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Economic Outlook: 2007/08 – 2009/10

Key findings:

- Economic growth in the SA and the Western Cape economies continues to be buoyant, underpinned by robust global growth.
- SA experienced real GDP growth of about 5,0 per cent a year between 2004 and 2006.
- Western Cape economy registered even higher growth at 6 per cent a year during 2004 and 2005, and estimated at 5,5 per cent during 2006.
- It is expected that the real economy will experience some slowdown during 2007/08. The anticipated slowdown of the economy may be mild; however, the composition of that growth may change more significantly.
- The robust regional growth continued to be driven by the services industries (outside of government) and construction.
- Evidence points to the manufacturing sector underperforming, with results below anticipated levels.
- Higher inflation and interest rates are likely to cool down the household spending momentum in the national economy.

- Regional business confidence recovered during the fourth quarter of 2006 and the first quarter of 2007. Business and consumer confidence remained poised at elevated levels during the early part of 2007 suggesting the robust economic growth could continue.

- Broad fixed investment intentions remain strong, with the public sector infrastructure investment drive taking off, unlikely to be affected by interest rates.

- The acceleration of economic growth to a higher level is exerting pressure on production capacities. Serious skilled labour constraints, production capacity constraints and infrastructure bottlenecks are developing, constraining the economy to elevate growth further.

- There are some leading indications of the impact of higher interest rates on the consumer sector – the growth in household credit extension has turned the corner and new vehicle sales growth contracted towards the end of 2006 and early 2007.

- Higher global interest rates are likely to cause tighter global liquidity conditions and higher risk aversion amongst international investors, affecting capital flows to developing countries.

- Both fixed investment spending and household consumption expenditure accelerated strongly. The latter has been driven by the acceleration in employment creation in recent years.

1. Introduction

The AsgiSA has as its primary thrust moving the SA economy onto a significantly higher growth trajectory of 6 to 8 per cent by 2014. A higher broad-based growth path is critical for the creation of sufficient jobs, enhancing economic participation and inclusion over the medium to long term.

The Western Cape shares this vision and strategic objective, encapsulated in the higher and shared growth thrust of *iKapa Elihlumayo*. The latter aims to shift the Western Cape economic growth to the 6 to 8 per cent level over the next five years.

Recent trends evidence the feasibility of such objective. Both the national and the regional economies experienced robust growth over recent years. Revised national account statistics show that between 2004 and 2006 real GDP growth averaged around 5 per cent a year and the growth momentum remained at 5 per cent during the second half of 2006. The Western Cape economy registered even higher growth according to the revised statistics averaging 6 per cent a year during calendar years 2004 and 2005, and estimated at 5,5 per cent during 2006.

Economic growth in the region and the wider SA economy benefits from robust growth in the world economy. In fact, compared to the economic growth rates achieved in SA's peers, SA's current 5 per cent growth tempo continues to lag and needs to be elevated further, which will require that key growth constraints be alleviated through proper policy and other interventions.

Suffice to say, that the economic outlook in the region and the wider SA economy is looking more promising compared to any stage in the past 30 to 40 years. The growth acceleration has structural foundations and the potential to be sustained.

The available evidence shows that the robust regional growth continued to be driven by the services industries (outside of government) and construction. Regional manufacturing growth came in at an estimated and relatively disappointing 3,7 per cent in 2006 and the sector suffered a sharp decline in confidence contrary to the situation in the rest of the country.

The financial environment changed in a short space of time following developments on the global financial markets in May and June 2006, the rand's depreciation since that time and the subsequent increase in inflation and interest rates.

The domestic real economic growth performance has proved to be remarkably resilient in the face of the increase in inflation and interest rates. Interest rates increased by a cumulative 200 basis points between June and December 2006, and the depreciation of the currency and high food and oil prices caused acceleration in inflation. The rand's depreciation was capped as international investors' risk appetite recovered towards the end of 2006.

It is still expected that the real economy will experience some slowdown during 2007 and 2008. The interest rate sensitive sectors – retail, construction and financial services – could in particular witness less vigorous growth. Manufacturing, on the other hand is benefiting from the more competitive currency. Broad fixed investment intentions also remain strong, with the public sector infrastructure investment drive taking off unlikely to be affected by interest rates. The anticipated slowdown of the economy may be mild; however, the composition of growth may change more significantly.

Higher inflation and interest rates are likely to cool down the 7 per cent household spending momentum in the economy, closer to 5 to 4,5 per cent but with the noted counterbalancing factors ensuring that national economic growth is sustained around a 5 per cent level.

The Western Cape economy business cycle broadly tracks that of the national economy. Therefore, the same factors currently affecting the national macro-economic climate will impact locally. The depreciation of the rand exchange rate and the increase in inflation and interest rates will impact both on the sectoral composition and level of growth in the Western Cape.

This having been said, the region suffered an unexpected decline in business confidence during the second and third quarters of 2006 to levels well below that in Gauteng, KwaZulu-Natal and the Eastern Cape where confidence still trended higher.

Regional business confidence recovered during the fourth quarter of 2006 and the first quarter of 2007. However, evidence points to an under performing manufacturing sector (see page 55).

The growth tempo remained exceptionally strong during calendar 2006 in the regional construction sector (estimated at close to 15%) and the services sectors, excluding government (growing by an estimated 6%).

This chapter discusses the short-term outlook for the SA economy (including global economic conditions) and the Western Cape economy. The first section briefly reviews the SA economic outlook. The second section takes a closer look at the regional economic outlook in its consideration of the regional economic linkages and the prospects for growth, employment and exports.

2. Trends in the South African economy

2.1 Recent developments

The SA economy registered a 5 per cent real GDP growth rate in 2006. This was the third consecutive calendar year of around 5 per cent growth. The economy remained remarkably resilient towards the end of the year and early in 2007 in the face of higher interest rates. Both the global and domestic financial markets have also shrugged off the jitters that surfaced in May and June 2006 and late February 2007.

Domestic business and consumer confidence remained poised at elevated levels during the early part of 2007 suggesting the robust economic growth could continue. With robust fixed investment spending across many sectors, employment growth is taking place and this is boosting household financial positions, in turn underpinning household consumption spending.

There are some leading indications of the impact of higher interest rates on the consumer sector – the growth in household credit extension has turned the corner and new vehicle sales growth contracted towards the end of 2006 and early 2007. PPI inflation[1] accelerated to 10 per cent during October/ November 2006 and further to 11,1 per cent in April 2007, reflecting strong pipeline price pressures. The pass through to CPIX inflation has been contained thus far, aided by low inflation expectations. However, CPIX inflation breached the upper 6 per cent boundary of the inflation target in April coming in at 6,3 per cent. After pausing with interest rate hikes in February 2007, the South African Reserve Bank (SARB) resumed tightening in June 2007.

The current account of the balance of payments, recording a deficit measuring 6,4 per cent of GDP during 2006, remains in a somewhat precarious position leaving the rand exchange rate vulnerable. The deficit on the current account continues to be handsomely financed by capital inflows, albeit that these inflows tend to be dominated by portfolio investments. This in turn results in an element of risk regarding the rand exchange rate. Between mid-May and mid-October 2006, the trade-weighted value of the rand exchange rate depreciated by 22 per cent; however the rand recovered back to a level of R7,00/US$.

Real domestic expenditure is projected to slow from an 8,7 per cent increase in 2006 to a 5 per cent pace during 2007, cooling down import growth, which will come under further pressure from the weaker rand exchange rate.

Furthermore, exports are expected to respond positively to the currency adjustment. These tendencies should benefit the current account of the balance of payments and render domestic growth more sustainable.

[1] Inflation at the producer level is measured by the Producer Price Index (PPI). The PPI consists of two components, that is a domestic component capturing producer selling price increases ex factory and an import component capturing the increase in imported prices.

Capacity constraints underpinning fixed investment spending, infrastructure investment and stronger net export growth are likely to be important countervailing forces to the slowdown in the domestic consumer market, ensuring a sustained 4,5 to 5 per cent level of growth in the economy overall.

CPI, CPIX and PPI inflation

The Consumer Price Index (CPI) measures price increases of consumer goods at the retail level. The CPI is compiled by Statistics SA on a monthly basis from a survey of all consumer goods prices. The CPI is therefore a comprehensive measure of the prices of a basket of consumer goods.

The weights of the various components of the index are revised every five years along with changes in consumer spending patterns, that is each component of the index receives a weight equivalent to the share of household spending directed towards the particular item.

For the purpose of monetary policy, the interest cost on mortgages is excluded from the CPI in order to arrive at the CPIX inflation rate. CPIX is therefore also a broad measure of consumer goods inflation; however, mortgage interest cost is excluded as changes in interest rates (due to monetary policy decisions) will reflect directly in CPI.

The objective of monetary policy is to influence inflation levels and maintain the CPIX inflation rate within the 3 to 6 per cent target range. CPIX inflation is targeted as it excludes the direct impact of monetary policy decisions on CPI inflation.

Therefore, in a time of increasing interest rates, CPI inflation will typically be above CPIX inflation; during March 2007, CPI inflation stood at 6,1 per cent compared to CPIX inflation of 5,5 per cent following the 200 basis points increase in interest rates during the second half of 2006. The converse applies during periods of declining interest rates.

The Producer Price Index (PPI) measures price increases at the producer level; the index consists of a domestic production component (80%) and an import component (20%). The domestic component is determined by price increases at the factory gate level while the import component is determined by imported inflation, that is price increases abroad and changes in the exchange rate of the rand.

