## Rapid global economic growth

During 2004 the global economy showed the strongest growth rate since the 1980s — a rapid expansion of 5% based on purchasing power exchange rates.

**Table 1: The world economic outlook – real GDP growth**

| | 2004 | 2005 | 2006 | | 2004 | 2005 | 2006 |
|---|---|---|---|---|---|---|---|
| **Industrial countries** | | | | **Developing countries** | | | |
| Major Seven | 3.2 | 2.6 | 2.8 | Emerging Asia [2] | 5.8 | 4.4 | 4.8 |
| USA | 4.4 | 3.7 | 3.4 | China | 9.3 | 8.2 | 8.5 |
| Japan | 2.9 | 1.5 | 2.1 | India | 6.0 | 6.5 | 7.0 |
| Euroland [1] | 1.8 | 1.9 | 2.2 | Latin America | 5.9 | 3.9 | 3.6 |
| Germany | 1.2 | 1.5 | 1.8 | Emerging Europe [3] | 6.6 | 4.9 | 4.7 |
| UK | 3.1 | 2.5 | 2.5 | Sub-Saharan Africa [4] | 4.6 | 5.8 | n/a |

1 The 11 Euro countries;

2 Taiwan, Hong Kong SAR, Singapore, South Korea, Malaysia, Indonesia, Thailand and Philippines;

3 Bulgaria, Czech Republic, Hungary, Poland, Slovak Republic, Russia, Turkey

4 Sub-Saharan Africa

Source: JP Morgan/IMF World Economic Outlook, September 2004.

Over the past decade, the South African economy has matured considerably and at present is reaching a higher growth band. Despite this consistent growth rate, it has faced a number of key challenges, most notably:

- A need to align macroeconomic policy with growth and development objectives.
- A strong and volatile exchange rate.
- Distorted input pricing in key sectors.
- A structural shift to higher skill, more capital-intensive activity.
- Slow pace of government and private investment.
- Critical skills shortages.
- Insufficient implementation coordination.

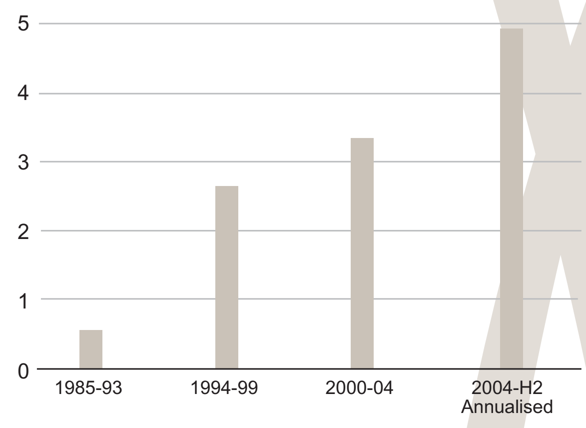
However, several positive factors support an environment for higher growth. Fiscal policy, particularly in the past five years, has switched to a more expansionary stance; inflation and nominal interest rates are at lower levels; consumer demand has grown; the political climate is the most stable in years, and business and consumer confidence are at historically high levels.

## Strong domestic economic growth

Domestically, real economic growth averaged 3% per annum from 1995 to 2004. This accelerated to 3.4% on average over the upswing phase of the current business cycle from the end of 1999.

In 2004 real GDP growth re-accelerated to 5% (figure 1) during the second half of 2004, averaging 3.7% for the full year.

**Figure 1: SA's growth performance in perspective**

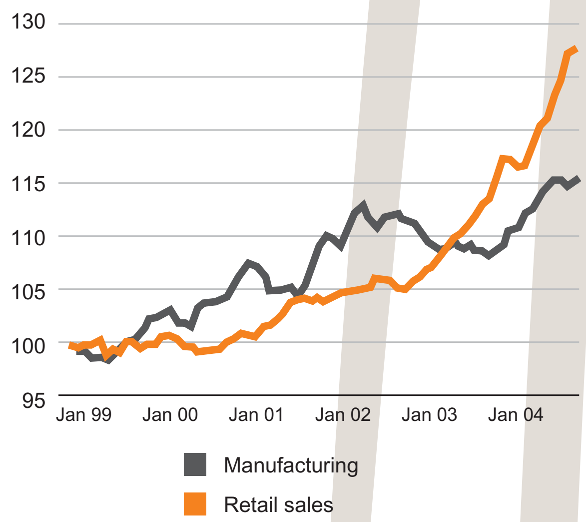



## The strong Rand: fuelling domestic demand, straining exports

The lower interest rate, coupled with lower inflation rates, has fuelled domestic demand. However, the strengthening Rand has had an adverse effect on the export sector, as imports started to compete fiercely with exporting manufacturers. This has contributed to a widening current account deficit as imports outstrip exports.

