



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

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

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ABBREVIATIONS

ACSA: Airports Company South Africa
CPI: Consumer Price Index
CRB: Commodity Research Bureau
FNB: First National Bank
GDP: Gross Domestic Product
GDPR: Gross Domestic Product Regional
IMF: International Monetary Fund
MPC: Monetary Policy Committee
PMI: Purchasing Managers Index
RMB: Rand Merchant Bank
SA: South Africa
SARB: South African Reserve Bank
Stats SA: Statistics South Africa
WC: Western Cape

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

Global economy

- After global economic output plunged by more than 7% (annualized) during 2008Q4 and the first quarter of 2009, the second quarter provided the first signs that the world economy is stabilizing. Global asset prices recovered strongly from the sharp losses experienced since September 2008. Furthermore, real economic indicators such as the global PMI (an indicator that measures the health of the manufacturing sector) showed that the pace of contraction is moderating, albeit still not back in positive territory. This spurred a return of investor appetite for risk as optimism rose that the worst of the global recession may have passed – perhaps best illustrated by the almost 32% surge in the Morgan Stanley emerging stock market index and a 10.5% gain in the CRB commodity index (a measure that tracks futures prices of 19 commodities) during 2009Q2.
- While there is little doubt that the financial markets seem to be discounting a robust global economic revival in the second half of 2009 as the dramatic inventory destocking comes to an end and the unprecedented fiscal and monetary stimulus kicks in, a question mark remains about how sustainable (and strong) any return to positive growth will be. Consensus seems to be that the world economy is in for a subdued, or patchy, return to growth, with output remaining below potential over the short- to medium term. Such a scenario would imply that commodity prices are unlikely to increase dramatically and that global inflation should not be a concern for the next 12 to 18 months (at this stage, deflation is a bigger threat). *In a July update to its April World Economic Outlook, the IMF marginally downgraded its 2009 world growth forecast to -1.4% (from -1.3%), but upwardly revised the 2010 view to growth of 2.5% from 1.9% expected in April.*

South African economy

- SA felt the full brunt of the global recession during 2009Q1 with the economy contracting by a surprisingly large 6.4% q-o-q (saar¹). The impact of the weak external demand on the domestic economy was highlighted by the 55.1% q-o-q (saar) export plunge in Q1, which combined with weak domestic household consumption were the main drivers of the sharp growth contraction.
- The rand benefited handsomely from the improved global economic outlook and reduced risk aversion during Q2 as investors took money out of, for example, low yielding US treasuries and invested it in countries such as SA where a higher return can be found. However, given the BER's view of a muted global revival, intermittent bouts of increased risk aversion should be expected for the next 12 to 18 months. This is set to result in a weakening bias for the rand, but volatility is expected to remain high – yielding periods of currency strength within a broader weaker trend. Against this background, the rand is projected to average R8.30/\$ during 2009Q4, weakening to an average of R8.80/\$ in the final quarter of 2010. Assuming a fairly steady euro against the US dollar, the rand is expected to average R11.87 and R12.36 versus the euro in 2009Q4 and 2010Q4 respectively.

¹ Expressed at a seasonally adjusted and annualized rate.