The PPI inflation rate was measured at 10,3 per cent in March 2007, well above the CPI and CPIX inflation rates. The recent increase in PPI inflation was mainly driven by the impact of the depreciating rand exchange rate (from R6/US$ early May 2006 to levels around R7/US$ currently), the increase in crude oil prices and food price increases (e.g. maize prices).

The current wide gap between CPI and PPI inflation suggests that retailers are absorbing much of the increased cost of goods procured from local producers. CPI inflation is not to the same extent exposed to the rand's depreciation in a direct sense. It is also important to point out that the CPI contains the prices of household services, which are not measured in the PPI.

It is therefore possible that the PPI and CPI inflation rates could differ from time to time. Over the longer term there usually is a good correlation between inflation at the producer and consumer levels.

Economic growth has clearly accelerated to a higher level and this is exerting pressure on production capacities. Serious skilled labour constraints, production capacity constraints and infrastructure bottlenecks are constraining the economy to elevate growth further.

It is the main objective of the AsgiSA initiative to alleviate these constraints and in that way to accelerate the economic growth rate further. While the 5 per cent real economic growth rate achieved over the past three years is encouraging, there is clearly no room for complacency.

2.2 Global economic developments

There is widespread consensus that the world economy is heading for slower growth in 2007. The International Monetary Fund (IMF) expects global growth could ease to a still very strong 4,9 per cent in 2007 from an estimated 5,4 per cent in 2006. While the IMF is forecasting slower growth for the United States (US), Europe and Japan, it is of the opinion that any easing in growth will be mild.

There is a considerable variance of opinion amongst analysts on how sharp the slowdown in the US economy will be. A harder landing in the US economy is likely to lead to a weaker world economic growth environment compared to the IMF projections.

Chinese economic growth continues to surprise on the upside with most analysts believing that the country will continue to grow by 9 to 10 per cent during 2007. Sustained strong growth in China and the fast industrialising developing economies of the world should remain a key support for commodity prices.

The commodity picture is somewhat mixed with some base metal markets in surplus, whilst demand continues to exceed supply in others. Nonetheless, the general tendency in industrial commodity prices is likely to be downward over the short term.

Whilst the US Fed has paused with the tightening of monetary policy, interest rates are expected to increase further in Europe and Japan. Higher global interest rates are likely to cause tighter global liquidity conditions and higher risk aversion amongst international investors, affecting capital flows to developing countries.

2.3 Business cycle prospects

The current expansion of the SA economy is more than seven calendar years old. The durability of the cycle resides in the stabilised macro-economic climate, the (partial) lifting of the balance of payments constraint on economic growth (via the liberalisation of the capital account of the balance of payments) and the gradual and accelerating income growth in the household sector of the economy on the back of improved employment creation (in recent years), low inflation and personal tax relief.

Cumulative growth over the period 1999 to 2002 led to improved demand conditions in the domestic market, which in turn stimulated the private sector to expand investment. Fixed investment spending accelerated strongly from 2003 (at a rate consistently exceeding 9 per cent a year). The expanding fixed investment rate is feeding back to employment creation, supporting the growth in household consumption spending.

Consumption spending momentum has furthermore been boosted by healthy household credit utilisation on the back of lower interest rates. The latter trend during 2003 to 2005 contributed to capping the country's debt service costs. The lower inflation environment is helping to make higher household indebtedness more sustainable[2].

Unfortunately the downside of the current expansion, particularly the period since 2002, is the poor export growth noted above, in turn related to the strong rand exchange rate and regulatory and infrastructure constraints in the mining sector. This has contributed to a sizeable current account deficit (6,4% of GDP in 2006).

The current economic expansion can be divided into two phases: the first phase, stretching from the third quarter in 1999 to 2002 and 2003 was characterised by moderate real GDP growth measuring 3,2 per cent a year. A key characteristic of this phase has been the poor formal sector employment record. This period was burdened by restrictive fiscal policy (implemented since 1996), rationalisation in the private sector as companies confronted the impact of trade liberalisation and globalisation pressures; and, finally, financial volatility in 2001 and 2002 (including a 400 basis point hike in domestic interest rates). However, the weaker rand exchange rate stimulated manufacturing exports and compressed imports (which were already restricted by the subdued growth in real domestic expenditure).

The moderate growth in real domestic expenditure over the first phase of the business cycle upswing should not be seen as a sign of economic weakness, but rather the impact of structural adjustment. The cumulative, steady growth introduced change, best reflected in an unrelenting increase in business confidence levels. In fact, the domestic economic resilience in the wake of the 2000 and 2001 global economic recession and the sustained increase in domestic business confidence suggested a newfound robustness in SA's economic growth performance.

The typical business cycle pressure points were largely absent. That is, the current account of the balance of payments registered a surplus three years into the upswing (2002) and apart from the currency-induced (temporary) supply shock in 2002, inflation pressures were non-existent.

The track record since 2003 speaks for itself. During the 'second phase' of the expansion, real GDP growth accelerated notably to 4,5 per cent a year on average and reached 5 per cent on average in the period 2004 to 2006. Both fixed investment spending and household consumption expenditure accelerated strongly as noted above. Key was the acceleration in employment creation delivering the back bone of the growth in household consumption.

[2] The household debt ratio increased from below 50 per cent at the end of 2002 to 73,8 per cent during the fourth quarter of 2006; however, the household debt service ratio has only increased to its long-term average of 9 per cent.

Credit utilisation also accelerated notably, driven by historically high consumer confidence on the back of deep interest rate cuts and low inflation. The financial impact of the strong inflows on the capital account of the balance of payments, driving a strong rand exchange rate and lower inflation has to be acknowledged in this regard.

However, this was not the primary driver of the growth. The roots of the expansion lay further back and acquired a sustainable momentum even in the face of the 2000 and 2001 global recession and domestic hike in interest rates in 2002.

The financial stimulus embodied in the strong capital inflows on the balance of payments upped the growth tempo. In the process, the current expansion became more typical for SA. That is, strong growth in real domestic spending, with a notable credit component, deteriorating net exports and current account and building inflationary pressure. The current account pressures were on the one hand relieved by the steady improvement in the terms of trade, but on the other hand exacerbated by a poor export performance (in turn related to the strong rand exchange rate and other factors noted above).

The economy is therefore currently facing some typical business cycle pressures. Inflation has accelerated, the current account deficit (measured at the fourth quarter of 2006) is uncomfortably high at around 7 per cent of GDP and capacity utilisation pressures are evident across many sectors of the economy. The increase in inflation appears to be under control and the 200 basis points interest rate hike during the second half of 2006 should assist in this regard.

The current account deficit is appropriately financed through healthy capital inflows and prospects in this regard remain optimistic, albeit that the quantum of the portfolio investment component of these inflows is cause for alert.

Finally, production capacity utilisation — in manufacturing, construction and the utilities — are at record highs, but fixed investment in all these areas is expanding to address capacity constraints.

All this evidence suggests a maturing business cycle upswing. Fortunately the macro-economic parameters are such that economic growth may be sustained. Following the interest rate hikes of last year, the economy is probably heading for some slowdown in 2007. It is important that economic growth becomes better balanced in terms of a reduced impetus from the consumer boom combined with a recovery in net exports.

SA's fixed investment rate (that is, the ratio of fixed investment to GDP) has picked up from below 15 per cent at the end of 1999 close to 20 per cent by the end of 2006. This is still below that achieved in other developing economies (e.g. East Asia) and explains the lagging domestic real economic growth rate.

In order to elevate SA's growth rate further the fixed investment rate needs to increase closer to 25 per cent; however, it will be critical to improve the national savings effort — national savings only measured 13,9 per cent of GDP in 2006. Some attention was accorded to savings in the 2007/08 national budget.

2.4 Towards more balanced domestic economic growth

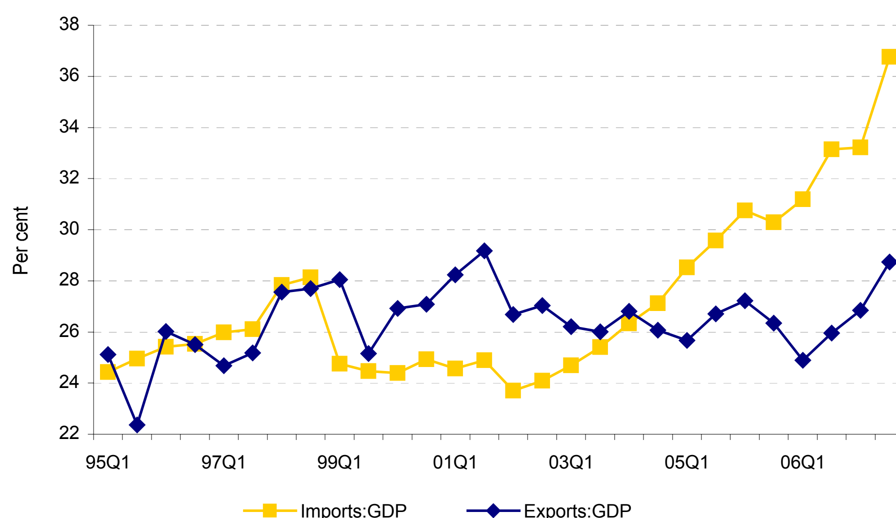
The deficit on the current account of the balance of payments widened to 7,8 per cent of GDP during the fourth quarter of 2006, exacerbated by strong oil imports. It may not be so obvious that this level of the current account deficit is not sustainable provided the strong capital inflows that SA has been attracting in recent years, adequately financing the deficit. However, considering the trends in the export and import ratios, it is immediately evident that the large current account deficit is mainly due to an adverse trade performance and not sustainable.