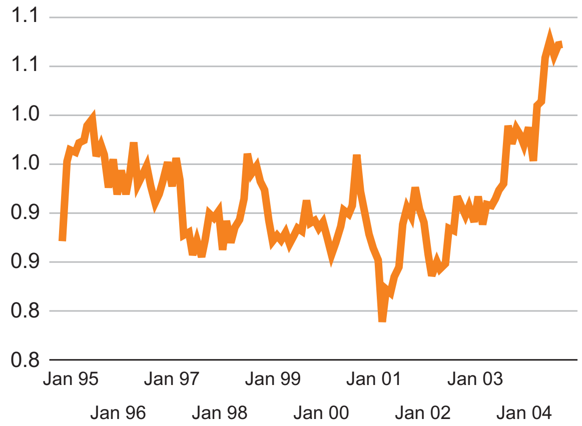
Furthermore, the widening gap between retail sales and manufacturing performance is a cause for concern as the increased demand is being met by imports (figure 2) causing an increase in the current account deficit (figure 3).

**Figure 2: Manufacturing production volume vs retail sales volume**




Source: Statistics SA/BER

**Figure 3: Ratio of imports to exports: Total**



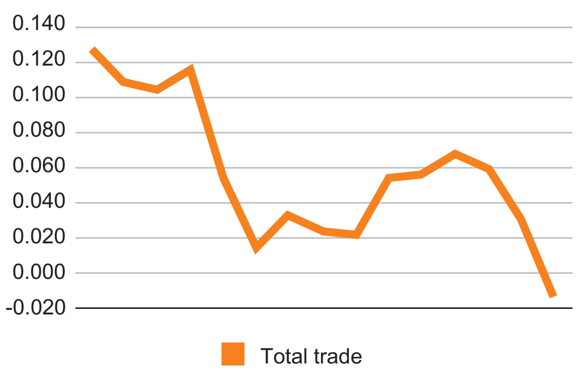

Source: SA Revenue Services/BER

### Inflation, interest rate and the exchange rate

The Consumer Price Index excluding the effect of interest rate adjustments (CPIX) inflation averaged 4.3% during 2004. This is the first calendar year since the inflation targeting monetary policy commenced in February 2000 that CPIX inflation averaged within the target range of 3 to 6%. The January 2005 year-on-year inflation rate came in at 3.6%, well below the mid-point of the inflation target range. CPIX inflation consistently undershot expectations during last year, mainly due to the unexpected strength of the currency. Producer Price Index (PPI) inflation averaged a meagre 0.7% during 2004, with the January 2005 reading coming in well below market expectations at 1.4%.

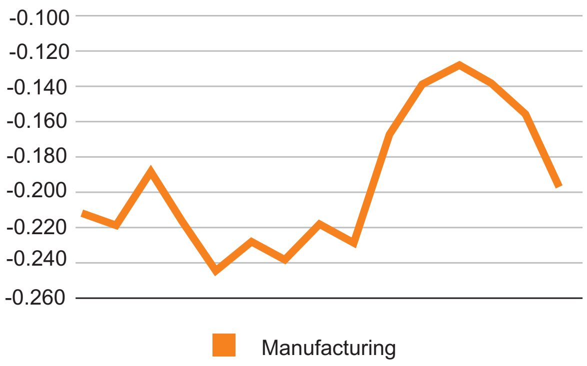
While the strong Rand is conducive to lower inflation and interest rates and, therefore, higher domestic expenditure, it is hurting the country s export and manufacturing growth performances. The manufacturing sector experienced a recession during 2004 as exports deteriorated and import competition intensified. Overall real GDP growth decelerated to a 1.3% annualised pace during the final quarter of 2003. Figures 4 and 5 reflect the deteriorating net export ratios in respect of South Africa s total and manufacturing trade.

**Figure 4: South Africa: Net export ratio**




Source: Quantec Research/BER

**Figure 5: South Africa: Net export ratio**




Source: Quantec Research/BER

### Gross domestic fixed capital formation (GDFCF)

GDFCF is currently expanding at a robust rate, both in the private and public sectors. Following growth of only 3.7% in 2002, GDFCF accelerated to growth of 9.0% in 2003. Revised national accounts statistics show that private sector fixed investment remained strong during the first nine months of 2004, growing by an annualised rate of 13% during the third quarter of 2004.

