# 2

# Economic policy and outlook

*Against the background of sound macroeconomic policies, continuing strength of international commodity prices and a consistent monetary policy framework, growth and employment creation in the South African economy have accelerated. Supported by the strength of the rand, inflation has remained subdued and interest rates remain at their lowest levels in twenty years.*

*Private sector investment growth has led the recovery, and will continue to be reinforced by rising public sector investment in transport infrastructure and household services. Over the period ahead, economic policy priorities will include raising the employment potential of the economy, lowering the regulatory burden on small businesses, improving communication and freight logistics systems and deepening skills and further education opportunities.*

*Economic growth is expected to exceed 4 per cent a year during the course of the next three years, and inflation will remain within the target range of 3 to 6 per cent. Prospects for further strengthening of the economic outlook depend in part on the sustainability of international growth, but will also be shaped by the impetus of policy reforms and improved coordination of national, provincial and local development initiatives.*

## Overview

*Building on a strong recovery in 2003, growth is expected to strengthen in the medium term*

Following real GDP growth of about 2 per cent in 2003, the South African economy has recovered strongly in the first half of 2004 supported by buoyant domestic demand and a low interest rate environment, coupled with robust consumer and business confidence. Continued strong domestic demand and the momentum of global growth are expected to underpin a strengthening of GDP growth in the medium term.

*The economy expanded by 3,3 per cent*

The economy has experienced broad-based expansion, attaining a seasonally adjusted and annualised growth rate of 3,3 per cent in the first half of 2004. Spurred by exceptional levels of demand in the domestic economy and taking advantage of the strength of the rand, local firms have stepped up expenditure in plant and equipment. Investment in the productive potential of the economy has been particularly robust, with real gross fixed capital formation rising by 8,5 per cent year-on-year in the first half of 2004.

*Inflation within target range*

CPIX inflation has been within the target range since September 2003 and inflation expectations are beginning to align with the target range. It is expected that this will continue in the medium term.

*Steady financial flows contributed to BOP surplus*

Net export growth slowed as imports surged, contributing to a widening current account deficit. However, steady financial inflows have led to a substantial surplus in the country's balance of payments, allowing the Reserve Bank to steadily increase its foreign reserves.

*Rand appreciation had a mixed impact*

The appreciation of the currency had a mixed impact on the economy. Lower import prices supported expenditure on capital equipment and contributed towards a low inflation environment. Low inflation, which translated into lower interest rates boosted consumer demand. While both exporters and import-competing sectors have been negatively affected by the strong rand, this has been partially offset by robust demand. Many firms have successfully adjusted to prevailing market conditions.

*Higher growth expected in the medium term*

Against this backdrop, real economic growth is expected to rise to 2,9 per cent in 2004 from 1,9 per cent in 2003, and to average about 4 per cent a year over the next three years. CPIX inflation is forecast to average 4,4 per cent in 2004 and to remain within the target range of 3 to 6 per cent, rising somewhat due to high demand pressures and exchange rate-related import costs to about 5 per cent in 2005.

*Investment growth will underpin long-term economic performance*

With a view to deepening the long term growth potential of the economy, Government seeks to raise the overall rate of capital formation from its present level of about 16 per cent of GDP to 25 per cent by 2014. Investment in roads, rail and ports infrastructure, more efficient communications and information technologies and accelerating the pace of investment in housing and community services will enjoy priority.

*Social development priorities include skills development and better local planning*

In order to halve the rates of unemployment and poverty over the decade ahead, economic participation needs to be broadened and the duality of the economy narrowed. Policy priorities include reducing the regulatory burden on businesses, investing in skills and education, land reform and agricultural development, improved municipal development planning and administration and a comprehensive response to HIV and Aids and associated social development challenges. These are important considerations in Government's budget priorities for the MTEF period ahead, but should also be significant elements in a shared understanding with the private sector and community constituencies on the framework for development.

**Growth and development challenge: bridging the divide between the first and second economi**

South Africa has modern industries and prosperous suburbs, but also deep poverty, fragmented communities and marginalised people. The divisions and interdependence between the "first" and "second" economies present policy challenges for South African society that are mirrored, in larger relief, between rich and poor nations of the world. The challenge is to broaden participation in sustainable economic activity, extend employment opportunities, build integrated communities and promote social and economic mobility – ultimately reducing dependency ratios.

Broad dimensions of unequal participation in the South African economy are illustrated below.

| Dimensions | Average Income | | Unemployment | | Skills/Education (% economically active with grade 12 and above) | |
|---|---|---|---|---|---|---|
| Whites : Blacks | R 8 277 | R 2 091 | 7% | 35% | 86% | 32% |
| Male : Female | R 3 553 | R 2 244 | 28% | 35% | 38% | 40% |
| >35 : <35 | R 3 254 | R 2624 | 18% | 43% | 31% | 46% |
| Urban : Rural | R 3 738 | R 1 380 | 31% | 32% | 47% | 22% |

*March 2003 Labour Force Survey*

The annual budget provides considerable direct income support to poor people, and also contributes to investment in housing, local services, human development and creating an environment conducive to development. Achieving an appropriate balance between these aspects of public policy – income transfers, and provision of public services – is one of the central challenges of budget policy.

Government also participates in a range of joint stakeholder initiatives to complement these direct efforts, seeking broad consensus around key priorities. The 2003 Growth and Development Summit brought together business, labour, community organisations and government to discuss concerns regarding economic growth and bridging the gap between the first and second economy. The summit culminated in an agreement on activities to be undertaken to improve job creation, promote sustainable investment, lower inequality and build sustainable communities. Progress on some of Government's undertakings in the Summit agreement is briefly noted below.

