2

Economic policy and outlook

Following a decade of prudent macroeconomic management, extensive transformation and restructuring, the economy has averaged growth of over 3 per cent a year since 2000. The economy will continue along this path in the medium term, with an expected average growth rate rising to 4,2 per cent in the period to 2007.

CPIX inflation has remained within the 3-6 per cent target range since the last quarter of 2003. During 2004, producer inflation increased at 0,7 per cent and CPIX inflation increased by 4,3 per cent. Medium-term inflation forecasts remain moderate, allowing the repurchase rate to decline by 6 percentage points since 2003.

Signalling rising business and consumer confidence, both gross fixed capital formation and consumption expenditure have grown strongly over the past year. Gross fixed capital formation grew by an estimated 7,5 per cent in 2004. Over the medium term, robust expansion of public sector investment in infrastructure will supplement and support private sector investment.

Stronger investment and consumption contributed to a rapid increase in imports, pushing up the current account deficit. The higher deficit was comfortably financed through capital inflows. A large increase in foreign exchange reserves has contributed to a rise in South Africa's credit rating and greater insulation of the economy from volatility in international financial flows.

Economic growth in 2004 has brought with it an increase in employment creation. However, matching acquired skills to the requirements of the economy remains critical to more rapid expansion in employment. Government aims to create a more favourable environment for small business and reduce regulatory constraints to enterprise development.

Achieving a 25 per cent of GDP investment rate by 2014 and broadening access to and participation in the formal economy will guide government policy in coming years. Key priorities include strengthening the competitiveness of the economy by lowering the cost of doing business, dealing with backlogs in the national logistics system, further modernisation of communications and information systems and streamlining regulatory requirements.

Introduction and overview

Firm growth above 3½ per cent in 2004

The performance of the South African economy in 2004 was encouraging, with growth accelerating above 5 per cent in the second half of the year. Domestic demand remained strong, propelling GDP to an annual growth rate of 3,7 per cent in 2004. This was a significant improvement on the 2004 Budget forecast of 2,9 per cent. The current momentum is expected to carry into the medium term, with GDP growth reaching a high of 4,4 per cent in 2007.

Consumption and investment supported by a low interest rate environment

Growth has been driven by a combination of robust consumption and investment, supported by low interest rates, an expansionary fiscal stance and rising consumer and business confidence. A favourable world economy also contributed to export growth and rising commodity prices have underpinned export revenues, partially offsetting the strength of the rand. Strong domestic demand has been met partly by domestic production, but also through higher imports. This resulted in a widening of the current account deficit to an estimated 2,3 per cent in 2004.

Improvement in the capacity to absorb labour

Positive growth was experienced in all sectors of the economy in 2004, with wholesale and retail trade, transport and communications, finance and business services and manufacturing being the main contributors to growth. The Labour Force Survey indicates that 419 000 jobs were created between March 2003 and March 2004. The three Surveys of Employment and Earnings in the first three quarters of 2004 also indicate a rising trend in the economy's capacity to absorb labour. The production and employment numbers signal a structural improvement in the overall performance of the economy.

CPIX inflation within target range for the last five quarters

The rate of CPIX inflation remains well within the inflation target range of 3-6 per cent, remaining around the mid-point for most of 2004. Inflation expectations reported by business and labour continue to fall. The low inflation environment supported investment in productive capacity and a boom in the residential property market.

Capital investment continues to grow

Gross fixed capital formation increased by an estimated 7,5 per cent in 2004 as companies took advantage of the strong rand and high domestic demand. Significant increases in investment were observed in the mining sector as platinum mines expanded capacity. New infrastructure in the cellular network industry and renewal of vehicle fleets also boosted investment in the transport, communications and storage industries.

Debt levels of households sustainable

Household consumption expenditure also continued to rise vigorously, due to a combination of factors including rising disposable income, wealth effects from house and share price increases, lower nominal interest rates and a decrease in the price of imported and domestic import-competing products. Although the increase in consumption expenditure reflected rising levels of credit extension, the ratio of household debt to disposable income remains moderate by international standards.

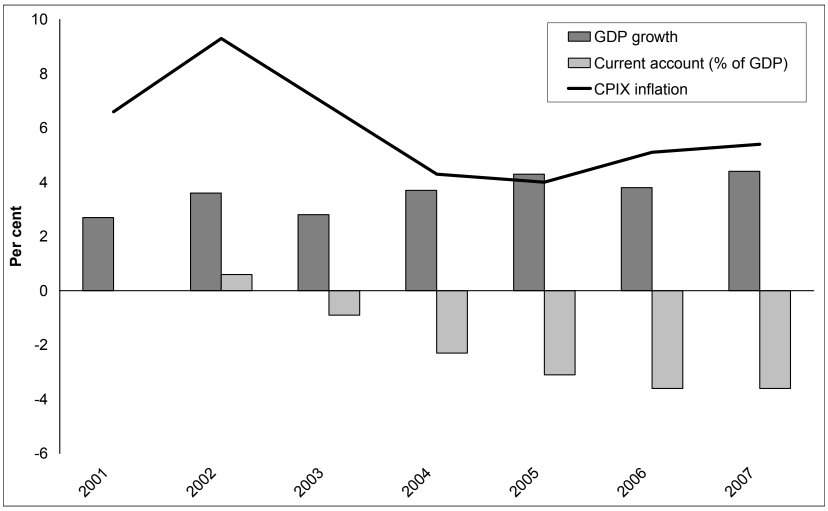
Upgrade in credit rating will lower borrowing costs

The upgrade in South Africa's credit rating by Moody's rating agency in January 2005 from Baa2 to Baa1 (6 notches below the highest grade) further affirmed the benefits of the macroeconomic and microeconomic reforms undertaken in the last decade. The rating upgrade will lower borrowing costs and attract foreign investment in fixed-income securities.

Growth momentum expected to continue into the medium term

Real economic growth is expected to accelerate to 4,3 per cent in 2005 from 3,7 per cent in 2004, and to average 4,2 per cent a year over the next three years. CPIX inflation averaged 4,3 per cent in 2004 and is expected to remain within the target range of 3 to 6 per cent, rising to 5,4 per cent in 2007 due to demand pressures and exchange rate-related import costs.

