as the rand's strong appreciation during the year.

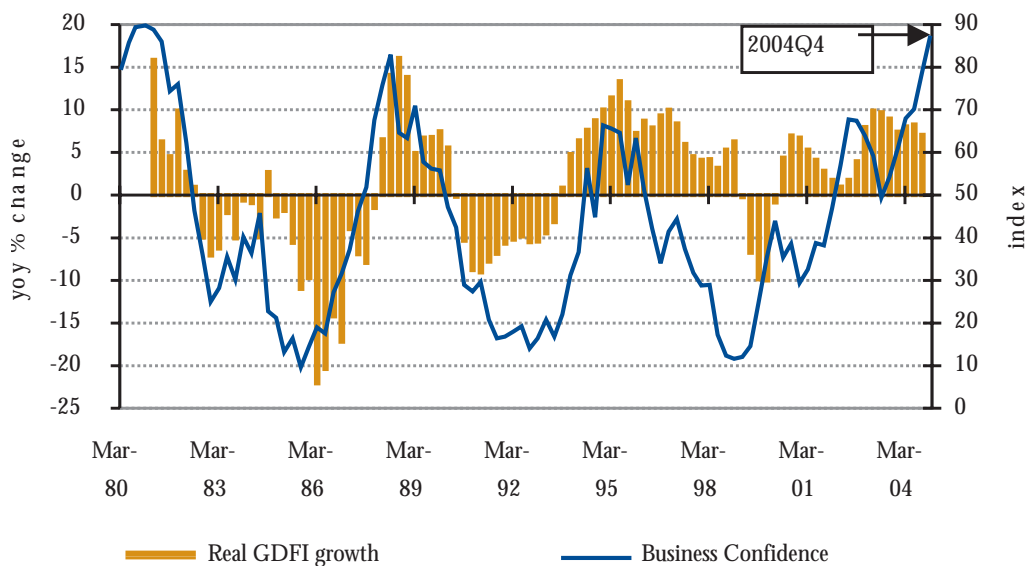
Considering volumes, total Western Cape exports increased by a moderate three per cent to five per cent in 2003 compared to 2002, as the decline in the value of exports (4% to 6%) was less than the decline in the non-gold price deflator (9%)¹⁹.

¹⁹ It is necessary to deflate the value of trade numbers in order to exclude the impact of currency and other price movements from the underlying trade flow.

The positive aggregate growth is mainly attributed to the sustained export growth of the Province's top three export categories – fruit, alcoholic beverages and iron & steel, which continued to register healthy growth of between eight per cent and 10 per cent in value terms. In real terms, growth was much higher (15% to 20%). Fruit and wine exports to the European market were sustained, and improving prices and keen global demand stimulated the region's basic metal exports. This compensated for the decline in the other manufacturing exports.

Excluding basic metals, the real Western Cape manufacturing exports declined by five per cent in 2003. In fact, table 10 shows that the decline in the 'non-core' export categories (including a number of late export bloomers) amounted to 13 per cent. Exports of processed food, textile products, machinery & equipment, automotive components and boat building, precious stones & jewellery and plastic products declined sharply. Clothing is an exception, with the volume of clothing exports continuing to increase at a rate similar to that achieved during the preceding five years. It is likely that the AGOA compensated for the impact of the strong rand on the clothing sector²⁰.

Figure 18 Manufacturing export volumes (BER survey), 1980 – 2004



[Source: BER]

It is possible that the weakening trend in the rand exchange rate over the period 1996 to 2002 assisted many of these exporters entering the world markets and who are currently finding the going tough at the strong levels of the rand exchange rate. The implication is that the sectors with well-established markets overseas might be able to survive the strength of the rand; however, those companies that ventured onto the world markets afforded by the weak rand may be faced with more permanent problems.

²⁰ The Western Cape clothing sector has a large export exposure to the US market (R230-million in 2002).

This has adverse implications for the region's export outlook. Export capacity may be lost in the process. It is not clear that any shelved export capacity will be revived, even in the event of an adjustment in the exchange rate over the short term. The BER's manufacturing survey in the Western Cape indicates that exports remained under pressure throughout 2004 (*see Figure 18*).

