




2

Economic Outlook: 2006/07 – 2008/09

Key findings:

- The SA economy has been remarkably buoyant during 2005, in spite of a (temporary) global slowing during the first half of the year and high oil prices.
- Growth for the country as a whole remains remarkably broad based.
- The Western Cape economic performance is expected to keep up with SA's over the short term, and may continue to out-perform the national economy on average.
- The future trajectory of the rand exchange rate could be an important determinant of the balance and sustainability of the national and Provincial economic growth performance.
- It seems likely that the domestic spending momentum will continue, further invigorating national and Provincial growth performance.
- Lower inflation in 2008 should allow a further decline in interest rates, continuing the dynamic of structurally lower inflation and interest rates projected over the medium term.
- SA's official unemployment rate is showing signs of moderating.
- Robust growth in the Province's wholesale & retail trade sector (around 7% a year over 1999 to 2004), construction (6,5%) and transport & communication (around 6,3%) is expected to continue.

- 
- The manufacturing and agriculture sectors are expected to recover, the latter if climatic conditions remain favourable.
 - The Province's established exports (fruit, processed foods & beverages, fish, iron & steel and electrical machinery) performed well, even in the face of the stronger rand.

1. Introduction

The Western Cape continues its strong economic growth performance. In 2004, the Provincial economy expanded by 5,3 per cent in real terms, compared to 4,5 per cent for SA. Strong Provincial performance continued in 2005, with estimated regional gross domestic product (GDPR) growth rising to around 5 per cent in real terms.

At the national level, real domestic expenditure expanded strongly in 2004 and 2005, and indications are that the domestic spending momentum continued into the early part of 2006. The production side of the economy is increasingly responding to the keen demand conditions, although the sustained strength of the rand presents important challenges to the tradable goods producing sectors, such as manufacturing.

The Western Cape was hard hit by the drought in agriculture as well as the adverse impact of the strong rand on manufacturing activity. A number of the rapidly growing niche manufacturing and services sectors have been affected by the rand strength. However, while the margin of difference has narrowed, prospects remain favourable that the Western Cape economy could still grow faster than the national economy on average.


The future trajectory of the rand exchange rate will be an important determinant of the balance and sustainability of the national and Provincial economic growth performance. Some adjustment in the value of the rand to a more competitive level is likely; however, the timing of such an adjustment is difficult to call.

At this point, rand strength seems likely to persist in 2006, while the inflation outlook is favourable and interest rates are expected to remain stable over the short term. The financial magnitudes, therefore, are highly likely to be supportive of the domestic spending momentum, further invigorating national and Provincial growth performance.

Any unexpected exchange rate and subsequent interest rate volatility are likely to be of manageable proportions and unlikely to derail the current favourable real economic growth performance. A more competitive currency should benefit the Western Cape economy, as its industrial base is sensitive to exchange rate movements.

On the external front, the global economy slowed closer to a trend growth pace in 2005. Global economic indicators have been upbeat since April 2005, indicating a re-acceleration of the global economy, in spite of the high crude oil prices.

Deepening imbalances remain a cause for concern and the upswing phase of the global business cycle (four calendar years old in November 2005) is threatened by a high and volatile crude oil price; risks remain on the downside. The normalisation of interest rate levels in the major industrial countries also has important implications for emerging market economies such as SA.



This chapter provides a short- to medium-term outlook for the Western Cape economy. As the Province's prospects are closely linked to those of the SA economy, the first section considers the outlook for the national economy, with particular reference to the sustainability of the domestic spending boom and the underlying competitiveness of the domestic economy.

The second section then provides a more in-depth focus on the Western Cape's economic outlook, considering regional economic linkages and the prospects for growth, employment, fixed investment and exports as the basis for the Province's higher and shared growth and integrated development agenda.

2. Trends in the SA economy

The SA economy has been remarkably buoyant during 2005, in spite of a (temporary) global slow-down during the first half of the year and high oil prices. Both business and consumer confidence levels scaled new heights during the second half of the year. Growth remains remarkably broad-based, and following the revision of national GDP statistics, came in close to 5 per cent in real terms for 2005.

On the demand side of the economy, final household consumption expenditure grew by 6,9 per cent in real terms in 2005, and government final consumption expenditure by an estimated 5,6 per cent.

However, growth is not entirely consumption-driven. Real private fixed investment grew by 8 per cent during 2005, including a particularly buoyant private residential construction sector. Public sector fixed investment spending is now taking off, with estimates suggesting strong growth of 10 per cent to 11 per cent during 2005.

While inventory investment has been less robust during the first half of 2005 following the strong stock build-up at the end of 2004, the third quarter saw a revival as businesses sensed the sustained buoyancy in domestic spending.

On the external front, non-gold export growth has been stronger than expected, coming in at double-digit growth rates during the first half of the year. This growth is concentrated in the non-gold commodity sector. Manufacturing exports have been under pressure from the strong rand exchange rate.

The strong commodity export growth on the back of favourable commodity prices has been an important counter for the keen import demand associated with vigorous domestic demand conditions and the rising oil import bill. Nonetheless, the current account of the BoP posted a deficit of 4,7 per cent of GDP during the third quarter of 2005.

Given sustained demand conditions, the production side of the economy is showing increasing response – a critical element for continued growth performance. During calendar 2005, growth accelerated to close to 4 per cent in the primary sector, 4,6 per cent in the secondary sector and 6,2 per cent in the tertiary sector (excluding government). While both mining and manufacturing show signs of recovery and adjustment to the strong currency environment, these sectors are under most pressure from the strong rand exchange rate – real value added contracted in both these sectors during the final quarter of 2005.

The growth in the manufacturing sector is still strongly influenced by developments on the exchange rate front. However, manufacturers appear to be more successful in



regaining market share in the buoyant domestic market at the stronger levels of the rand. Nonetheless, there appears to be little reprieve on the export side. Respondents to the BER's quarterly manufacturing survey continue to report steep year-on-year declines in export volumes.

The domestic market, as noted, continues to boom. This is reflected in sustained high confidence levels in the retail sector, unprecedented unit car sales (growing by 25,6% in 2005 on top of the 22% volume growth in 2004) and keen overall credit demand. The strong currency environment (inducing lower inflation and interest rates) benefits the non-tradable goods sectors, such as wholesale & retail trade, construction, transport & communication and – to a lesser extent – financial & business services.

Revision of SA's GDP statistics

Based on more complete statistical sources, Stats SA revised SA's national production accounts at the end of 2005. Real economic growth over the period 2004 to mid-2005 has been significantly stronger than previously measured – real GDP growth came in at 4,5 per cent in 2004 compared to 3,7 per cent measured previously. From the first quarter in 2004 to the second quarter in 2005, the growth rate has been revised upwards by 0,8 percentage points on average, suggesting economic growth came in close to 5 per cent over this period.

Substantial revisions have been made to individual sectoral growth performances. The two most prominent sectors given their contributions to overall GDP (21% and 18%, respectively) are financial & business services (the growth rate revised from 4,3% to 8% per annum over the period 2004Q1 to 2005Q2) and manufacturing (from 2,8% to 4,8% per annum). Combined, the revision of these two sectors' GDP growth rate accounts for the bulk of the aggregate upward revision.

The real growth of the construction sector – much smaller in size (3% of total GDP) – was also revised upwards substantially, from 6,7 per cent to 10,3 per cent a year over the corresponding period.

For some sectors, growth was revised downwards. The two sectors that stand out here are CSP services (revised down from 4% to 1,7% a year) and agriculture (down from 3,9% to 0,6% a year).

Smaller downward revisions were made in the case of mining (-1,2 percentage points a year on average), wholesale & retail trade (-0,5 percentage points), transport & communication (-1,0 percentage point) and general government (0,1 percentage point).

The revisions confirm the strong growth in the non-tradable goods sectors over the period under consideration, particularly in financial & business services (8% a year) and construction (10,3%).

Real GDP growth revision: 2004Q1 – 2005Q2 (%)

Sector	Average growth: 2004Q1 – 2005Q2		
	Old	Revised	Difference
Agriculture, forestry & fishing	3,9	0,6	-3,2
Mining & quarrying	4,4	3,2	-1,2
Manufacturing	2,8	4,8	2,0
Electricity & water	2,0	2,5	0,4
Construction	6,7	10,3	3,7
Wholesale & retail trade	6,2	5,7	-0,5
Transport & communication	5,8	4,8	-1,0
Financial & business services	4,3	8,0	3,7
General government	1,3	1,2	-0,1
CSP services	4,0	1,7	-2,3
Total GDP	4,0	4,8	0,8

Source: Stats SA

Growth in the wholesal & retail trade sector (5,7%) and in transport & communication (4,8%) also remains strong by comparison, even though slightly slower against previous estimates.

The other significant aspect of the revisions is the faster growth of the manufacturing sector over this period (4,8% compared to 2,8% measured previously). This is somewhat surprising, given what we know about export growth and import competition in this sector over the period.

The revision certainly highlights the fact that the SA economy is growing at a faster rate than previously believed and measured. The Bureau for Economic Research's (BER's) estimate of calendar year 2005's real GDP growth rate is 5,1 per cent. At this level, SA's real economic growth rate compares very well to that of its emerging market peers. While sustainability is of course the critical issue, this is the first confirming evidence that SA's economic growth rate is moving to a higher plane. There are furthermore solid reasons to believe that the sustainability of growth has improved – inflation and interest rate levels have moderated on a sustainable basis, the BoP constraint has changed and formal sector employment creation has improved significantly.

3. Global economic developments

Global growth continues as the upswing phase of the global business cycle entered its fifth year in November 2005. 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 US and Chinese economies.

Global economic indicators began turning upwards again from the middle of 2005, signalling a new leg of accelerated growth. However, hurricanes Katrina and Rita have had a material impact on the global economic outlook due to their effect on the US economy and the international crude oil price. Higher crude prices are pushing inflation higher, drawing the attention of central banks globally.

Expectations are that expansion in the global economy will be sustained. Corporate fixed investment spending and hiring, supportive interest rates and strong developing country economic performances – in particular that of China – underpin positive global growth prospects. However, the risks are loaded on the downside.

The spike in international crude oil prices

Following the easing of international oil prices at the end of 2005, prices spiked again early in 2006, reaching US\$65 a barrel at the beginning of January. The high crude oil prices have been an important feature of the global economic scene the past two to three years. Fundamentally, oil prices are high due to a supply-demand imbalance in the international oil market. The lack of spare production capacity, for both OPEC¹ and non-OPEC producers, a tapering off of the rapid oil production growth in the Former Soviet Union (FSU) and political instability in key oil-producing countries (Iraq, Nigeria, Venezuela and of late, the Iranian nuclear crisis) are all factors characterising the global oil supply side.

The problem is that demand is growing, with the global economic upswing in its fifth year and oil demand in fast-growing East Asia (for example, China) rising rapidly. The fear is that capacity constraints could lead to yet higher prices for longer before demand could be curbed or the required supply capacity could be developed.

Furthermore, facing low interest rate yields in the major industrial countries, international investors have honed in on this underlying oil supply-demand imbalance, exacerbating price increases (and volatility). Climatic conditions have also had an impact (for example, hurricanes Katrina and Rita in the Gulf of Mexico during the third quarter of 2005).

Regarding oil price prospects there are two scenarios at play:

The first foresees a confluence of (mainly cyclical) factors – the global economic upswing since the end of 2001, the low global interest rates, the Iraq war, disappointing non-OPEC supply growth, etc. – behind the higher crude oil prices. An unwinding of these factors could go a long way in restoring stability and balance in the oil market. This is, more or less, the rationale for the current consensus view anticipating a moderation in crude oil prices over the short term (around \$50/b at the end of 2007).

The second, emanating from the structuralist school, foresees that the lack of investment in production capacity (or more extreme, resource limits) and rapidly growing demand underlie the higher oil prices.

¹ Organisation of the Petroleum Exporting Countries

This scenario highlights that during 2004, \$8-billion were spent on oil production globally but only \$4bn worth of oil reserves were discovered. International oil reserves have gone past their half life – to uncover the second half of the oil reserves will be more difficult and much more expensive. According to this view, a much higher price would be required for longer to restore balance in the market.

The bottom line is that oil prices have spiked and medium- to longer term projections have been raised. Due to under-investment in oil refining and distribution infrastructure, oil supply bottlenecks have emerged which will not be resolved overnight. Furthermore, with global spare oil production (and refining) capacity at low levels, the risk of stronger spikes in prices is real, particularly in the event of supply disruptions. A particular problem with refining capacity is that the growth in global demand is for the lighter/sweeter crudes, while existing refining capacity is mainly geared to the heavier/sour crudes.

