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BUREAU FOR ECONOMIC RESEARCH

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

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

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CONTENTS

LIST OF FIGURES

LIST OF TABLES

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

Global economy

- There is widespread consensus that the world economy is heading for slower growth in 2007 principally as a consequence of an expected slowdown in the USA economy. However, considerable variance of opinion exists amongst analysts on how sharp the slowdown in the USA economy will be. Fortunately, important global supports remain, e.g. the robust economic growth performances in China and other developing economies, sustained growth in Japan and a promising economic recovery in the Euro area. These factors are likely to contain the expected slowdown in the world economy and support export recovery. The improved growth performance in the Euro area, in particular, has favourable implications for the SA and Western Cape economies, given the strong trading links with this region.
- The general tendency in industrial commodity prices has been downward since May 2006 and is likely to remain so over the short term.
- Whilst there has been a pause in the tightening of monetary policy by the US Fed, 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 short-term capital flows to developing countries.

South African economy

- All indications are that real economic growth remained strong during the third quarter and probably into the fourth quarter on a par with the second quarter's close to 5% real GDP growth rate. The booming conditions in the retail, construction and financial services sectors continued and growth was augmented by a promising recovery in the manufacturing sector. The growth momentum in real domestic expenditure is strong, interest rate hikes have a delayed impact and the weakening rand exchange rate stimulates economic activity, particularly in manufacturing.
- Having said that, the current buoyancy in the economy should not conceal the fact that a more challenging growth environment is unfolding. Apart from slower global growth, there are leading indications that the interest rate increases are starting to impact on the domestic economy. The favourable pricing environment of recent years is also rapidly changing and financial volatility has reared its ugly head.
- The lively domestic market of recent years is likely to cool down and growth will depend more on the expected export recovery. The BER remains optimistic that the SA economy will overcome these challenges in relatively good shape, with growth expected to move down only a notch or two – from the heady 5% level closer to 4% over the short term. Sustained fixed investment and associated employment growth and an expected recovery in exports should compensate for the projected slowdown in the interest rate and price sensitive components of real domestic expenditure. *Real GDP growth of 4.3% and 4.1% is projected during 2006 and 2007 respectively, despite a slightly more pessimistic outlook on inflation and interest rates.*

- The high producer inflation rate (9% in September) suggests strong pipeline inflation pressures. While inflation expectations have remained relatively well-behaved and within the 3-6% target range (5.3% in respect of CPIX inflation in 2007), we are likely to witness some pass-through from the currency depreciation and PPI inflation to CPI inflation; food prices are also on the increase. *CPIX inflation is projected to peak at 6.2% (2007Q1) and to average 5.9% during 2007, before moderating to 5.7% during 2008.*

- Interest rates are projected to increase by another 100 – 150 basis points over the next 6 to 8 months (on top of the June, August and October 50 basis point hikes). The anticipated high level of inflation (around the upper range of the 3-6% inflation target during the course of 2007) will make it difficult for the SARB to relax monetary policy before the end of next year.

- While we expect two-way movements in the rand exchange rate, i.e. bouts of weakness followed by recoveries, the rand may prove vulnerable over the short term as global interest rates rise, commodities decline and the domestic balance of payments current account deficit remains on a high level.

- Higher inflation and interest rates are likely to cool down the 6-7% domestic spending momentum in the economy, closer to a 4% level. This and the weaker rand exchange rate should cool down import growth and – combined with a currency-induced recovery in exports – allow net exports to make a more positive contribution to overall GDP growth.

- Sustained fixed investment spending – driven by production capacity pressures – and associated employment growth are expected to compensate for the negative impact of higher interest rates on the interest rate sensitive components of domestic spending. The favourable fixed investment trend is also likely to be supported by a recovery in export growth. Manufacturers' export expectations have improved, albeit most of the renewed growth impetus may only be visible next year and during 2008.

Table 1: Macro-economic outlook for South Africa: 2006 to 2008

	Ave 2000-05	**2005**	**2006F**	**2007F**	**2008F**
Expenditure on GDP (real % change):					
Household consumption	4.6	6.9	6.6	3.6	4.1
Fixed investment	6.1	9.2	9.4	7.7	8.0
Gross domestic expenditure (GDE)	**4.9**	**5.9**	**7.5**	**3.6**	**5.1**
Exports	3.3	6.7	2.4	6.9	6.1
Gross Domestic Product (GDP)	**3.8**	**4.9**	**4.3**	**4.1**	**4.2**
Inflation, interest & exchange rates					
CPIX inflation	6.5%	3.9%	4.6%	6.0%	5.7%
PPI inflation	6.2%	3.1%	7.4%	8.3%	6.3%
Prime overdraft interest rate (eop)	13.5%	10.5%	12.5%	13%	12%
R/$ exchange rate (ave)	7.74	6.36	6.84	7.93	8.48
R/euro exchange rate (ave)	8.09	7.92	8.60	10.48	10.87