- The Expanded Public Works Programme has been organised into four clusters: infrastructure, environmental programmes, social services and economic activities. The programme was launched in April 2004, and had created 37 995 direct jobs by the end of June 2004. The initial focus of the public works programme has been:
    - Construction and maintenance of provincial roads
    - Community based care for HIV/AIDS patients
    - Land care projects to minimize soil erosion in rural communities.
- Small business promotion remains an important building block in Government's overall employment and growth framework. Building stronger links between small enterprise support and the skills development programme is a key focus area. Approximately 6 712 businesses have received discretionary grants.
- Implementation of the Learnership Programme has met its initial targets. In August 2004, there were 108 693 registered learners of whom 75 000 were previously unemployed.
- The number of operational Multi-Purpose Community Centres (MPCCs) has increased to 57, several of which are contributing to promotion of local economic development through the creation of Business Zones.
- An initial overview of administered price-setting has been conducted, with a view to understanding the cost-efficiency of regulated and unregulated utilities or industries, and the links between their price trends and inflation. Statistics SA has released a discussion document on alternative definitions of administered prices and the possible introduction of an administered price index.

## Global developments

*Strong global recovery led by China*

The global recovery strengthened in the first half of 2004 – reflected in healthy industrial production trends, a rebound in trade, firm business confidence and investment growth. While the recovery was experienced in most economies, the upturn in global growth was most prominent in China and the United States.

**Table 2.1 Annual percentage change in GDP and inflation, selected countries/regions**

| Country/region | 2002 | 2003 | 2004[1] | 2005[1] | 2004[1] | 2005[1] |
|---|---|---|---|---|---|---|
| | GDP growth | | | | Inflation | |
| World | 3,0 | 3,9 | 5,0 | 4,3 | 3,8 | 3,6 |
| US | 1,9 | 3,0 | 4,3 | 3,5 | 3,0 | 3,0 |
| EU | 1,2 | 1,1 | 2,6 | 2,5 | 2,2 | 2,0 |
| Japan | -0,3 | 2,5 | 4,4 | 2,3 | -0,2 | -0,1 |
| China | 8,3 | 9,1 | 9,0 | 7,5 | 4,0 | 3,0 |
| Africa | 3,6 | 4,3 | 4,5 | 5,4 | 8,4 | 8,1 |
| Developing Asia | 5,3 | 6,5 | 7,6 | 6,9 | 4,5 | 4,1 |
| Central and Eastern Europe | 3,9 | 4,1 | 5,1 | 4,4 | 6,9 | 5,9 |
| Sub-Saharan Africa (excl RSA and Nigeria) | 3,6 | 3,7 | 6,0 | 7,4 | 14,1 | 12,0 |

*Source: IMF WEO, September 2004*

*1. Forecasts.*

*The main engine of growth has shifted back to Asia*

The main engine of growth has shifted back to Asia. In 2003, China contributed some 28 per cent of global growth, supporting activity in countries within Asia and those outside the region. The April 2004 IMF World Economic Outlook indicates that China is now the third largest importer in the world.

*Commodity boom since second half of 2003*

The global recovery has underpinned a commodity boom that has continued since the second half of 2003 on the back of strong demand from growing economies, dollar weakness and supply constraints. Against expectations of lower oil prices this year, the price of Brent crude oil increased above US$35 in the first half of 2004. Sustained high prices could place pressure on global growth and inflation in the medium term.

*Although inflation is rising in some countries, global inflation remains low*

Despite inflationary pressures in some economies, the rate of price increases remains low in most advanced economies. This improves the prospects for sustained growth, and also benefits South Africa by helping contain imported inflation.

*World growth to continue on current momentum*

Over the medium term, world growth is expected to be strong, led by China and the United States. Although growth in the Eurozone is expected to pick up, it will continue to lag behind the global trend. Asian economies will continue to drive the recovery, despite efforts by Chinese officials to moderate the pace of Chinese expansion.

## Developments in the domestic economy

*Policy reforms have contributed to the improved performance of the economy*

The improved outlook for the South African economy is in part an outcome of policies that have been adopted in the last decade. Trade reforms, the lowering of exchange controls and improved coordination of fiscal and monetary policy have contributed to a more favourable macroeconomic environment.

**High oil prices and the South African economy**

Owing to strong demand from Asia and the United States and supply constraints, crude oil prices increased to levels above $30 a barrel in the first half of 2004. Supply disruptions and speculative pricing spurred by geopolitical concerns such as the production losses and transport bottlenecks in Iraq, strikes in Nigeria, Norway and Venezuela, and problems surrounding Russian oil companies have since further propelled prices upward. Although OPEC has increased production since the price surge (in June and August) and US crude oil reserves have improved, this has not brought prices down. Oil prices reached new highs above $50 a barrel early in October. This raises a strong potential risk that oil prices may have reached a higher structural level, on the back of supply constraints.

Recent supply side studies indicate that high prices are in part the outcome of two decades of underinvestment in the global infrastructure to supply and deliver oil. Given the combination of strong demand and supply constraints, it is likely that oil prices will remain at levels above US$30 a barrel in the medium term.

South Africa is a net importer of oil. While the strong rand has dampened the domestic price impact of the rising crude oil price, it has contributed to a widening of the current account deficit. An Inflationary effect of further continued high prices can also be anticipated. On average, oil imports account for approximately 10 per cent of total imports.

Modelling done by the National Treasury using its quarterly econometric model indicates that a $5 a barrel (about 10% at current prices) permanent increase in the price of oil at the beginning of 2005 will raise the average CPIX inflation (year-on-year) rate by about 0.5% with a turning point of about 0.65% in the fourth quarter. Although import prices are expected to rise strongly during the course of the year, due to such a shock (i.e. by about 1% towards the end of 2005), the increase will be partly countered by lower output levels (largely due to lower exports commensurate with the slowdown in G7 growth), which should somewhat reduce wage pressures and overall mark-ups in the economy.

A stable and predictable policy stance has improved investor confidence in the economy, while tax reforms and financial deepening have contributed to competitiveness and the flow of capital investment. A more open international environment for trade and investment has contributed towards enhancing productive capacity, while at the same time providing opportunities for South African businesses to explore overseas markets. Both factors have contributed to the maintenance of a surplus in the overall balance of payments.

*Inflation targeting contributes to monetary stability*

The inflation-targeting framework has contributed to macroeconomic stability by keeping inflation low and has been successful in maintaining the credibility of monetary policy. The low inflation environment has not only brought about higher investment as a by-product of low interest rates but also increased disposable income, boosting demand, which in turn has supported real production growth.

