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

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

Global economy

- Global growth became broader based during 2005 as sustainable recoveries took root in the lagging Euro area economies and Japan. Even though risks prevail, the economic outlook for the USA remains relatively benign. The robust growth in China, India and other developing economies of the world continues. Global growth is expected to maintain an above trend growth tempo in 2006, i.e. slightly faster than during 2005. Global interest rate levels are gradually drifting higher and the escalating oil and industrial commodity prices are driving inflation higher.
- A fair degree of uncertainty remains on how the US economic imbalances will be resolved, regarding crude oil prices and geopolitical tensions (e.g. the Iranian nuclear crisis). Apart from inflation concerns and supply constraints, these risks probably explain the historically high precious metal prices.

South African economy

- During 2005 the South African economy recorded the strongest growth in 25 years, i.e. close to 5%. Furthermore, the economy is experiencing the longest business cycle upswing on record (79 months old). It is no coincidence that both business and consumer confidence levels are at historical highs. This bodes well for consumer spending and fixed investment spending (the latter being bolstered by a concerted public sector capex drive) over the short to medium term. Important risks lurk on the international terrain and the SA current account deficit is uncomfortably high. Should these forces not become destabilising in any big way, the short-term economic outlook remains decidedly upbeat.
- General inflation expectations firmly adjusted to around the mid-level of the government's 3-6% target range and trend inflation is also poised at this level. This augurs well for inflation and short-term interest rates down the line. The actual domestic rate of inflation has continued to surprise on the low side, coming in below 4% in 2005 and March 2006. Rand strength has countered the inflationary pressures caused by the high level of the international crude oil price.
- Oil price volatility remains an obvious risk to the outlook for inflation. In the absence of unforeseen shocks, the stable interest rate pattern is expected to continue over the short term. The rand exchange rate is likely to continue benefiting from the strong global commodity cycle; however, it remains at risk of some adjustment as global interest rate levels and international risk aversion levels normalise and due to the rising local current account deficit (4.5% of GDP, 2005Q4; and projected at 4.9% in 2007).
- Real GDP growth slowed down during the second half of 2005, from 5.4% (quarterly annualised) in the second quarter to 4.2% in the third and 3.3% in the fourth quarter. However, a closer inspection of the sectoral growth pattern shows that this slowdown was limited to the mining and manufacturing sectors, which both contracted towards the end of the year. Excluding these two sectors, aggregate real GDP continued to expand at a 5% rate during the fourth quarter. Furthermore, special factors contributed to the contraction of mining and manufacturing GDP during the final quarter of 2005. The latest Investec PMI readings also point to a revival in the manufacturing sector (March/April). Mining should also recover given above-trend global growth and sustained strong commodity prices.

- The sustained economic momentum is confirmed by the expenditure statistics; real final demand accelerated to a quarterly annualised growth rate of 8.4% during 2005Q4. The strong momentum in household spending is led by the durable and semi-durable goods markets. These markets have been the prime beneficiaries of accelerated consumer spending, posting double-digit real growth on average over the past six years. The durable goods boom is also supported by the increased buying power of the upwardly mobile and asset-accumulating black middle class.
- Renewed employment creation, social transfer payments and infrastructure development is also benefiting consumer spending. A notable feature in this regard is the acceleration in the real growth of household spending on non-durable goods, posting a 5% growth rate last year (up from 1% per annum during the 1990s/early 2000s). On the other hand, the growth of household spending on services is normalising following the above-average growth witnessed during the second half of the 1990s.
- Accelerated fixed investment spending should compensate for slowing household spending over the short term. Excluding mining investment, private fixed investment grew by close to 14% in 2005. The government's infrastructure spending plans (valued at R372 billion over the next three to five years) have also kicked in being led by Eskom and Transnet's efforts to upgrade SA's electricity and transport grids. Both public and private sector fixed investment are expected to be robust going forward.
- We have upgraded our forecast for the South African economy; the revised national GDP figures reveal a faster growing economy compared to what was thought before. The global situation is also looking a bit stronger, albeit that nagging imbalances and geopolitical tensions generate a fair amount of risk.
- While GDE growth is expected to moderate somewhat, the tempo could remain above 5% per annum over the 2006-08 period. Due to a negative contribution from net exports (in turn due to rising import penetration), real GDP growth is projected to come in at 4.5% this year, decelerate to 4.2% next year and revive again to 4.6% in 2008 – *see Table 1 below for more detailed macro economic forecasts.*