- CPI inflation moderated to 8% y-o-y in May, 5.7 percentage points below the recent high of 13.7% reached in August 2008. While services inflation – a key driver of underlying inflation – is expected to remain at an elevated level, the BER projects a continued moderation in headline inflation as consumer food prices catch up to the sharp easing of agricultural and manufactured food prices. The sustained strength of the rand exchange rate and recent fall in the oil price back towards \$60/bbl, if sustained, also bodes well for domestic fuel prices. The BER's forecast suggests that CPI inflation will remain above 6% through February 2010 with a sustained fall below 6% only forecast from 2010Q2. *CPI inflation is expected to average 7.4% during 2009 before easing to an average of 5.8% in 2010. The 2009 forecast makes provision for Eskom's recently announced 31% electricity tariff hike.*
- After reducing the repo rate by a cumulative 450bps between December 2008 and May 2009, the MPC decided to keep the policy rate unchanged at 7.5% in June. The June rate decision can be interpreted as a pause in the rate cycle in order to give the MPC an opportunity to gauge the impact of the rate cuts (which work with a lag) already implemented. An alternative interpretation is that we have reached the end of the monetary easing cycle, i.e. the repo rate will remain unchanged at 7.5% for the foreseeable future. At this stage the BER favours the latter scenario.
- The RMB/BER Business Confidence Index declined to 27 index points during 2009Q2 (down only one index point from the first quarter's 26). The decline in business confidence levels is surprisingly small in view of the poor actual business conditions and points to perceptions that the economy is approaching the lower turning point of the present cycle.
- From the production side of the economy, the data already available (April and May) indicate that another GDP contraction is on the cards for Q2. *A return to (mild) positive GDP growth is expected from Q3, but the economy is forecast to contract by 2% during 2009 with fairly muted growth of 2.7% projected for 2010 (see Table 1 for a summary of the BER's latest SA economic forecast).*

Table 1: Macro-economic outlook for South Africa (2009-10)

	Average 2004-08	2008	2009F	2010F
<u>Expenditure on GDP</u> (real % change):				
Household consumption	6.1	2.3	-1.7	2.9
Fixed investment	11.6	10.2	-1.1	2.6
Gross domestic expenditure (GDE)	6.4	3.1	-0.5	3.8
Exports	5.2	1.7	-18.4	7.9
Gross Domestic Product (GDP)	4.7	3.1	-2.0	2.7
Non-agric formal sector employment	2.1	1.8	-2.8	1.5
<u>Inflation, interest & exchange rates</u>				
Consumer inflation*	6.1%	11.3%	7.4%	5.8%
PPI inflation	7.3%	14.3%	1.4%	6.5%
Prime overdraft interest rate (eop)	12.3%	15.4%	11.0%	11.0%
R/\$ exchange rate	6.98	8.26	8.66	8.65
R/euro exchange rate	9.23	12.06	11.91	12.11

* Targeted measure of consumer inflation: CPIX until 2008 and new redefined headline CPI from 2009

Source: Bureau for Economic Research

Western Cape economy

Historic Trends

- The latest real GDP growth statistics, as released by Stats SA, indicated that economic growth in the Western Cape remained high and stable at 5.8% during 2007 (SA GDP growth averaged 5.1% in 2007 and the regional economy also expanded at a rate of 5.8% in both 2005 and 2006). According to current estimates by Quantec Research, growth came in at around 4% during 2008; i.e. again slightly higher than the national GDP growth rate of 3.1%.

Table 2: Gross Domestic Product data

Industry <i>Based on GDP figures at basic prices (constant 2000 Rand)</i>	<i>Contribution</i> <i>percentage (based on 2007)</i>		2007 Growth figures <i>year-on-year % change</i>		2008 Growth figures <i>year-on-year % change</i>	
	SA	WC	SA	WC	SA	WC*
Agriculture, forestry and fishing	2.5	4.0	2.9	3.1	18.8	12.4
Mining and quarrying	6.1	0.2	0.0	-0.3	-6.5	2.9
Manufacturing	17.8	17.6	4.5	4.7	1.2	0.9
Electricity, gas and water	2.3	1.6	3.0	2.8	-1.2	-2.0
Construction	3.7	5.0	17.1	17.2	13.9	14.9
Wholesale & retail trade; catering and accommodation	15.5	16.8	5.2	5.3	0.5	0.7
Transport, storage and communication	10.9	11.0	5.6	5.9	4.0	4.1
Finance, insurance, real estate and business services	21.6	30.1	6.8	6.6	5.0	5.6
Personal services and other	5.9	4.6	4.0	3.8	4.1	4.0
General government services	13.7	9.1	3.7	3.7	3.9	3.1
All industries at basic prices	100	100	5.1	5.8	3.2	4.1