While the current general fixed investment picture is robust, this does not conceal the more sombre fact that the fixed investment ratio only picked up to 16.1% of GDP during the third quarter of 2004. This is well short of the government s unofficial 25% target and the historically high investment rates during growth periods in the economy (e.g. during the 1960s and 1970s).

This is expected to improve with public corporations fixed investment boosted by SAA s aircraft acquisition programme, the Coega harbour development and other general infrastructure development. Public corporations capital spending is set to rise strongly in the coming five years with the R165 billion planned to upgrade Eskom s and Transnet s infrastructure. Including public-private sector partnerships (PPP) and public corporations fixed investment, the Minister of Finance recently budgeted for total public sector infrastructure fixed investment spending to accelerate from R72.6 billion in fiscal 2004/5 to no less than R121.8 billion in fiscal 2007/8.

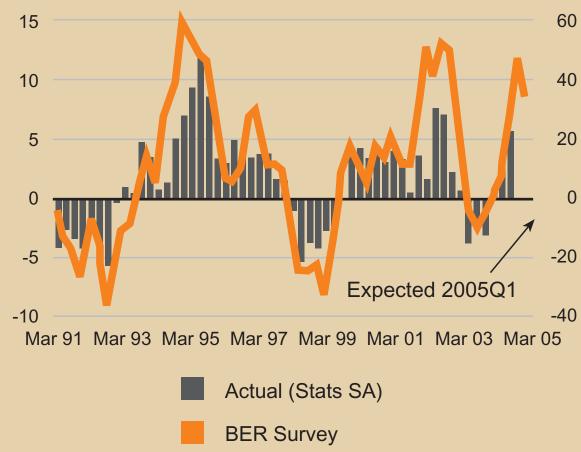
### Formal employment increases in most sectors

The latest labour market analyses point to a more benign overall employment performance over the past decade than previously believed. There has been overall net job growth in the South African economy over the past ten years contrary to popular belief. However, as job growth has lagged, the increase in work seekers and the overall unemployment rate has increased, reiterating the need for productive investment and job creation.

**Figure 6: Average employment growth by sector: 2004**

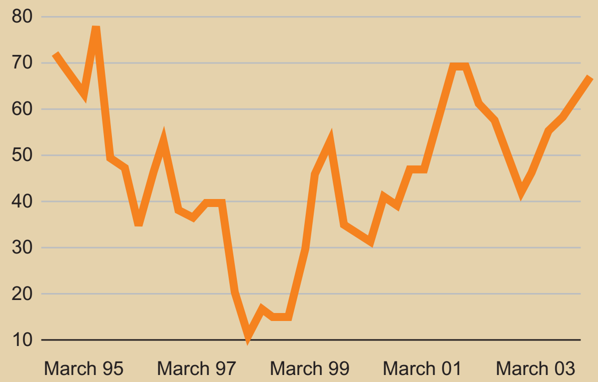

Source: Quantec Research

**Figure 7: Manufacturing production volume (Stats SA actual vs BER survey results)**




Source: Statistics SA/BER

**Figure 8: Manufacturing business confidence (BER survey results)**




Source: BER

Figure 6 shows that most sectors reported positive employment growth in 2004. The robust employment growth reported in the non-metal minerals sector, particularly in building materials, which showed an increase of close to 10%, reflects the buoyant business conditions in the building and construction sector. Mining (6.2%), and wood products and paper (5.7%) also registered strong employment gains, as well as financial and business services (3.6%), which have been a key job creator in recent years. Other sectors that registered employment growth include radio, TV and instruments, electricity and water, furniture, transport equipment, metals and machinery, agriculture, transport and communication, internal trade and catering, as well as the government.

**Manufacturing performance slows down**

Accelerated growth in manufacturing of 4.7% per annum over the 2000/2 period slowed to 1% during 2003/4 with the appreciation of the Rand. Both manufacturing real value-added and production moved sideways during the final quarter of the year. Furthermore, as noted, the sector is experiencing a deteriorating trade balance, reversing the favourable trend discernible over the second half of the 1990s when the Rand was in decline.