Impact of the high oil prices

The most notable aspect of the past almost three years' oil price spike is the fact that it has had such a limited impact on global real economic growth and inflation. The International Monetary Fund (IMF) previously estimated that a \$10/b increase in international crude oil prices for a 12-month period would shave 0,5 percentage points off the global real GDP growth rate.

However, while the high crude oil prices were a factor in the global economic slowdown during the run-up to the Iraq war and during the second half of 2004/early 2005, the global economy re-accelerated each time. Currently there is no sign of recession so typical of the 1970s (and early 1990s) oil price spikes. It is also a fact that oil prices gradually ticked up to their current elevated levels, in contrast to the 1970s when prices shot up overnight, imparting a much bigger shock to the global economy.

This time around the impact on inflation is much more muted, both because the oil price spikes do not lead to secondary inflationary effects and because non-energy inflation rates are so low, inter alia influenced by disinflation from China. Without the inflation consequences, there is no monetary policy reaction and no global economic recession. While global core inflation measures have increased, the current outlook for global inflation remains favourable and should not lead to undue interest rate hikes.

That leaves the direct impacts of more expensive energy. For SA there are three key impact channels:

- The energy import bill (the impact on the BoP);
- The direct cost-push impact on domestic inflation; and
- The direct growth impact.

The high crude oil price has made SA a net energy importer. In 2002, SA was still a net energy exporter (national coal and bunker fuel exports exceeded the oil import bill). However, by the middle of 2005, SA's net annual energy trade balance deficit stood at a hefty R17bn. Consequently, the rising oil price contributed to a widening domestic current account deficit (estimated at 4,3% of GDP in 2005).

Further, the impact on local inflation has been well contained – here SA shares fully in the international experience. Generally we have witnessed an absence of secondary inflationary processes developing; it is only the domestic petrol and diesel prices that spiked. However, the strengthening rand exchange rate has countered/softened this impact. CPIX inflation came in at a lower than expected 3,9 per cent in 2005, despite the 44 per cent increase in crude oil prices (domestic petrol prices only increased by 18% in 2005 due to the rand's appreciation). Suffice to say that the inflation impact and the consequent monetary policy reaction would have been more severe in a weaker currency scenario.

While the indirect impact is limited, there remains a direct impact. Merrill Lynch calculates that SA consumers spent R80bn on petrol and diesel in 2004, but that this expense rose to around R100bn in 2005 due to the oil price increase. They also estimate that the net increase in energy prices subtracted 0,4 percentage points from real GDP growth over the 12-month period up to the middle of 2005. Furthermore, the impact is regressive in nature in that lower income consumers are disproportionately affected, as energy and transport expenses comprise a larger share of their household budgets (15% to 20%). Consumers usually have to cut back on other spending (for example, clothing and footwear) to shoulder the higher transport costs.

The elevated level of crude oil prices is likely to persist, although there is a slight tapering off factored into the projections. At \$67/b, real crude oil prices are 25 per cent above that in the run-up to the Gulf War in the early 1990s, which sparked a global recession. This time, global growth has been remarkably resilient in the face of the high oil prices. Rather than a recession, global growth is expected to remain close to its potential pace over the short term.

From a regional perspective, the US economic performance is exposed to the most risk. The US BoP current account deficit continues to grow. 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. This could have important implications for the global economy.

On the other hand, Japan is emerging as a growth engine in Asia, along with sustained strong growth in China. The outlook for real GDP growth in Japan is still a rather pedestrian 2,5 per cent; however, it is a healthy outlook. There is a strong recovery in consumer confidence and household expenditure, combined with keen fixed investment spending driven by a vastly improved corporate sector. The end of deflation is in sight and the financial sector is regaining its previous lustre.

The economic under-performance of the Euro area is expected to persist. However, the latest regional economic indicators point to a revival in domestic demand, leading to upgraded forecasts. The household sector in the region is exposed to the high crude prices and business fixed investment spending, and hiring is not as strong as in other parts of the global economy. Nonetheless, regional real GDP growth is projected to accelerate to a 2 per cent to 2,5 per cent pace over the short term, which represents a welcome improvement in the economic outlook for the region.

The US dollar is expected to depreciate further during the second half of 2006, dictated by the widening US current account deficit (measuring 7% of GDP in the fourth quarter of 2005). Non-oil commodity prices continue to escalate and are expected to remain strong in 2006. Increases in the gold and platinum prices have been particularly strong towards the end of 2005 and into early 2006, despite the increase in US interest rates. This lent further support to the rand and could continue to do so over the near term. Crude oil prices are expected to moderate over the short term. However, oil price forecasts continue to be scaled upwards and there is a real risk of continued high crude oil prices.

Global financial markets remained flush with liquidity in the early part of 2006. The US Federal Reserve (the 'Fed') is likely to persist with gradual monetary tightening up to the middle of the year (taking the Fed funds rate to 5%), when it is expected to pause due to a slowing economy.

Policy interest rates in Japan and the Euro area are also expected to increase. The European Central Bank (ECB) hiked interest rates by 25 basis points (a quarter of a per cent) in December 2005. The normalisation of interest rate levels in the major industrial countries has implications for emerging country capital and currency markets.

Emerging economies have been the beneficiaries of the period of low interest rates in the main industrial countries since the end of 2001. This has translated into strong capital inflows into emerging market countries and appreciating exchange rates (depending on the host countries' currency regimes) as international investors went on the rampage in search of yield. The weak US dollar and the commodity boom compounded these flows to countries such as SA. SA's accumulated net capital inflow amounted to R184bn during 2002 to 2005.

Wider interest rate spreads and increased international investor risk aversion, possibly compounded by softer commodity prices, could see a reversal/ sharp slowdown of these capital inflows. There are attendant risks of widening current account deficits for emerging market economies such as SA.

Table 1: World economic outlook – real GDP growth (%)

	2005	2006	2007		2005	2006	2007
Industrial countries				Developing countries			
Major Seven ¹	2,6	2,8	2,9	Emerging Asia ³	4,5	4,6	4,8
US	3,6	3,5	3,4	China	9,3	8,5	8,8
Japan	2,5	2,6	2,8	India	8,0	7,0	7,0
Euroland ²	1,5	2,1	2,4	Latin America	4,2	4,2	3,6
Germany	1,1	1,8	1,9	Emerging Europe ⁴	4,9	5,3	5,2
UK	1,6	2,2	2,6	Sub-Saharan Africa ⁵	4,8	5,9	n/a

Source: JP Morgan /⁵ IMF World Economic Outlook, October 2005

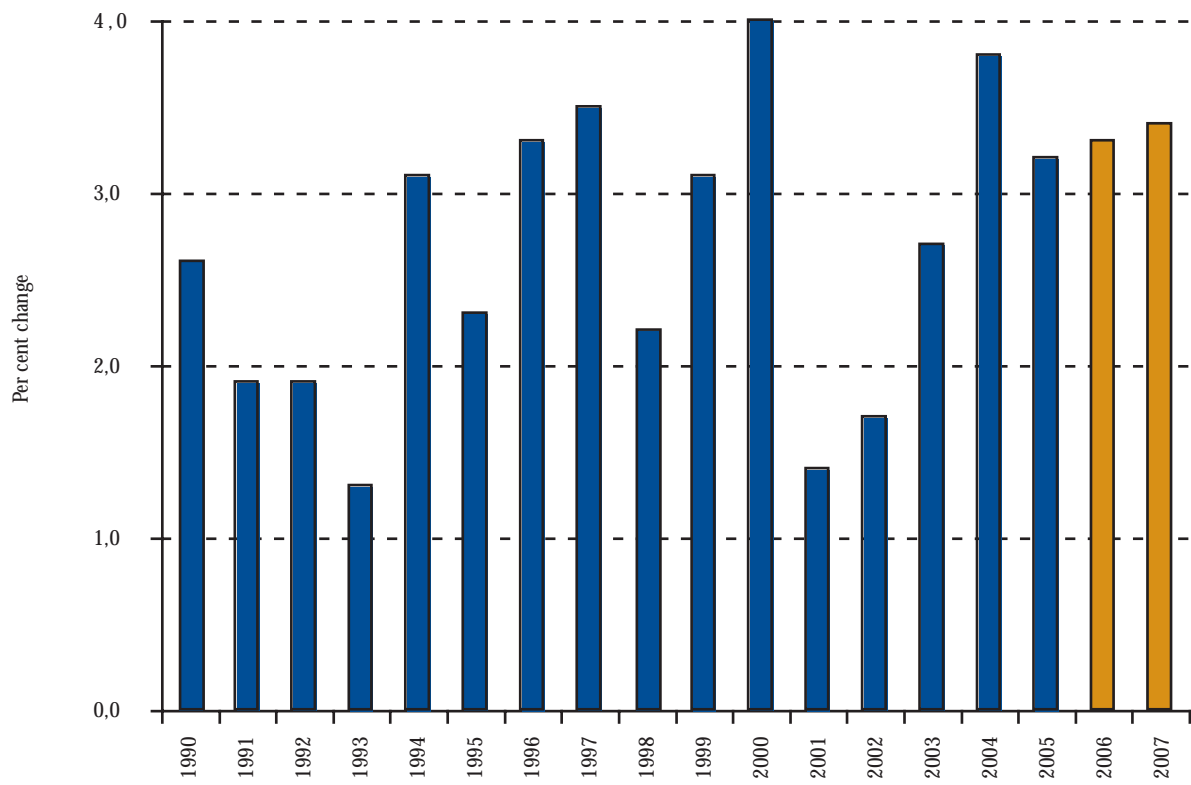
Notes: ¹ UK, US, France, Canada, Italy, Japan and Germany;

² The 11 Euro countries – Belgium, Austria, Finland, France, Luxembourg, Ireland, the Netherlands, Germany, Portugal, Italy and Spain;

³ Taiwan, Hong Kong Special Administrative Region (SAR), Singapore, South Korea, Malaysia, Indonesia, Thailand and Philippines;

⁴ Bulgaria, Czech Republic, Hungary, Poland, Slovak Republic, Russia, Turkey

Figure 1: World real GDP growth: 2006/07



Source: JP Morgan

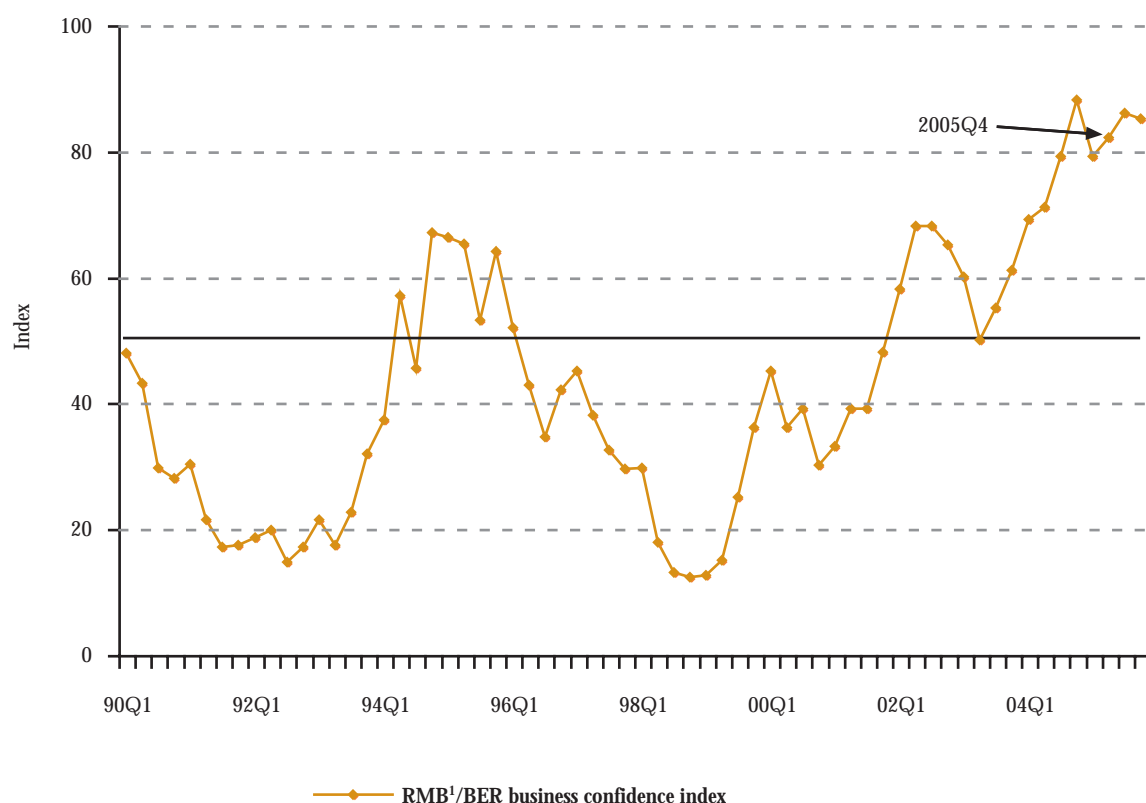
4. SA's unprecedented economic upswing

The SA economy is experiencing a strong spending boom, which has its origins in the late 1990s, with the onset of the current historically long business cycle upswing in September 1999.