Figure 2.1 Real growth, CPIX inflation and current account balance



Global developments

Global growth accelerated to its best levels since the 1980s

Growth in the world economy accelerated from 2,4 per cent in 2003 to just below 4 per cent in 2004, the highest growth rate experienced since the 1980s. This achievement is primarily due to rapid growth in the United States of America (USA) and Developing Asia (including China).

Following optimistic projections in the first half of 2004, the sudden increase in oil prices and sluggish growth in G7 countries resulted in the outlook for world growth being revised downward from 5 per cent in September 2004 to just under 4 per cent in February 2005.

US growth remains strong

With significant upward growth in final sales, consumer spending, investment and exports, the USA is expected to continue to lead growth in industrial countries at 4,4 per cent for 2004. Consumer sentiment was buoyed by the good performance of the stock and labour markets. After experiencing the fastest rate of growth last year since 1999, GDP growth is expected to moderate to 3,5 per cent in 2005. However, the US economy confronts record high current account and fiscal deficits, regarded by some analysts as a significant risk to world growth.

Table 2.1 Projections of global GDP and inflation, selected countries, 2003 – 2006

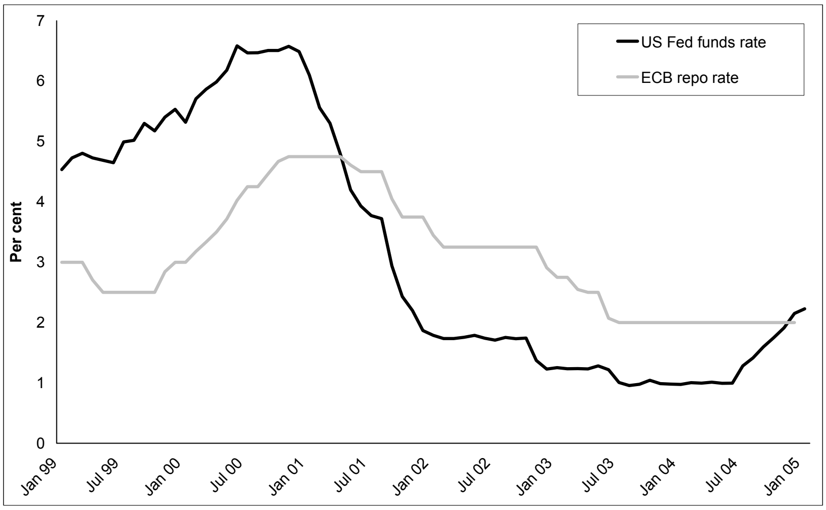
Region / Country	2003	2004[1]	2005[1]	2006[1]	2004[1]	2005[1]
Percentage	GDP growth				Inflation	
World[2]	2,4	3,9	3,0	3,1	2,5	2,3
USA[2]	3,0	4,4	3,5	3,4	2,7	2,4
Canada[2]	2,0	2,7	2,8	3,0	1,8	1,9
Euro-zone[2]	0,5	2,0	1,7	2,0	2,1	1,8
UK[2]	2,2	3,1	2,5	2,4	2,3	2,2
Japan[2]	2,5	2,9	1,1	1,8	–	–
China[3]	9,1	9,0	7,5	n/a	4,0	3,0
Developing Asia[3]	7,7	7,6	6,9	n/a	4,5	4,1
Africa[3]	4,3	4,5	5,4	n/a	8,4	8,1
Asia Pacific[2]	3,0	4,4	2,9	3,4	1,2	1,1

1. *Forecast .*
2. *Consensus Economics, February 2005.*
3. *World Economic Outlook, September 2004.*

USA interest rates expected to climb

Inflation forecasts for the US economy have been revised upward as stubbornly high oil prices and rising wages remain a risk in the medium term and expectations for the dollar remain uncertain. Since June 2004 the Federal Reserve increased the federal funds rate six times from a record low 1 per cent to 2,5 per cent.

Figure 2.2 Benchmark interest rates, US Fed vs ECB



Growth in the Euro region remains subdued

Economic growth in the Euro region is modest, with a growth rate of 2 per cent forecast for 2004. Production slowed in the year to October 2004. Forecasts for industrial production were revised downwards and growth in 2005 is expected to remain subdued.

Rapid growth in China despite higher interest rates

The Chinese economy continues to grow at a rapid pace, reaching a growth rate of about 9 per cent forecast for 2004. Despite policy shifts to slow the overheating economy, consumer price inflation picked up to 4 per cent 2004 from 1,2 per cent in 2003.

The commodity boom continued in 2004

The commodity price boom that began in the second half of 2003 continued throughout 2004, particularly for base metals. Demand continues to be driven by Chinese imports, along with dollar weakness. In South Africa, this benefited the platinum, coal and gold-mining industries. The gold price reached a sixteen-year high of approximately US$456 per fine ounce in early December 2004, rising from an average US$310 in August 2002.

Global growth expected to slow in 2005 and 2006

Global growth in 2005 is expected to slow to about 3 per cent and 3,1 per cent in 2006 due to the lagged impact of high oil prices and a relatively poor growth performance in the Euro region and Japan. However, higher growth is possible, particularly if oil prices ease in the latter half of 2005.

A reform agenda for Africa

The global community will come together this year to review progress towards achieving the Millennium Development Goals (MDGs). According to a United Nations report, published on 17th January 2005, the proportion of people living in extreme poverty fell from 28 per cent to 21 per cent in the developing world between 1990 and 2001, with the benefit mostly evident in East and South Asia. In sub-Saharan Africa there has been little progress – in 2001, almost half the population in the region was struggling to survive on US$1 per day or less, the same proportion as in 1990. A similar picture is evident in respect of the other goals, with sub-Saharan Africa lagging well behind targets.

However, over the past ten years, governments across Africa have taken important steps towards sustainable development. Governance indicators are improving faster in Africa than elsewhere in the world. Africa has also achieved unprecedented macroeconomic stability. The average growth rate for Sub-Saharan Africa is expected to reach 5,4 per cent in 2005. Inflation is expected to average 9,9 per cent in 2005, with the high inflation rate countries the exception rather than the rule. Underpinning these improving inflation figures are fiscal balances that declined from an average deficit of 5,2 per cent to GDP in 1994 to an average of 0,9 per cent in 2005.