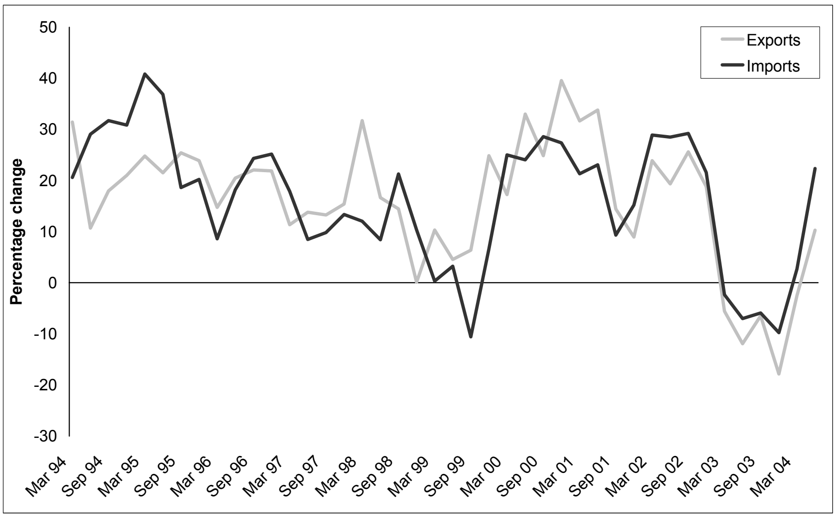
## Balance of payments

### *Current account*

*Widening current account deficit supported by financial account surplus*

Due to weaknesses in export trade, coupled with lumpy imports, the current account deficit widened to 2,5 per cent of GDP in the first half of 2004 from 0,8 per cent of GDP in 2003. However, this was more than adequately covered by the surplus in the financial account. The second quarter estimate of the current account deficit increased to 3,8 per cent of GDP, but this was partly a consequence of once-off items (new aircraft, a naval corvette and a large volume of crude oil imports).

**Figure 2.1: Growth in exports and imports (y-o-y), 1994 - 2004**




*Importation of capital goods high*

The volume of merchandise imports increased by 8,8 per cent in the first half of 2004. This was in part explained by higher demand for capital goods related to the strong growth in fixed capital formation. Capital goods constituted approximately half of total imports.

*Opportunity to explore new markets in China and India*

Despite modest growth in the last five years, Europe remains South Africa's largest trading partner. Exports to Europe account for 34 per cent of total exports, while 45 per cent of imports originate from Europe. China accounts for 2½ per cent of total exports and India accounts for 1 per cent of total exports, despite China accounting for almost one third of global growth in the last year.

*Strengthening trade with Africa a priority*

Trade with other African countries (excluding intra SACU trade) has historically been low as a share of total trade. Strengthening trade and investment links with the continent is a key priority for government in the medium term.

*Trade with other African countries still low but improving*

In June 2004, trade with other African countries accounted for 8,7 per cent of South Africa's total trade compared to 8,1 per cent in 1998. Exports to Africa accounted for 13 per cent of total exports in June 2004 while imports made up 4,5 per cent of total imports, an improvement on the 3,4 per cent achieved in 2003. The bulk of exports go to the SADC region and are predominantly manufactured goods, followed by agriculture and mining products. The biggest trading partner in Africa remains Zimbabwe, although Nigeria is the largest supplier of imports from the continent.

### *Financial Account*

On the back of strong portfolio investment, the financial account surplus increased to R40 billion in the first half of 2004, compared to R18,5 billion in the first half of 2003. Net capital inflows totalled R25,7 billion in the first half of 2004.

*Strong portfolio investment drove the financial account surplus*

The attraction of sustainable foreign direct investment remains a challenge in the context of mature equity markets. In the first half of 2004, non-residents acquired an impressive R17,8 billion of South African portfolio assets, while net foreign direct investment decreased by R3,2 billion.

*Attraction of sustainable FDI remains a challenge*

The current investment flows and the strengthening of regional and bilateral agreements indicates South Africa's confidence in opportunities that are untapped in the continent. In December 2002, South Africa had direct investments of an estimated R14,2 billion in the rest of Africa, representing 7 percent of South African direct investment assets around the world. Africa in turn held an estimated R5,5 billion of assets in South Africa, representing 2,2 per cent of total direct investment liabilities.

*South Africa business is undertaking investment in Africa*

### *Foreign reserves*

In February 2004, the South African Reserve Bank closed its forward foreign exchange book, eliminating a key source of external vulnerability and pressure on money market operations. With a reduced need for the sterilisation of activities arising from forward contracts, the Reserve Bank has normalised its money market activities and has been able to increase the net international reserves.

*SARB forward exchange market operations terminated*

**Further steps in the liberalisation of exchange controls**

Since 1995, South Africa has gradually relaxed exchange controls in line with progress in achieving relevant preconditions such as macroeconomic stability, strengthening of the balance of payments and financial sector development. This has facilitated the steady reintegration of South Africa with the global economy, while guarding against the macroeconomic risks of disruptive capital flows.

To further support the global expansion and international competitiveness of South African companies:

- Exchange control limits on new outward foreign direct investments by South African corporates are abolished. Application to the South African Reserve Bank's Exchange Control Department is still required for monitoring purposes and for approval in terms of existing foreign direct investment criteria, including demonstrated benefit to South Africa. The South African Reserve Bank reserves the right to stagger capital outflows relating to very large foreign investments so as to manage any potential impact on the foreign exchange market.
- South African corporates will be allowed to retain foreign dividends offshore. Foreign dividends repatriated to South Africa after 26 October 2004 may be transferred offshore again at any time for any purpose.

