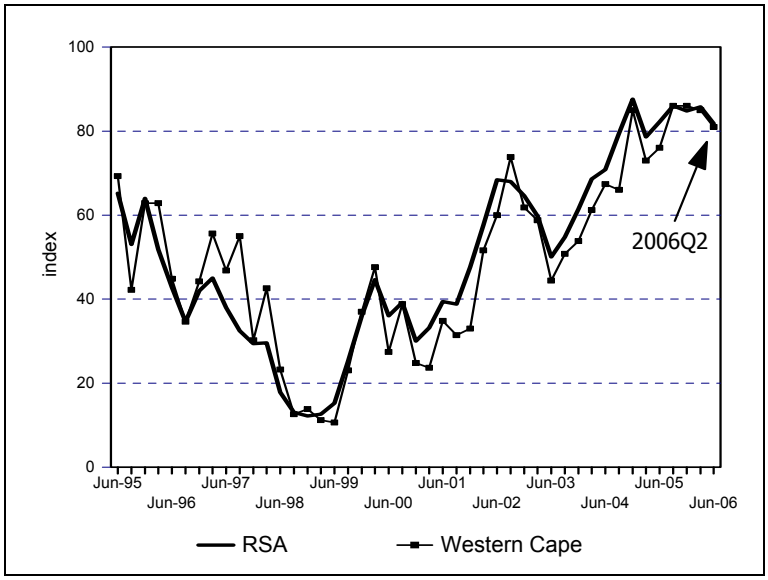
The current state and short-term prospects for the Western Cape economy

The South African financial environment has been shaken by a depreciating currency, interest rate hikes and a strong dose of "emerging market jitters", with South Africa being one of the more notable "victims" faced with a current account deficit measuring 6.4% of GDP during the first quarter of 2006. However, the BER expects *resilience* on the back of healthy structural business cycle characteristics and a competitive boost to manufacturing activity. The financial reactions are expected to be of a contained nature. While the overheating consumer sector is likely to slow down, this is not expected to unduly harm the underlying private fixed investment and employment creation drive. Furthermore, public sector fixed investment will be a counter-balancing factor in terms of wider economic growth.

The Western Cape economy business cycle broadly tracks that of the national economy – *see Figure 1.* Therefore, the same factors currently affecting the national macro-economic climate will impact locally. The depreciation of the rand exchange rate and the projected increase in inflation and interest rates will impact both on the sectoral composition and level of growth in the Western Cape.

Real GDP growth in the region in all likelihood continued at a relatively robust pace during the second quarter of 2006, with the services industries (excluding government) continuing to put in strong growth performances in line with the national situation. However, considering the BER's latest business tendency survey results in the region, a number of cyclically sensitive sectors suffered a decline in business confidence, which was more serious compared to the national situation.

Figure 1: Western Cape business confidence index



Source: Bureau for Economic Research

Overall Western Cape business confidence declined by 4 index points (in line with national); however, in the retail sector the decline was sharper (14 index points compared to 3 points nationally) and in manufacturing (13 index points compared to 3 points nationally). In fact, whereas the national manufacturing sector shows signs of a recovery during the first half of 2006, this revival is not yet evident in the Western Cape. Only 54% of the Western Cape manufacturing respondents reported satisfactory business conditions during the second quarter.

The BER manufacturing survey results showed that while domestic order volumes picked up during the second quarter, export orders and sales deteriorated and production contracted. The skilled and semi-skilled labour constraints and insufficient demand for product constraint picked up sharply. The regional manufacturing business confidence index declined from 67 to 54. These developments contrast with the national picture where the June/July Investec PMI readings signalled a firm competitive boost to manufacturing activity.

It remains to be seen what the impact of higher interest rates and inflation will be on the lively retail and construction sectors. Regional consumer confidence has been trending at slightly lower levels compared with national over the past couple of quarters. 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 and energy prices, particularly at the lower end of the market.

The changed financial environment will also impact 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. Particularly, private residential construction is likely to cool down significantly over the short term. The property and financial services sectors may also be peaking, albeit that this is not yet so evident from the available statistics.

Therefore, the sectoral composition of the region's growth is likely to change. 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 during the second half of the year and next year. The regional employment tendencies are already reflecting this pattern: the adverse factory employment situation is bottoming out (despite the disappointing production tempo), while job growth in the retail and construction sectors has tapered off.

It is likely that the projected regional GDP growth will have to be scaled down. Previously, growth was projected to soften from an above 5% tempo in 2005/6 to 4.5% in 2007/8, before picking up again. *It is likely that growth will come in closer to the 4% level in 2006/7*. The Western Cape economy also remains exposed to downside risks. The global economy could be weaker in the event of a US recession next year, while geo-political event risks continue to cloud the horizon and the outlook for the oil price. Domestically, balance of payments risks could see a sharper weakening of the rand exchange rate sparking higher Inflation and interest rates compared to the baseline assumptions.

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31 August 2006