3.5.2. Outlook, 2005 to 2007

The global economic outlook is favourable; however, the strength of the rand exchange rate has prevented Western Cape exporters to benefit fully from the favourable global economic conditions. Regarding specific export markets, the following issues are of note:

- Real economic growth in the Western Cape's main export market, the Euro area, remains moderate. Consumer spending is particularly under pressure due to high unemployment levels in the region. While an improvement is underway and expected to continue, it is likely to lag that in the rest of the world.
- The European market absorbs 50 per cent of Western Cape exports (Wesgro, 2003: 7)²¹. However, as the 2003 export statistics reveal, exports to these well-established markets continued to grow and could survive the impact of the strong rand exchange rate – exports to Europe are known to be less price sensitive. The South Africa-EU Free Trade Agreement (SA-EU FTA) is likely to be a compensating factor. Furthermore, export potential to the accession EU countries (Poland, Bulgaria, Czech Republic, Slovenia and Estonia, to name but a few) is promising. The Western Cape's export exposure to these countries is small at this stage (Wesgro, 2003: 12).
- A positive factor in terms of the export outlook is the increasing diversification of the Western Cape's export market (Wesgro, 2003: 9-10). Exports to countries such as China, Nigeria and Mauritius have grown strongly from a low base in recent years. The short-term outlook for the SSA region is the best in years, which should stimulate Western Cape exports to the region.
- On the negative side, the Multi-Fibre Agreement (regulating international trade in clothing and textile products) expired at the beginning of 2005, which implies that the quotas, which effectively restricted large and low-cost producers such as China and India's exports of clothing and textile products to the major industrial countries, will come to an end.
- It is specifically expected that China will capture a large share of this market to the detriment of clothing and textile exporters in Africa and elsewhere. The AGOA is not expected to compensate, as China is likely to become the preferred supplier of apparel to the large US buyers.
- This is likely to be a significant negative factor for the domestic clothing & textile sector, although the Western Cape clothing industry could be less exposed than Gauteng and KwaZulu-Natal due to a lower export propensity and a different (more upmarket) focus. Nonetheless, it is evident that the Western Cape clothing & textile sector is confronted by the dual threat of an overvalued currency and import and

²¹ According to Wesgro, the UK, Netherlands, Belgium, Germany, Italy and Spain are the most important European trading partners. The most important export products to the region are fruit, wine, beer & spirits, processed foods and iron & steel.

export competition due to the changing clothing & textile international trade dispensation.

- A stronger than expected rand exchange rate could have a negative bearing on Western Cape industry. While the Western Cape is not well positioned to benefit from the commodity-intensive growth of the Chinese economy (apart from Saldanha Steel), favourable industrial commodity prices, driven by Chinese demand, could lead to a stronger rand exchange rate. There is a strong historical link between commodity prices and changes in the rand exchange rate. An uncompetitive currency, in turn, could impact negatively on Western Cape tourism, manufacturing (including clothing & textiles and metals processing) and agriculture.

The Western Cape region's export outlook therefore has to be qualified. The outlook for the Province's agro-industrial exports is positive, and this sector may survive the impact of the strong rand as markets are well established and not price sensitive. Although European economic growth is lagging that in the rest of the world, the SA-EU FTA could compensate, and new opportunities may be opening up in the accession EU countries and other regions. Exports of basic metals and other minerals from the Province should also fare well in view of strong global demand and favourable commodity prices.

On the other hand, the outlook for the Province's remaining manufacturing exports hinges on the outlook for the exchange rate. Should the rand exchange rate adjust closer to a 'fairer value' over the short term, as is expected (say R7,00/US\$ at the end of 2005), export growth should recover from 2003's slump (also if we assume that export capacity has not been lost permanently).

However, in the event of a stronger than expected rand exchange rate, prospects for the region's manufacturing exports may be less promising. While one should allow for some adjustment on the part of Western Cape manufacturers to adapt to the level of the currency, the recent export performance reveals that firms simply fail to compete at the current over-valued level of the exchange rate, particularly in the clothing & textile, machinery & equipment and other smaller ('non-core') sectors.

4. Conclusion

The Western Cape's agricultural and manufacturing sectors were hard hit by the strengthening rand exchange rate and adverse climatic conditions, which led to a deceleration of real economic growth from 4,6 per cent in 2002 to 3,2 per cent in 2003. The regional employment conditions also deteriorated as a result, but an improving tendency was observable since 2000.