Manufacturing production volumes only expanded by 4% in 2004 after contracting by 2% in 2003. Fixed investment and employment creation in the sector remained positive. Real manufacturing fixed investment is estimated to have expanded by 6.7% in 2004 and the number of employment opportunities grew by 0.9% according to Quantec Research. Regarding fixed investment it appears that manufacturers are taking a longer-term view in expanding and upgrading production capacity, as well as exploiting the opportunity to import capital equipment at reduced import cost. Some sectors are also better able to exploit increased domestic demand, which is leading them to expand production capacity and employment although some ground has been lost to manufactured imports.

Table 2: Manufacturing sector (SIC 3) performance: 2005/6

| | 2004 actual | 2005F | 2006F |
|---|---|---|---|
| **Manufacturing variables** | | | |
| Production volumes | 4.1% | 3.5% | 3.8% |
| Real value added | 2.6% | 3.5% | 3.7% |
| Export volume (excl. basic metals) | 2.8% | 3.8% | 5.7% |
| Fixed investment | 6.7%[1] | 6.9% | 5.9% |
| Employment | 0.9% | 1.5% | 1.7% |

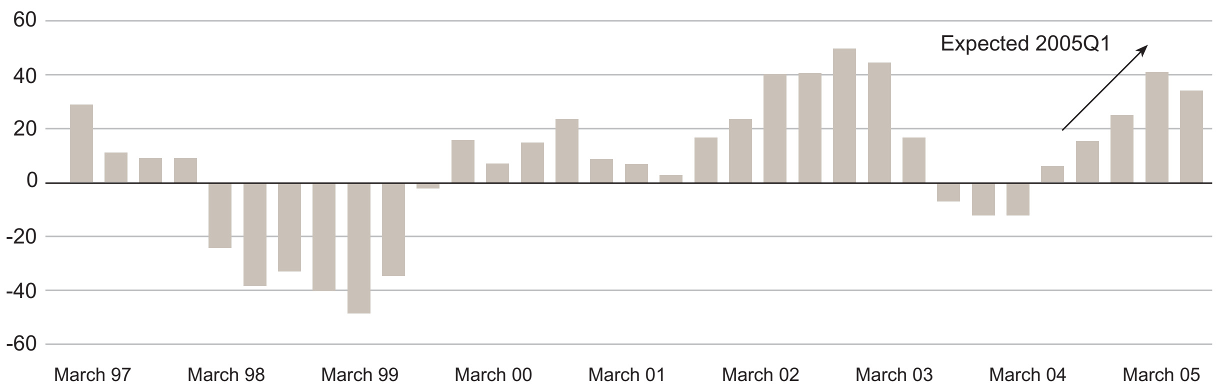
Source: Bureau for Economic Research

**Domestic demand conditions: manufacturers battle**

Real manufacturing value-added expanded by 2.6%, compared with the 6.5% growth in the real value-added of the internal trade sector, including retail, wholesale and accommodation, over the corresponding period.

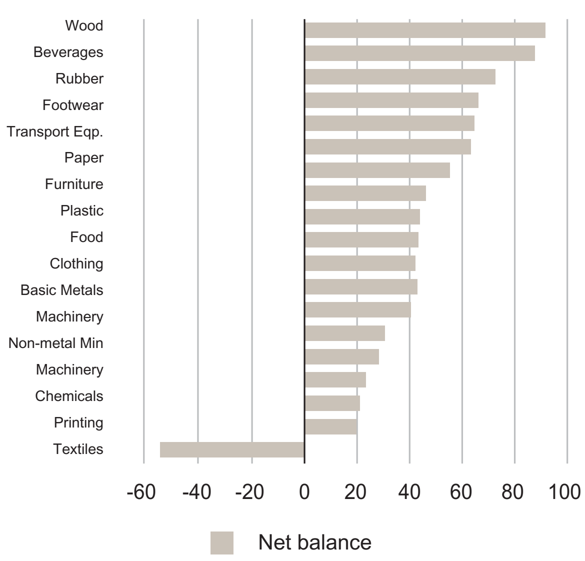
Manufacturing and South Africa s aggregate real imports are estimated to have grown by 17.5% and 13.4% respectively in 2004. In other words, most of the increased domestic demand is not fully benefiting manufacturers as a large part of the increase is met by imports, subtracting from real GDP growth.