**estimates by Quantec Research*

Source: Stats SA; Quantec Research

- The performance of the Western Cape economy is driven by growth in the services (excluding government) sector, with particularly the finance, insurance, real estate and business services sector recording strong growth of 6.6% during 2007. This category is estimated to have grown by 5.6% during 2008. Furthermore, another force behind the 2007 Western Cape real GDP growth rate was the construction sector, which expanded by 17.2% per annum after registering 14.1% in 2006. Nationally, construction grew at a real rate of 17.1% in 2007. In 2008, the Western Cape construction industry is likely to once again outperform the national average with an estimated expansion of 14.9%, compared to 13.9% for SA.
- While real growth in output was consistently higher than the national, total (formal and informal) employment growth in the Western Cape came in notably lower between 2005 and 2007: the average growth in total employment was 1.4%, compared to a national growth rate of 2.0% (Quantec Research). With the exception of the community, social and personal services sector, employment growth in all sectors was less rapid (than for the national) over this period. However, particularly the following trends biased the Western Cape employment performance downwards: the trade & tourism (wholesale & retail, catering & accommodation) and the construction industries underperformed in terms of employment growth compared to the national. Furthermore, retrenchments in the manufacturing as well as agriculture, forestry and fishing sectors (relatively large employers in the

region) occurred at a faster pace than at the national level. Notwithstanding, the regional unemployment rate has remained firmly beneath the SA average over this period (as documented by Stats SA in the Labour Force Surveys).

Table 3: Employment data

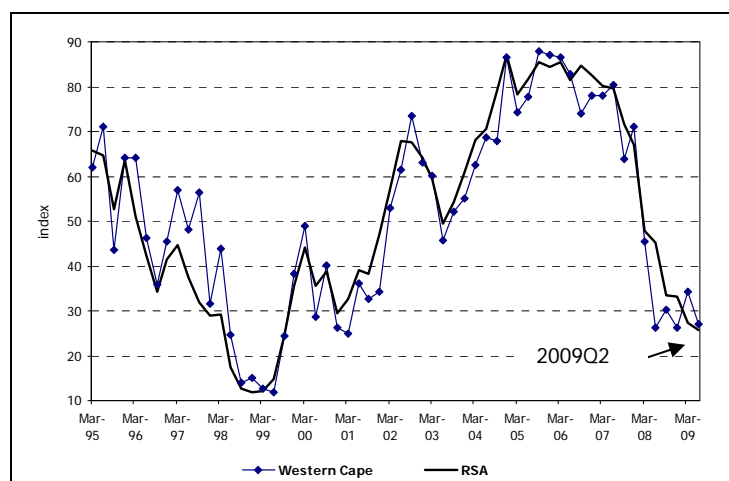
	<i>Contribution</i> <i>percentage</i> <i>(based on 2007)</i>		2005-07 Average growth figures <i>year-on-year % change</i>	
	SA	WC	SA	WC
Formal employment	80.8	78.2	1.7	1.2
Agriculture, forestry and fishing	6.2	9.4	-2.2	-2.8
Mining and quarrying	4.0	0.3	4.0	3.2
Manufacturing	10.7	11.0	0.0	-1.3
Electricity, gas and water	0.3	0.3	3.3	3.1
Construction	3.8	5.1	5.5	3.8
Wholesale & retail trade; catering and accommodation	14.1	13.6	3.6	2.5
Transport, storage and communication	2.9	2.7	2.3	1.4
Finance, insurance, real estate and business services	14.7	14.9	2.2	2.0
Community, social and other personal services	24.1	20.9	1.3	2.6
Informal employment	19.2	21.8	3.4	2.2
Total (formal and informal) employment	100	100	2.0	1.4

Source: Quantec Research

Latest Statistics and Economic Outlook for 2009/10

- Regional business confidence² remained low; currently 27% of the BER's regional respondents are satisfied with business conditions – compared to 26% nationally (see Figure 1 and Table 4).