In the household sector, key contributing factors are gradually accelerating income growth on the back of a lower rate of retrenchment in the formal sector of the economy, a return to positive employment creation from 2002, higher real economic growth, substantial cumulative personal tax relief, lower inflation and moderating interest rates.

During 2003 and 2004, the spending drive received added impetus from historically low levels of interest rates and inflation in the wake of the rand's remarkable recovery and buoyant capital inflows. External contributing factors included a weak US dollar, notably low interest rates in the major industrial countries and a commodity boom. The rand's appreciation forced inflation and interest rates to historically low levels – key in driving real final demand growth in the economy to between 6 per cent and 7 per cent in 2005.

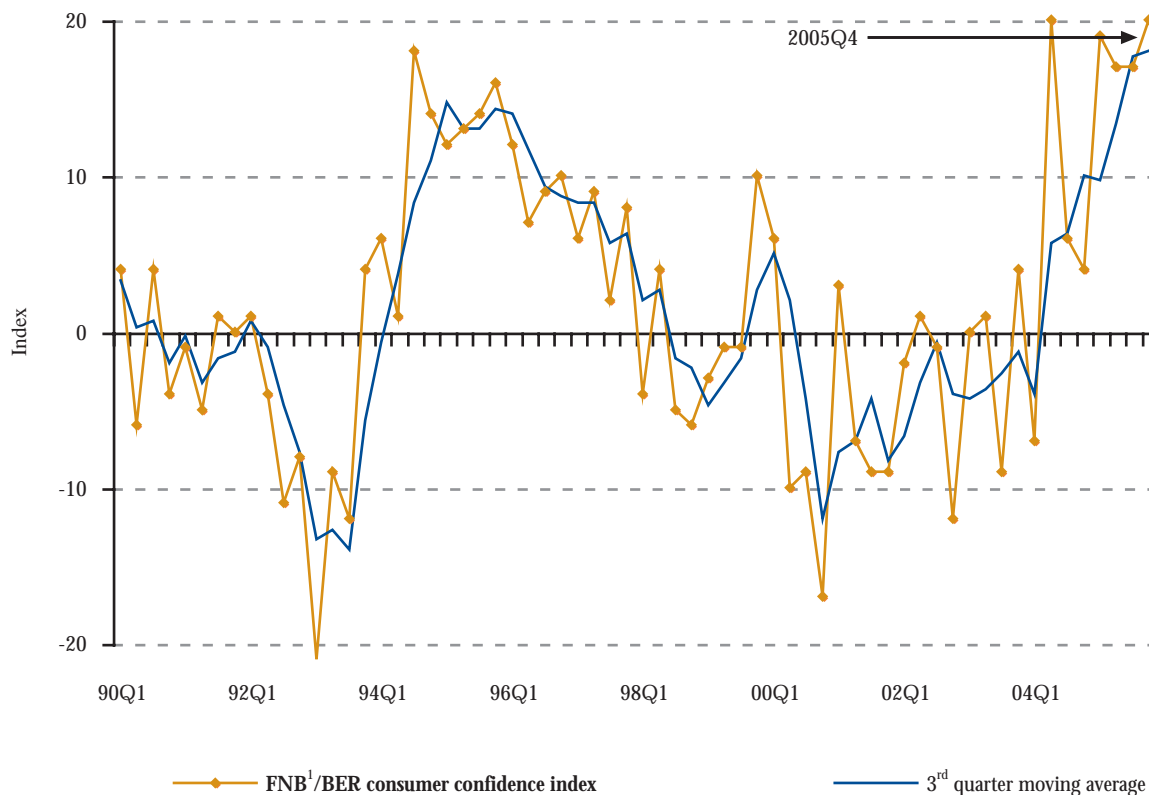
Figure 2: SA business confidence



Source: BER

Note: ¹ Rand Merchant Bank

Figure 3: SA consumer confidence



Source: BER

Note: ¹ First National Bank

Spending momentum is expected to decelerate over the short term, in the absence of further interest rate cuts and as the rand weakens. On the other hand, the 2006 Budget will continue stimulating consumer spending, which should contain the anticipated slowdown. While inflation is expected to increase marginally, it is possible that interest rates will remain unchanged for the foreseeable future. The anticipated slowdown in real domestic expenditure could therefore be mild. Even unexpected exchange rate and interest rate volatility is not expected to derail the otherwise sound economic momentum.

Over the medium term, a more competitive currency should stimulate production in the tradable goods sectors, particularly exports. This should alleviate the cumulating pressures on the trade account of the BoP and enable the domestic economic upswing to continue. However, it is critical that key microeconomic reforms are implemented to improve economic competitiveness and capitalise on the healthy spending momentum.

National real GDP growth is forecast to reach 4,6 per cent in 2006 and remain around 4 per cent in 2007.

4.1 Durability of domestic spending boom

Key to the sustainability of the spending momentum is income growth and a sustainable BoP position. Over the past five years, solid income growth has been driven by improved formal sector employment creation, enhanced productivity growth, personal tax cuts, a structural adjustment to lower levels of inflation and real interest rates, and higher levels of real economic growth. The process is well underway, but far from complete.

Formal sector employment growth is essential, as it boosts the multiplier effects of increased fixed investment spending in the economy and sustains the spending momentum. Whereas the macro-economic stimulus embodied in the lower level of inflation and interest rates acted as an important catalyst in the elevated spending levels, accelerated fixed investment spending and employment creation, driven by the improved levels of economic growth, act as a central force to sustain the economic momentum.

Fixed investment spending must become a stronger component of domestic spending to drive higher sustained growth. Some progress is being made, signalled by a faster fixed investment rate, historically high business confidence levels and robust public sector infrastructure fixed investment plans.

The domestic spending momentum therefore has favourable structural characteristics. There is little sign of overspending and/or exorbitant general household indebtedness. Inflation and interest rates are at sustainable lower levels. There is sound fiscal stimulation and a higher fixed investment rate (both in the private and public sectors). Furthermore, the BoP position is a function of external developments, the exchange rate and SA's competitiveness.

Transnet infrastructure investments in the Western Cape

The total investment plan of Transnet's core business amounts to R37bn over the next five years. Details of the investments per division are as follows:

National Ports Authority (NPA)

- Expansion of the Cape Town container terminal, creating additional capacity to meet container growth.
- Development of an oil and gas hub in the Western Cape. The expected impact will be:
 - Provision of a logistics hub for the oil & gas cluster to consolidate value-added logistics services to industry.
 - A reduction in cost of business through centralisation and specialisation.

SA Port Operations (SAPO)

- The Cape Town terminal equipment renewal and expansion programme will increase throughput capacity to 20 per cent, and allow higher stacking density in the terminal. SAPO will invest in six new container cranes and 26 four high-straddle carriers.
- Iron ore expansion in Saldanha will meet growth requirements and increase tonnage beyond 42 mega-tonnes per annum.

Spoornet

- Spoornet will implement various projects relating to fleet renewal and modernisation.

In summary, the investments per corridor are as follows:

	Gauteng-Cape Town (Rbn)	Sishen-Saldanha (Rbn)
NPA	0,35	1,26
SAPO	0,38	0,79
Spoornet	0,87	0,00
Total	1,60	2,05

Source: Wesgro²

4.2 The rand and competitiveness

The current strong spending momentum in the economy has been accompanied by the remarkable recovery of the rand exchange rate. However, the economic upswing is not dependent on the strong currency. In fact, it may be argued that the rand's overvaluation compromises improved economic growth performance due to the imbalances it is creating. These are best reflected in the widening current account deficit and an under-performing manufacturing sector.

A softer value for the rand above R7/US\$ would curb an overheating of the spending momentum and induce a recovery in the manufacturing (and tradable goods) sectors. It would also allow the resources sector to benefit more from the global commodity boom. In turn, the BoP is likely to improve, rebalancing domestic economic performance as producers respond to the buoyancy in domestic demand conditions and, hopefully, keen world economic conditions.

A more competitive currency environment would strengthen the underlying economic and employment dynamic, supporting the sustainability of spending growth, rather than pushing the level of such growth temporarily higher.

While firms adjust to the stronger currency environment, an overvalued currency exposes the economy to risk through generating an unsustainable BoP position. The eventual depreciation of the rand could be more volatile, causing sharper than expected increases in inflation and interest rates, and consequent adverse impacts on the economic growth momentum. SA's external financial position has improved immensely, minimising the chances for such repeated financial volatility, but the country's economy is not as yet immune to these tendencies.

² Wesgro is the official Trade and Investment Promotion Agency for the Western Cape, and is responsible for attracting investment, growing exports and promoting the business image of the Province.

The Investec PMI

The BER at the University of Stellenbosch publishes an index of current business conditions in the SA manufacturing sector. The index is based on the widely used and highly regarded Purchasing Managers Index (PMI) produced by the Institute of Supply Management (ISM) in the US. In SA, the monthly survey is financially sponsored by Investec Asset Management, hence the index's name. The index is compiled on a monthly basis by the BER, in collaboration with the Institute of Purchasing and Supply SA (IPSA), and focuses on business conditions in the manufacturing sector. In the US, and other developed countries for which PMIs are available, the index serves as an important indicator of business conditions.

The survey is conducted by way of mailed questionnaires to a panel of purchasing managers in the manufacturing sector. The questionnaire consists of nine questions on the monthly changes in business conditions in the manufacturing sector. The respondents have to indicate qualitative changes only – whether a particular activity has increased, decreased or remained unchanged.

The questions are on: business activity (production), new sales orders, employment, backlog of sales orders, purchasing inventories, purchasing commitments, purchasing supplier deliveries, purchasing prices and purchasing conditions. The questionnaires are completed during the second and third week of every month and processed during the final week of the month. The results are made available on the first working day of the following month.

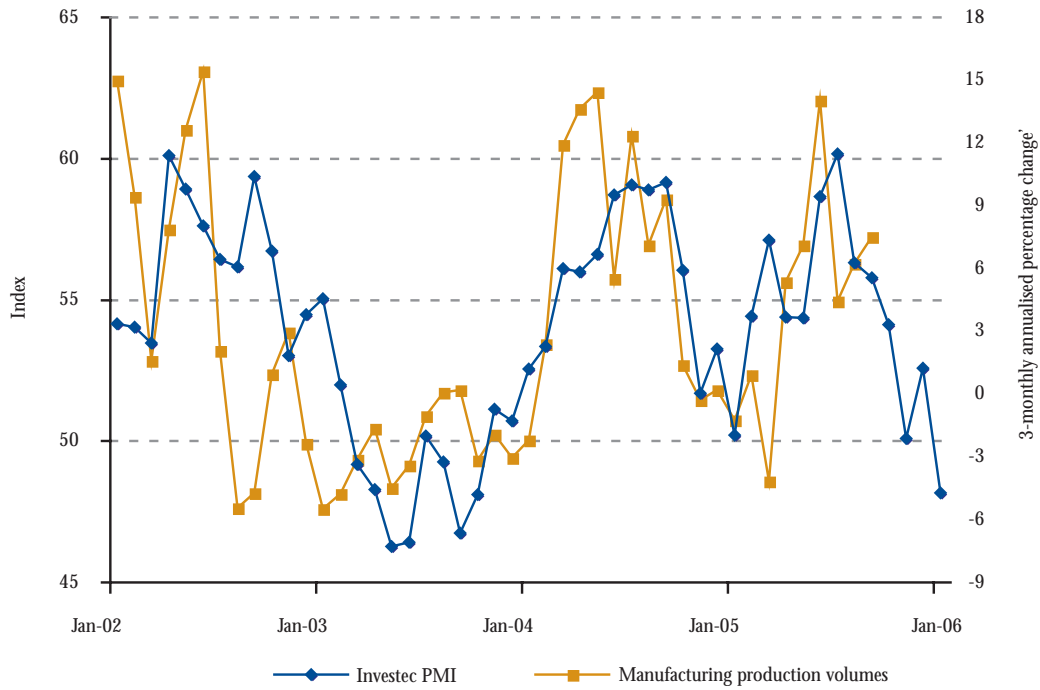
The results of the responses on each question are processed in the form of an index. The index is constructed as the sum of the percentage of respondents that indicated an increase plus one-half of the percentage of respondents that indicated no change. This provides an index that ranges between 0 and 100, with 0 indicating a decline experienced by all the respondents and 100 indicating an increase experienced by all the respondents. An index value of more than 50 indicates increased activity.