The ratio of real exports to GDP declined by four percentage points (from 29 to 25%) between mid-2001 to mid-2006, while the ratio of imports to GDP increased by no less than nine percentage points (from 24 to 33%) over the corresponding period. This reflects a poor export performance particularly in view of the fact that the global economy experienced an upswing phase over this period (2002 to 2006), real export growth averaged 3,3 per cent a year and domestic import penetration skyrocketed over this period.

The strong rand exchange rate over the period 2003 to the first half of 2006 added fuel to the domestic spending boom (indirectly via lower inflation and interest rates) and import demand, whilst at the same time constraining the export effort, particularly in manufacturing.

Furthermore, infrastructure constraints and regulatory uncertainties, which impacted negatively on mining fixed investment spending, constrained SA's export growth, preventing the mining sector from fully participating in the global commodities boom in recent years.

Figure 1: Imports and exports as a ratio of GDP



Source: SA Reserve Bank

The rand's recent depreciation should be welcomed. While it will impact negatively on the favourable pricing environment of recent years, this impact could be manageable given the monetary policy credibility of the SARB and hopefully a contained reaction in domestic inflation expectations.

The latest available evidence supports this view. The current account of the balance of payments should improve as import demand cools down (on the back of higher import costs and slower domestic spending) and exports recover.

In fact the recovery in net exports (that is, exports minus imports) can to a large extent compensate for the projected slowdown in the interest rate sensitive components of real domestic spending. Therefore, while the composition of domestic economic growth may change, the level of growth could remain robust and better balanced.

Inflation targeting

SA adopted inflation targeting as its formal monetary policy framework in February 2000, after a range of industrial and developing countries adopted inflation targeting monetary policies during the 1990s (e.g. New Zealand, Australia, Brazil, Canada, Chile, Mexico, Sweden and the United Kingdom).

Before that, the SARB followed an essentially eclectic approach of 'informal inflation targeting' relying very much on the monetary aggregates as the anchor for policy decisions. However, much uncertainty arose as structural changes in the economy rendered the monetary aggregates inappropriate guides for monetary policy making.

Inflation targeting was then adopted, *firstly*, to improve the transparency of monetary policy decision making; *secondly*, to improve the co-ordination between the various economic policy departments in the pursuit of higher economic growth and lower unemployment; *thirdly*, to increase the accountability of the SARB; and, *finally*, to influence the level of inflation expectations as a means to reduce actual inflation in SA (Van der Merwe, July 2004: 1-2).

The latter-mentioned rationale for inflation targeting monetary policy is arguably its most important, that is through the setting of the inflation target the policy authorities aim to influence general inflation expectations and consequently the wage and price setting processes in the wider economy so as to reduce actual inflation.

Inflation targeting is more than just setting a numerical target for inflation to be attained over a specific time horizon; it is about co-ordination with other economic policy departments, accountability and transparency. While national practices differ, the SA government sets the inflation target in consultation with the SARB.

The SARB has the responsibility to attain the inflation target, but it has independence in choosing the instrument with which to do this. The key policy instrument used by the SARB is the repo interest rate, which determines the whole structure of short-term interest rates in the domestic financial markets.

While a whole range of options existed regarding the definition and time-specification of the inflation target, SA eventually (November 2003) opted for a continuous inflation target of 3 to 6 per cent for the CPIX inflation rate (that is, the overall CPI inflation rate, excluding mortgage interest costs), to be attained from 2006 onwards. This implies that the SARB should strive to maintain the year-on-year CPIX inflation rate within the 3 to 6 per cent target range for each month.

The SARB's focus is on the *expected rate of inflation* as changes in interest rates only influence the actual inflation rate with a considerable time lag (up to 18 to 24 months). Interest rate decisions — taken by the *Monetary Policy Committee (MPC)* of the SARB — therefore have to be *pre-emptive*. Initially, four quarterly MPC meetings were scheduled; however, from June 2003, it was decided to change the frequency to six bi-annual meetings in order to facilitate more timely monetary policy decision making.

The Government and the SARB have from the onset been not too rigid in applying inflation targeting, that is they allowed for exceptional circumstances (e.g. supply shocks) to deviate from the set target, that is the so-called escape clause. From November 2003, the escape clause was replaced by an explanation clause, i.e. the SARB had to explain why the target may be missed in particular conditions and how the SARB intended to restore price stability.

Furthermore, whilst always at risk to damage credibility, the Government and the SARB appear to be sensitive to the attainment of other economic objectives such as the eradication of poverty, the reduction of unemployment, the stabilisation of output growth and the attainment of a competitive exchange rate.

However, the whole success of implementing inflation targeting monetary policy depended on the SARB's success in generating the necessary credibility amongst business people, analysts, labour unions and the broader society; it follows that the lowering of inflation expectations and actual inflation required top priority during the initial phase of the policy.

During the years preceding the inflation targeting monetary policy, 1996 to 2000, core inflation averaged close to 8 per cent a year. Apart from the currency-induced spike in inflation during 2002, inflation expectations and actual inflation gradually declined to within the target range, with CPIX inflation for the first time measured below the 6 per cent upper range in September 2003.

CPIX inflation has since averaged well within the 3 to 6 per cent target range for 44 consecutive months (averaging 4,4%); general inflation expectations also remained within this target range (that is, slightly above 5%) at the time of writing.

One may therefore conclude that the SARB has largely been successful in establishing a high degree of anti-inflation credibility. Research also points to much weaker inflation pass-through from currency depreciation and other supply shocks to eventual CPI inflation, which could be, amongst other factors, a reflection of the measure of credibility attained by the SARB.

This success may provide a foundation for the SARB (and the Government) to embark on a more flexible approach to inflation targeting by giving increasing weight to the other economic policy objectives, such as output and exchange rate stabilisation, without damaging the Bank's inflation fighting credentials.

2.5 Short-term inflation and interest rate outlook

CPIX inflation has increased from 3,7 per cent in April 2006 to 5 per cent in August and remaining at this level for the remainder of 2006, but picking up further to 6,3 per cent in April 2007. PPI inflation accelerated from 5,5 per cent in April 2006 to 10 per cent in October and November 2006 and 11,1 per cent in April 2007, mainly driven by higher food and energy prices, as well as the rand's depreciation.

The pass-through from the currency depreciation and the high PPI inflation to CPI inflation has thus far therefore been contained. In a fiercely competitive global environment, pass-through has been moderated. Cost increases are rather absorbed in margins and/or via productivity improvements rather than to pass these through to consumers in order to retain market share. These structural changes will weigh up to domestic firms being eager to hike prices in order to catch-up with recent years' price restraint and/or to insulate company earnings from lower sales volume growth.

Pressures emanating from producer prices indicate that some negative effects on inflation can be expected. CPIX inflation is projected to trend slightly above the upper 6 per cent target range over the next 8 to 10 months, before moderating again closer to the 5 per cent level towards the end of 2008.

The SARB decided to resume with interest rate hikes in June 2007. Fortunately, inflation expectations remain well-anchored, which could contain the increase in actual inflation and therefore any potential increases in interest rates.

There may be scope to reduce interest rates in 2008, but the magnitude of this will depend on the decline in actual inflation and the overall balance of payments position.

2.6 Fixed investment and employment creation to drive growth

The revised national account statistics show that real gross domestic fixed investment growth averaged 10 per cent a year over the past four calendar years, that is, 2003 to 2006, while the momentum accelerated close to 16 per cent during the fourth quarter of 2006.

The robust capital spending is led by the private sector and the public corporations expanding production capacity. The cumulative growth of the SA economy over the past seven years has led to production capacity constraints across many industries.

Figure 2 below points to the historical high rate of manufacturing capacity utilisation during the fourth quarter of 2006.

Figure 2: Manufacturing production capacity utilisation

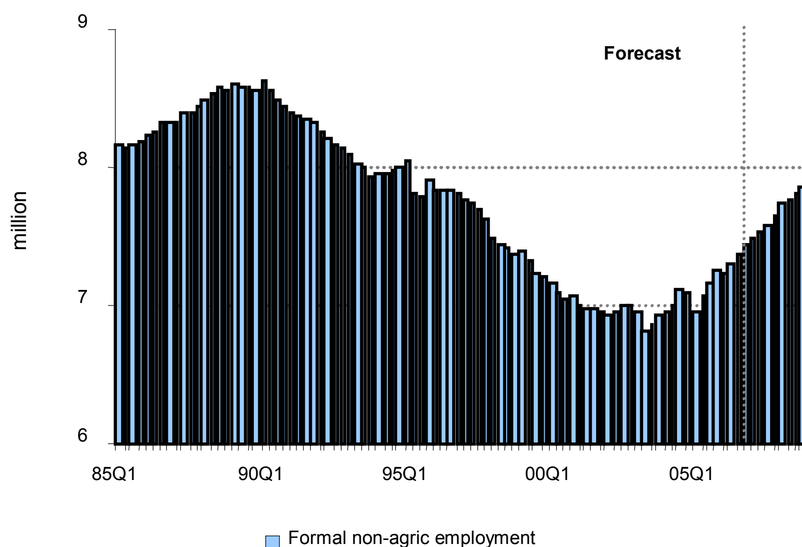
Source: SA Reserve Bank

In a sustained 4,5 per cent to 5 per cent real GDP growth scenario, these production capacity constraints will continue to underpin fixed investment spending. In the private sector, healthy balance sheets may also make companies less sensitive to the higher level of interest rates. It is expected that private fixed investment spending will remain robust over the short to medium term. Combined with the public sector infrastructure spending programme this will increasingly drive economic growth.