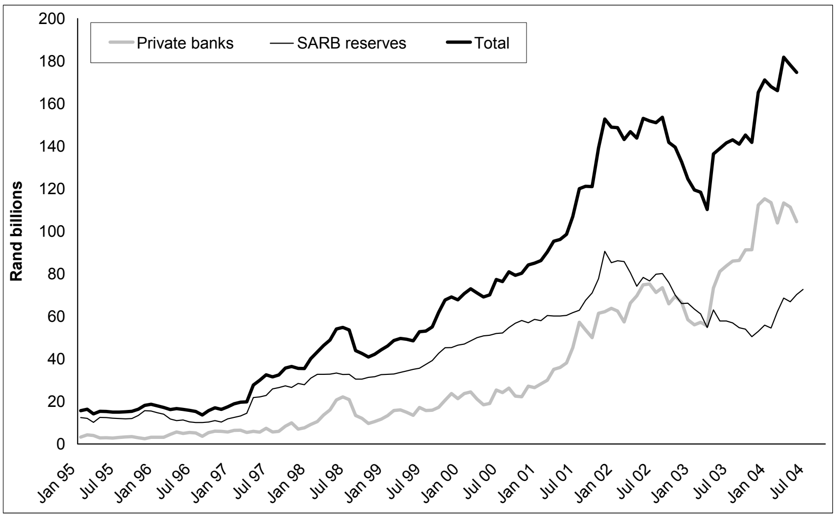
As announced in the 2004 Budget, foreign companies, governments and institutions may list on South Africa's bond and securities exchanges. This aims to promote foreign investment into South Africa and to support the positioning of South Africa as a regional financial centre better able to cater for the capital raising needs of the continent. To further support these aims, South African private individuals will now be able to invest, without restriction, in inward listed instruments on South African exchanges.

*Improved international reserve position*

Gross gold and other foreign exchange reserves rose strongly in dollar terms, reaching US$12,2 billion at the end of September 2004. The net international liquidity position rose to US$9 billion, boosted by a sizeable balance of payments surplus. Import cover of total gross international reserves remains healthy at around 21 weeks compared to 19,5 weeks between 2002 and 2003, while short term debt cover rose to an average of more than 340 per cent in the first half of 2004 from an average of 126 per cent in 2003. This should contribute to reduced currency volatility, over time.

Figure 2.2 shows the gross gold and foreign exchange reserve position between 1995 and 2004.

**Figure 2.2: Gross gold and other forex reserves, 1995 - 2004**




## *Exchange rate*

*Rand appreciation continued*

The nominal effective exchange rate of the rand appreciated by 8,2 per cent in the first half of 2004 following an appreciation of 16,2 per cent in 2003 and 24,2 per cent in 2002. The major factors behind the rand appreciation in 2003 and the first half of 2004 include the continued weakness of the US dollar, rising commodity prices, the attractive interest rate differential between South Africa and major trading partners and much improved investor sentiment.

*The value of the rand remains market-determined*

The policy stance on the exchange rate remains that the value of the rand should be determined in the foreign exchange market. Taking into account the overall surplus on the balance of payments for much of the past year, the Reserve Bank has been able to add to its foreign reserve holdings from time to time as a participant in the market.

**Impact of the exchange rate on the economy**

After depreciating by 34 per cent between the end of 2000 and the end of 2001, the nominal effective exchange rate (the value of the rand relative to a trade-weighted basket of currencies) has returned to a level last seen in the second half of 2000. Such large variations in the value of the currency have material economic effects, including impacts on domestic inflation, trade performance, industry growth and tourism.

National Treasury analysis of the South African experience indicates the following:

- Currency depreciation raises profitability in the export sector, which increases production.
- Improved profitability of export production through depreciation tends to be eroded over time by rising domestic cost and wage increases.
- Thus, while a nominal depreciation of the currency provides a boost to domestic profitability and export supply (and together with the reduction in imports improves the trade balance), this effect is not fully sustained, as domestic inflation erodes the competitive advantage.

To extend this analysis, a computable general equilibrium model was used to evaluate the sectoral impact of an appreciation of the rand.

- As expected, at an aggregate level, a firmer currency supports private consumption and gross fixed capital formation, but leads to a weakening of the trade balance.
- At the sectoral level, changes in the real exchange rate have varying effects: mining is negatively affected by rand appreciation, the domestic construction sector tends to benefit from the income effects of a strong rand and producers of other investment-goods, such as electronic machinery and communication equipment also benefit from a currency appreciation.
- The stronger currency also generally raises the purchasing power of households, with the employment impact generally following the sectoral output effects.

For many firms it is not the level of the rand, but capacity to absorb risk and adapt market strategies, that is critical. Smaller businesses and the poor generally have limited capacity to hedge against economic risks. Thus, the primary focus of Government's exchange rate policy is to reduce rand volatility. The closure of the net open forward position of the Reserve Bank, healthy capital inflows and low and stable inflation within the target band should contribute to greater stability of the rand over the medium term.

## Real output and expenditure trends

### *Domestic output*

*Buoyant domestic output growth*

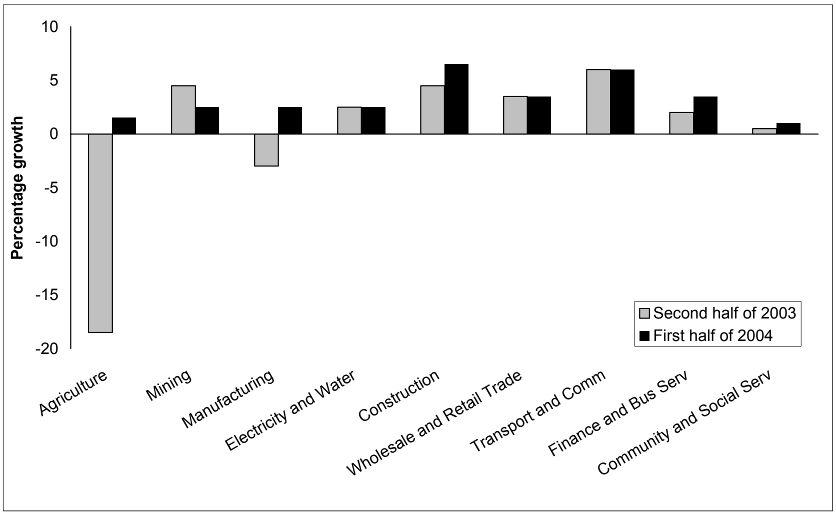
Growth in domestic output has been buoyant and broad based over the first part of 2004, supported by the global recovery, strong domestic demand and moderate interest rates. Total value added grew at a seasonally adjusted and annualised rate of 3,3 per cent in the first half of 2004. The services sectors continue to be the main source of growth, with transport and communications expanding at a rate of 5,8 per cent in the first half of 2004. Manufacturing and construction have also recorded encouraging growth during the current year.

