BUREAU FOR ECONOMIC RESEARCH

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

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

5 September 2005

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## The current state and short-term prospects for the South African and Western Cape economies

**Global economy**

- The upswing phase of the global business cycle is nearing four calendar years. Following strong and synchronised growth in 2004 (around 5%), the global economy slowed down during the second half of 2004 and the early part of 2005; growth also became more uneven. The Euro area and Japan lagged the strong performances of the USA and China.
- It is expected that the expansion in the global economy will be sustained, with corporate fixed investment spending and hiring, supportive interest rates and strong developing country economic performances (e.g. China) underpinning growth. However, the risks are loaded on the downside.
- The spike in crude oil prices to above $70/b in response to the impact of hurricane Katrina is likely to affect growth, particularly in the USA. At current levels, real crude oil prices are 25% above that in the run-up to the Gulf War in the early 1990s, which sparked a global recession
- While general global economic indicators have been encouraging, suggesting a re-acceleration in growth from the middle of the year, growing imbalances pose a threat to the outlook. The US balance of payments current account deficit continues to grow and the highly indebted US household sector is vulnerable to a reversal of fortunes in the US housing market and higher energy prices. US economic growth is therefore at risk of being much weaker than currently expected, which could have important implications for the global economy.
- The US dollar is expected to depreciate further, dictated by the wide US current account deficit. Non-oil commodity prices may be close to a peak, particularly should global economic growth slow significantly over the short term. Crude oil price are also expected to moderate over the short term; however, oil price forecasts continue to be scaled upwards and the risk of high crude oil prices for longer is real.

**South African economy**

The South African economy is experiencing a strong spending boom. This has its origins in the late 1990s with the onset of the current historically long business cycle upswing (i.e. commencing in September 1999). In the household sector, gradually accelerating income growth on the back of a lower rate of retrenchment in the formal sector of the economy at first and eventually a return to positive employment creation (2002), higher real economic growth, substantial cumulative personal tax relief, lower inflation and moderating interest rates all set the wheels in motion.

During 2003/4 the spending drive received added fuel from the historically low levels of interest rates and inflation in the wake of the rand's remarkable recovery and buoyant capital inflows tied to the special external conditions (of a weak US dollar, historically low interest rates in the major industrial countries and a commodity boom). The rand's appreciation, forcing inflation and interest rates to historically low levels, played an important part in driving real final demand growth in the economy to 6-7% last year.

Encouragingly, the spending momentum has favourable structural characteristics. There is little sign of overspending and/or exorbitant general household indebtedness, sustainable lower levels of inflation and interest rates, sound fiscal stimulation and a higher fixed investment rate (both in the private and public sectors). The higher fixed investment rate is corroborated by the historically high business confidence levels.

Some slowdown is anticipated in the spending momentum over the short term as the rand weakens, inflation accelerates and interest rates are hiked. Inflation is forecast to accelerate to between 5-6% in 2006, prime interest rates to rise to 11.5-12% and the R/$ exchange rate to fall to R7.50 at the end of next year. This should not derail the otherwise sound economic momentum. A more competitive currency is expected to stimulate production in the tradable goods sectors, particularly exports. This should alleviate the cumulating pressures on the trade account of the balance of payments and render the domestic economic upswing more sustainable. It remains imperative for the necessary micro-economic reforms to be implemented in order to capitalise on the healthy spending momentum in the South African economy. *Real GDP growth is forecast to come in at 4.2% in 2005, decelerating somewhat to 3.9% in 2006*.

The risk is for a sharper slowdown in the domestic economy. *Firstly*, global economic conditions could be worse than argued in the baseline forecast of "trend growth". *Secondly*, the depreciation of the rand exchange rate could be more volatile causing sharper than expected increases in inflation and interest rates. SA's external financial position has improved immensely, minimising the chances for such repeated financial volatility; but the SA economy is not immune to these tendencies.

**Western Cape economy**

- The Western Cape economy has shared in the general revival of the South African economy over the past five to six years. In fact, the regional economy grew at a faster rate than national over the period 1999 to 2003. The margin of out performance may have narrowed in 2004/5 due to the impact of the drought in agriculture (2003/4) and a proportionately more negative impact of the strong rand exchange rate on the region's industrial base. Real GDP growth in the region is estimated at 3.9% for calendar 2004 (compared to 3.7% for South Africa) and could be close to the 4.2% forecast for the national economy in 2005.
- The regional economy is well represented in the fast-growing national service industries, e.g. retail & catering (stimulated by tourism activity), financial & business services and transport & communication. The construction & property development sectors have also performed strongly in recent years. A number of niche manufacturing and services industries also contributed strongly to regional growth, e.g. agro-processing, automotive components, boat & ship building, high-end clothing and furniture manufacturing, call centres, the film industry, etc. Unfortunately, the strong rand exchange rate has dampened activity in a number of these blossoming industries.
- The regional economic performance has also been characterised by strong export growth over the period 1996 to 2002 (8-9% per annum in real terms), which came under pressure in 2003/5 due to the impact of the strong rand. While the region's core exports to well-established markets (e.g. fruit & alcoholic beverages, iron & steel & processed food) continued to grow in real terms, a number of the "non-core" export products contracted sharply in 2003/4.