The favourable fixed investment trend has also had a positive impact on employment creation. Figure 3 illustrates the extent to which formal sector employment creation has picked up over recent years, refuting concerns about 'jobless growth' in latter years.

Lower-income household consumer confidence has been boosted on the back of improved employment growth in the broader economy, both in the formal and informal sectors.

Figure 3: Formal non-agricultural employment



Source: SA Reserve Bank, Bureau for Economic Research

Statistics SA's Labour Force Survey (LFS) and the Quarterly Employment Statistics (QES) reveal accelerating employment growth across most sectors of the economy.

The LFS suggests an increase in economy-wide employment of 500 000 in the year to September 2006. The same survey suggests close to 400 000 of these employment opportunities were created in the formal non-agricultural sectors of the economy.

Tracking the SA labour market: Statistics SA's LFS and QES

Statistics SA is SA's primary source of labour market statistics. SA's employment statistics have been a source of much criticism due to discontinuities in the survey methods and samples. However, in recent years many of the problems have been attended to rendering the employment statistics more reliable.

Statistics SA conducts two surveys in order to measure the employment growth in the economy. The first of these surveys is the bi-annual Labour Force Survey (LFS), which is a survey of 30 000 households (that is, around 67 000 individuals of working age 15 to 65 years) and tracks the employment status of individual households over a broad front across the nine provinces.

This survey is a comprehensive survey of labour market trends measuring both formal and informal sector employment, the industrial and occupational structure of the labour force and it is the country's primary source of unemployment statistics.

According to the September 2006 release 25,5 per cent of the labour force is unemployed at the national level if the discouraged work seekers are excluded; including the latter, the broad definition of unemployment is closer to 38 per cent.

The second survey is the Quarterly Employment Statistics (QES) survey produced by Statistics SA. This is a survey of formal sector enterprises outside of the agricultural, forestry & fishing sectors and replaces the previous enterprise surveys which were more restricted in their coverage of the labour market (e.g. the Survey of Employment and Earnings).

As a survey of actual businesses, the sectoral data tend to be more stable to reveal trends in employment creation in the formal non-agricultural sector of the economy. However, the shortcoming of the survey is the fact that it does not keep track of employment in the informal sector of the economy and it does not track domestic workers.

The sample of businesses surveyed each quarter is drawn from Statistics SA's Business Register, which has been expanded recently by including new information from the SA Revenue Service's (SARS) PAYE records and the Department of Labour's UIF databases.

According to the new estimates, based on the March 2006 Business Register the level of formal non-agricultural employment is 0,75 million bigger in June 2006 compared to the previous survey based on the June 2004 Business Register. The growth in the economy, the increased registration of previous informal businesses and improved data records are reported as reasons for the increased size of formal employment.

There are bound to be differences between a household-based survey of employment and a business-based survey, e.g. due to sampling errors, inaccuracies in household responses, different reference periods (the LFS refers to a week, while the QES refers to a quarter) and the differences in coverage.

It is therefore encouraging that both these surveys currently appear to be in agreement regarding the rate of formal non-agricultural employment growth in the economy, i.e. around 400 000 new jobs a year.

The QES reflect an increase of 107 000 formal non-agricultural job opportunities during the final quarter of 2006; annualised, this rate of employment growth corresponds to the LFS' number; that employment creation is occurring across most sectors. Improved income growth is boosting the financial positions of households, which in turn, buoys consumer confidence and spending. Real personal disposable income growth measured 6,6 per cent last year. While the new momentum in employment creation is encouraging, there is scope for further improvement, particularly in the tradable goods sectors.

Real GDP growth is projected to decelerate moderately from a 5 per cent tempo during 2004 to 2006 to 4,8 per cent during 2007 due to the impact of higher inflation and interest rates. However, the upbeat domestic economic growth outlook remains in place over the medium term. Growth is projected to accelerate again in 2008 and in the run-up to the 2010 FIFA World Cup.

Sustained fixed investment spending and associated employment growth are expected to compensate for the negative impact of higher interest rates on the interest rate sensitive components of household spending and private fixed investment, notably residential construction. The favourable fixed investment trend is also likely to be supported by a recovery in export growth.

Comparing the BER and National Treasury's macro-economic forecasts

The BER's macro-economic forecast was used as a basis to generate the Western Cape regional economic forecast. It is therefore necessary to briefly highlight the differences between the BER's macro-economic forecast and that of National Treasury. The differences are relatively small and can be briefly summarized as follows:

- The near term real GDP growth forecasts are almost identical — both units see real GDP growth slowing from 5 per cent in 2006 to 4,8 per cent in 2007 and then re-accelerating to the 5 per cent level in 2008 (National Treasury, 5,1%). While the BER forecasts the 5 per cent growth tempo will persist in 2009, the National Treasury projects it to pick up to 5,4 per cent. The BER projects a similar growth rate in 2010. The slightly stronger growth momentum in the National Treasury forecast results from a stronger projected household spending and fixed investment momentum. The projected export growth rates are similar.
- A notable difference between the two sets of forecasts relates to the expected slowdown in household consumption expenditure over the short term. Interest rates were hiked by 200 basis points during the second half of 2006 and this is expected to have a delayed negative impact on the interest rate sensitive components of consumer spending in 2007. Whereas the BER forecasts real household spending to slow from 7,3 per cent in 2006 to 4,8 per cent and 4,3 per cent in 2007 and 2008 respectively, National Treasury projects growth of 5,7 per cent and 4,8 per cent, respectively.
- The BER is slightly more pessimistic regarding inflation. CPIX inflation is projected to average 5,3 per cent over the period 2007 to 2009 in the BER forecast compared with the National Treasury forecast of 4,8 per cent. The BER sees CPIX inflation tapering off from 5,6 per cent on average in 2007 to 5,2 per cent in 2009; the corresponding National Treasury numbers are 5,1 per cent and 4,5 per cent. While it is not possible to compare, the BER's higher inflation forecast probably results from a weaker exchange rate assumption or simply a more negative evaluation of the inflation pressures foreseen over the short term.
- Both units see the deficit on the current account of the balance of payments averaging at 5,6 per cent of GDP over the 2007 to 2009 period.

In all, the most prominent difference between the two sets of forecasts relates to the momentum in household consumption spending and fixed investment spending, which is projected at a faster rate in the National Treasury forecast. The BER anticipates more of a slowdown in these components of GDP over the short term. The BER is also slightly more pessimistic regarding the inflation outcome.

The April 2007 Reuters consensus forecast for real GDP growth in 2007 to 2009 is 4,8 per cent, 5 per cent and 5,2 per cent, i.e. in the middle of the BER and Treasury projections; the consensus outlook for CPIX inflation was 5,4 per cent, 5 per cent and 4,7 per cent respectively over the corresponding period, i.e. closer to the National Treasury forecast.

Table 1: Macro-economic outlook for SA: 2007 to 2010

	Ave 2001-2006	2006	2007F	2008F	2009F	2010F
Expenditure on GDP (real % change):						
Household consumption	5,1	7,3	4,8	4,3	4,5	4,9
Fixed investment	8,1	12,8	10,1	8,4	7,7	9,1
Gross domestic expenditure (GDE)	**5,8**	**8,7**	**5,2**	**4,9**	**5,0**	**5,7**
Exports	3,3	5,5	7,3	6,5	6,5	7,7
Gross Domestic Product (GDP)	**4,1**	**5,0**	**4,8**	**5,0**	**4,9**	**5,4**
Inflation, interest & exchange rates						
CPIX inflation	5,9	4,6	6,0	5,6	5,2	5,5
PPI inflation	6,0	7,6	9,1	6,4	5,2	5,3
Prime overdraft rate	12,94	11,12	12,97	13,31	12,50	12,50
R/US$ exchange rate	7,71	6,77	7,44	7,93	8,41	8,89
R/euro exchange rate	8,44	8,50	9,94	10,44	10,71	10,96

Source: Bureau for Economic Research

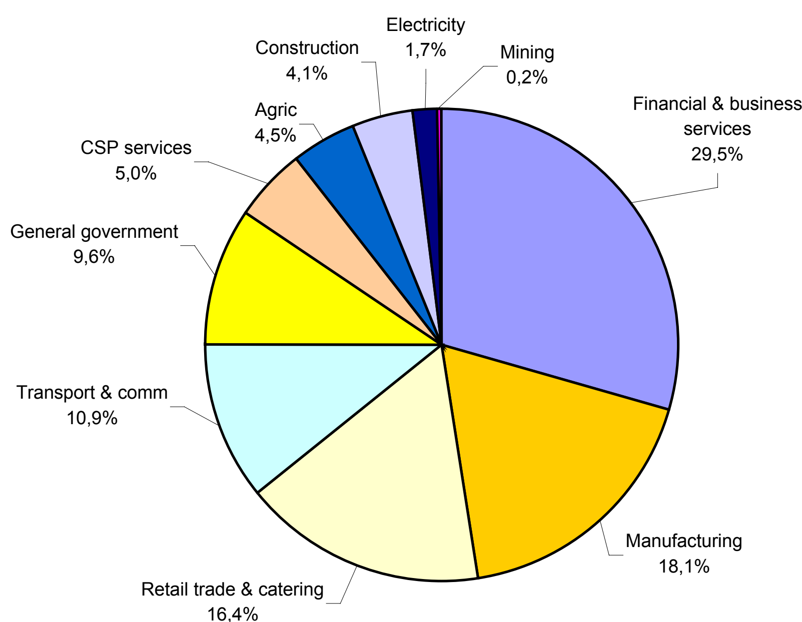
3. The Western Cape economy

3.1 Introduction: recent developments

The revised real GDPR growth statistics indicate that the regional economy expanded by around 6 per cent a year during 2004 and 2005. According to current estimates, growth came in at 5,5 per cent last year.