### *Agriculture*

*Contribution of agriculture to GDP supported by horticulture and animal products*

Although agriculture, forestry and fishing output declined between the first half of 2003 and 2004, quarterly data indicate that growth is picking up, recording an annualised growth rate of 7,4 per cent in the second quarter. Output of the horticultural sector and animal products were the key contributors, while field crop production slowed in the face of declining prices.

**Figure 2.3: Sectoral growth in the first half of 2004 (saar)**




*Government to support emerging farmers*

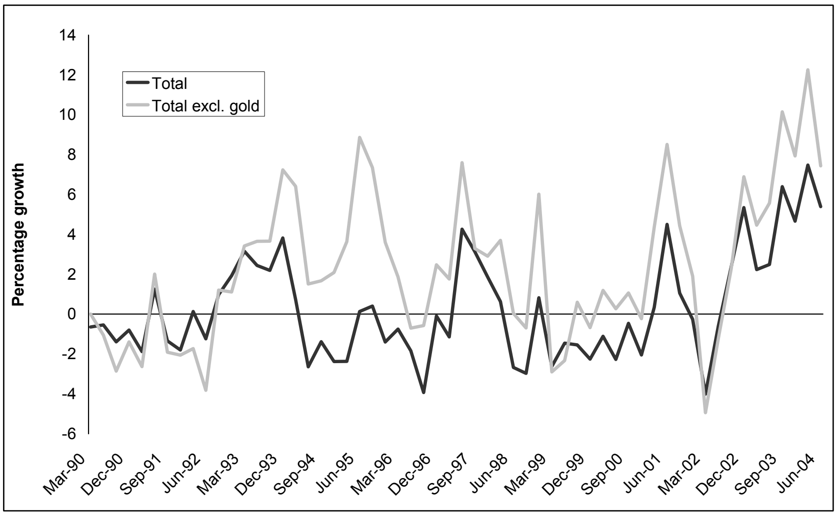
An amount of R1 billion has been set aside to re-establish an Agricultural Credit Scheme, focused on the needs of emerging farmers and the small-scale agriculture sector. The scheme is aimed at providing grants and loans for land acquisition and expansion as well as improving the productive capacity of small farmers.

## *Mining*

*Platinum and diamond mining production continue to drive mining growth*

The growth in real gross value added by the mining sector increased by 3,5 per cent in the first half of 2004, buoyed by favourable commodity prices (partially offsetting the strength of the rand). Growth in production volumes is mainly attributable to the platinum group metals, while gold production continues to decline. Diamonds and coal remain important contributors to mining output. Growth in this sector will support foreign exchange receipts and generate new projects for the construction sector.

**Figure 2.4: Year-on-year growth in mining production, 1999 - 2004**



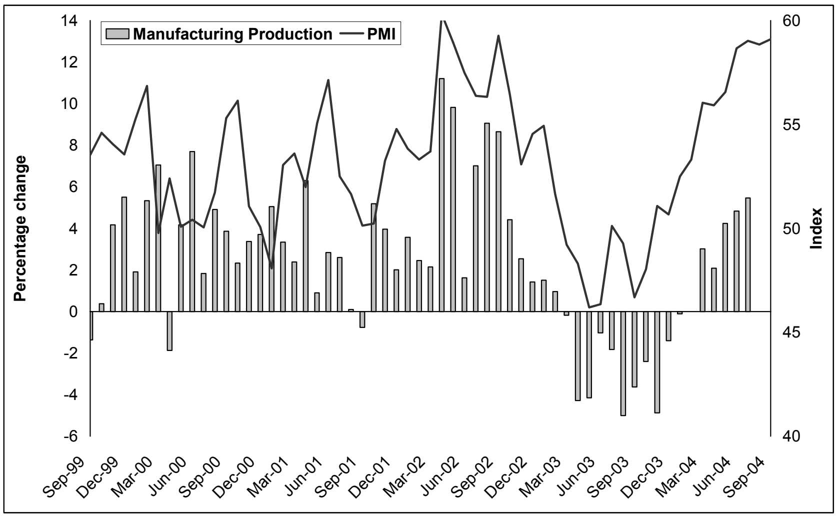
### *Manufacturing*

*Manufacturing has rebounded with growth across all sub-sectors*

The manufacturing sector rebounded in the first half of 2004 on the strength of domestic demand and export demand from Asia. Investment in manufacturing capacity has strengthened despite subdued prices of manufactured products. The seasonally adjusted annualised growth rate in real value added increased by 2,7 per cent in the first half of 2004.

The growth momentum in manufacturing production appears to have continued into the second half of the year, as illustrated by leading indicators such as the Purchasing Managers' Index.

**Figure 2.5: Manufacturing production (y-o-y) and the PMI, 1999 – 2004**




### *Construction*

*Value added by construction increased by 5,3 per cent*

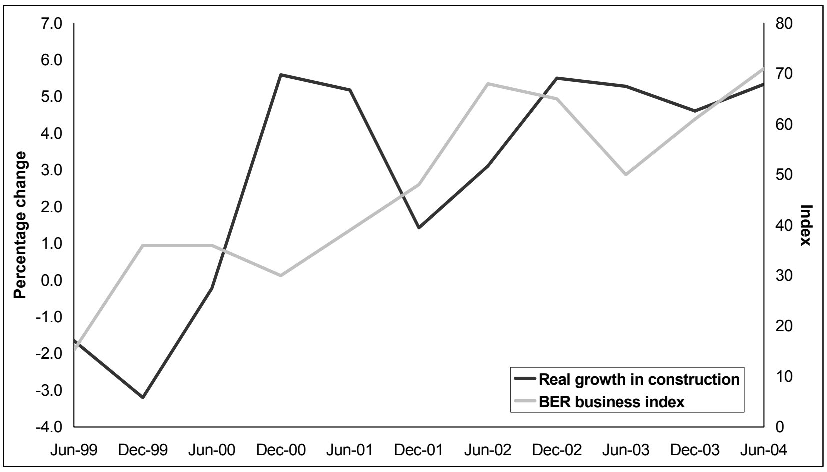
The construction sector continues to grow at a rapid pace, with real value added expanding at an annual rate of 5,3 per cent in the first half of 2004. The expansion is mainly attributed to lively conditions in the construction of new residential buildings, supported by rising disposable incomes and growing consumer confidence. The non-residential sub-sector also experienced growth.