The PMI is then calculated as a weighted average of five of the individual indices. The choice of indices included and the weights currently used for the Investec PMI are identical to that of the ISM in the US. Consequently the Investec PMI is calculated as follows:

$SA\ PMI = 0,25\ \text{business activity} + 0,30\ \text{new sales orders} + 0,20\ \text{employment} + 0,15\ \text{supplier deliveries} + 0,10\ \text{inventories}$

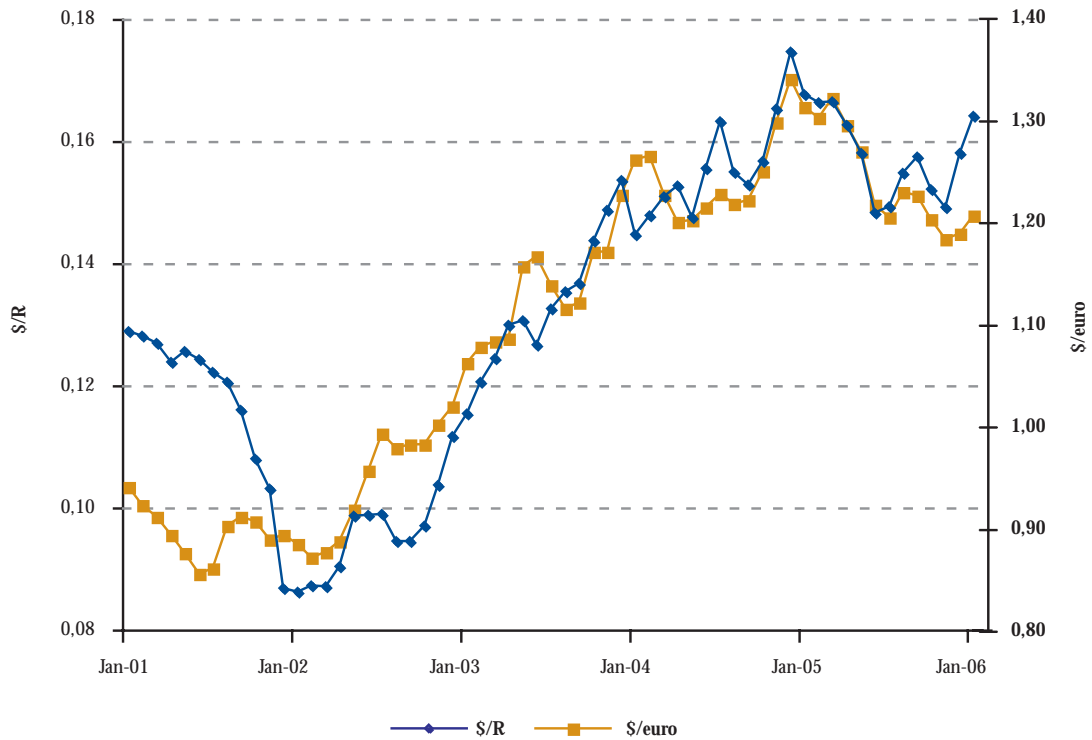
The PMI is adjusted for seasonal variation of the data. The survey has been run on a monthly basis since September 1999 and the statistics on the individual indices and the Investec PMI are released on the BER website (www.ber.sun.ac.za). The Investec PMI has an exceptionally good track record as a reliable indicator of SA manufacturing conditions – figure 4 shows the good correlation between the Investec PMI and the three-monthly annualised percentage change in actual manufacturing production volumes (released by Stats SA).

Figure 4: The Investec PMI dips below 50 in January 2006



Source: BER

Figure 5: Close link between the US\$/R and US\$/euro exchange rates



Source: SA Reserve Bank

5 Outlook for the SA economy: 2006/07 – 2008/09

5.1 Economic growth and employment

Economic indicators from the second half of 2005 reveal a stronger than expected cyclical momentum in the SA economy. Consumer spending remains firm and the country's fixed investment rate is picking up. There are both cyclical and structural elements in the continued growth of consumer spending and gross domestic fixed investment spending in SA.

The sustained buoyancy in consumer spending is reflected in historically high consumer confidence levels. Optimism in SA prevails across income and racial groups. Even though strike activity and localised social upheaval through 2005 tended to cloud the picture, there is clear evidence of solid income gains on the part of households. Consumers are generally upbeat regarding their financial positions. The lower end of the consumer market has lagged this improvement. However, renewed employment creation and the accelerated social grants from government are increasingly benefiting this market segment.

SA's official unemployment rate is showing signs of moderating. According to the Labour Force Survey (LFS) of Stats SA, the narrow definition of unemployment in SA subsided from 27,9 per cent in March 2004 to 26,2 per cent in September 2005. Nationally, a total of 658 000 new jobs were created over the 12-month period up to the third quarter of 2005 – 295 000 in the formal non-agricultural sector and 516 000 informal sector job opportunities (160 000 jobs were lost in agriculture and the domestic worker sector).

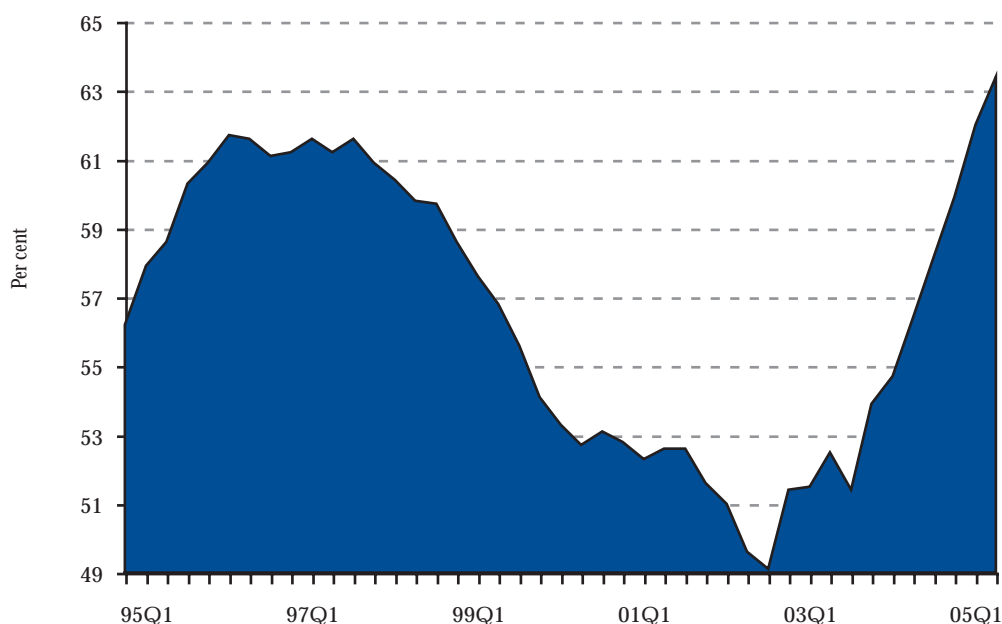
BER's business surveys in the wholesale & retail trade, construction and financial & business services sectors also reveal strong employment growth. Government's expanded public works programme and its public infrastructure fixed investment drive provide a further impetus.

While household credit utilisation is picking up sharply, income growth, tied to strong real wage growth and employment gains, remains on a solid basis. Despite the higher overall level of household indebtedness, household debt service ratios remain close to historical lows (6,5%) due to lower interest rates.

Government's policies on employment equity and black economic empowerment (BEE) have boosted the spending power of the black population group. Given low penetration levels of this market segment, these policies will remain an important structural support to consumer spending in a number of markets.

Personal income tax relief has amounted to more than R70bn over the past seven years, and a healthy cash position afforded the fiscus further opportunity for tax relief in the 2006 national budget. Government's roll-out of social grants is also likely to continue underpinning income growth in the lower end of the consumer market.

Figure 6: Household debt to GDP ratio



Source: SA Reserve Bank

The strong housing market and financial asset markets have introduced potent wealth effects, supporting consumer spending. While these positive wealth effects are exposed to the risk of higher interest rates, the medium-term outlook for consumer spending is positive.

In all, consumer spending is estimated to have grown by 6,9 per cent in 2005 and is expected to moderate slightly to 4,7 per cent in 2006 and further to 3,9 per cent in 2007. The favourable tendency in employment creation is projected to strengthen.

SA's fixed investment rate is accelerating, albeit off a low base. Economic indicators suggest that this revival is more than a purely cyclical phenomenon.

Robust public sector investment plans among general government and public corporations, such as Eskom and Transnet, are contributing strongly to gross domestic fixed investment over the next five years. Plans to upgrade and expand electricity supply and distribution capacity and transport infrastructure are valued at R165bn over the period 2005 to 2009. This will become an important component of the fixed investment revival and economic impetus over the medium term.

Private sector investment plans are also responding to buoyant demand conditions. Following growth of close to 11 per cent in 2004, year-on-year growth came in above 8 per cent during the first three quarters of 2005. The private residential construction sector made a strong contribution to this growth – fixed investment spending in this sector

expanded by no less than an estimated 20 per cent in 2005 and is projected to come in at 9,3 per cent in 2006. Solid growth in real disposable incomes, favourable property prices and improving formal sector employment conditions are driving residential construction. The non-residential sector is also booming of late and has more scope to grow over the short term.

Mining and manufacturing fixed investment has been hampered by the strong rand exchange rate, and private fixed investment (excluding residential building) slowed somewhat during the first half of 2005. However, private fixed investment spending rebounded again during the third quarter of 2005.

The favourable demand conditions, the low interest rate environment and the improved outlook for economic growth are proving strong drivers of accelerated fixed investment spending in the private sector. Business confidence remains close to historically high levels and this is typically associated with strong fixed investment spending going forward.

Overall real GDP growth is estimated at 4,9 per cent during 2005 and is projected to slow somewhat to 4,6 per cent in 2006 and 4,1 per cent in 2007.

Given the solid basis of the domestic growth momentum, the SA economy is well-positioned to weather any unexpected hostile external developments and sustain the current growth trajectory. Policy authorities and other economic stakeholders must implement key microeconomic reforms that will enhance economic competitiveness and further elevate economic growth and employment performance.

5.2 Inflation and interest rates

While rand strength has played an important role in the magnitude of disinflation in the current period, its contribution is partial. Key drivers are the international competitive environment (including 'Chinese deflation'), liberalisation of SA's trade (including expanding trade agreements), deliberate macroeconomic policies of financial restraint (including disciplined fiscal policies and inflation-targeting monetary policy) and changing price and wage setting behaviour on the part of business and labour.

CPIX inflation came in at a lower than expected 3,9 per cent in 2005 – it decelerated unexpectedly to 3,7 per cent in November. CPIX inflation is expected to drift higher in the early part of 2006 (it came in at 4% in December 2005). Credit and money supply growth is accelerating and the full impact of the oil price spike has not been absorbed.

While inflation is likely to increase moderately over the medium term due to the high energy prices, demand-pull effects and some exchange rate depreciation, it is projected to remain within the 3 per cent to 6 per cent target range over the short term (CPIX inflation is estimated to reach 5,2% in 2007).

While the SA Reserve Bank remains vigilant to prevent second-round inflationary impacts from the spike in energy prices, the improved inflation outlook has altered the monetary policy tone. Interest rates are expected to remain stable for the foreseeable future. Should the currency come under more selling pressure in 2007, it is possible that interest rates will increase. However, this is unlikely to derail the current favourable economic outlook.

Lower inflation in 2008 should allow a further decline in interest rates, continuing the dynamic of structurally lower inflation and interest rates projected over the medium term. This should enhance economic growth acceleration on a sustainable basis.

Table 2 details key macroeconomic forecasts for the SA economy for 2006 to 2008.