**Figure 9: Manufacturing domestic sales volume**




Source: BER

**Figure 10: Domestic sales volume (BER Survey: 04Q4 compared to 03Q4)**




Source: BER

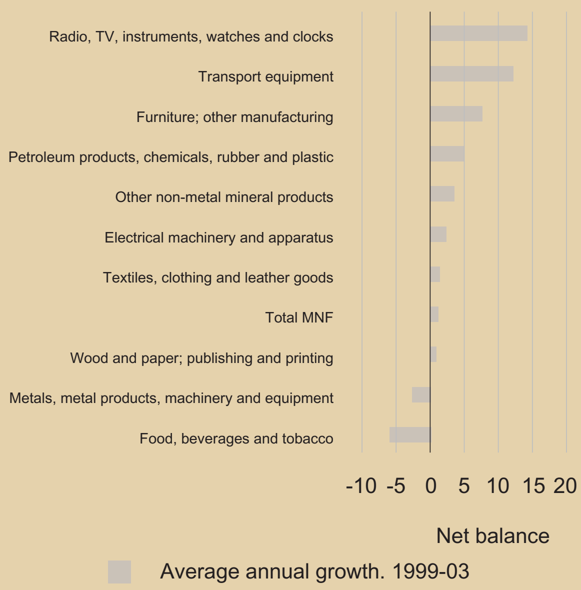
***Export demand conditions: a mixed outlook***

The outlook for manufacturing exports is mixed. The demand for commodity-intensive products, such as basic metals, paper pulp and basic chemicals, should continue strongly provided there is sustained growth in the world economy. Favourable steel and metal commodity prices should benefit the iron and steel, as well as the non-ferrous metal sectors. Exports of transport equipment should also remain strong as more Original Equipment Manufacturers (OEMs) present in the country embark on export drives (e.g. Ford). However, the currency could determine the domestic/ export mix of vehicle production.

The clothing and textile sector also has to contend with increased competition from countries such as India and China in third markets due to the expiry of the Multi Fibre Agreement (MFA), which previously restricted their textile exports to the major industrial country markets by way of quotas.

Real manufacturing exports (excluding basic metals) are projected to grow by 3.8% during 2005 and 5.7% during 2006 on the assumption that the Rand exchange rate adjusts to a level above R7/$ next year.

**Figure 11: Manufacturing fixed investment: Average annual growth: 1999-03**

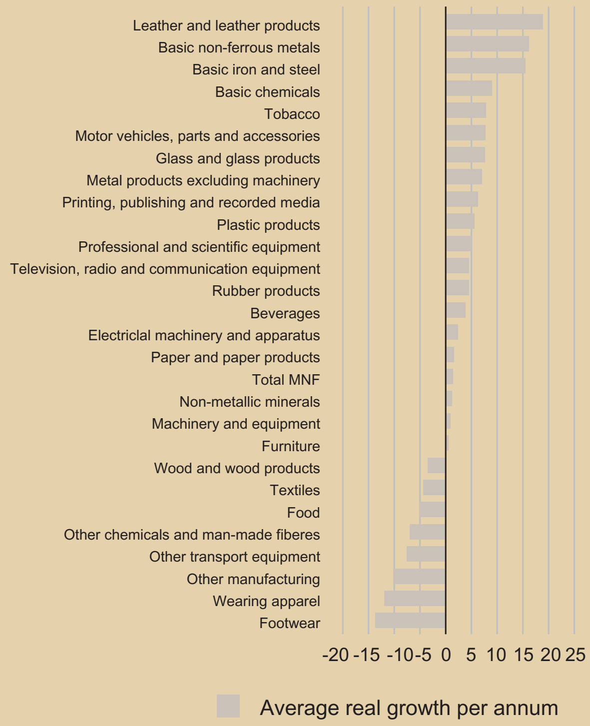



Source: Quantec Research

***Manufacturing fixed investment spending***

The manufacturing sector contributed 6.4% of the growth in aggregate real fixed investment spending in the economy over the period 1999 to 2003. The only manufacturing sub-sectors that contributed significantly to the growth in real gross domestic fixed investment are the automotive and the petro-chemical sectors; each contributed around 10% of the annual growth over the past five years; real fixed investment spending in the radio, TV and instruments, and furniture sectors also expanded strongly.