The services industries (excluding government) continue to power the growth performance, growing by 6,5 per cent a year on average during calendar years 2004 and 2005 and an estimated 6 per cent during 2006. The construction sector is also expanding strongly, growing by a real 12 per cent a year during 2004 and 2005 and an estimated 15 per cent during 2006. The strong momentum in real domestic spending on the back of erstwhile low interest rates and inflation continue to benefit these sectors.

Figure 4: Sectoral composition of Western Cape GDPR, 2005 (%)



Source: Statistics SA 2006

According to the revised GDPR statistics growth in the manufacturing sector came in at a respectable 5 per cent during 2004 and 2005; however, the sector suffered a substantial setback in business confidence in 2006 (see below). The high manufacturing growth in the regional manufacturing sector during 2004 and 2005 according to the revised GDPR statistics does not agree with the BER's business survey evidence in the sector and the available export data showing deep contractions in real exports from the region.

Regional manufacturers also reported continued employment cutbacks in 2006. Quantec Research estimates an annual contraction of 0,6 per cent in 2006. This tendency is borne out by the BER's regional manufacturing survey.

Overall formal sector regional employment growth did improve during 2005 and 2006 according to revised Quantec Research data. According to the data around 50 000 new jobs were created in the Province during both years, that is an average annual employment growth rate of 3 per cent. This compares to an average annual contraction of 0,1 per cent in regional formal sector employment over the 2000 to 2004 period. According to the latest LFS released by Statistics SA, the regional unemployment rate declined to 15 per cent in September 2006 from 18,9 per cent over the 2001 to 2005 period.

This is the lowest in the country; Gauteng has the second lowest unemployment rate, namely 23,2 per cent. However a number of sectors are continuing to retrench workers. These include the agriculture, clothing & textiles, wood & paper, furniture and communication sectors. The sectors that reported healthy employment growth are financial & business services, electricity & water, wholesale & retail trade, construction, transport & communication and general government.

Therefore, the overall economic growth picture remains upbeat, particularly in the leading services industries and in construction. However, there is scope for stronger and more broader-based employment growth. The unsatisfactory employment picture is influenced by the struggling manufacturing sector and the large-scale retrenchments in the agricultural sector.

3.2 The struggling manufacturing sector

While the revised GDPR statistics reveal a recovery in manufacturing and agricultural real value-added growth during 2004 to 2005, the five year average growth rates in these sectors (that is, 3% and 1,6% a year, respectively) reveal a disappointing growth performance.

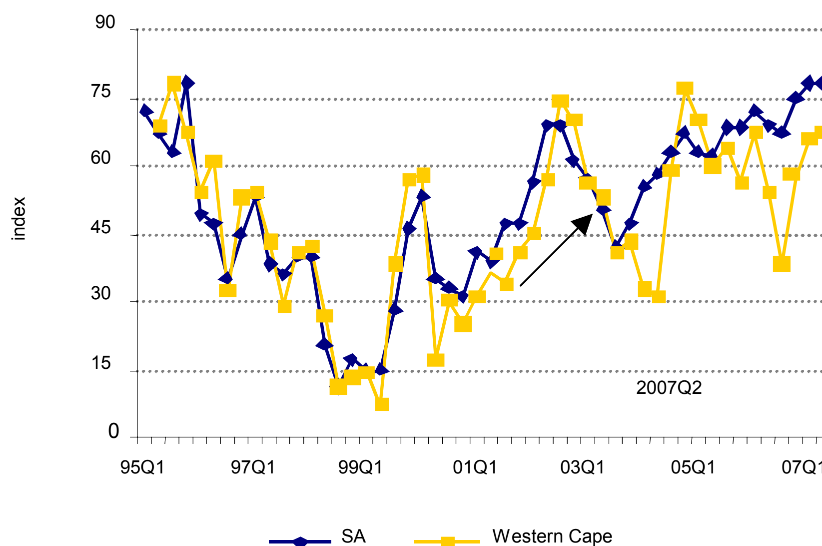
It also appears that the manufacturing situation in the region deteriorated during 2006 – the estimated growth in real value-added came in at 3,5 per cent from above 5 per cent in 2004 and 2005.

Figure 5 shows that business confidence deteriorated sharply in the sector during 2006. Less than 40 per cent of the BER manufacturing respondents in the region reported satisfactory business conditions during the third quarter of 2006 compared to 76 per cent in Gauteng, 80 per cent in KwaZulu-Natal and 65 per cent in the Eastern Cape. This represented a decline of 30 index points in the Western Cape manufacturing business confidence index during 2006. Business confidence recovered during the final quarter of the year and the first quarter of 2007, but production volumes continued to contract on a year-on-year basis.

Analysing the pattern of business constraints reported by regional manufacturers in the BER's manufacturing survey, it is clear that skilled labour constraints is a key issue – the constraint index value increased from 28 to 39 between the end of 2005 and the end of 2006 in respect of skilled labour and 20 to 30 in respect of semi-skilled labour. Skilled labour constraints are reported as the most binding constraint.

Furthermore, raw material shortages (17 to 31), higher interest rates (18 to 39) and a more constraining general political climate (16 to 28) are all areas that contributed to the deterioration in the business conditions.

Figure 5: Manufacturing business confidence

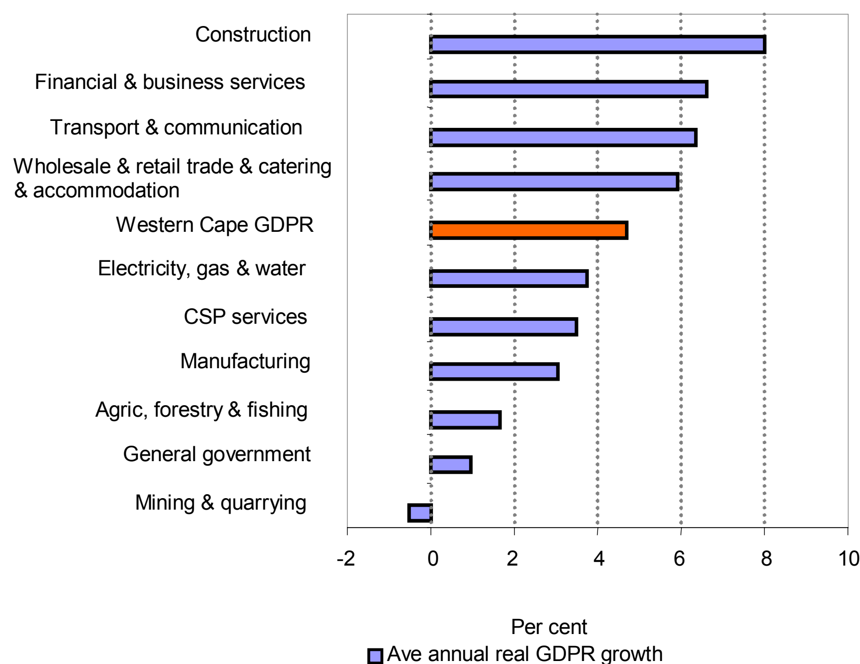


Source: Bureau for Economic Research

Regional manufacturers' short-term expectations are relatively upbeat. Hopefully the recovery in the national manufacturing sector will catch up with the Western Cape. The adverse export situation, which developed between 2003 and 2005 (see below) is slow to improve. We may have to look towards 2007 and 2008 to see a more meaningful recovery in this regard.

The evidence of an under-performing manufacturing sector in the Western Cape economy amounts to a key challenge to the regional policy authorities. The manufacturing sector is best situated to absorb lower- and semi-skilled labour of which there exists an oversupply. Furthermore, the sector's contribution to exports is critical for sustainable high economic growth, both at the regional and national levels. It is necessary to investigate the region's under-performance in manufacturing in order to gain a better understanding whether this is a short term or longer term trend.

Figure 6: Western Cape real GDPR growth by sector: 2000 – 2005



Source: Statistics SA

3.3 Trends in the sectoral pattern of GDPR growth

Table 2 shows that the Western Cape economy expanded by 4,7 per cent a year on average over the period 2000 to 2005. This compares to a national real GDP growth rate of 3,9 per cent over the corresponding period.

Table 2 below shows that the growth in the services industries (excluding the government) averaged 6,1 per cent over the corresponding period, with financial & business services (6,6%) and transport & communication (6,4%) performing strongest; internal trade, that is wholesale & retail trade, catering & accommodation, also performed strongly (6%).

The construction sector grew the fastest, with real value-added growth over the 2000 to 2005 period upgraded to 8 per cent a year. The electricity, gas & water sector grew by 3,7 per cent a year and CSP services by 3,5 per cent. The weakest performing sectors have been mining (contracting by 0,5% a year), general government (growing by 1% a year), agriculture (1,6%) and manufacturing (3,1%).

It remains to be seen what the impact of higher interest rates and inflation will be on the lively retail, construction and financial services sectors. Regional retailing business confidence tended to be somewhat volatile over recent years, falling below national during the first part of 2005, rising above national during the second half of 2005 and in 2006 declining sharply again. Over the past few quarters regional consumer confidence has been trending at slightly lower levels compared with national.