Positive retail activity coupled with rising consumer confidence levels has given impetus to the development of community and regional shopping centres in recent years. The introduction of favourable tax allowances for inner-city property development and greater investment in township renewal will also support further investment in the built environment.

*Growth in construction expected to continue in the medium term*

In the medium term, construction activity will be boosted by significant further investment in infrastructure by government and public corporations. These include extensions to the Johannesburg and Cape Town airports and harbours of Durban and Richards Bay as well as the investment in dams and roads in less developed provinces.

**Figure 2.6: Growth in construction and the BER business index**




### *Transport and communication*

*The transport and communication sector grew at a rate of 5,8 per cent*

Real value added by the tertiary sector, which accounts for more than 60 per cent of GDP, expanded by an annualised 2,9 per cent in the second half of 2003 and 3,5 per cent in the first half of 2004. The transport and communications sector grew by 5,8 per cent in the first half of 2004. Work is under way to review the national logistic systems and their impact on the cost of doing business. In the areas of telecommunications, Government aims to achieve a competitive environment in which modern technologies will contribute both to lower costs and improved access to services. Discussions are in progress with potential investors in a second fixed line operator. Government will also ensure effective competition by allowing mobile operators open and non-discriminatory access to all fixed line networks.

### *Tourism*

*Travel account continued to make steady contribution to current account*

Tourism continues to be an important contributor of foreign exchange. The contribution of travel income to the current account continues to show an upward trend despite the decline in the second quarter of 2004. However, the growth in the number of tourists slowed in the first half of 2004, reflecting the base effect of the large number of tourists in the first quarter of 2003 associated with the Cricket World Cup.

### *Financial sector*

*Low interest environment boosted value added*

The financial sector remained robust in the first half of 2004, with real value added growing at 2,9 per cent over this period. Against the backdrop of low interest rates, growth in the financial sector was underpinned by growth in banking services, buoyant real-estate markets and a strong demand for residential property.

Within the framework of sound regulation and transparency, the focus remains on improving access to financial services and consumer protection. The issue of effective competition, particularly in banking services, has been under scrutiny. The findings of a study commissioned earlier this year to review competition in banking are being reviewed, after which the National Treasury will engage with stakeholders to explore options to deal with identified problems.

*Regulations introduced to improve consumer protection*

**Focus on savings**

Raising domestic savings is important in reducing the economy's exposure to volatile foreign capital flows as well as providing security for vulnerable households. The level of domestic savings as a percentage of GDP has fallen to 14,4 per cent in the second quarter of 2004 from highs of over 20 per cent during the 1980's. While corporate savings continue to be positive and government has reduced its level of dissaving, household saving remains very low, currently just 0,5 per cent of GDP. Thus, government has focused its current initiatives on improving the level of household savings and building a culture of saving.

Building a culture of individual and household savings begins with affordable access to savings and transaction services. As part of the Financial Sector Charter commitments, the banking sector undertook to introduce a simple, low-cost *u-Mzansi* Bank Account on 25 October 2004.

The Dedicated Banks Bill and the Co-operatives Banks Bill, which seek to create the opportunity for the establishment of second and third tier banks, will be put out for public comment later this year. Institutions expected to apply for banking licenses under the Dedicated Banks Bill include communication companies, large retailers and perhaps micro lenders. Banks established under the Co-operative Banks Bill will be membership-based banks where depositors and lenders have a common bond. Institutions envisaged here include village banks, stokvels, small building societies and credit unions.

Saving for retirement is one of the most important financial decisions that households make and retirement saving generally constitutes one of the largest components of household saving. Evidence suggests that many people accumulate insufficient retirement savings, and funds are undermined by leakage as members resign or change jobs, and also because funds available for retirement are reduced through a combination of administrative costs and taxation.

Against the background of the ongoing review of the taxation of retirement funds and the need to review the Pension Fund Act, which was first promulgated in 1956, the National Treasury is undertaking a holistic review of all aspects of the retirement funding system. Key issues include:

- Compulsory preservation and compulsory provision
- Portability
- Prudential regulation
- Empowerment and education of trustees
- Appropriate governance of pension funds.

A discussion paper will be released for further consultation with stakeholders, leading to the development of principles to guide legislative reform in the course of 2005. Much of the above developments will underpin the work for the Charter Council, which was convened early in October.

## Domestic expenditure

Gross domestic expenditure continued to strengthen during the first half of 2004, rising by 5,7 per cent, reflecting the lagged response to falling interest rates and the strong rand. This increase in real gross domestic expenditure at more than twice the rate of real gross domestic production, contributed to the current account deficit of 2,5 per cent of GDP in the first half of the year.

*Expenditure has increased at twice the level of GDP*

### Household consumption expenditure

*Household consumption increased on the back of increases in real disposable income*

Real consumption expenditure by households increased further during the second quarter of 2004, from a real year-on-year rate of 4 per cent in the first quarter to 4,4 per cent. Household spending has been boosted by tax relief provided in recent years, reductions in interest rates of 600 basis points since June 2003 and a 5,1 per cent increase in real wages in a low inflation environment.