Figure 1: Western Cape business confidence index



Source: Bureau for Economic Research

² The Western Cape business confidence index is calculated as the unweighted average percentage of the BER's Western Cape respondents in the manufacturing, building, retail, wholesale and new vehicle trade sectors rating prevailing business conditions as satisfactory. The index could vary between zero and 100, where zero indicates all respondents rated prevailing business conditions as unsatisfactory and *vice versa*. A reading of 50, i.e. where half of respondents is satisfied, is taken as neutral.

Table 4: Confidence index data for Western Cape vs. national indices

	2008Q1	2008Q2	2008Q3	2008Q4	2009Q1	2009Q2
WC Building Contractors	56	41	50	34	37	18
Building Contractors	68	47	41	42	33	23
WC Manufacturing	22	18	31	39	35	24
Manufacturing	46	37	30	31	16	11
WC Retail	61	38	30	38	47	35
Retail	49	53	49	49	52	47
WC Services*	71	62	49	43	44	40
Services*	64	61	59	55	53	45
Ernst & Young Life Insurance Index	100	63	51	48	50	51
Ernst & Young Investment Management Index	77	81	57	42	45	66
Ernst & Young Financial Services Index **	84	70	58	47	40	49
WC Business Confidence Index#	45	26	30	26	34	27
RMB/BER Business Confidence Index#	48	45	34	33	27	26
WC Consumer Confidence Index	-3	-19	-19	-21	-22	-9
FNB/BER Consumer Confidence Index	12	-6	-1	-4	1	4

* Preliminary survey results; not yet published or included in the calculation of the overall RMB/BER Business Confidence Index. The reliability of the survey has not yet been established and currently the total is taken as the unweighted average of the following sectors: catering, accommodation, transport, storage, communication, real estate, business services and personal services.

** The overall index sums up developments in the retail banking, investment banking, life insurance and investment management industry.

Calculated as the average confidence in the manufacturing, retail, wholesale, new vehicle trade and building sectors.

Source: Bureau for Economic Research

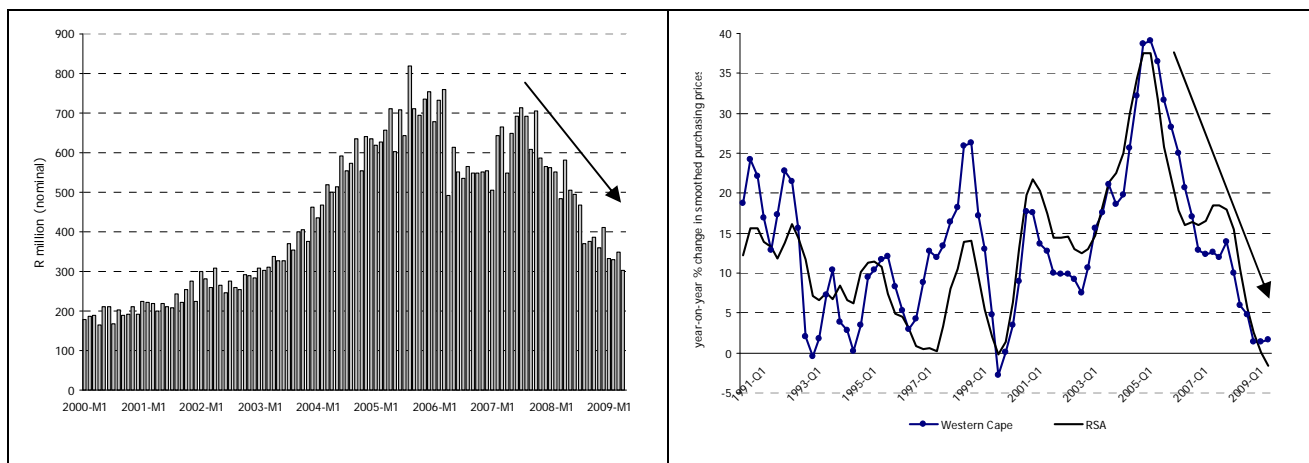
- Consumer confidence in the Western Cape remained notably lower than at the national average. This gap reached a peak in 2009Q1, when the overall index moved into positive territory while the Western Cape index remained depressed at -22, but the regional index has since improved to -9 in 2009Q2. The main reason why the gap in consumer confidence between the Western Cape and the rest of the country widened since the start of 2009 is that black consumer confidence recovered by more than those of the other racial groups. Given that black consumers makes up a smaller share of the total population of the Western Cape, consumer confidence did not rebound to the same extent than nationally.
- The BER Retail Survey reveals a similar trend, with retail confidence in the Western Cape dipping earlier (in 2008Q2; but from a relatively high level) and remaining lower thereafter than the overall index.
- Data from the preliminary services³ sector survey shows that the retailers' experience echoed in the services industry from 2008Q3. Except for transport (rail, bus, airlines, cargo handling and travel agencies), all the other sub-sectors – namely catering (restaurants), accommodation (hotels and guest houses), storage, real estate (estate agents), business services (car rental, IT, attorneys, accountants, advertising, marketing, security services, call centres) and personal services (washing and dry cleaning,