Looking ahead, the regional retail sector will be exposed to the anticipated national slowdown, the impact on interest rate sensitive components of spending and the impact of higher food prices, particularly at the lower end of the market.

Table 2: Real GDPR growth of the Western Cape economy: 2000 — 2005

	2000	2001	2002	2003	2004	2005	Ave 2000 — 2005
GDPR by sector (real % change):							
Agric, forestry & fishing	-2,3	0,8	7,1	-3,6	3,0	4,8	1,6
Mining & quarrying	7,5	-13,4	-1,3	1,8	1,2	1,0	-0,5
Manufacturing	5,7	2,9	1,1	-2,2	5,7	5,3	3,1
Electricity, gas & water	2,8	-1,9	2,8	11,3	3,5	3,8	3,7
Construction	5,0	-15,8	34,1	0,7	11,8	12,3	8,0
Wholesale & retail trade, catering & accommodation	9,9	5,7	1,3	6,9	5,8	6,3	6,0
Transport & communication	7,9	5,8	5,6	7,1	5,3	6,5	6,4
Financial & business services	4,0	9,9	5,3	5,9	8,7	6,0	6,6
CSP services	4,8	2,2	2,4	4,1	2,1	5,3	3,5
General government	-3,2	-0,5	0,8	2,2	3,6	2,9	1,0
Western Cape GDPR	**4,5**	**4,2**	**4,1**	**3,6**	**6,2**	**5,8**	**4,7**
Services (excl. government)	6,3	7,3	4,0	6,2	6,7	6,1	6,1

Source: Quantec Research, 2007

The changed financial environment is likely to impact negatively on the booming construction, property and financial services sectors. An upper turning point is evident in the building and construction sector in line with the national situation. The property and financial services sectors may also be peaking, albeit that this is not yet so evident from the available statistics. However, the construction sector will also be underpinned by non-residential property development and civil engineering activity tied to infrastructure development. The anticipated slowdown is therefore expected to be of moderate proportions.

These factors all contribute to a likely change in the sectoral composition of the region's growth. The momentum will in all likelihood slow in the retail, construction, financial services and property sectors, while that in the manufacturing and agricultural sectors should benefit from the depreciation of the rand exchange rate. Both the climatic conditions and the more competitive currency are bolstering the outlook for the Western Cape agricultural sector.

While the expected recovery in manufacturing has disappointed thus far, it is likely to happen. However, it is not expected that the growth in the manufacturing sector will surpass that in construction sector or the services industries over the forecast period.

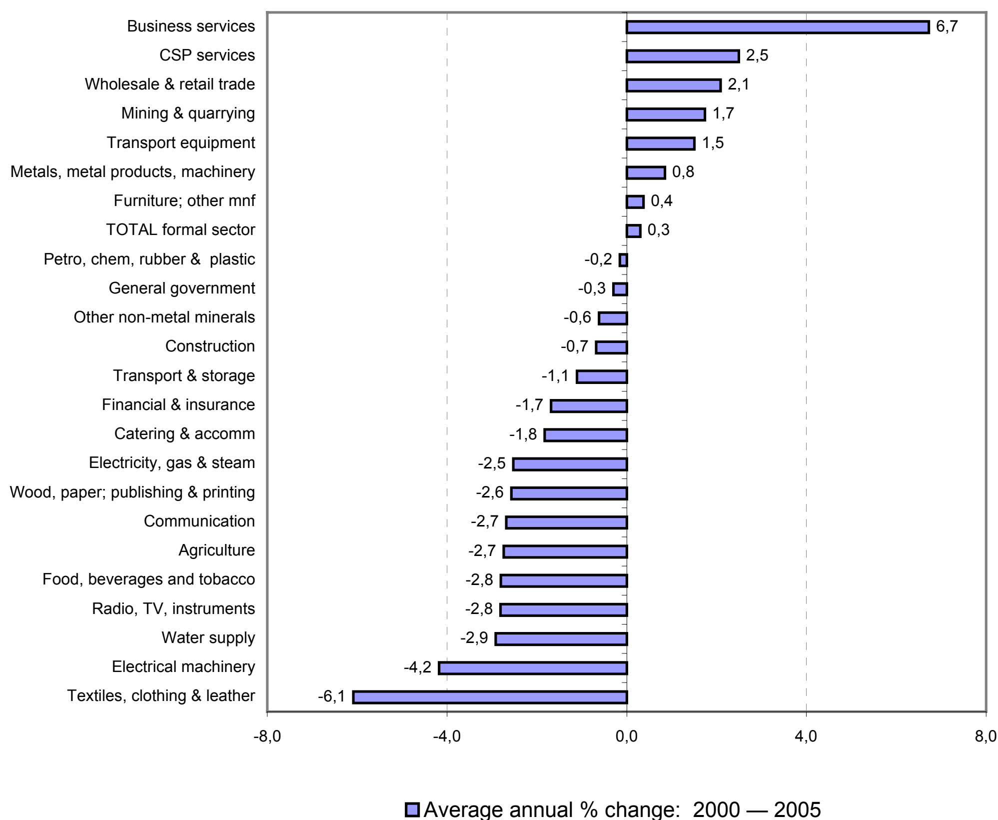
3.4 Employment creation may have turned the corner

Formal sector employment creation in the Western Cape economy lagged behind the rest of the country in recent years. Between 2000 and 2005 formal sector employment grew by 0,3 per cent a year. This compares to positive formal sector employment growth of 0,6 per cent a year nationally over the corresponding period. However, in 2005 and 2006 the regional picture improved, along with the improving national trend, according to the latest data and estimates.

The regional sectors responsible for this disappointing employment trend over the 2000 to 2005 period are agriculture (-2,7% a year), electricity, gas & water (-2,6%), manufacturing (-2,3%), transport & communication (-1,5%), construction (-0,7%)[3] and government (-0,3%).

Within the manufacturing sector, retrenchments have been the sharpest in clothing & textiles (employment declining by 6,1% a year), electrical machinery (-4,2%), food & beverages (-2,8%), radio, TV & instruments (-2,8%) and wood & paper products (-2,6%).

Figure 7: Western Cape formal sector employment growth: 2000 – 2005



Source: Quantec Research, 2007

3 The declining tendency in construction employment contradicts the robust growth this sector experienced over the period 2000 to 2005. The data probably reflect structural changes in employment practices, e.g. the rise of outsourcing and sub-contracting, rather than real retrenchments. It also appears that the declining tendency was arrested during 2005.

The sectors that experienced positive employment growth over the period 2000 to 2005 are financial & business services (5,2% a year), CSP services (2,5%), wholesale & retail trade, catering & accommodation (1,3%) and mining (1,7%). At a sub-sector level, the leading job creating sectors over this period were business services (6,7% a year), community services (2,5%) and wholesale & retail trade (2,1%). Within manufacturing, transport equipment (1,5%), metals & machinery (0,8%) and furniture & other manufacturing (0,4%) recorded positive employment creation over the period.

The 2005 data and estimates in respect of 2006 point to a recovery in employment creation in the region, with around 40 000 annual formal jobs being created in the province. The positive growth is being led by the sectors that experienced job growth over the 2000 to 2005 period. Strong fixed investment intentions, combined with the Government's infrastructure fixed investment activities should underpin employment creation in the Province going forward.

3.5 Reviving export growth a key regional economic challenge

The regional export growth performance deteriorated sharply in recent years. Compared to double digit growth in total export volumes over the 1995 to 2002 period, growth decelerated to a meagre 2,9 per cent a year over the 2003 to 2005 period.

The deteriorating export tendency in the manufacturing sector led this reversal of the Provincial export buoyancy. In the period 2003 to 2005 real manufacturing exports actually contracted by 2 per cent a year. This compares to real growth of 12,5 per cent a year over the 1995 to 2002 period.

Table 3: Western Cape real manufacturing export growth: 1995 to 2002 versus 2003 to 2005

Real % change a year	**1995 – 2002**	**2003 – 2005**
Food, beverages & tobacco	10,0	1,6
Textiles, clothing & leather goods	8,1	-9,2
Wood & paper; publishing & printing	13,4	-3,0
Petroleum products, chemicals, rubber & plastic	24,6	-0,2
Other non-metal mineral products	19,6	-4,8
Metals, metal products, machinery & equipment	8,9	8,0
Electrical machinery & apparatus	-6,3	7,7
Radio, TV, instruments, watches & clocks	31,6	26,4
Transport equipment	39,3	-13,3
Furniture & other manufacturing	25,3	1,9
Total manufacturing	**12,5**	**-2,0**

Source: Quantec Research, 2007

The sharpest reversal of export fortunes occurred in the transport equipment sector, declining from positive growth of close to 40 per cent a year over the period 1995 to 2002 to -13,3 per cent a year between 2003 and 2005; clothing & textiles (8,1% to -9,2%), non-metal minerals (19,6% to -4,8%) and wood & paper products (13,4% to -3%) and petro-chemicals (24,6% to -0,2%).