More rapid economic growth is needed for Africa to meet the MDGs. Efforts to achieve those growth rates include a range of initiatives, such as NEPAD, enhanced support for regional and national projects by the World Bank, improved donor harmonisation, and the Commission for Africa. International efforts to raise the level of development finance through debt relief, increased development assistance, and alternative means of financing, such as the commitments made in the Monterrey Consensus, are making some headway. Such measures are expected to supplement progress by African countries in developing their public finance management and revenue administration systems.

The Commission for Africa will make recommendations in March 2005 on practical ways of promoting development in Africa. The Minister of Finance of South Africa serves on the commission as one of three finance ministers responsible for a set of economic themes. In January 2005, a workshop of senior political leaders from African governments met in Cape Town to discuss the relevance and practicalities of the Commission's draft recommendations.

Accelerating regional integration in Africa could become a powerful springboard to creating more competitive industries. Realising the potential of regional integration is a core theme of NEPAD, which focuses on strengthening Africa's regional economic communities. The Commission conference stressed the importance to regional integration of infrastructure investments and removing intra-Africa barriers to trade, including tariff reductions, trade facilitation, more effective and non-corrupt customs administration and better air and sea regulation. Such efforts need to be supplemented with better access to the markets of developed countries and dramatic reductions in agricultural subsidies – issues central to the Doha Round of trade negotiations.

Balance of payments

Financial account

Healthy financial account surpluses continue

The cumulative surplus on the financial account of the balance of payments was R60,4 billion in the first nine months of 2004, more than double the R28,5 billion recorded in the equivalent period in 2003 and just slightly below the surplus of R63,1 billion recorded in the year 2003 as a whole.

The net inward flows of capital reflected in robust equity and bond markets

Net foreign portfolio inflows in the first nine months of 2004 were robust, increasing to R22,2 billion compared to R7,8 billion in 2003 as a whole. The high level of inward portfolio investment was reflected in the 37 per cent increase in the value of shares traded at the JSE Securities Exchange in 2004. Net foreign purchases of equities reached R32,9 billion and net foreign purchases of bonds amounted to R400 million.

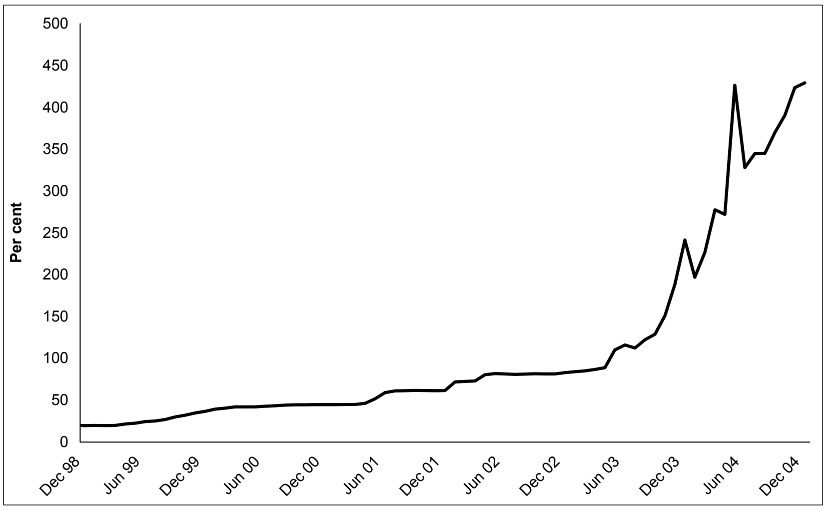
FDI outflows rise as South African firms acquired assets offshore

Foreign direct investment inflows in the first nine months of 2004 stood at R6,1 billion, a marked increase on the R2,4 billion experienced over the same period in 2003, but still below desirable levels. On a net basis, there was an outflow of R3,8 billion in the first nine months of 2004. South African companies took advantage of a relatively strong exchange rate to acquire controlling interests in foreign companies and repay offshore long-term loans.

Foreign reserves

The net international liquidity position rose strongly to US$11,7 billion at the end of January 2005, boosted by a sizeable balance of payments surplus.

Figure 2.3 Gross official reserves as a percentage of short-term debt



Gross official reserves reached US$15,1 billion at the end of January 2005

The gross gold and other foreign exchange reserves of the Reserve Bank increased to US$15,1 billion at the end of January 2005, representing over 438 per cent of short-term debt. The improvement in official reserves was accompanied by a strong rise in private banking sector reserves from US$1,9 billion at the end of February

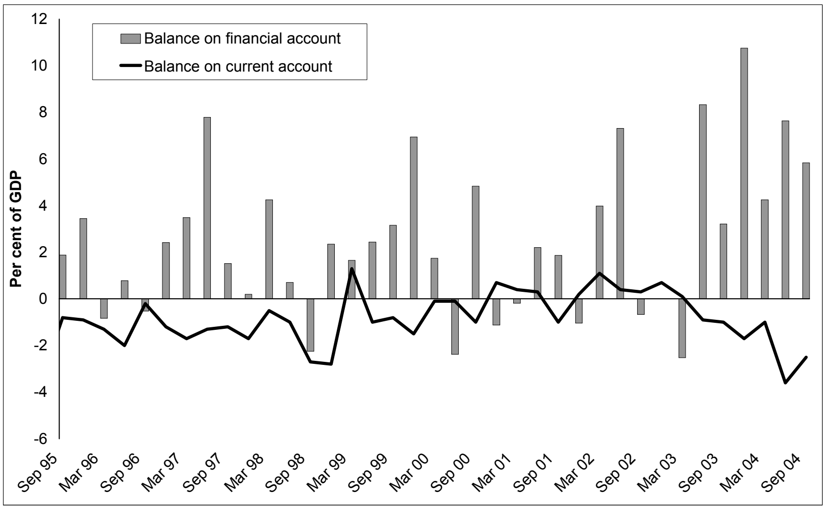
1998 to US$18 billion at the end of December 2004. This contributed to a further upgrade of the sovereign rating, from Baal to Baa2, by Moody's in January 2005.