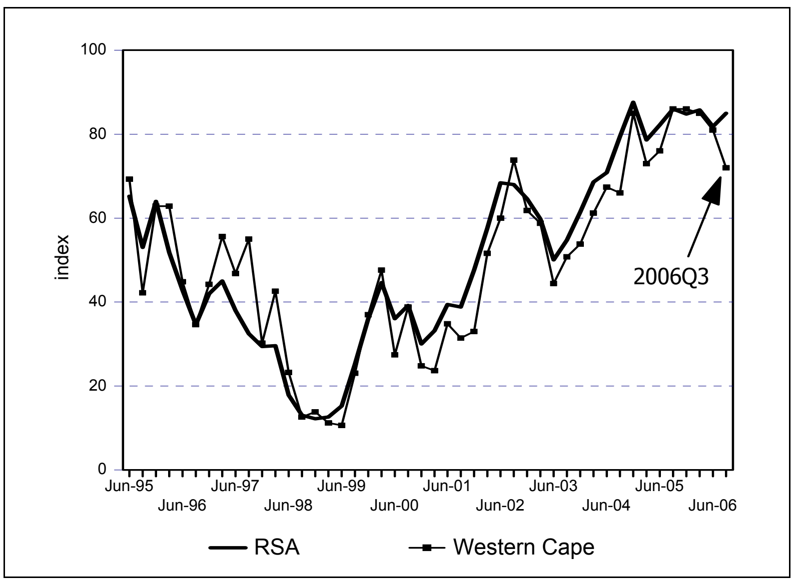
Source: Bureau for Economic Research

Western Cape economy

- The Western Cape economic outlook has been bolstered recently by the announcement of major capital spending projects, ranging from the expansion of the Cape Town harbour and international airport and a major upgrade of the metro's transport infrastructure, to the foreign direct investment in the V&A Waterfront development, construction plans for the World Cup soccer stadiums and Eskom's expansion plans (with two new gas-fired power generation plants already under construction and a new nuclear power station under consideration).

- The public and private sector fixed investment activity is evidence of the buoyant regional economic conditions – *real GDPR growth averaged 4.6% per annum over the 2000–2005 period and came in at an estimated 5.6% last year*. The cumulative growth is creating infrastructure and logistics bottlenecks and in the private sector it is leading to production capacity constraints, which all are stimulating fixed investment spending.

Figure 1: Western Cape business confidence index



Source: Bureau for Economic Research

- The favourable fixed investment trend may also be some indication of likely economic growth in the region over the short to medium term future. The increase in consumer demand is likely to continue to slow as higher interest rates and inflation impact on household budgets, reversing the extra-ordinary stimulus of recent years. Capacity-driven private fixed investment spending and public sector infrastructure investment will take up the slack and be the main drivers of growth. On this basis, the short- to medium term regional economic outlook remains decidedly upbeat. The shift from consumption to fixed investment spending driving growth is to be welcomed. It will provide the foundation for raising the long-term rate of growth and the underlying growth potential of the economy.

- However, there are challenges. The point was already made that a more challenging macro-economic growth environment is unfolding, with increased financial volatility rearing its head. *Secondly*, the deterioration in retail and manufacturing business confidence in the region during the middle quarters of the year (not observed in the rest of the country) is cause for concern. Manufacturers report serious skilled and semi-skilled labour constraints, raw material shortages, a more constraining general political climate and the impact of higher interest rates. *Finally*, the pace of employment creation is less than satisfactory. Quantec Research employment data (derived from the official labour market data sources) suggest a small (0.7%) contraction in formal sector employment in the region in 2005. However, the improved fixed investment outlook will buoy the employment prospects in the region.

- Overall Western Cape business confidence declined by 14 index points during the second and third quarters of 2006, led by a 30 index point fall in the manufacturing business confidence index. The sharp deterioration of manufacturing export growth during 2003–05 appears to be a key problem area; regional industrial exporters have also been slow to respond to the more competitive level of the rand exchange rate. Western Cape manufacturing exports contracted by 2.5% per annum over the 2003–05 period compared to real growth of 12.5% per annum registered over the 1995–2002 period. A recovery in this poor export performance will be critical to the future growth of the region. It is not clear by Western Cape manufacturers have not benefited in terms of reduced import competition in the wake of the currency depreciation since May this year as the case was with non-Western Cape manufacturers.

- Outside of manufacturing, the buoyant business conditions in the region's services and construction industries appear to continue, despite the increase in interest rates since June this year. Excluding government, the tertiary sector is estimated to have expanded by 6.8% in 2005 and 5.8% during 2006. In line with national trends, the strong growth in these industries continued during the third quarter of the year and probably the final quarter as well. While the regional retail situation appears less buoyant compared to the rest of the country, it remains on a firm footing.

- Considering the outlook for regional economic growth, the picture remains similar to that reported in the previous *Economic Brief (3rd Quarter 2006)*. The interest rate sensitive sectors are likely to cool down over the short term, albeit that this impact is only likely to become more visible going into next year. It is expected that the manufacturing sector will eventually catch up with the recovery happening at the national level on the back of a more competitive currency, particularly on the export side.

- Construction conditions are expected to remain buoyant, even though the residential sector may witness a softer trend given the deterioration in the property market and the increase in interest rates. Non-residential building activity and civil construction works should continue to buoy the rest of the sector. Skilled labour constraints may prove to be the most serious constraint hampering progress.

- A less buoyant national macro-economic environment and the impact of higher inflation and interest rates is expected to lead to slower regional growth over the near term. *Real GDPR growth is projected to slow from an above 5% tempo in 2005/6 closer to a still lively 4-4½% rate in 2007/8; thereafter growth is projected to re-accelerate in the run-up to the 2010 World Cup Soccer event*.

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