Table 2: Macroeconomic outlook for SA: calendar 2006 – 2008

	Average '99-'04	2004	2005	2006 (forecast)	2007 (forecast)	2008 (forecast)
Expenditure on GDP (real % change):						
Household consumption	3,7	6,5	6,9	4,7	3,9	4,4
Fixed investment	3,5	8,8	8,0	8,3	9,5	10,5
Gross domestic expenditure (GDE)	3,8	7,5	5,9	5,2	5,0	5,3
Exports	2,4	2,5	6,7	7,0	4,7	5,9
GDP	3,4	4,5	4,9	4,6	4,1	4,7
Inflation, interest and exchange rates:						
CPIX inflation (%)	6,9	4,3	3,9	4,5	5,2	4,9
PPI inflation (%)	6,7	0,7	3,1	5,0	4,9	5,0
Prime overdraft rate (%)	14,71	11,31	10,64	10,50	10,50	10,75
R/US\$ exchange rate	7,70	6,45	6,36	6,35	6,92	7,54
R/euro exchange rate	7,85	8,02	7,93	7,79	8,66	9,28

Source: BER

Comparing the BER and National Treasury's macroeconomic forecasts

The BER macroeconomic forecast was used to generate the Western Cape regional economic forecast. It is necessary to compare this forecast to that of the National Treasury. The differences are small and can be broadly summarised as follows:

- The National Treasury is more optimistic regarding real GDP growth, which the Treasury projects to average 4,9 per cent per annum over the period 2006 to 2008, compared to the BER average of 4,5 per cent. The National Treasury is also slightly more optimistic regarding final household consumption expenditure, government consumption expenditure, fixed investment and real export growth. Both units see a slight slowdown in overall real GDP growth in 2007, but the BER more so than the National Treasury.
- The National Treasury is also more optimistic in its inflation outlook. Whereas the BER forecasts an average CPIX inflation rate of 4,9 per cent over the forecast period, the National Treasury forecasts 4,5 per cent.
- As the National Treasury does not reveal its interest rate and exchange rate assumptions, it is not possible to compare the forecasts quantitatively. However, the National Treasury refers to a "stable exchange rate and stable interest rates". While the BER also anticipates stable interest rates (with only a small increase towards the end of the projection period), its exchange rate assumption possibly allows for more depreciation in 2007/08 compared to the National Treasury, partly explaining the relatively higher BER inflation forecast.
- The BER's current account forecast is also slightly more negative than the National Treasury's. The current account deficit is projected to average 4,6 per cent of GDP between 2006 and 2008, compared to the National Treasury's forecast of 4,3 per cent.

In broad terms the differences between the two sets of forecasts are small and consistent. The BER anticipates more currency depreciation, a slightly higher inflation trend, some increase in interest rates and a slightly weaker real GDP growth trend; in all these respects the National Treasury takes a slightly more optimistic view.



6. The Western Cape economy

6.1 Recent developments

The Western Cape economy has shared in the historic upswing phase of the SA economy over the past five to six years. Moreover, the Province grew at a faster rate than national over the period 1999 to 2004, with the margin of out-performance 0,7 per cent a year.

This lead was sustained in 2004, despite the Province experiencing a serious drought in agriculture. According to revised GDP statistics, in 2004 real GDP growth in the Western Cape topped 5,3 per cent, compared to 4,5 per cent for SA. Estimates suggest that this growth tempo was sustained in 2005.

The Province's growth performance is remarkable in view of a number of headwinds experienced during 2004 and 2005:

- The drought in 2003 and 2004 negatively affected the agriculture sector and the agro-processing industry, both key economic sectors in the Western Cape.
- The strengthening of the rand also had a proportionately more negative impact on the Province's industrial base and agriculture. Rapidly growing niche manufacturing and services industries, such as yacht & boat building, higher-end clothing and furniture-making, the film industry and call centres were all affected by the strengthening rand exchange rate. In line with the national experience, Provincial manufacturing exports plummeted, whilst import competition picked up strongly, mainly due to the influx of cheap Asian imports.
- There are also indications that information technology (IT)-linked technological change is benefiting Gauteng-based national head offices to the detriment of Western Cape-based regional head offices in the field of corporate management and logistics.
- Finally, the erstwhile boom in European tourist arrivals appears to be tapering off, or has at least also been affected by the strong rand.

The fact that the Western Cape economy could still register an estimated 5,3 per cent growth rate during 2004 and 2005 is testimony to the strong economic performances of other sectors in the region such as construction, wholesale & retail trade, financial & business services (including property development & real estate) and transport & communication.

As noted in the *PER&O 2005*, the Western Cape economy is well represented in these nationally fast-growing industries, even out-performing their national counterparts. Excluding general government services, the estimated real value-added growth in the Province's tertiary sector is 6,2 per cent for 2004.

This is in line with the 6,2 per cent average real growth rate registered over the 1999 to 2004 period. The real value-added growth in the construction sector is estimated at 9,4 per cent for 2005 and averaged 6,5 per cent over the 1999 to 2004 period.

The fast growth in these sectors contrasts with the rather pedestrian per annum growth registered in the agriculture (1,7%) and manufacturing sectors (2,1%) over the 1999 to 2004 period. However, the manufacturing sector recovered during 2004, growing by a surprisingly strong 5,7 per cent.

This recovery has proved to be hesitant in 2005 – growth remains constrained by the strong rand. However, there appears to be some adjustment in the manufacturing sector to import competition in the domestic market. The movement of the rand to the R6,50/US\$ level through the middle of 2005 provided some additional impetus.

Manufacturing business confidence recovered during the third quarter of 2005. While general Western Cape business confidence lagged the other major provinces during the second quarter, Provincial business confidence recovered strongly during the third quarter and remained on this level during the fourth quarter of 2005. Unfortunately, the Investec PMI indicator dipped below the critical level of 50 in January, indicating a contraction in the manufacturing sector nationally. It remains evident that the strong rand presents this sector with great difficulties.

Investment performance in the Western Cape

Since January 2004, Wesgro has secured just over R3bn of direct investment into the Western Cape, creating an estimated 10 000 jobs.

For the 2005/06 financial year, Wesgro has secured R1,2bn in investments to date, of which R527-million were investments in the Business Process Outsourcing (BPO) and Call Centre sector, secured by CallingtheCape. The services sector continues to be the driving force of the Western Cape economy, accounting for a 70 per cent share of total committed investments secured by Wesgro. The majority of these investments are targeted towards Call Centres and BPOs, business and financial services, and tourism.

Major investment deals for the period include:

- Cableman Manufacturing and Repairs, a local investment project worth R250m rand situated in the City of Cape Town. Cableman is involved in the design, repair and manufacturing of automotive components.
- Project Sunrise, a R260m UK investment in a 370-seat call centre in the City.
- Amazing Estates International, a R40m investment by a Belgian company in the construction and development of a holiday resort and expansion of a shopping complex in Plettenberg Bay. An estimated 200 jobs have been created as a result of the investment.

Traditional European markets such as the UK and Germany continue to be a source of investment for the Western Cape. SA also presents itself as a key source of investment which not only suggests local confidence in the domestic market, but confirms the fact that the business environment remains favourable to bullish investment growth.

Source: Wesgro

6.2 Structure and dynamics of the Western Cape economy

Turning to the sectoral make-up of the Western Cape economy, revised GDP statistics note that it continues to be well represented in the fast-growing national service industries, such as wholesale & retail trade (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 have contributed strongly to regional growth. These include agro-processing, automotive components, boat & ship building, high-end clothing and furniture manufacturing, call centres and the film industry. Unfortunately, the strong rand has dampened activity in a number of these emerging industries.

The Western Cape's economic performance has also been characterised by strong export growth over the period 1996 to 2002 (8% to 9% a year in real terms). This came under pressure in 2003 to 2005 due to the impact of the strong rand. While the region's core exports to well-established markets (including fruit and alcoholic beverages, iron & steel and processed food) continued to grow in real terms, a number of the 'non-core' export products (such as electrical machinery, transport equipment and furniture) contracted sharply in 2003 and 2004.

Nonetheless, as the Western Cape business cycle is closely linked to that of the national economy, the favourable general outlook for the SA economy augurs well for the Province.

Wesgro Western African Trade Corridor Programme (WATCP)

Wesgro launched its Western African Trade Corridor at the beginning of 2005. The overall aim of this programme is to contribute to the growth and development of the Western African region. The programme has a three-tiered approach to achieving this objective:

- Facilitate Western Cape business penetration of the Western African market;
- Promote inter-regional trade among the two regions; and
- Foster outward investment by SA and Western Cape firms into the region.

Western Cape exporters have demonstrated much interest and enthusiasm in taking advantage of the business opportunities throughout Africa, and this interest is reciprocated by buyers within these African markets who would like to source products and services from the Cape.

Over the period 2000 to 2004, Western Cape exports to African countries have grown significantly at an average rate of 8,8 per cent, accounting for 16 per cent of total Western Cape exports. It is the third-largest regional market after Europe and Asia. Western African countries are increasingly becoming an important export destination for the Western Cape, with oil-rich countries such as Nigeria and Angola being the dominant trading partners, followed by Ghana, Senegal and Cameroon. Other Western African markets showing significant growth over the period include Burkina Faso, Togo, Guinea-Bissau, Niger and Guinea.

The foreign exchange generated by oil exploration activities within these countries has created a demand for goods and services. Due to the Province's proximity to the Western African region, Western Cape exporters can exploit the opportunities existing in these markets and become primary suppliers of goods and services, particularly as an Oil and Gas Service hub. The Western Cape export basket mainly consists of agricultural goods, processed foods, chemicals and machinery. Its imports from Western Africa are dominated by imports of crude oil, which account for 98,2 per cent of total imports from the region. Other import goods include cotton, fish, cocoa and wood, with import growth being observed in the imports of frozen fish, ornaments of wood, jewellery and percussion musical instruments.

Promoting intra-African trade is not only conducive to business, but also strengthens relations between the regions, which are the building blocs of initiatives such as the New Partnership for Africa's Development (Nepad) and the African Union. Wesgro is committed to contributing to the growth and development of Africa and aims to do so by promoting inter-regional trade and outward investment by SA and Western Cape firms, using the WATCP as a vehicle to achieve this objective. Key services offered by this programme include market intelligence, inward and outward buying and selling missions, and opportunities for network building.

Source: Wesgro

6.3 Impact/implications of global and domestic macroeconomic forces on the Western Cape economy

The high degree of openness of the Western Cape economy raises its sensitivity to global economic trends.

As noted above, the outlook for the global economy over the short term is positive, in the absence of unexpected shocks. However, the Western Cape's most important trading partner, the Euro zone, is forecast to continue under-performing. Export growth to this region will therefore depend to a larger extent on new markets being developed.

In this regard, SA's Free Trade Agreement (FTA) with the EU remains an important source of growth, particularly for the agro-processing sector. It is encouraging that the growth outlook for the region has improved in recent months. There are also new export opportunities opening up to the Eastern European states. However, competition from Latin American countries has tightened due to the weak US dollar.

On the other hand, Asia is coming to the fore as a key world economic growth engine, led not only by China, but also by an increasingly upbeat Japan. The Western Cape's iron & steel exports should benefit from this rapidly expanding source of demand. With Asian currencies also on an appreciating trend, price competitiveness vis-à-vis the East should improve. Trade with Asia could therefore present interesting opportunities to local industry over the short to medium term.

The Western Cape economy obviously remains exposed to downside global risks. The high and volatile crude oil price will have both a direct and indirect impact – directly due to

the impact on energy costs and indirectly due to the negative impact on global economic growth and demand of exports.

There is also financial risk involved with the normalisation of interest rate levels in the major industrial countries over the short term. The Province could be affected by the same economic forces that the national economy would suffer in the case of a more hostile external financing environment. The exchange rate and interest rates would be the main channels along which these impacts could be transmitted.

Domestically, the Western Cape economy is well-positioned to continue benefiting from the demand conditions. Retail conditions remain strong and the Province's links with the rest of the country in this respect are robust. While sectors sensitive to interest rate and price changes 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 for lower income earners who are exposed to the escalating transport and energy costs. This will have a disproportionate negative impact on the non-durable goods retail sector.

Fortunately, the non-durable goods retail sector is benefiting from income growth in the lower end of the market on the back of renewed employment growth in the economy, as well as the accelerated social transfer payments from Government. The positive income growth in this market segment could counter the negative impact of higher petrol prices and higher inflation and interest rates over the short term.

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. However, interest rate forecasts remain favourable and the financial reactions are not expected to be destabilising over the short term.

Residential construction activity may begin to taper off, given the high basis established over the past two years (real growth of around 20% a year). The year-on-year increases in property prices are also slowing down but it is not expected that the housing market will decline substantially.

A more competitive currency should bring welcome relief to the embattled Western Cape manufacturers. The BER's 2005 second- and third-quarter business survey evidence revealed a rapid improvement in manufacturing production and sales in response to the weaker tendency in the rand at the time.

The second-quarter improvement in manufacturing value-added was confirmed by Stats SA's release of the national GDP numbers, with nationwide manufacturing GDP growing by more than 7 per cent on an annualised basis. The improvement in manufacturing business conditions continued during the third and fourth quarters.