Current account

Current account deficit widens on the back of capital expansion

The current account deficit reached an estimated 2,3 per cent of GDP during 2004 compared to 0,9 per cent of GDP in 2003. Higher imports of capital goods and relative weakness in exports resulted in the surplus on the trade account decreasing to an estimated 0,7 per cent of GDP from 2,2 per cent of GDP in 2003.

Figure 2.4 Current and financial account balances



Base metals lead export growth

The volume of exports grew at a relatively fast pace in 2004, with base metals, chemical products and precious metals experiencing the largest increase as a share of total exports. The value of exported goods, excluding gold, increased by 7 per cent in 2004. The export value of textiles and mineral products declined, while vehicle exports remained unchanged.

Table 2.2 Exports by commodity

Products	Value 2004 R million	% change on 2003	% share of total 2002	% share of total 2004
Precious metals	80 033	7,2%	19,6%	27,4%
Base metals	56 696	30,7%	13,5%	19,4%
Mineral products	34 261	1,4%	13,7%	11,7%
Vehicles	24 877	-0,2%	8,7%	8,5%
Machinery	26 136	7,8%	8,9%	8,9%
Chemicals	17 847	13,5%	6,3%	6,1%
Textiles	4 872	-20,1%	2,3%	1,7%
Other	47 539	-5,6%	27,0%	16,3%
Total	**292 261**	**7,0%**	**100,0%**	**100,0%**

Source: South African Revenue Services, January 2005.

Merchandise imports surged

The volume of imports surged in 2004, boosted by extraordinary items (including maritime defence vessels and airplanes) in the second quarter. The value of imported goods increased by 18 per cent on the strength of robust domestic expenditure and declining rand prices of imports.

Table 2.3 Imports by commodity

Products	Value 2004 R million	% change on 2003	% share of total 2002	% share of total 2004
Machinery	79 447	12,8%	27,8%	26,1%
Vehicles	40 036	34,5%	9,3%	13,1%
Chemicals	27 679	6,7%	11,1%	9,1%
Mineral products	46 581	41,9%	13,2%	15,3%
Base metals	12 869	19,6%	4,2%	4,2%
Plastics	11 412	13,5%	4,2%	3,7%
Textiles	10 090	23,6%	3,2%	3,3%
Other	76 635	11,0%	27,0%	25,1%
Total	**304 749**	**18,6%**	**100,0%**	**100,0%**

Source: South African Revenue Services, January 2005.

Higher dividend payouts to non-residents

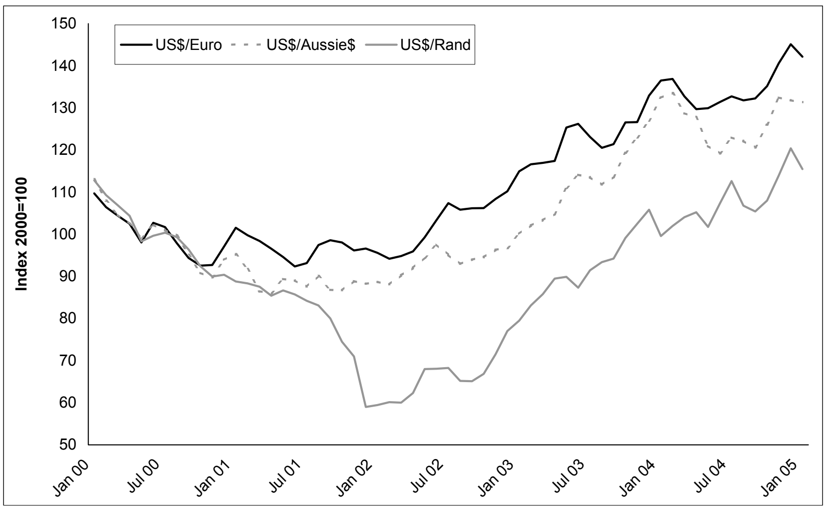
The deficit on the net services, income and current transfer account continued to widen, rising to R42,1 billion in the first nine months of 2004 from R38,7 billion in 2003.

Exchange rate

The rand continued to strengthen amid dollar weakness

The nominal effective exchange rate of the rand continued to strengthen in the second half of 2004, rising by 6,6 per cent. The currency appreciated by 11,6 per cent over the year. The average real effective rand was 7,5 per cent higher in the first ten months of 2004 compared with the equivalent period in 2003. Following an appreciation of 30,1 per cent in 2003, the rand appreciated by 18,1 per cent against the US dollar in 2004. The rand also appreciated by 9,5 per cent against the euro and by 9,6 per cent against the pound.

Figure 2.5 Performance of US Dollar against other currencies



Implications of the twin deficits in the USA

The US current account deficit reached an all time high in 2004 – 5,5 per cent of GDP in the fourth quarter. At the end of 2004, the US budget deficit was 3,5 per cent of GDP. While most economists agree that continued growth of the twin deficits is unsustainable and that the overvaluation of the dollar against Asian currencies will have to be corrected, there is little consensus on the timing or degree of correction required. This will be influenced by the extent of market confidence towards the US economy.

In a recent paper, Maurice Obstfeld and Kenneth Rogoff[1] argue that the inevitable reversal of the current account deficit will precipitate at least a 12 per cent depreciation of the real dollar exchange rate. Since the end of 2002, the dollar has lost approximately 10 per cent of its value against a broad basket of currencies.

The realignment of the twin deficits will require an increase in the level of US saving. Higher saving combined with dollar depreciation would imply a decline in US demand for imports. A general reduction in US demand for imported goods could have significant negative economic effects throughout the world economy. The US takes about 12 per cent of South African exports, 31 per cent of total Asian exports and about 23 per cent of EU exports. Indirectly, South African exports would be further affected by slower growth in Asia and Europe, which account for about 25 and 35 per cent of South African exports, respectively.