Table 4: Composition of Western Cape exports: 2006 (constant 2000 prices)

Sector	R million	% share
Agriculture, forestry & fishing	7 456,5	20,2
Food, beverages & tobacco	7 004,7	18,9
Petroleum products, chemicals, rubber & plastic	6 618,8	17,9
Metals, metal products, machinery & equipment	1 440,2	3,9
Textiles, clothing & leather goods	1 068,6	2,9
Radio, TV, instruments, watches & clocks	980,4	2,7
Furniture & other manufacturing	977,3	2,6
Transport equipment	962,6	2,6
Mining	612,5	1,7
Wood & paper; publishing & printing	355,1	1,0
Electrical machinery & apparatus	175,5	0,5
Other non-metal mineral products	147,4	0,4
Other	9 166,0	24,8
Total Western Cape exports	**36 965,9**	**100**

Source: Quantec Research, 2007

In the period 2003 to 2005 all the manufacturing sub-sectors experienced a substantial deterioration in export performance. The sole exception was the electronics industry – the electrical machinery and radio, TV & instrument sectors either improved or maintained their export growth; however, growth is from a low base. Basic metal exports were also sustained at a robust rate.

The poor export growth can explain much of the problems in the lagging regional manufacturing sector. It can also explain why the Province's manufacturing sector is not responding positively to the competitive boost provided by the rand's depreciation since May 2006. It is possible that local manufacturers are focussing more on the buoyant domestic market and neglecting exports, a tendency that is picked up nationally in particularly the consumer goods manufacturing industries.

Nationally, the export response has proved to be slow. However, whereas Western Cape manufacturers were previously more dependent on export growth and less on domestic demand, they may be in a more serious predicament compared to their regional counterparts. It is evident that regional export prospects will depend on how strong the recovery in manufacturing conditions will be over the short to medium term.

3.6 Robust fixed investment spending

Over the period 2000 to 2005 real fixed investment spending in the Western Cape economy accelerated to 6,8 per cent a year compared to only 4 per cent a year over the decade from 1995. Fixed investment spending was particularly strong during 2004 (up 12,8%), 2005 (up 11,9%) and estimated at 10,7 per cent last year. This compares to an average growth rate of 10,3 per cent a year in real gross domestic fixed investment nationally.

Over the same period, fixed investment grew strongly in construction (13,7% a year), electricity, gas & water (10,1%), financial & business services (9,5%), CSP services (9,4%), wholesale & retail trade (8,2%), transport & communication (5,8%) and general government (5,4%); whereas manufacturing fixed investment grew by a slower 4,3 per cent a year.

Infrastructure fixed investment spending in the Western Cape

Investment in infrastructure is anticipated to be a major driver of economic growth in the Western Cape. The AsgiSA has infrastructure investment as one of its key interventions for growing the economy and creating employment.

Better infrastructure helps poor communities connect to the mainstream economy. By building roads, improving the public transport system and providing other critical infrastructure, more people are able to take advantage of economic opportunities and the cost of doing business drops significantly.

Over the Medium Term Expenditure Framework (MTEF) period, the Provincial Government of the Western Cape budgeted R6,629 billion for building and maintaining roads, public transport, social services and administrative infrastructure.

The 2010 FIFA World Cup is also set to have a major influence on the level of infrastructure investment activity in the Western Cape. A multi-purpose stadium, which can be used for ball sport, major events and concerts, will be constructed at Green Point at a cost of R2,85 billion.

The City of Cape Town is contributing R400 million towards the construction of the stadium and an additional R100 million for contingency funds. The Provincial Government will contribute R212 million in 2008/09 to support the construction of the Green Point Stadium.

The supporting infrastructure for hosting this event, including transport infrastructure, accommodation projects and the upgrading of the Athlone Stadium will also have an impact on infrastructure development in the Province.

Cape Town's poor and working class people live furthest from their places of work, as a result of the apartheid planning system. Many of these people rely heavily on public transport. The Province has also developed a mobility strategy to revitalise the public transport system and address some of the problems created by the existing infrastructure.

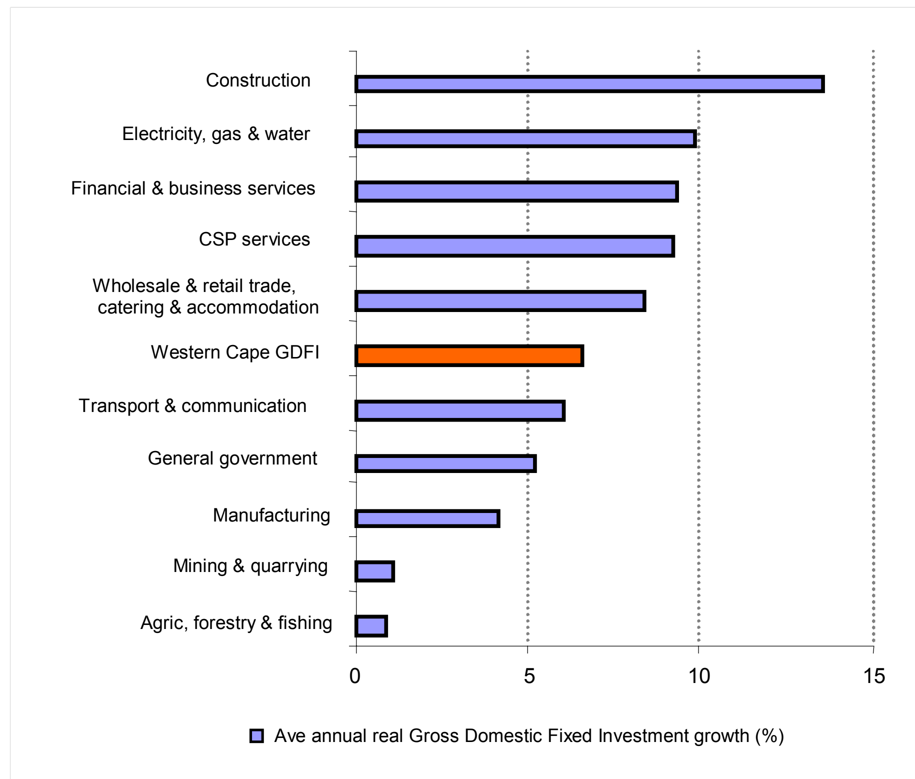
The first phase of this extensive project will be the introduction of a rapid bus transit (RBT) system along the Klipfontein corridor. This will entail a dedicated bus route from Khayelitsha to Mowbray, along with improved cycling and pedestrian paths. It is expected that the development of Klipfontein Road into a transport corridor will result in many advantages for businesses, communities and public transport operators. The estimated cost of this transport initiative is R300 million.

The Western Cape will also benefit from infrastructure interventions under the AsgiSA programme. About 37 per cent of the R409,7 billion budgeted for infrastructure investment by national government over the MTEF period will be spent by State-Owned Enterprises across the country mainly for power generation, transmission and distribution investments by Eskom and municipal distributors and also for port, rail and pipeline infrastructure investments by Transnet.

The Airports Company of SA (ACSA) is embarking on a capital expenditure programme to address 2010 needs, which will entail the expansion and upgrading of the Cape Town International airport. ACSA will spend a total of R1,3 billion at Cape Town international airport, of which R900 million will be spent on a new terminal building. The remainder will be spent on projects such as a multi-storey parkade and construction of an elevated road above the existing ring road.

In addition, Transnet will spend R3,2 billion on the expansion of Cape Town's container terminal. This project is aimed at increasing the turnaround time for ships and also at giving better support to refrigerated cargo.

Figure 8: Western Cape real fixed investment growth by broad sector: 2000 – 2005



Source: Quantec Research, 2007

The outlook for fixed investment remains bullish as production capacity constraints are expected to underpin capital spending. The Cape Town harbour will be expanded, the new owners of the Victoria & Alfred (V&A) Waterfront development are preparing for a major overhaul and expansion, construction of the World Cup soccer stadiums are in the offing, Eskom is building two new gas-fired power generation plants (scheduled for completion mid-2007) and planning a new nuclear power station, transport infrastructure will witness a major upgrade, to name a few.

Both public and private sector fixed investment spending are projected to continue growing strongly over the projection period. The rate of fixed investment growth in the Province should at least track that projected for national as the trend has been over the past five to six years, i.e. around 8 per cent a year.

3.7 Trends in direct investment into the Western Cape

At the international level, the United States, European Union and Japan (also known as the "Triad") were the dominant sources of foreign direct investment (FDI) for many developing countries in 2005. Global FDI inflows registered a nominal increase of 22 per cent in the period 2004 to 2005 (US$955 billion in 2005).

In 2005, the primary source of investment into SA was from European countries constituting 89 per cent of investment inflows. Of all countries in Africa, SA had the largest inflow of FDI in 2005 largely driven by the acquisition of ABSA bank by the UK's Barclays' Bank. Emerging markets have led the recovery in global FDI inflows accounting for the bulk of the increase in global FDI inflows.

Global FDI inflows, as forecasted by the Economist Intelligence Unit (EIU), are projected to grow at an annual average rate of 8 per cent over the medium term, exceeding the projected rate of growth in global output and lagging growth in global trade.

This forecast is underpinned by assumptions that world economic growth is set to remain buoyant; the trend towards better business environment continues; progress is made with regional integration; technological change and overall sharper competition. It is expected that the services sector will continue to maintain its majority shareholding in global FDI flows and that South-South FDI will be of greater importance.

3.7.1 FDI trends in SA

The main source of FDI into SA is primarily the European countries, which contributed 89 per cent of FDI inflows in 2005. Among the top three contributors were the United Kingdom, Germany and the Netherlands. The Americas (with a share of nearly 7 per cent) is the second largest source of FDI. Germany is another major source of FDI for SA, having increased its contribution by 36 per cent since 2002. The Bric[4] countries are also emerging as important sources of FDI for developing countries in the form of South-South investment.