³ Please note that the results of the BER Services Survey (which commenced in 2005) presented here are preliminary and have not yet been published or included in the RMB/BER Business Confidence Index. However, given the relevance to the Western Cape economy, the information is a useful addition to this analysis.

hairdressing, beauty treatments, funeral services, gyms, cinemas, theatres and casinos) – experienced bigger contractions in business activity during the second quarter of 2009.

- The regional tourism industry is likely to have come under pressure since the onset of the global economic crisis and subsequent domestic recession. ACSA reports that passenger arrivals at Cape Town International and George Airports are down almost 12% on a year-on-year basis in 2009Q1. However, the range of sporting events hosted in 2009 could soften the blow somewhat. Looking ahead to 2010, international economic conditions may be more conducive to tourism and the hosting of the 2010 FIFA Soccer World Cup should provide a boost. The lower number of tourists adversely affected the retail trade, restaurants, hotels, car rental companies and entertainment industry.
- Real estate activities remained at historically weak levels (as clearly illustrated by the figures below showing the trends in real estate transfer duties as well as average house price movements) and adversely affected other business services (such as attorneys and bond originators) as well as retail banks.

Figure 2: Real estate transfer duties and annual percentages changes in average house prices



Source: SARB; ABSA

- The Ernst & Young Financial Services Survey indicates that the global financial crisis adversely affected the life insurance and the investment management industries, which dominates in the Western Cape. However, confidence in these two sub-sectors has already moved above that of the overall industry during the first two quarters of 2009 as risk aversion declined, net inflows recovered and high non-performing loans (impairments) weighed down retail and investment banks, which do not dominate in the Western Cape. Short term insurers, which also play a big role in the Western Cape, were battered by rising claims and falling investment income.
- Employment in the investment management industry makes up a large share of total employment in the financial sector in the Western Cape. If the recovery in the industry continues, total lay-offs could be kept at a minimum.
- The recent performance and outlook for the regional economy's dominant services, trade and tourism industries hinge on the national as well as global economic situation described above. Hence, significant

weakness can be expected this year, with a muted recovery projected for 2010. In particular, the key driver of domestic consumption expenditure, i.e. household disposable income, is expected to remain under pressure given the sizeable contraction in employment that is on the cards for 2009. This despite the aggressive (450bps) interest rate reductions since December 2008, the lower projected inflation, increase in the value and number of beneficiaries of social grants and R13.6bn worth of personal income tax relief announced in the 2009/10 Budget. *Overall real household consumption expenditure is forecast to fall by 1.7% before recovering to growth of 2.9% during 2010 as personal incomes are lifted by a further inflation easing, the positive lagged impact of lower interest rates, less stringent bank lending standards, and (importantly) an expected improved employment situation.*