1. *Maurice Obstfeld, Kenneth Rogoff, "The Unsustainable US Current Account Position Revisited", NBER Working Paper No. 10869, October 2004*

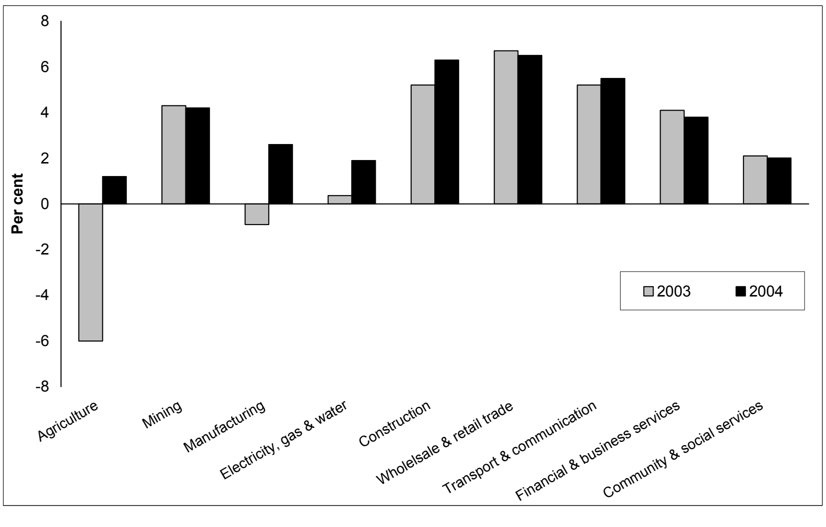
Real output trends

Buoyant growth across all sectors of the economy

Domestic production and value added grew vigorously in 2004, buoyed by a combination of a stronger global economy, improved consumer confidence, lower domestic interest rates, robust commodity prices and an expansionary fiscal stance. The annual growth rate for 2004 was 3,7 per cent.

Mining, transport and communication, construction and retail trade grew by over 4 per cent in 2004. Growth in previous years and for 2004 was revised higher in the national accounts rebasing exercise conducted in November 2004.

Figure 2.6 Annual growth by sector, 2003 and 2004



Agriculture

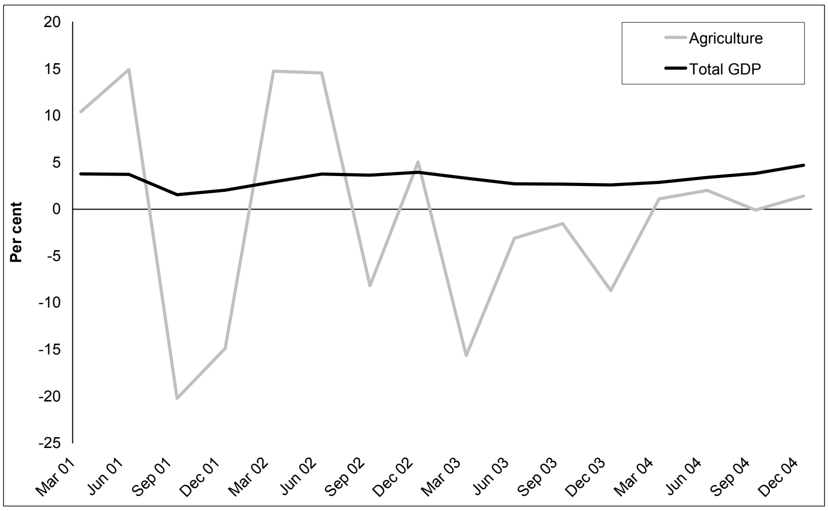
A good harvest sustained growth in agriculture

The agricultural sector grew moderately in 2004 after two years of declining output. Real value added increased by 1,2 per cent compared to a 6 per cent decline in 2003, largely due to a better than expected harvest of field crops.

Production expected to rise

The sector is expected to record further growth in 2005, despite drought in some areas. The 2004/05 maize crop is likely to be higher than that of the preceding season due to recent good rains across most maize producing regions. Wheat production for the 2004/05 season is estimated to increase by 12 per cent compared to 2003/04.

Figure 2.7 Year on year growth in the agricultural sector



Mining

Growth in mining production follows commodity price boom

Mining production was robust in 2004, with real value added growing at a rate of 4,2 per cent. This was driven by the non-gold sector, which grew at year on year rate of 9,6 per cent in 2004. Production of platinum group metals (PGMs) increased by 13,5 per cent, while gold production declined by 8,4 per cent. Diamond and coal production also expanded as a result of robust world demand.

Platinum exports surged while gold exports declined

Export sales revenue from gold mining decreased by 11,7 per cent in the first nine months of 2004, while export revenue from platinum sales increased by 18,6 per cent. Coal mining exports have been relatively stable.

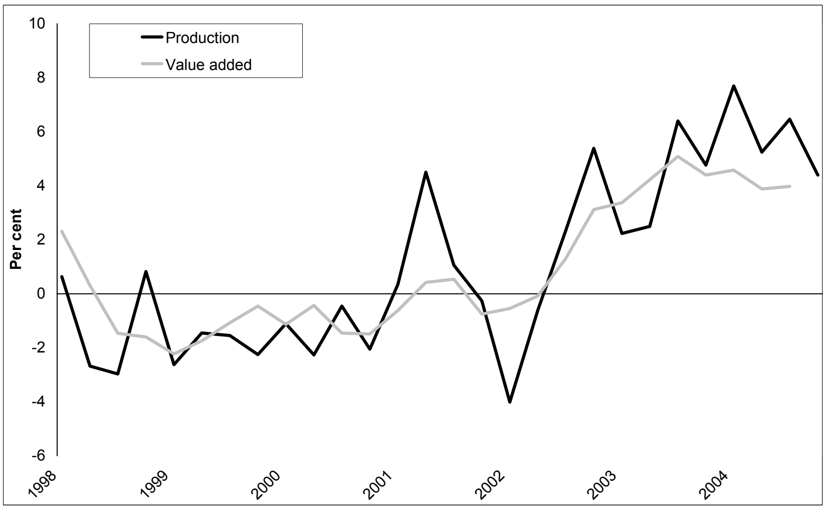
Increased use of catalytic converters to boost platinum sales in medium term

Annual global consumption of platinum has increased by over 1,2 million ounces since 1998 to a high of 6,59 million ounces in 2003. The demand for platinum is expected to grow further in coming years, due to the increased use of catalytic converters in advanced economies and higher consumption of platinum in fuel cell development programmes.