The beneficial impact of a more competitive currency is almost immediate where import competition is concerned, while the benefit to exports tends to filter through with some time lag. The strengthening of the rand at the end of 2005 and early 2006 again had an adverse impact on the manufacturing sector.

The rand is expected to depreciate should commodity prices decline in 2007 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-2006), expected selling pressure in 2007 is likely to lead to moderate depreciation. This should stimulate the Western Cape's industrial sector, particularly those sub-sectors that have been hard hit by the strong currency. However, a relatively strong rand environment is likely to persist and industry will have to adapt to the new economic parameters.



7. Western Cape economic outlook: 2006/07 – 2008/09

7.1 Economic growth

The short-term economic outlook for the Western Cape remains upbeat, despite the external risks. Nationally, SA should be in a favourable position to weather the impact of higher oil prices and/or other shocks. In the case of externally induced financial volatility, the currency is bound to act as a shock absorber, while the domestic spending cycle is built on sound foundations.

The rand is expected to continue trading at strong levels throughout 2006 and the national inflation outlook has improved, with positive implications for interest rates. While some slowdown in real domestic expenditure is likely in the absence of further interest rate stimulus and when the rand depreciates (in 2007, particularly in durable goods retailing, construction and financial services), such a slowdown is likely to be relatively mild. Furthermore, Western Cape industry should benefit from a more competitive currency.

Table 3: Western Cape economy: real GDP growth, 1999 – 2004 (%)

	1999	2000	2001	2002	2003	2004
Agriculture, forestry & fishing	6,7	-2,3	0,8	7,1	-3,6	1,8
Mining & quarrying	-22,8	7,5	-13,4	-1,5	1,7	1,3
Manufacturing	-0,7	5,7	2,9	1,1	-2,2	5,7
Electricity, gas & water	8,3	2,8	-1,9	2,9	11,3	7,1
Construction	10,5	5,0	-15,8	34,1	0,7	4,5
Wholesale & retail trade	9,8	9,9	5,7	1,3	6,8	9,7
Transport & communication	6,3	7,9	5,8	5,6	7,1	5,2
Financial & business services	6,2	4,0	9,9	5,3	5,9	5,3
CSP services	3,9	4,8	2,2	2,4	4,1	1,4
General government	-2,4	-3,2	-0,5	2,2	1,7	0,8
Western Cape GDP	4,2	4,5	4,2	4,2	3,5	5,3

Source: Stats SA

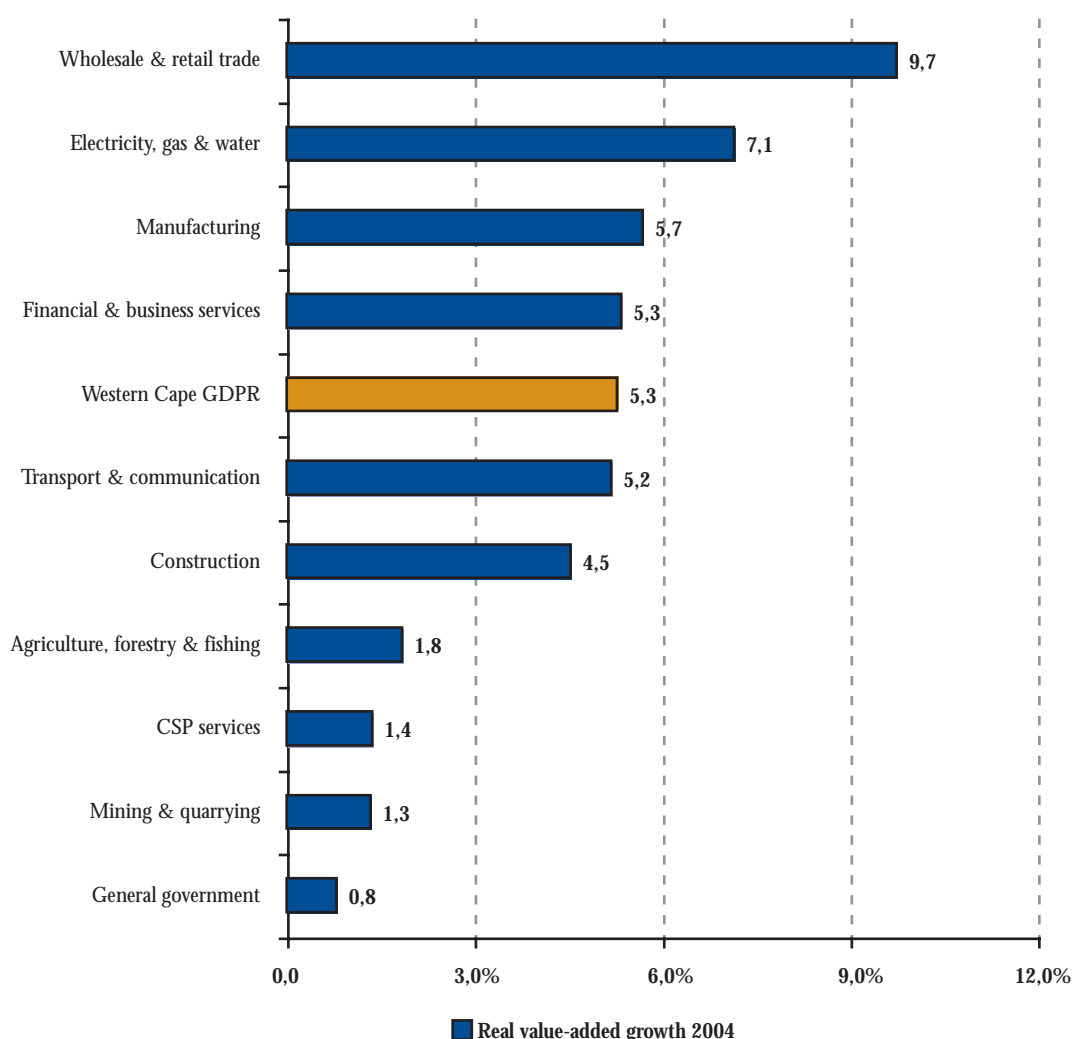
The robust growth in the Province's wholesale & retail trade sector (around 7% a year over the period 1999 to 2004), in construction (6,5%) and the transport & communication sectors (around 6,3%) is expected to continue.

The sustained growth in domestic expenditure and a more stable financial environment should remain conducive to robust growth in excess of 5 per cent a year in the Western Cape's tertiary sectors (excluding government services). The property and financial services sectors are somewhat exposed to the risk of higher interest rates.

The manufacturing and agriculture sectors are expected to recover, the latter if climatic conditions remain favourable. The manufacturing sector did rebound in 2004 following the slump in 2003; however, this recovery petered out again during the second half of 2005 as the rand appreciated. A more competitive currency is key to sustainable recovery in this sector, stimulating growth via import replacement and accelerated exports. Real value-added growth in manufacturing is projected to accelerate to close to 4 per cent over the medium term. However, this estimate is heavily dependent on a good recovery in the export sector.

Both private and public sector agencies in the region have responded to the impact of the strong rand, embarking on marketing initiatives, capital investment and technological upgrading programmes, joint ventures with foreign firms, skills upgrading and improved management practices. These initiatives should enable the Province to regain the growth momentum.

Figure 7: Western Cape real GDP growth by broad sector: 2004



Source: Quantec Research

The Western Cape economic performance is therefore expected to keep up with that of SA over the short term, and may continue to out-perform the national economy on average.

Table 5 shows that real GDP growth is forecast to average 4,8 per cent a year over the period fiscal 2005/06 to 2008/09, slightly higher than the projected national average of 4,4 per cent. Growth is forecast to peak at 5,3 per cent in 2005/06.

Inflation is forecast to average 4,3 per cent over the projection period, in line with the national average. Historically a close correlation exists between the regional and national inflation rates. Similar factors driving national inflation lower over the medium term will impact locally.

7.2 Employment

The Western Cape has the lowest unemployment rate compared to the other provinces. However, unemployment is increasing rapidly due to considerable growth in the labour force compared to the national situation.

The latest available employment data – produced by Quantec Research to fit the LFS employment trend – show that formal sector employment in the Western Cape economy expanded by 3,8 per cent a year on average over the period 1999 to 2004. This is a substantial improvement compared to our previous understanding of formal sector employment growth in the Province³.

Figure 8 highlights the sectoral formal employment trends over 1999 to 2004, according to the revised Quantec dataset. It appears that:

- business services (10,5%);
- CSP services (8%);
- wholesale & retail trade (7,5%);
- transport equipment (6,4%);
- furniture & other manufacturing (6,2%);
- mining & quarrying (6,1%); and
- the metals & machinery sectors (4,4%)

were the largest employment creators, with the employment growth in these sectors being above average.

Other sectors that also contributed significantly to the employment growth include:

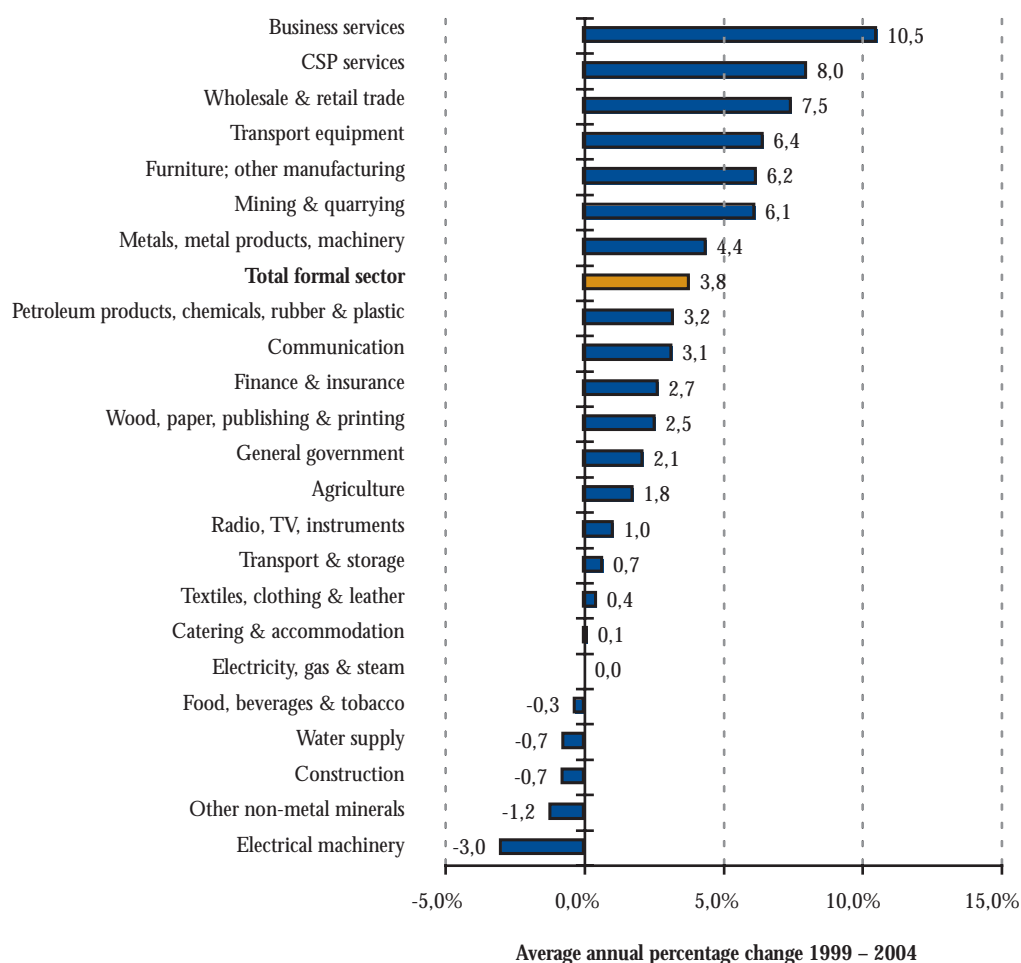
- petroleum products & chemicals (3,2%);
- communication (3,1%);
- finance & insurance (2,7%);
- wood & paper (2,5%);
- general government (2,1%); and
- agriculture (1,8%).

³ These employment growth trends are closer to the LFS data. It was pointed out in the PER&O 2005 that the LFS may overstate the formal sector employment growth in the region. The average formal sector employment elasticity over 1999 to 2004, according to Quantec's revised dataset, is close to 0,9 per cent, which is quite high and suggests relatively labour-intensive growth in the region. This issue may require further investigation.