- The Western Cape business cycle is closely linked with that of the national economy. The favourable general outlook for the South African economy therefore augurs well. However, it is of some concern that regional business confidence levels currently tend to lag that of the other major provinces. This could be related to an under performing manufacturing sector, as well as tourist arrivals being dampened by the strong rand, in turn affecting the retail sector.
- Nonetheless, retail conditions remain strong. While the interest rate and price sensitive sectors are exposed to higher rates of interest and inflation and a softer currency over the short term, the underlying growth in consumer spending is expected to remain resilient, in line with the national situation. On the downside, the high oil prices and the consequent sharp increases in energy prices will impact negatively on household disposable incomes; particularly lower income earners' household budgets are exposed to the escalating transport and energy costs. This will have a disproportionate negative impact on the non-durable goods retail sector.
- The booming construction, property and financial services sectors are also exposed to a likely change in the financial environment going forward. These sectors have performed strongly in recent years and have reached peak levels; it is likely that some slowdown is in store in an environment of higher interest rates.
- On the other hand, a more competitive currency should bring welcome relief to the embattled manufacturers. The BER second quarter business survey evidence suggests a rapid improvement in manufacturing production and sales in response to the weaker tendency in the rand exchange rate at the time. The second quarter improvement in manufacturing value added was confirmed by Statistics SA's release of the national GDP numbers, with nationwide manufacturing GDP growing by more than 7% on an annualised basis. The beneficial impact of a more competitive currency is almost immediate regarding import competition, while the benefit to exports tends to filter through with some time lag.
- The rand is expected to depreciate should commodity prices decline in 2006 in response to weaker global economic conditions, even in the event of the US dollar depreciating further. While rand strength could persist over the near term (end-2005), the BER forecasts a R7.50/$ exchange rate towards the end of next year. This should stimulate the Western Cape's industrial sector, particularly those sub-sectors that have been hard hit by the strong currency. However, it has to be emphasised that the exchange rate equation is fundamentally different – gone are the days of a chronically weak currency. Industry will have to adapt to the new economic parameters.
- BER survey data reveals that employment conditions are improving in the region's retail, construction and manufacturing sectors, albeit that manufacturing lags this improvement. In this regard, the region shares the corresponding development nationally. However, it has to be emphasised that this improvement in formal sector employment appears to be in its infancy and needs to be nurtured.
- More stable and growing employment conditions ensure sufficient income growth to sustain the spending momentum and generate the required savings. Serious attention to micro-economic reforms (e.g. lowering the cost of doing business, relieving key infrastructure constraints and skills development) is critical at this stage to up the region's fixed investment rate and thereby employment creation.
- The short-term outlook for the regional economy remains upbeat, despite the cumulating external risks. Nationally, SA should be in a favourable position to weather the impact of higher oil prices and/or other

shocks. The currency is bound to act as a shock absorber, while the domestic spending cycle is built on sound foundations. Depending on the magnitude of the currency "adjustment" over the short term, the incumbent increase in inflation and interest rates could be of manageable proportions. Some slowdown is expected in the interest and price sensitive sectors, 2006/7 (e.g. durable goods retailing, construction and financial services); however, Western Cape industry should benefit from a more competitive currency.

- The Western Cape economic performance is therefore expected to keep up with that of South Africa over the short term, even out-performing in favourable conditions as the trend has been in recent years. This suggests a regional real GDP growth rate around 4% per annum over the short term. *Key macro-economic forecasts for the South African economy are contained in the accompanying table*.

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

| | **Ave 1999-2004** | **2004** | **2005F** | **2006F** |
|---|---|---|---|---|
| **Expenditure on GDP** (real % change): | | | | |
| Household consumption | 3.7 | 6.1 | 5.4 | 3.9 |
| Fixed investment | 3.7 | 9.4 | 8.4 | 8.5 |
| **Gross domestic expenditure (GDE)** | 3.6 | 6.3 | 5.0 | 4.8 |
| Exports | 2.3 | 2.9 | 4.1 | 5.8 |
| **Gross Domestic Product (GDP)** | 3.2 | 3.7 | 4.2 | 3.9 |
| **Inflation, interest & exchange rates** | | | | |
| CPIX inflation | 6.9% | 4.3 | 4.3 | 5.0 |
| PPI inflation | 6.7% | 0.7 | 3.1 | 4.7 |
| Prime overdraft interest rate (eop) | 14.71% | 11.00 | 10.50 | 11.50 |
| R/$ exchange rate (eop) | 7.70 | 5.66 | 6.75 | 7.50 |
| R/euro exchange rate (eop) | 7.85 | 7.53 | 8.45 | 9.53 |

**Source**: Bureau for Economic Research

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6 September 2005