Coal benefits from higher prices and demand

Global coal prices are likely to rise as China's coal exports are progressively diverted to domestic power generators. South African mines will also benefit from higher electricity production, particularly as four mothballed Eskom power stations come on stream in 2007.

Figure 2.8 Change in mining volumes and value added



Rebasing, benchmarking and revision of national accounts in November 2004

The rebasing of national accounts and benchmarking of the GDP is a regular exercise in compliance with the recommendations of the 1993 System of National Accounts (SNA). The SNA emphasises the development of complete and consistent macroeconomic accounts based on internationally agreed concepts, classifications, definitions and accounting rules.

Statistics South Africa and the South African Reserve Bank are jointly responsible for compiling national accounts. The former estimates GDP on the production and income approaches, while the latter estimates GDP in terms of the expenditure approach. At five-year intervals GDP is benchmarked, revised and rebased to ensure data consistency and accuracy over time. This is done in addition to the annual revisions to the national accounts.

Rebasing involves changing the base year of the real or constant price estimates of the national accounts. This eliminates the effect of price changes from the base year and accurately reflects changes in the volume of goods and services produced or consumed. In November 2004, the base year of the national accounts aggregates was changed from 1995 to 2000, and was estimated from 1998. Benchmarking is undertaken to accurately reflect the structure of the economy, by incorporating new areas of economic activity previously not covered or undercovered, new and improved data, and methodological changes to the compilation of data. The improvements that contributed to the revising of national accounts estimates in 2004 include:

- Data from a new business register based on firms liable for value-added tax payments,
- Data derived from large sample surveys which replaced industry censuses, and
- Data from the introduction of sectoral Economic Activity Surveys

Sector contribution to GDP after rebasing and benchmarking

Sector	1995	2000
Agriculture	3,9	3,3
Mining	7,0	7,6
Manufacturing	21,2	19,0
Electricity, gas & water	3,5	2,7
Construction	3,2	2,5
Wholelsale and retail trade	14,3	15,2
Transport and communication	8,9	9,6
Financial and business services	16,4	18,0
Community and social services	21,7	22,0

The average annual real growth rate for the period 1998 to 2003 was revised upward from 2,4 to 2,7 per cent, primarily because of improved data from mining, manufacturing and trade industries. The benchmarking also indicated a significant improvement in GDP per capita, increasing from R20 300 in 2000 on the old basis to R21 100 after the benchmarking. The contribution of the tertiary sector to total value added increased and the contribution of the primary sector remained unchanged, while the contribution of the secondary sector declined.

Manufacturing

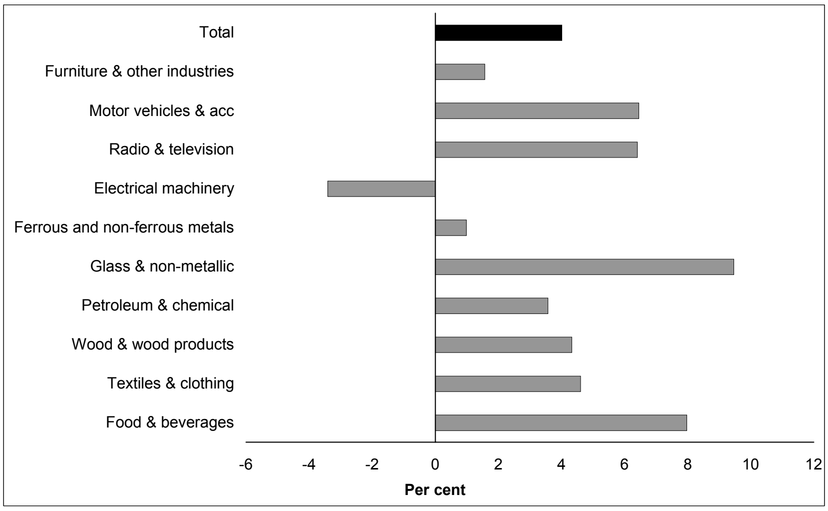
Manufacturing growth of 2,6 per cent in 2004

After contracting by 0,9 per cent in 2003, the manufacturing sector rebounded in 2004, with real value added growing by 2,6 per cent. Manufacturing particularly benefited from robust conditions in the retail market and better utilisation of production capacity, which on a net basis more than offset the impact of the strong rand.

Manufacturing growth widespread

Growth within the manufacturing sector was spread across all sub-sectors, with the exception of electrical machinery, which was affected by the availability of cheaper imports. Motor vehicles, radio and television, glass and non-metallic products, as well as food and beverages grew by over 5 per cent.

Figure 2.9 Manufacturing output growth, 2003 - 2004



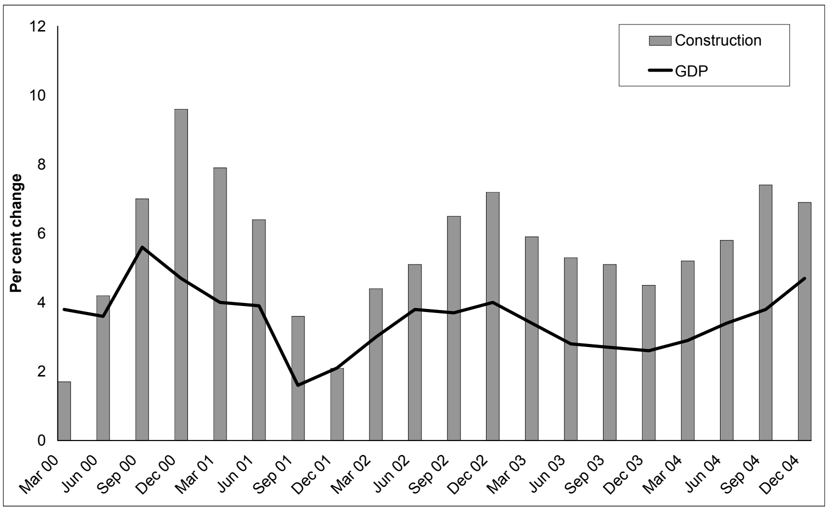
Construction

Boom in residential and other buildings continued in 2004

Real value added in the construction sector increased at an annual rate of 6,3 per cent during 2004. The favourable business environment is expected to continue throughout 2005. New residential developments resulted in a rise in demand for new retail outlets and office space for financial and other business services. The growing retail market also increased the demand for warehouses and distribution centres.