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

	Ave 2000-05	**2005**	**2006F**	**2007F**	**2008F**
Expenditure on GDP (real % change):					
Household consumption	3.7	6.1	5.7	3.9	3.3
Fixed investment	3.7	9.4	7.9	7.9	9.2
Gross domestic expenditure (GDE)	**3.6**	**6.3**	**4.4**	**4.6**	**4.4**
Exports	2.3	2.9	6.0	6.1	5.5
Gross Domestic Product (GDP)	**3.2**	**3.7**	**4.3**	**4.1**	**3.9**
Inflation, interest & exchange rates					
CPIX inflation	6.9%	4.3	4.1	5.0	4.7
PPI inflation	6.7%	0.7	3.1	5.2	4.9
Prime overdraft interest rate (eop)	14.71%	11.00	10.50	11.50	10.50
R/$ exchange rate (eop)	7.70	5.66	6.60	7.15	7.70
R/euro exchange rate (eop)	7.85	7.53	7.85	8.94	9.39

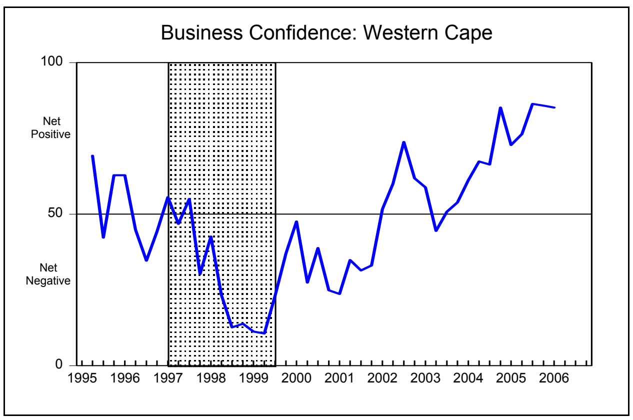
Source: Bureau for Economic Research

Western Cape economy

- According to the revised GDPR statistics, Western Cape real GDP growth was 5.3% for calendar 2004 (compared to 4.5% for South Africa) and current estimates show that this growth tempo was sustained in 2005. The available information regarding the first quarter of 2006 do not indicate any sign of a slowdown yet. In this regard the Western Cape economy mirrors the favourable economic picture reflected by the national economic indicators; in fact, regional economic growth is likely to continue exceeding national real GDP growth consistent with the historical trend.

- The fact that the Western Cape economy registered an estimated 5.3% growth rate during 2004/5 amidst a number of headwinds in agriculture and manufacturing is testimony to the strong performances put in by the construction, retail & wholesale, financial & business services (including property development & real estate) and transport & communication sectors. These sectors benefit from the strong currency environment and account for the bulk of the growth in the Western Cape economy.

Figure 1: Western Cape business confidence index



Source: Bureau for Economic Research

- Western Cape business confidence recovered strongly during second half of last year after lagging the other major provinces. Confidence remained on this high level during the first quarter of 2006, with 85% of the Western Cape executives responding to the BER business surveys being satisfied with the general business conditions. Retail sales slowed somewhat, but retail confidence remained at a high level with 90% of the retail respondents reporting satisfactory sales. Likewise the business situation in the construction and financial services sectors remain poised at historically high levels.

- Manufacturing activity remained under pressure, which corresponded with the rest of the national economy. However, the March/April Investec PMI readings point to some improvement driven by the buoyant domestic demand conditions; the year-on-year declines in export volumes continue.

- 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. The jury is also still out on how the huge USA current account deficit (and surpluses in other regions) will adjust over the short- to medium term. The regional economy could be affected by the same economic forces than 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.

- The Western Cape economy is well-positioned to continue benefiting from the lively demand conditions in the national economy. The outlook for the booming construction, property and financial services sectors also remain positive, even though these sectors are exposed to interest rate hikes if they do occur. These sectors have performed strongly in recent years and have reached peak levels; some slowdown could be in store in the absence of further interest rate cuts. However, financial developments are not expected to be destabilising over the short term.

- A weakening of the US dollar and persisting strong commodity prices are expected to sustain rand strength for the remainder of 2006, which should continue to constrain the region's manufacturing growth. Headway against import competition in the lively domestic market may, however, continue to feed an improvement in production and hopefully employment creation; unfortunately the 2006Q1 BER business survey results continue to point to retrenchments in the region's manufacturing sector.

- *Regional real GDP growth is estimated at 5.3% during 2005/6, but is projected to slow to 4.5% in 2007/8 before recovering again to 4.8% in 2008/9.* The robust growth rates in the region's tertiary sectors are expected to continue, albeit slowing somewhat; while manufacturing should recover on the assumption of above-trend global growth and a more competitive currency next year. The agricultural sector also stands to benefit from a more normal rainfall pattern over the short term.

Table 2: Outlook for the Western Cape economy: 2005/6 to 2008/9[1]

	Ave 1999-2004	**2004/5**	**2005/6e**	**2006/7F**	**2007/8F**	**2008/9F**
GDPR by sector (real yoy%):						
Agric, forestry & fishing	1.7	3.6	7.4	2.3	1.0	0.8
Mining and 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 and 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
Retail trade & catering	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**

1. Fiscal years ending 31 March

Source: Provincial Economic Review & Outlook, 2006

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