Sectors that shed jobs over the corresponding period include:

- food, beverages & tobacco (-0,3%);
- water supply (-0,7%);
- construction (0,7%);
- non-metal minerals (-1,2%); and
- electrical machinery (-3%).

Figure 8: Western Cape formal sector employment growth: 1999 – 2004



Source: Quantec Research

The contraction in construction employment is probably a statistical blur; increased sub-contracting and seasonal employment in the sector are probably not reflected in the official statistics. The BER's quarterly building and construction survey in the Western Cape shows strong employment growth in the sector.

The positive tendency in formal sector employment creation is expected to continue, given the upbeat outlook for economic growth in the Western Cape.

However, as noted in the national outlook above, it is critical that Government focuses on implementing key microeconomic reforms, such as lowering the cost of doing business, relieving key infrastructure constraints and skills development to enhance the Western Cape's fixed investment rate and thereby employment creation in the Province.

Employment time series data: circumventing the statistical shortcomings

Any employment estimates in SA 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 has constructed an employment database with sectoral and provincial employment time series data (1970 – 2004) using the following sources:

Regional statistics

- LFS, 2000 – 2004: Stats SA
- October Household Survey/General Household Survey (OHS/GHS), 1995 – 2004: Stats SA
- Population Censuses, 1970 – 2001: Stats SA
- Industry Censuses (various): Stats SA
- EasyData Standardised Provincial Demographic Database, 1970 – 2004: Quantec Research

National statistics

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

Stats SA's OHS (surveyed annually, from 1995 to 1999), the LFS (replacing the OHS and surveyed bi-annually since 2000) and the GHS (replacing the OHS and surveyed annually, from 2002 to 2004) are household-based surveys. The current LFS sample size is approximately 30 000 households (0,3% of all households), but 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 here.

In contrast to the LFS, the SEE is a quarterly, enterprise-based survey covering a sample of approximately 10 200 employers of 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 also revamped during 2002 to cover the service industries comprehensively. The sample for the SEE is designed and drawn from Stats SA's re-engineered Business Sample Frame (BSF), which excludes non-value-added tax (VAT) paying businesses (firms with a turnover of less than R300 000 per annum and/or unregistered firms).

Two main shortcomings of the SEE are therefore as follows:

- The SEE's coverage is not comprehensive, as the agricultural and informal sectors are not surveyed. In addition, the coverage of the small, medium and micro enterprise (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).

- 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 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 this chapter relied upon the Quantec Research database.

Source: Quantec Research

7.3 Fixed investment

Western Cape real fixed investment growth has averaged 4,4 per cent a year over 1999 to 2004, slightly faster than the national performance of 3,5 per cent.

Evidence points to fixed investment acceleration, albeit off a low base. The real growth in 2004 is at 8,4 per cent, increasing the Province's ratio of fixed investment to GDP from 16,5 per cent in 2001 to close to 18 per cent in 2005. While not particularly high by international standards (for example, East Asian countries' fixed investment rates typically lie between 25% and 40% of GDP), the recent improvement is likely to be the beginning of a longer term improvement in the Western Cape's fixed investment rate.

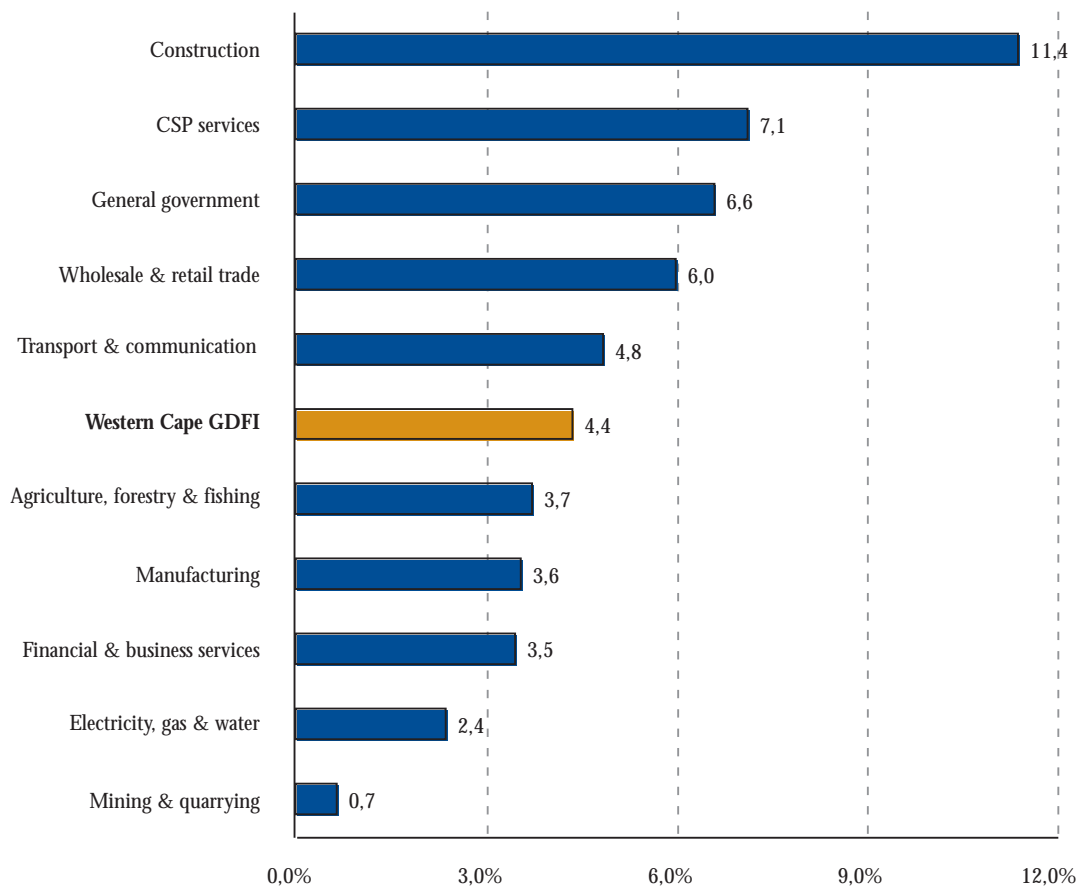
The faster fixed investment tempo is linked to the strong rand (reduced import costs) and the brighter economic outlook. The low interest rate environment is also conducive to accelerated fixed investment spending. Furthermore, business confidence is high, signalling higher fixed investment spending in the Provincial economy.

Figure 9 shows the real growth in fixed investment over the 1999 to 2004 period by broad economic sector. At 11,4 per cent a year, the construction sector showed the highest growth in fixed investment spending. This is followed by the CSP services sector

(7,1%) and general government (6,6%), wholesale & retail trade (6%) and transport & communication (4,8%).

The real growth in fixed investment spending in the manufacturing, agriculture and financial & business services sectors averaged around 3,5 per cent over the corresponding period.

Figure 9: Western Cape average real GDFI⁴ growth: 1999 – 2004



Source: *Quantec Research*

Figure 10 shows that the sectoral picture changes somewhat when the contribution of each sector to regional fixed investment spending is taken into account. In weighted terms, at 24,4 per cent of the cumulative growth, the financial & business services sector made the strongest contribution to fixed investment growth over the past five years. Manufacturing and government sectors followed, each contributing slightly more than 17 per cent of the cumulative growth. Transport & communication (15,7%), wholesale & retail trade (10,5%) and construction (close to 6%) also made substantial contributions.

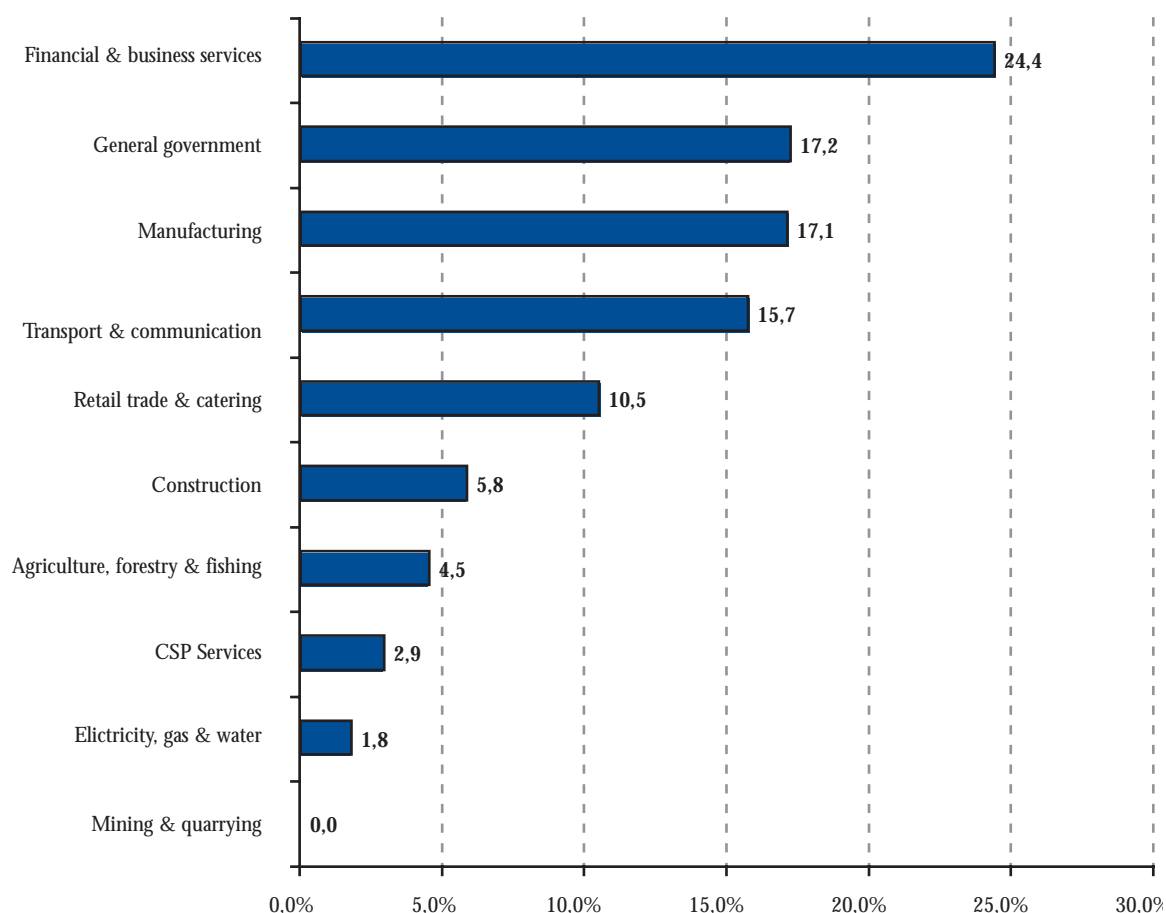
⁴ Gross domestic fixed investment

Looking ahead, the medium-term outlook for regional fixed investment spending is rosy. Projections estimate that the Western Cape's real fixed investment rate will grow by 9,1 per cent a year over the forecast period, more or less equivalent to the anticipated fixed investment growth nationally.

While private fixed investment spending is at risk of slowing over the short term, this is likely to be compensated for by public sector fixed investment spending. Aggregate fixed investment spending is projected to accelerate to 9,5 per cent in 2006 and 2007. This is strong growth and extends the favourable performance over the past three years.

Should this fixed investment growth materialise, the Western Cape's fixed investment rate could pick up further to 20 per cent of GDP. Such a fixed investment environment should be conducive to Provincial employment creation and accelerated economic growth.

Figure 10: Sectoral contribution to cumulative Western Cape real GDFI growth, 1999 – 2004



Source: Quantec Research

7.4 Exports

Table 4 shows that Western Cape exports performed strongly over the four-year period 1999 to 2002, growing by 9,4 per cent a year in real terms. However, export performance slowed sharply during 2003 (growing by a mild 1,5%) and then in 2004 contracted by close to 5 per cent due to the impact of rand strength.

Table 4: Western Cape real export growth, 1999 – 2004 (%)

	1999	2000	2001	2002	2003	2004
Agriculture, forestry & fishing	45,3	-8,0	-3,6	25,3	37,5	3,8
Mining & quarrying	67,8	41,0	47,5	31,6	-37,5	38,1
Manufacturing	-1,4	18,5	0,8	7,7	-4,7	-12,6
Wholesale & retail trade	0,8	6,5	10,0	12,0	13,2	11,8
Transport & communication	4,1	9,7	5,8	9,1	18,4	-14,0
Financial & business services	-0,9	-8,0	18,0	7,3	12,4	-26,8
CSP services	16,8	13,5	4,2	11,6	15,9	-6,7
Western Cape total exports	7,1	11,9	5,9	12,6	1,5	-4,8

Source: Quantec Research

The contraction of export growth during 2003 and 2004 is particularly evident in the manufacturing sector. Real exports of this sector contracted by 4,7 per cent and 12,6 per cent respectively during 2003 and 2004. Transport & communication, financial & business services and CSP service exports also contracted sharply during 2004.