Government has introduced an urban renewal tax incentive to encourage refurbishment and new construction in the inner cities of seven major urban areas in the country. This incentive, which complements Government's housing policy, is expected to stimulate the property sector of the inner cities, create more jobs and reduce transportation costs for people who live and work there.

Figure 2.10 Year on year growth in the construction sector



Government infrastructure projects to boost construction activity

Although building costs have risen substantially due to supply constraints, the favourable business conditions of the last two years are expected to continue into 2005. Government's planned economic infrastructure projects and the infrastructure needs for the 2010 soccer world cup will support construction sector growth in the medium term.

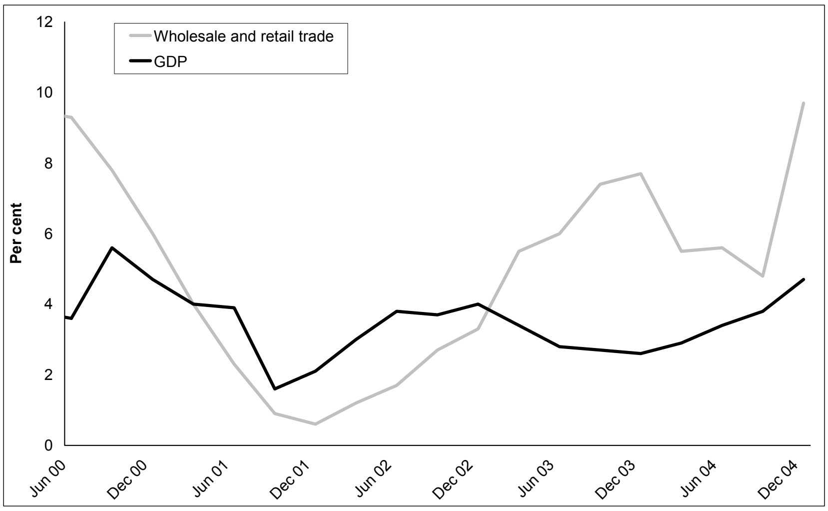
Wholesale and retail trade

Buoyant conditions in the retail and wholesale sector

Real value added by the wholesale and retail trade, catering and accommodation sector accelerated by 6,5 per cent during 2004. Growth in this sector was supported by higher levels of economic activity in several sub-sectors due to buoyant demand conditions and lower import prices.

The motor industry benefited from strong consumer and investment demand. The National Association of Automobile Manufacturers of South Africa (NAAMSA) reported that new car sales improved by 22 per cent in 2004, with an all time record sales number of over 481 500 vehicles.

Figure 2.11 Year on year growth in the wholesale and retail sales sector



Transport and communication sector

The real value added by the transport, storage and communication sector grew at a rate of 5,5 per cent in 2004. Investment in productive capacity expanded sharply, growing at a rate of 9 per cent in the first nine months of 2004 to address the increase in demand for transportation services linked to strong domestic and international trade and broadens domestic telecommunications services.

An amount of R2 billion has been approved for the improvement of the Durban and Cape Town container terminals. Approximately R1,4 billion and R600 million has been set aside to develop and upgrade container terminals in Durban and Cape Town.

Streamlining national logistics and the cost of doing business

The South African system of national logistics is characterised by escalating costs, bad service delivery, poor response to customer needs, and a weak skills base. The situation is further exacerbated by under-investment in infrastructure. Monopoly control within certain modes of transport, poorly defined institutional relationships and few incentives within the rail and ports to reduce costs give further rise to inefficiencies in the delivery of services.

The cumulative result is high logistics costs to the economy and reduced international competitiveness. Logistics costs as reported in the first annual state of logistics survey conducted by the CSIR[1] represent 14,7 per cent of GDP in South Africa, compared to 8,5 per cent in the US economy.

In 2003, Cabinet approved the creation of a task team to conduct an investigation into the state of national logistics and develop a national logistics strategy to realign the system to the needs of the economy. This involves:

- Reducing the cost of logistics to the economy and exploring different supply chain options
- Enhancing the value that customers receive by improving service
- Improving the quality of the underlying asset base
- Ensuring that social and developmental objectives are met.

Among the various issues being considered is the separation of infrastructure from operations, the roles of government and the private sector in national logistics and infrastructure provision, introducing competing operators across the spectrum of logistics services, and the enforcement of existing regulations.

To date, the task team has consulted with key industry stakeholders regarding bottlenecks in the national logistics system and consultants have been commissioned to conduct further research. A draft freight logistics strategy is under review by the Minister of Transport. Areas proposed for focus in 2005 include the following:

- Establishing a ports regulator
- Corporatisation of the National Ports Authority
- Separation of infrastructure and operations within Spoornet
- Increasing the level of outsourcing and private sector funding in rail transport
- Establishing a framework for self regulation in road transport
- Assessing the appropriateness of changing gross vehicle mass limits and licence fees for heavy vehicles.

1. Source: CSIR, The first state of logistics survey for South Africa 2004, February 2005

Tourism

Foreign tourism abates in 2004

The number of foreign tourists visiting South Africa grew by 1 per cent in the first nine months of 2004, which is well below the 12 per cent growth of tourist arrivals globally. Rand strength probably contributed to the fall in South Africa's attractiveness as an international tourist destination from a ranking of 28th in terms of tourist arrivals in 2002 to 30th today.

The World Tourism Organisation's forecast of higher global tourism in 2005 (a 5 per cent increase for the year), and improvements to tourism infrastructure and services, should contribute to a moderate recovery in South African tourism numbers.

Financial sector

Continued growth in financial services

The financial sector continued to expand strongly in an environment of favourable interest rates and low default rates. The increase in demand for financial services is linked to higher disposable income and increased demand for real estate and motor vehicles.

The benign interest rate environment, strong housing and vehicle sales and buoyant consumer demand should provide further impetus for growth in this sector in 2005.

Transforming the financial sector

Transformation of the financial sector is critical to overcoming the duality of the South African economy. Access to finance, in the form of appropriate savings, credit, or insurance products, enables people to engage, many for the first time, in small business development and wealth accumulation.