*Strong consumption growth boosted retail sales and services*

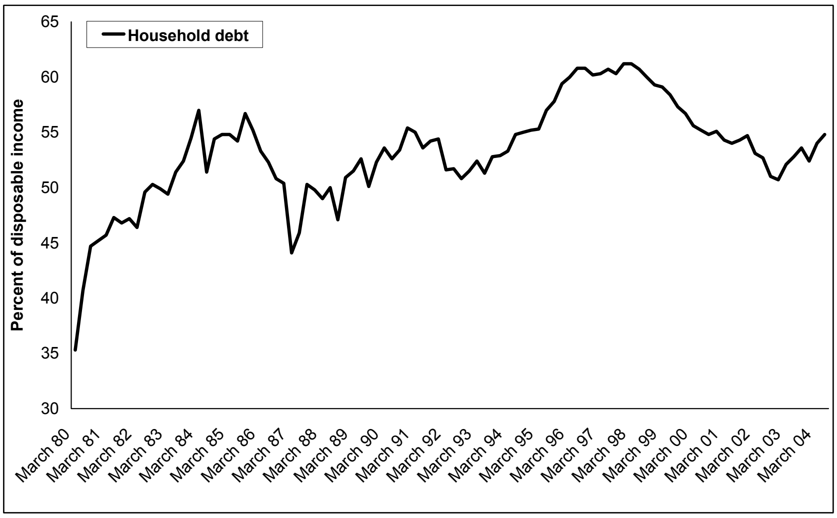
Real retail sales continued to experience positive growth, increasing by 6,2 per cent in the second quarter of 2004. Expenditure on durable and semi-durable goods rose by 10,1 per cent year-on-year, aided by the falling prices of imported goods.

*The increase in mortgage advances reflects the attractiveness of fixed property as an investment*

The growth in mortgage advances reflects the attractiveness of fixed property as an investment in a low-interest rate environment, wealth effects emanating from higher property prices and improved confidence levels of households.

While expenditure growth on durable and semi-durable goods is likely to slow somewhat, household debt relative to disposable income remains moderate and robust consumption growth is expected to continue over the period ahead.

**Figure 2.7: Household debt as a percentage of disposable income, 1980 – 2004**




### Gross fixed capital formation

*Growth in capital investment by public corporations contributed to growth in fixed capital formation*

Real gross fixed capital formation has expanded for the past nineteen quarters, accelerating by 8,5 per cent year-on-year in the first half of 2004. Investment by private businesses is the main source of growth, but there has also been a substantial contribution by public corporations this year, mainly from the addition of new aircraft to the fleet of South African Airways.

The upward trend in private business fixed capital formation is expected to continue, with low interest rates, the strong rand and increasing domestic demand fuelling further investment in productive capacity. Over the longer term, investment in new electricity supply capacity, several major water schemes, road and rail network rehabilitation, expansion of harbour capacity and expansion of stadiums ahead of the 2010 Soccer World Cup will add to the capital spending trend, financed in part through public-private partnerships.

*Expansion in productive capacity to continue in the medium term*

## Labour market

The March 2004 Labour Force Survey (LFS) indicates an increase in total employment in the South African economy of some 419 000 jobs since March 2003. The estimate of the unemployment rate declined from 31,2 per cent in March 2003 to 27,8 per cent in March 2004. These estimates are subject to some statistical uncertainty but, are nonetheless encouraging indicators of a turnaround in the employment trend.

*Signs of a turn around in formal sector employment although absorption rate still low*

**Table 2.2 Change in employment by sector, 2003 – 2004**

| thousands | March 2003 | March 2004 | Change |
|---|---|---|---|
| Formal sector, excl. agriculture | 7 358 | 7 827 | 469 |
| Commercial agriculture | 865 | 930 | 65 |
| Subsistence agriculture | 420 | 337 | -83 |
| Informal sector | 1 845 | 1 834 | -11 |
| Domestic sector | 1 005 | 1 013 | 8 |
| **Total employment** | **11 565** | **11 984** | **419** |
| **Unemployment rate** | **31,2%** | **27,8%** | |

*Source: Labour Force Survey, March 2003 and March 2004*

The LFS indicates growth in employment across most of the formal sectors of the economy, indicative of a broad-based recovery in job creation between 2003 and 2004. The most notable increases in employment were in non-gold mining and commercial agriculture.

*Broad employment growth across sectors*

A study published by the Human Sciences Research Council in August 2004 indicates increased use of contract workers and casual workers, together with rising demand for more skilled and qualified workseekers. Factors that have affected employment trends include technological change, labour market regulations, organisational change in enterprises and changing skills requirements.

*More evidence that employment problems are of a structural nature*

Nominal remuneration per worker rose 8,7 per cent in 2003 and by 8,9 per cent in the year to the first quarter of 2004 – against a growth of 5,9 per cent in nominal unit labour costs. Bargaining council agreements and wage settlements are expected again to lead to nominal remuneration increases above inflation in 2005. In keeping with a forward-looking approach to wage determination, Government has concluded a three-year

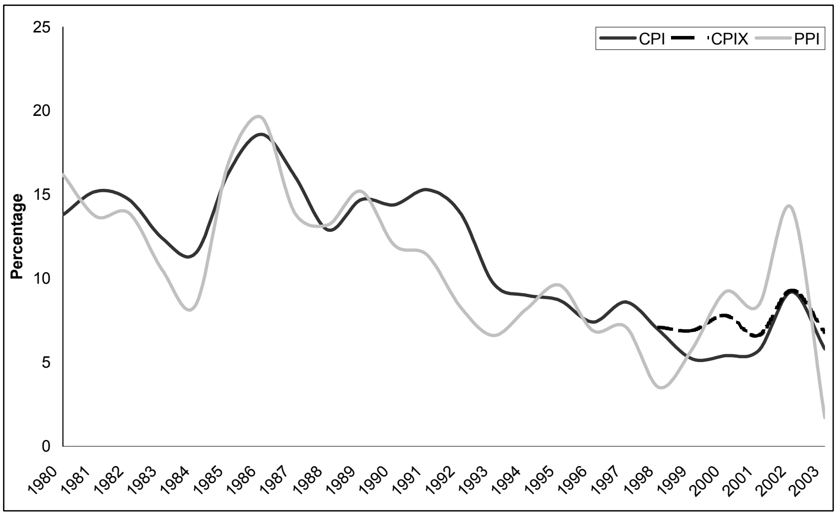
*Nominal wages in the private sector expected to be above inflation* settlement with public sector unions providing for wage adjustments 0,4 per cent above CPIX in 2005 and 2006.

## Inflation

*Structural decline in inflation since the 1980s*

Inflation has seen a structural decline from over 15 per cent in the mid 1980s to single digit figures in the early nineties and subsequently. This can be partly attributed to microeconomic reform, including trade reforms, and the broadening of competition, as well as the decline in the budget deficit and public sector borrowing requirement. This moderation of inflationary pressures shows an alignment with the world trend towards greater price stability and is increasingly reflected in inflation expectations.