FDI into SA have largely been in the services or tertiary sectors. On a sub-sectoral level the commercial services followed by mining and manufacturing attract the most foreign investment. These three sectors accounted for 91 per cent of all FDI in SA in 2005. The Barclays/ABSA deal dominated FDI inflows into SA in 2005. Apart from this, FDI inflows have generally been disappointing. According to Reserve Bank figures, outward FDI exceeded inward FDI in SA over the period 2002 to 2006.

[4] Brazil, Russia, India and China.

Whilst the improved real economic growth performance is stimulating foreign investor interest capital inflows have been dominated by portfolio investments. However, an improved real economic growth performance should in time stimulate inward direct investment.

As noted above, AsgiSA has as its main objective to increase the real GDP growth rate to an average of 6 per cent by 2010 to 2014. Central to this strategy is a strong focus on infrastructure investments.

The 2010 FIFA World Cup is also set to have a major influence on the level of investment activity in SA as new projects arise in preparation for this event.

3.7.2 Direct investment trends in the Western Cape[5]

Since 2004, Wesgro attracted total investments amounting to R2,2 billion into the Western Cape, largely following the national trend of investment being concentrated in the services sectors[6]. The Western Cape's real fixed investment growth has averaged 6,6 per cent a year over the period 2000 to 2005, in line with the national performance.

3.7.3 Sources of Western Cape direct investment

Prior to 2005, the primary source of direct investment in the Western Cape has been from elsewhere in SA, indicative of marked investor confidence by SA businesses. In 2005 and 2006, about 43 per cent of all foreign direct investment facilitated by Wesgro was from the UK. Germany was the second most significant source at 27 per cent.

The Western Cape's investment links with other developing countries are quite low, albeit that there is potential for expansion. Despite being an increasingly important outward investor, the Asian economies have not featured prominently as source markets for the Western Cape, hence the need for more proactive investment targeting of the emerging Asian markets. The recent V&A Waterfront acquisition by a Saudi-Arabian-based consortium and optimistic prospects in terms of future interest by Middle Eastern countries may be indicative of the potential in this regard.

[5] Detailed statistics on the Western Cape FDI performance are not readily available. For the purpose of this analysis, Wesgro's investment performance is used as a proxy for the Western Cape FDI performance. Wesgro is the official trade and investment promotion agency for the Western Cape Province.

[6] Wesgro reports on total *committed investments*. Committed investments are classified as those projects where the investor has already incurred substantial expenditure towards the implementation of the investment project. Furthermore, all of Wesgro's committed investments are direct investments defined as investments in fixed assets that are used over a number of years to produce goods and/ or services. Wesgro's committed (direct) investment figures are periodically reviewed to update any changes in investor plans. Wesgro's definition of FDI also complies with the SARB standards.

The services sector attracted a considerable amount of direct investment; a trend that reflects the Province's economic structure whereby the services accounts for 70 per cent of the GDPR. Table 5 below shows that almost three quarters of direct investment into the Western Cape occurred in the film & media and accommodation sub-sectors. The socio-economic impact of these investments is substantial, contributing to an estimated additional 6 288 jobs in the Western Cape since 2004.

Table 5: Top – 10 Sub-sectors of Direct Investment, 2006/07

Sub-sector	Investment (R million)	Share of total investment (%)
Film & media	433,2	34
Accommodation	268,2	21
Call centre	164,9	13
Metals & engineering	55,0	4
Tourism	52,4	4
Biotechnology	44,0	4
Catering	31,7	4
Medical & dental & veterinary services	31,6	3
Other manufacturing	25,2	2
Clothing & textile	20,2	2

Source: Wesgro, 2007

3.7.4 Direct investment within the Western Cape

Cape Town is regarded as the financial and business hub of the Western Cape, contributing about 76 per cent of the Western Cape's GDPR in 2005. The largest proportion of direct investment is directed towards business services, call centres, BPO and ICT within the City of Cape Town.

Table 6 below shows that the level of direct investment facilitated by Wesgro in the other districts is relatively low. These investments are directed largely towards tourist activities, accommodation, catering and agriculture.

A most notable trend is that the Central Karoo did not attract any investments for two consecutive financial years. Also the share of agriculture in the Western Cape's total inward investment portfolio is very low.

Table 6: Direct Investment trends by Western Cape district

District	2004/2005 R'000	2005/2006 R'000	2006/2007 R'000
City of Cape Town	430,3	520,3	1 196,90
Overberg	30,7	12,3	5,6
West Coast	31,5	72,9	3,8
Cape Winelands	313,4	23,8	33,3
Eden	34,1	78,4	18,3
Central Karoo	-	-	-
Total	**840,0**	**707,7**	**1 256,9**

Source: Wesgro, 2007

3.7.5 Outlook

Projecting forward, the medium-term outlook for the Western Cape's fixed investment spending is favourable.

As indicated in the 2007 national Budget, Government and public enterprises infrastructure fixed investment expenditure for the period from April 2007 to March 2010 is planned to be about R416 billion (US $57 billion).

This investment is expected to not only raise current growth, but will also allow for sustained growth through better transport, communication and electricity provision to ultimately attract further foreign and domestic investment.

4. Outlook for the Western Cape economy: 2007/08 – 2009/10

The broader economic conditions in the national economy remained robust through the end of last year and early in 2007 despite the changed financial climate, that is higher inflation and interest rates. However, leading indications of the impact of higher interest rates are evident and economic growth is projected to moderate during the second half of 2007 and next year, albeit only mildly so.

The global economy is also expected to register slower growth during 2007, leading to lower commodity prices, but is expected to remain supportive to domestic growth.

The Western Cape economic performance is currently characterised by sterling growth (5 to 6%). While the employment creation trend has been unsatisfactory, the latest data and estimates point to a recovery, which is projected to be sustained.

There is continued evidence of an under-performing manufacturing sector, with a weak export performance being an important drag. It is not expected that the manufacturing sector will attain the projected growth rates of the construction and leading services industries in the Province, but growth in the sector should improve.

While the booming retail, construction and financial services sectors are exposed to the higher level of interest rates, the projected slowdowns in these sectors are of moderate proportions. In manufacturing, much will depend on the incumbent export recovery in the region to sustain growth and employment creation at a satisfactory pace.

Table 7 below sets out the macro-economic and sectoral outlook for the Western Cape for the fiscal years 2007/08 to 2009/10. Regional GDPR growth is projected to soften from 5,7 per cent in 2005/06 and an estimated 5,3 per cent in 2006/07, to 4,9 per cent in 2007/08; thereafter growth is projected to re-accelerate in the run-up to the 2010 FIFA World Cup event to 5,7 per cent in 2009/10[7].

The regional economic growth momentum is therefore expected to remain vigorous and exceed that of national. From the accompanying table it is evident that the region's services sectors are projected to continue making a strong contribution to aggregate GDPR growth.

Excluding the general government, the region's tertiary sectors are projected to grow at a rate of 6 per cent a year over the projection period, which compares to the 5,3 per cent average for aggregate GDPR. Financial & business services, wholesale & retail trade, tourism, transport & communication are the key growth sectors in this regard. Furthermore, the forecast suggests that the growth in manufacturing is likely to accelerate somewhat.

The construction sector is also expected to accelerate substantially, from an average 8 per cent real growth over the 2000 to 2005 period closer to 13 per cent over the forecast period. The growth in this sector will be driven by robust infrastructure development and the buoyant conditions in the residential and non-residential building sectors. Such growth is bound to create substantial challenges for the construction industry in terms of skills training and fixed investment spending in order to implement the required capacity.

Should it be assumed that the labour intensity of regional GDPR growth (measured by the employment coefficient) remains around 0,53 per cent (i.e. an estimated 3,1 per cent formal sector employment growth compared to 5,8 per cent real GDPR growth during 2005/6) over the forecast period, the projected growth should translate into between 40 000 to 50 000 new formal sector jobs a year. This will be a big improvement compared to the previous five years and will be key in sustaining the growth momentum and spreading the benefits of growth wider.

[7] The projected growth rates are higher compared to those contained in the MTBPS compiled before the revisions of the GDPR data by Statistics SA.

Table 7: Outlook for the Western Cape economy: 2007/08 – 2009/10[1] (%)

	Ave 2000 – 2005	2005/06	2006/07E	MTEF		
				2007/08F	**2008/09F**	**2009/10F**
GDPR						
R billion (current prices)	**-**	**232,7**	**260,3**	**288,5**	**318,5**	**354,7**
Real GDPR % growth	4,7	5,7	5,4	5,1	5,3	5,7
GDPR deflator	6,7	5,4	6,2	5,8	5,3	5,4
CPI inflation	5,2	4,6	4,8	5,8	5,2	4,9
GDPR by sector (real % change)						
Agric, forestry & fishing	1,6	4,4	2,7	1,9	2,4	2,8
Mining & quarrying	-0,5	0,9	0,8	2,0	2,6	2,7
Manufacturing	3,1	4,9	3,7	3,5	3,5	3,6
Electricity, gas & water	3,7	3,8	3,6	3,4	3,7	4,1
Construction	8,0	13,1	15,2	13,8	12,2	12,7
Wholesale & retail trade, catering and accommodation	6,0	6,6	7,0	5,5	6,1	6,4
Transport & communication	6,4	6,3	5,6	6,3	6,6	7,0
Financial & business services	6,6	5,9	5,6	5,7	5,9	6,3
CSP services	3,5	4,8	3,1	3,0	3,2	3,5
General government	1,0	3,0	3,3	2,9	2,9	3,2
Western Cape GDPR	**4,7**	**5,7**	**5,4**	**5,1**	**5,3**	**5,7**

Source: Bureau for Economic Research

Note: [1] Fiscal years ending 31 March

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