However, GDP growth still came in above the national average for 2003 (2,8%) as the region's services industries grew strongly, outperforming their national counterparts. A recovery is currently underway in the agricultural and manufacturing sectors, although constrained by the persisting strength of the rand and dry climatic conditions.

As a result, the margin of the region's economic out-performance (0,8% per annum over the period 1999 to 2003) shrunk. Real GDP growth in calendar year 2004 is therefore estimated at 3,9 per cent – only 0,2 per cent above the national average.

In all, Western Cape real GDP growth averaged higher compared to that of South Africa over the period 1999 to 2003. It is likely that this national out-performance will continue over the short term; however, this could be a function of where the exchange rate is headed and/or local industry's adaptation to the changed macroeconomic parameters. The following aspects include some of the more salient features of the region's economic performance:

- The Western Cape economy is well represented in the nationally faster growing services industries, such as financial & business services, transport & communication and retail trade & catering. The booming tourism industry has been part and parcel of the growth story. The regional construction and property development sector has also outperformed the remainder of the national sector by a wide margin, partly tied to the healthy 'retirement sector' in the region. The short-term outlook for these sectors is favourable.
- The regional economy also has strong linkages with the rest of the country, particularly in respect of financial & business services and parts of manufacturing. The higher end of the South African consumer market is growing strongly and general South African economic prospects are the best in a long time. National real GDP growth is projected to reach 4,1 per cent in 2006.
- A number of niche manufacturing and services industries, which have shown strong growth and/or potential, have emerged in the Western Cape. It is expected that these industries will continue to perform well given the required policy support.
- The region's exports have also grown strongly over the past number of years, with the established export sectors performing well, even in the face of the strong rand exchange rate in 2003 and 2004. The Province's coastal location has been a strong positive with the country's re-entry into the world economy over the 1990s. However,

it is evident that some export-oriented manufacturing industries, particularly those manufacturing 'non-core' export products, have suffered a strong negative impact from the rand's appreciation during 2003 and 2004. In this respect, the export outlook needs to be qualified.

- On the downside, the region's overall manufacturing performance has been disappointing, albeit remaining one of the largest sectors. The clothing & textile sector failed to grow over the past five years, the food, beverages & tobacco sector has added little to cumulative growth, and some other sub-sectors performed worse than their national peers, in particular wood & paper and printing & publishing. Problems were compounded by the strength of the rand. Likewise, the agricultural sector added little to cumulative growth, and also contracted sharply in 2004 due to adverse climatic conditions which persisted in 2004.

In all, the Western Cape economy is recovering from the headwinds experienced in 2003 and 2004. While business tends to adjust to the strong rand, the direction of the exchange rate could be an important determinant of the regional economic performance. A strong currency benefits the non-tradeable goods sectors and disadvantages the tradeable goods sectors.

Western Cape business confidence jumped sharply at the end of 2004, catching up with the rest of the country. The outlook for fixed investment and employment creation is positive following years of capital-deepening investment and formal sector retrenchment of workers. The challenge is to develop downstream and niche manufacturing and services industries which have more potential to create jobs.

The positive employment trend in the retail, tourism and business services sectors is likely to persist and this needs to be supported. With improved formal sector job growth, the chances are maximised to alleviate poverty in the Province in the medium term beyond Government's social welfare and infrastructure development spending.

Table 11 Summary of Western Cape's Economic Outlook 2005/06 – 2007/08¹

	2003/04	2004/05est	2005/06F	2006/07F	2007/08F	Ave2005/06 -2007/08
GDPR (R-billion, current market prices)	185,4	203,0	222,5	244,4	263,4	-
Real GDPR growth (%)	3,3	4,1	4,3	4,0	3,9	4,1
Primary sector	-6,0	1,7	2,5	2,2	1,7	2,1
Secondary sector	-0,2	3,8	4,5	3,7	3,2	3,8
Tertiary sector	5,4	4,4	4,8	4,5	4,5	4,6
GDPR inflation (%)	6,3	5,3	5,1	5,7	3,8	4,8
Western Cape CPI inflation (%)	4,6	2,3	4,5	5,5	3,7	4,6

¹ Fiscal years ending 31 March.

[Source: BER]