The Province's established exports (ranging from fruit and processed foods & beverages, iron & steel and fish to electrical machinery) have performed well, even in the face of the stronger rand. The Western Cape's top 10 exports grew by close to 5 per cent in real terms over the period 2002 to 2004, that is, at the time of the rand's appreciation. However, the Province's volume of 'non-core' exports declined over the period 2002 to 2004. In 2002, 'non-core' exports contributed close to 30 per cent of total exports. In 2004 this contribution was down to 20 per cent.

It is possible that the weaker rand in the period before 2002 assisted many of these exporters in entering the world markets and that they now find the going tough in a strong rand environment.

Figure 11 shows that more than 50 per cent of the Western Cape's exports are generated in the agricultural, mining, food & beverage, wholesale & retail trade and metals & machinery sectors.⁵

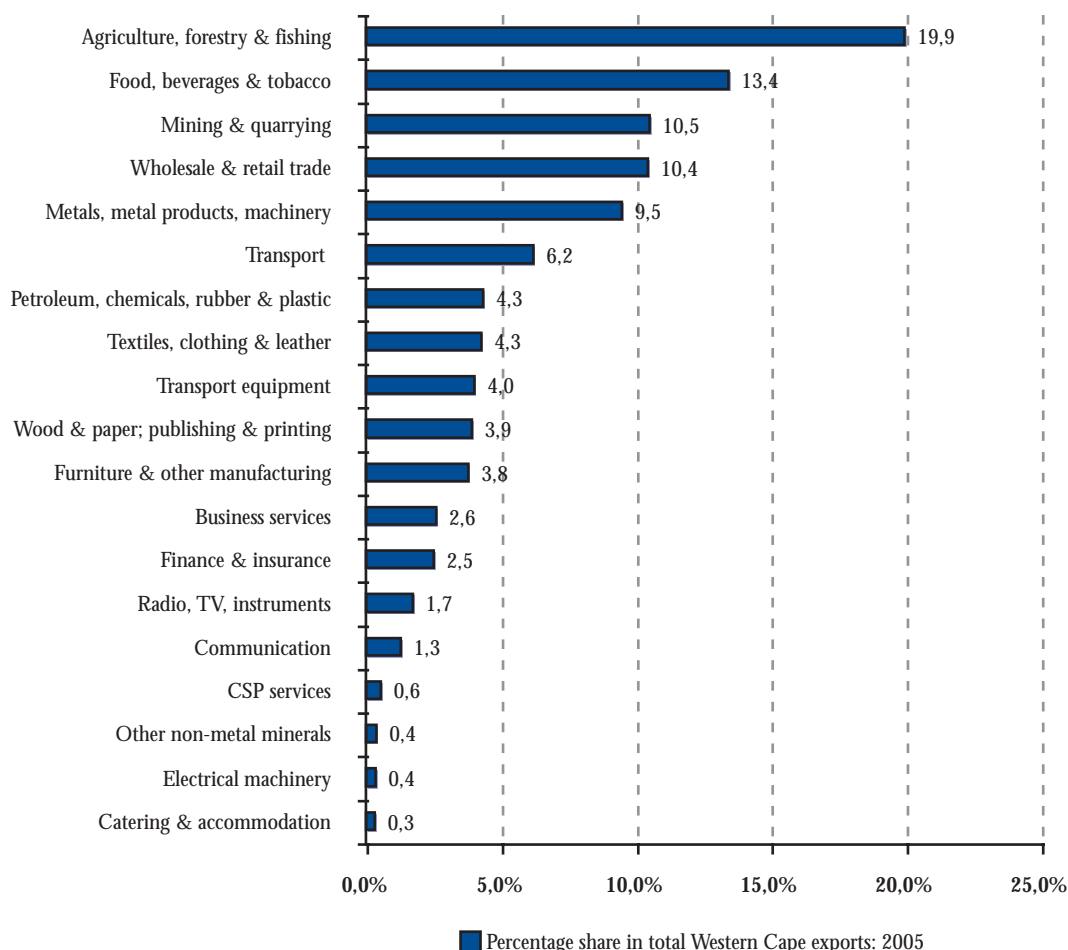
While the general prospects for the Province's main exports remain favourable, third-country competition in the European market has intensified due to US dollar weakness.

⁵ Western Cape exports are classified here according to the Standard Industrial Classification (SIC), which is different from a commodity classification (as used, for example, in chapter 4).

The Western Cape's agricultural and processed food exports are particularly exposed to this competition. In fact, contraction of food & beverage export volumes in 2003 and 2004 suggests the price elasticity of Western Cape agro-processing exports to Europe may be on the increase.

Overall, the medium-term outlook for the Western Cape's agro-industrial and base metal exports is favourable. However, a broader recovery in manufacturing exports could be influenced strongly by the direction of the rand exchange rate. Global demand conditions are relatively favourable and Western Cape manufacturers that have succeeded to maintain a foothold in the export market should be able to benefit from a more competitive currency.

Figure 11: Composition of Western Cape exports: 2005



Source: Quantec Research

Table 5: Outlook for the Western Cape economy: 2006/07 – 2008/09¹ (%)

	Average '99-'04	2004/05	2005/06 (forecast)	2006/07 (forecast)	2007/08 (forecast)	2008/09 (forecast)
GDPR (Rbn; current prices):	–	186,3	205,3	225,1	247,6	271,5
Real GDPR % growth	4,1	5,3	5,3	4,7	4,5	4,8
Real GDFI % growth	4,4	7,8	8,6	9,3	9,5	9,5
GDPR deflator	6,8	4,5	4,1	4,2	5,4	4,6
CPI inflation	5,5	3,4	3,8	3,5	5,2	4,6
GDPR by sector (real % change):						
Agriculture, forestry & fishing	1,7	3,6	7,4	2,3	1,0	0,8
Mining & quarrying	-4,5	1,6	2,5	2,4	0,9	1,1
Manufacturing	2,1	5,1	3,5	4,1	3,4	3,8
Electricity, gas & water	5,1	6,9	6,1	6,0	5,1	5,0
Construction	6,5	5,8	8,8	7,3	8,2	8,6
Wholesale & retail trade	7,2	9,2	7,0	5,0	4,6	5,3
Transport & communication	6,3	5,4	6,2	6,0	5,8	6,2
Financial & business services	6,1	5,2	4,9	4,7	4,9	5,2
CSP services	3,1	1,8	3,3	3,6	3,5	3,6
General government	-0,2	1,7	4,4	4,0	3,9	3,6
Western Cape GDPR	4,3	5,3	5,3	4,7	4,5	4,8

Source: BER

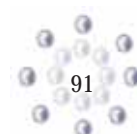
Note: ¹ Fiscal years ending 31 March

8. Conclusion

The SA economy is currently experiencing an unprecedented upswing phase of the business cycle, and the Western Cape economy shares in this revival. While some external risks cloud the horizon, the domestic economic upswing exhibits sound structural characteristics and has the potential to be sustained and to weather any unexpected external shocks.

The growth outlook is favourable, there is some projected exchange rate depreciation over the medium term, and inflation and interest rates are settling in at sustainable lower levels. Private business is adapting to these new economic parameters.

However, it is imperative that the required microeconomic reforms are implemented to capitalise on the golden opportunity presented by the historic economic upswing and elevate the region's economic growth and employment creation performance even higher.



Glossary of terms

- **Balance of Payments (BoP)**

The BoP is a measure of the payments that flow into and out from a particular country from and to other countries. It is determined by a country's exports and imports of goods, services and financial capital, as well as financial transfers. If more money flows into a country than out, that country has a positive BoP; if, on the other hand, more money flows out than in, the BoP is negative.

- **Business cycle**

The business cycle refers to shifts over time between periods of relatively rapid growth in output (recovery and prosperity) and periods of relative stagnation or decline (contraction or recession).

- **Commodities**

Commodities are articles of trade or commerce – especially an agricultural or mining product – that can be processed and resold.

- **Consumer Price Index (CPI) and CPIX**

The CPI, or retail price index, is a statistical measure of a weighted average of prices of a specified set of goods and services purchased by wage earners in urban areas. It is a price index which tracks the prices of a specified set of consumer goods and services, providing a measure of inflation. The CPI is a fixed quantity-price index and a sort of cost-of-living index. The CPIX is the CPI excluding mortgage interest rates.

- **Economic sectors**

In economics, economic activity is often categorised into sectors, in a variety of schemes – private sector versus public sector, service sector versus manufacturing sector, or primary/secondary/tertiary sector.

The primary sector generally involves the conversion of natural resources into primary products. Most products from this sector are considered raw materials for other industries. Major businesses in this sector include agriculture, agribusiness, fishing, forestry and all mining and quarrying industries. Downstream manufacturing industries that aggregate, pack, package, purify or process the raw materials close to the primary producers are normally considered part of this sector, especially if the raw material is unsuitable for sale or difficult to transport long distances.

The secondary, or manufacturing, sector of industry generally takes the output of the primary sector and manufactures finished goods or products to a point where they are suitable for use by other businesses, for export, or sale to domestic consumers. This sector is often divided into light industry and heavy industry. Many of these industries consume large quantities of energy and require factories and machinery to

convert the raw materials into goods and products. They also produce waste materials and waste heat that may pose environmental problems or cause pollution. Divisions of this sector include automobile manufacturing; chemical industry; engineering; energy industries, including the production of petroleum, gas and electric power; steel production; telecommunications; metalworking and the clothing industry.

The tertiary sector involves the provision of services to other businesses as well as final consumers. Services may involve the transport, distribution and sale of goods from a producer to a consumer as in wholesale & retail trade, or the provision of a service, such as in tourism, banking and health care. For the last 20 years there has been a substantial shift from the primary and secondary industry sectors to the tertiary sector in industrialised countries. Public utilities are often considered part of the tertiary sector as they provide services to people, while creating the utility's infrastructure is often considered part of the secondary sector, even though the same business may be involved in both aspects of the operation.

- **Euroland**

'Euroland' is the informal shorthand term for the group of 11 members of the European Union (EU) who have decided to adopt a single currency from the beginning of 1999. It differentiates these countries from the other members of the Union, such as the UK, which are not joining.

- **Fixed investment**

Fixed investment refers to an increase in the amounts of real capital goods (real means of production) used in production or to replace depreciated capital goods. Fixed investment therefore increases the number of factories, machines, tools, housing, office buildings and other structures available – or deal with the effects of wear and tear, natural destruction and the like.

- **Foreign direct investment (FDI)**

FDI is the movement of capital across national frontiers in a manner that grants the investor control over the acquired asset. Thus it is distinct from portfolio investment which may cross borders, but does not offer such control. Control is defined as owning 10% or greater of the ordinary shares of an incorporated firm, having 10% or more of the voting power for an unincorporated firm or development of a greenfield branch plant that is a permanent establishment of the originating firm.

- **Gross domestic expenditure (GDE)**

GDE is the total value of spending on goods and services within a country.

- **Gross domestic product (GDP)**

GDP estimates the value of goods and services produced in a specific period and used to measure the performance of the economy as a whole, as well as that of different industries in the economy. $GDP = \text{consumption} + \text{investment} + \text{exports} - \text{imports}$

The regional gross domestic product (GDPR) is the total value of final goods and services produced within a particular region, for example, the Western Cape.

- **Gross geographic product (GGP)**

The GGP of a particular area amounts to the total income or payment received by the production factors (land, labour, capital, and entrepreneurship) for their participation in the production within that area.

- **Purchasing Managers Index**

The PMI is an indicator of the economic health of the manufacturing sector. The index is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment.

- **Producer Price Index (PPI)**

The PPI measures the average change over time in the selling prices received by domestic producers for their output.

- **Real versus nominal value**

Nominal value is the value of anything expressed in money of the day, versus real value, which removes the effect of inflation. Nominal numbers, such as nominal wages, interest rates and GDP, refer to amounts that are paid or earned in money terms. Nominal GDP refers to the amount of money spent to buy the production of a country.

Real numbers – real wages, interest rates, and GDP – are corrected for the effects of inflation. They indicate the value of these numbers in terms of the purchasing power of wages, interest, or total production; that is, they try to estimate how many goods and services a wage, an interest payment, or total domestic income will buy.

- **Trend growth**

Trend growth refers to the smooth path of long-run output growth.