**Figure 12: Manufacturing: Average real export growth by sub-sector: 2003-04**




Source: Quantec Research

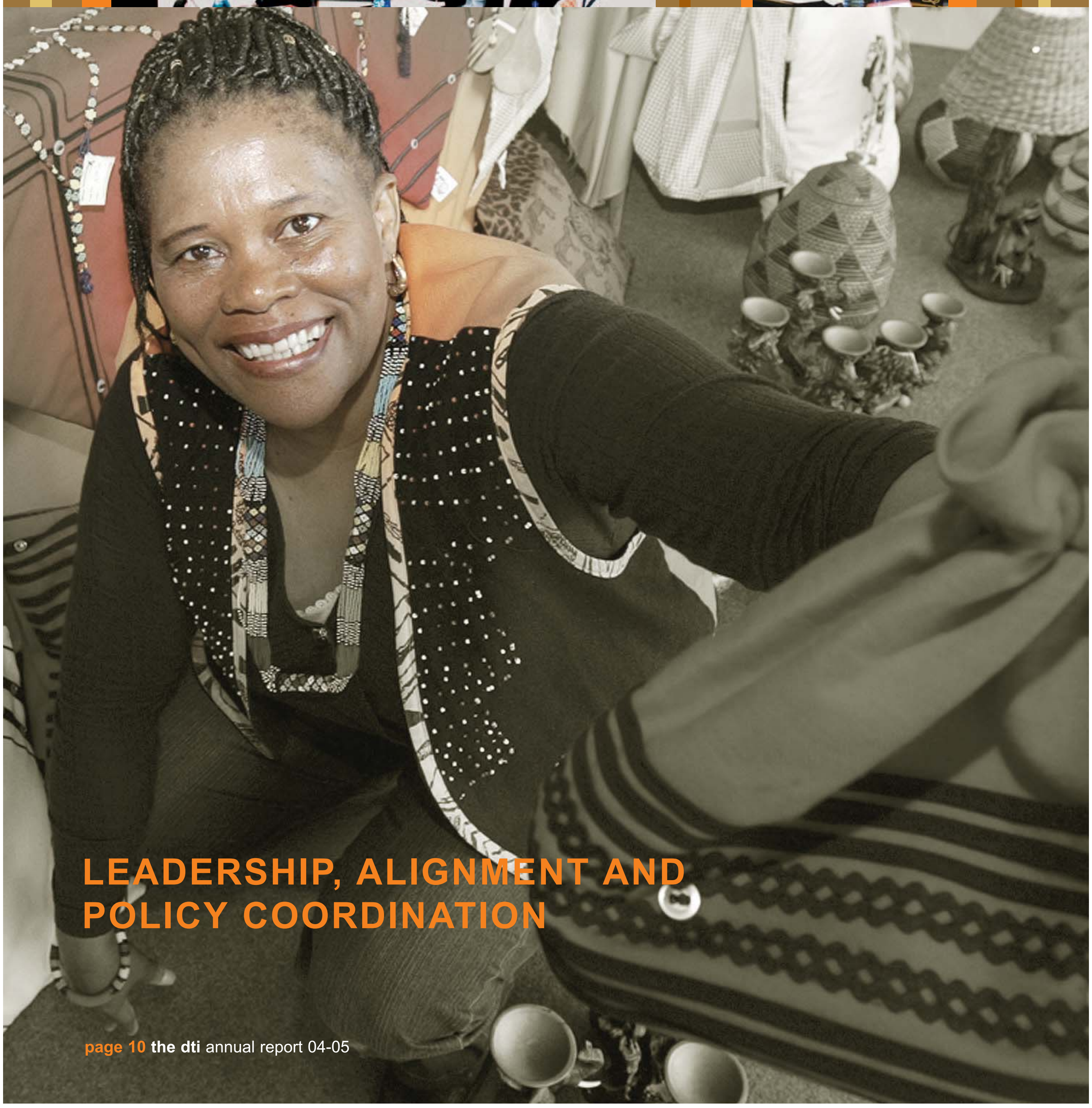
***Employment conditions in the manufacturing sector***

The sustained increase in production levels during 2004 contributed to net employment growth in the fourth quarter of 2004 - for the first time since 2002 according to the BER manufacturing survey. Overall manufacturing employment expanded by 0.9% in 2004 according to Quantec Research.

Companies are contemplating expansion plans given the favourable economic growth environment, low interest rates and high business confidence levels and these expansion plans also appear to be making provision for job growth.

In all, manufacturing employment is projected to grow by 1.6% in 2005/6 on average on the assumption of some recovery in the manufacturing export sector as the Rand adjusts to a more competitive value over the short term.

*"To ensure that the economy benefits everyone, the dti will intensify its focus on collaboration and alignment, and leverage its resources, partners and stakeholders to achieve its objectives"*



# LEADERSHIP, ALIGNMENT AND POLICY COORDINATION