**Figure 2.8: Structural change in inflation, 1980 – 2003**




*Headline inflation at a historic low and CPIX inflation within target band*

Annual CPIX inflation has been within the target band of 3-6 per cent since September 2003, and for August 2004 was 3,7 per cent. Producer price inflation also continued its sharp downward trend in the first half of 2004.

*The exchange rate appreciation contributed to lower imported inflation*

The appreciation of the rand since the beginning of 2002 has contributed significantly to reducing the rate of inflation, as imported items account for 27 per cent of the producer price index. The strength of the rand has also mitigated the impact on the economy of the rise in the international oil price, resulting in more stable retail prices for petrol, diesel and paraffin.

*CPIX inflation near the mid-point of target range in 2004*

CPIX inflation is forecast to average 4,4 per cent during 2004, in the context of a benign international inflation environment, lower food prices and moderate capacity utilisation. Upside risks to this forecast include the high and volatile international crude oil prices, exchange rate movements and private sector wage settlements in excess of the inflation target.

For the period ahead, a continuous CPIX inflation target agreed between the Minister of Finance and the Governor of the Reserve Bank will remain 3 to 6 per cent. The CPIX basket comprises the consumer price index, excluding mortgage interest costs.

*CPIX inflation target is 3 to 6 per cent*

## Domestic and global outlook

World growth is expected to remain strong in 2004 and moderate over the forecast period. The latest IMF World Economic Outlook (September) projects global growth to average 5 per cent in 2004, characterised by strong growth in industrial production, global trade flows, private consumption growth, investment growth and improving labour market conditions. While the IMF's projections show a slight slowdown in the international economy next year, the overall growth outlook in the world economy will support South Africa's economic recovery.

*World growth will remain strong*

South Africa's projected GDP growth of 2,9 per cent in 2004 is driven by strong domestic demand. A favourable external environment and rising investment will benefit GDP growth going forward and the expectation is for growth of 3,9 per cent in 2005, 3,7 per cent in 2006 and 4,2 per cent in 2007.

*GDP growth expected to average 2,9 per cent in 2004*

Household consumption is expected to gather momentum in 2004, spurred by substantial gains in disposable income and manageable debt levels, the lagged effect of the cuts in interest rates since 2003, a strong currency and strong real wage growth (boosted by both employment and real wages).

*Household consumption expected to gather momentum*

Government consumption growth will continue to reflect an expansionary fiscal stance, reinforced by rapid growth in social transfers to households. Expenditure on government services is expected to moderate in the outer years, although public sector capital expenditure will continue to grow strongly.

*Government consumption growth to reflect expansionary fiscal stance*

Investment growth is expected to continue to expand at a firm pace over the medium term, comprising both private sector capital formation in response to demand growth and trade opportunities and more rapid investment in public infrastructure, especially through the state owned enterprises.

*Investment growth to continue on the back of strong public sector spending*

Over the medium term, exports are expected to accelerate as global growth and commodity prices remain strong and the real trade-weighted rand weakens somewhat. Import volumes will remain robust in 2004 due to buoyant domestic aggregate demand, investment in plant and machinery and the relatively strong currency. The bulk of parastatal investment is expected to be import intensive.

*A current account deficit of 2,2 per cent expected in 2004*

The current account deficit is expected to widen further over the medium-term, with a deficit of 2,2 per cent of GDP expected in 2004. This level of the current account deficit should be easily financed from capital inflows.

*CPIX inflation to remain within target*

CPIX inflation is expected to remain within the target range over the MTEF period, although high oil prices and currency depreciation are likely to lead to some upward pressure on prices in 2005 and beyond.

**Table 2.3 Macroeconomic projections, 2001 – 2007**

| Calendar year | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|---|---|---|
| | | Actual | | Estimate | | Forecast | |
| *Percentage change unless otherwise indicated* | | | | | | | |
| Final household consumption | 3,2 | 3,2 | 3,0 | 4,3 | 3,9 | 3,5 | 3,7 |
| Final government consumption | 3,2 | 3,7 | 4,6 | 5,4 | 2,9 | 3,1 | 3,3 |
| Gross fixed capital formation | 2,1 | 6,1 | 8,4 | 9,6 | 8,2 | 7,7 | 8,0 |
| Gross domestic expenditure | 2,1 | 4,7 | 4,2 | 5,4 | 4,5 | 3,9 | 4,3 |
| Exports | 2,7 | -0,8 | -0,5 | 2,3 | 3,7 | 4,9 | 6,9 |
| Imports | 0,2 | 3,4 | 9,7 | 12,7 | 5,9 | 5,7 | 7,0 |
| **GDP growth (real)** | **2,7** | **3,6** | **1,9** | **2,9** | **3,9** | **3,7** | **4,2** |
| GDP deflator | 7,8 | 10,1 | 5,9 | 5,7 | 4,9 | 5,3 | 5,2 |
| **GDP at current prices (R billion)** | **983,5** | **1 120,9** | **1 209,5** | **1 315,0** | **1 433,7** | **1 564,9** | **1 715,9** |
| CPIX (Metropolitan & urban, average for year) | 6,6 | 9,3 | 6,8 | 4,4 | 5,1 | 5,0 | 5,1 |
| Current account balance (% of GDP) | – | 0,6 | -0,8 | -2,2 | -2,7 | -2,5 | -2,8 |

**Table 2.4 Macroeconomic projections, 2003/04 – 2007/08**

| Fiscal year | 2003/04 | 2004/05 | 2005/06 | 2006/07 | 2007/08 |
|---|---|---|---|---|---|
| | Actual | Estimate | | Forecast | |
| GDP at current prices (R billion) | **1 232,5** | **1 340,7** | **1 466,8** | **1 598,6** | **1 755,7** |
| GDP growth (real) | 1,7 | 3,5 | 3,9 | 3,6 | 4,3 |
| GDP inflation | 5,3 | 5,1 | 5,3 | 5,2 | 5,3 |
| CPIX (metropolitan & urban, average for year) | 5,5 | 4,5 | 5,1 | 5,1 | 5,0 |