- Manufacturing activity in the Western Cape seems to be slightly more shielded against the effects of the global economic crisis than is the case at the national level. The BER Manufacturing Survey revealed consistently higher business confidence amongst Western Cape manufacturers (from 2008H2) when compared to the overall index. Manufacturers of consumer goods (particularly food and beverages) make up the largest share (also disproportionately large compared to the national industry structure) of production activity. Given the fact that this is a less cyclical industry, these producers have had more success in weathering the economic turbulence.
- Real value-added in the manufacturing sector expanded by 4.7% in 2007 (according to Stats SA) and although this figure is estimated at only 0.9% in 2008 (Quantec Research); evidence suggests that Western Cape manufacturers should outperform their national counterparts in 2009. The BER Manufacturing Survey indicates that a net majority of only 2% of respondents in the province reported declines in production volumes during 2009Q2 – compared to 62% nationally. Hence, the contraction in regional production has been significantly less pronounced than in the rest of South Africa during the first half of 2009, and this is expected to continue for the rest of the year. The outlook beyond 2009 remains uncertain given the global economic situation, but growth in the sector should recover – with indicators of expected business conditions in 12 months' time rising notably. Risks to this outlook include a stronger rand exchange rate, which may hamper provincial exports.
- According to Quantec Research estimates, regional fixed investment spending averaged 13.9% real growth in 2007. This rate is slightly less robust than the national growth rate of 16.3%, which slowed to 10.2% during 2008. Western Cape fixed investment spending growth in 2008 is estimated to have decelerated to 9.6%. Stats SA reported that the construction sector in the province expanded by 17.2% in 2007 and Quantec Research projects this at 14.9% for 2008. The BER Building Survey indicates a closing of the gap between Building Contractors' confidence levels at national and provincial level. The average confidence index for 2008 was 45 in the Western Cape, compared to 50 nationally. For 2009H1, both these came in at 28 index points. The Provincial Government budgeted capital spending worth R2.393 billion in 2009/10, up from a revised estimate of R2.037 billion in the 2008/09 financial year. Capital expenditure in public works, transport, education and health accounts for almost 97% of the budgeted spending. The share of capital expenditure in the provincial budget is however projected to decline from 8.25% in 2009/10 to 7.52% in 2011/12. However, one can conclude that the construction sector will remain a driver of economic growth in the Western Cape.

- In view of the national economic outlook and the expected world economic conditions, the regional economic growth picture for 2009 is quite bleak. However, the contraction is likely to be somewhat less pronounced in the Western Cape than at national level. Mining activity is limited in the province (and has been one of the key sectors driving the economic deterioration at national level) and the regional manufacturing sector seems to be performing less dismally than the national average. Furthermore, agricultural activity (grain, fruit and wine) seems to be relatively lively and makes up a larger share of the provincial value added. Finally, the regional services (excluding government), trade and tourism industries should not underperform their national counterparts by any large margin.
- Moreover, in contrast with the historic trend of underperforming Western Cape employment growth, the latest Labour Force Surveys (released by Stats SA in May and July 2009) indicated that the region was one of few provinces which did not register contractions in total employment during the first and second quarters of this year. Rather, year-on-year growth rates of 3.3% and 0.4% were reported respectively, with relatively healthy employment growth data for the trade, construction, and services sectors.
- Regional GDP should accelerate in 2010, in line with the national trend. However, the outlook contains notable risks as uncertainty remains about both the global economic and SA outlook. Whereas previously the global uncertainty was based on how severe the recession would be and when it would end, it has been replaced by doubts about the strength of the recovery. Here the risk goes both ways – if the recovery does not materialize as expected, perceived riskier assets (including the rand) could experience a sharp sell-off with negative domestic inflation repercussions. Such a scenario will also increase the downside risks to SA GDP growth in 2010, but as mentioned the BER is already assuming a sluggish global growth recovery. However, an upside risk would be a stronger than expected global revival on the back of unprecedented policy support. A weaker rand also bodes well for agricultural and manufacturing exporters as well as the tourism industry – all important sectors in the Western Cape.

Christelle Grobler

George Kershoff

Hugo Pienaar

BUREAU FOR ECONOMIC RESEARCH

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