Financial Sector Charter

The banking sector has committed to increase access to savings and transaction services to 80 per cent of people in the Living Standards Measure (LSM) 1 to 5 by 2008. Since the launch of the Mzansi accounts for low-income customers in October 2004, over 550 000 accounts have been created. Progress is being made in finalising the targets for the collective investments, life officers and short term insurance industries. Further research will be conducted during 2005 to consider generic access standards for banking, insurance, collective investment and other parts of the sector.

The sector will also increase targeted lending to SMMEs, agricultural enterprises, development infrastructure and low-cost housing. Empowerment finance targets agreed to date include:

- Low income housing finance of R42 billion by 2008
- Transformational infrastructure finance of R25 billion by 2008
- Black SME financing of R5 billion by 2008
- A Corporate Social Investment target of 0,5 per cent of post-tax profit.

A multi-tier banking system

Government's efforts to improve access to finance include pension reform (see text box below) and the introduction of second and third-tiers of banks – the Dedicated and Cooperative Banks.

Cooperative banks are member-based financial institutions such as village banks and credit unions, which provide financial services for people who traditionally do not benefit from the commercial banking sector. The Cooperative Banks Bill will bring these community banks into a formal regulatory framework to afford primarily rural and low-income depositors the same safety and stability as that enjoyed by the formal commercial bank's depositors.

The Dedicated Banks Bill seeks to create a second tier of commercial banks and enhance competition in banking. The capital entry requirements for these banks will be lower, but their activities will be restricted to core functions such as savings, lending and transaction services. The legislation is designed to facilitate the entry of non-traditional financial service providers into the banking arena, such as retailers or cell phone companies.

The National Treasury aims to table the Cooperative Banks Bill and the Dedicated Banks Bill in Parliament during the course of 2005.

Deposit Insurance

The National Treasury is considering a policy framework for the creation of a deposit insurance scheme for South Africa. The scheme would pay out a pre-specified amount to depositors in the event of a bank failure. In addition to the protection of small and medium-sized depositors, the scheme will further support the appropriate and secure extension of financial services to the poor, encourage saving, and increase confidence in the banking system. An appropriately designed deposit insurance scheme will further enhance systemic stability of the financial sector by ensuring that any bank failures are contained.

Employment and remuneration

Employment expanded in 2004

The March 2004 Labour Force Survey (LFS 2004) showed an additional 419 000 jobs in the economy compared with March 2003. Most of the employment creation occurred in the formal economy. While net informal employment appears to have remained the unchanged, complications in the counting of casual and contract labour remain a concern. The official rate of unemployment has decreased from 31,2 per cent in March 2003 to 27,8 per cent in March 2004.

A comparison of the findings of the March 2000 Labour Force Survey and the March 2004 survey indicates that there has been a steady increase in employment across all sectors of the economy, broadly in line with the average rate of economic growth.

Table 2.4 Employment trends by sector[1], 2000 – 2004

	2000			2004		
Thousands	**Formal**	**Informal**	**Total**	**Formal**	**Informal**	**Total**
Mining	462	4	**467**	584	5	**588**
Manufacturing	1 277	178	**1 469**	1 484	181	**1 670**
Electricity	86	2	**88**	107	4	**110**
Construction	388	196	**596**	427	239	**674**
Trade	1 449	962	**2 434**	1 590	859	**2 461**
Transport	445	99	**547**	467	130	**599**
Business services	770	62	**837**	1 023	78	**1 104**
Community and unspecified	1 724	158	**1 900**	2 114	164	**2 283**
Total	**6 601**	**1 661**	**8 338**	**7 796**	**1 660**	**9 489**

1. Excluding agriculture.

Source: Labour Force Survey, March 2000 and March 2004.

Various initiatives provide temporary employment

The Expanded Public Works Programme and other initiatives such as the National Youth Service Programme have provided short term employment. However, the challenge remains to assist people in attaining permanent formal sector employment. As part of the National Skills Development Strategy, Government set a target of a minimum of 80 000 people under the age of 35 entered in learnerships by March 2005. This target was met in October 2004 with SETAs recording a total of 82 425 learners.

Moderation in nominal wages

The average increase in nominal remuneration in the formal sector moderated from 9,6 per cent in 2002 to 8,7 per cent in 2003 and 7,6 per cent in the second quarter of 2004. Unit labour costs, however, rose year on year by 5,4 and 7,1 per cent in the first and second quarters, respectively, as labour productivity growth slowed.

Table 2.5 Year on year changes in average remuneration, productivity and labour cost

Percentage	Nominal remuneration	Labour productivity	Nominal unit labour costs
1999	7,7	4,4	3,1
2000	9,2	7,1	1,9
2001	9,0	4,7	4,2
2002	9,6	3,4	6,0
2003	8,7	4,5	4,0
2004[1]	8,9	3,3	5,4
2004[2]	7,6	0,5	7,1

1. First quarter 2004.

2. Second quarter 2004.

Measuring informal employment

According to the March 2004 Labour Force Survey (LFS), approximately 2,2 million people (18 per cent of total employment) are employed in the informal sector. By comparison, India has an informal economy that has been estimated at close to 90 per cent of total employment. The size of South Africa's informal economy may be underestimated.

Three criteria are used internationally to distinguish formal from informal employment: i) registration of the business for tax or other regulatory purposes; ii) registration of the employee which commits the employer to pay benefits or subjects the employer to general labour regulation; and, iii) size of the business.

The LFS surveys households, which, in line with international standards, should facilitate identification of individuals involved in informal work. A series of questions elicit information about the registration status of the employer, the contractual relationship of the employee, and the size of the business.

In many instances, respondents may not understand the distinction between informal and formal sector work. The LFS asks general questions about the types of activities undertaken by the respondent and is able to capture informal work even if the activity is undertaken for less than one hour per week and even if the individual does not consider the activity to be work. Such activities might include guarding cars, brewing beer, hairdressing or ploughing.

Domestic consumption expenditure

Growth in real gross domestic expenditure surged to an estimated 5,7 per cent in 2004 on the back of favourable credit conditions. Expenditure by households was robust and real final consumption expenditure by Government rose by an estimated 6,7 per cent in 2004 compared to 6,4 per cent in 2003.

Household consumption expenditure

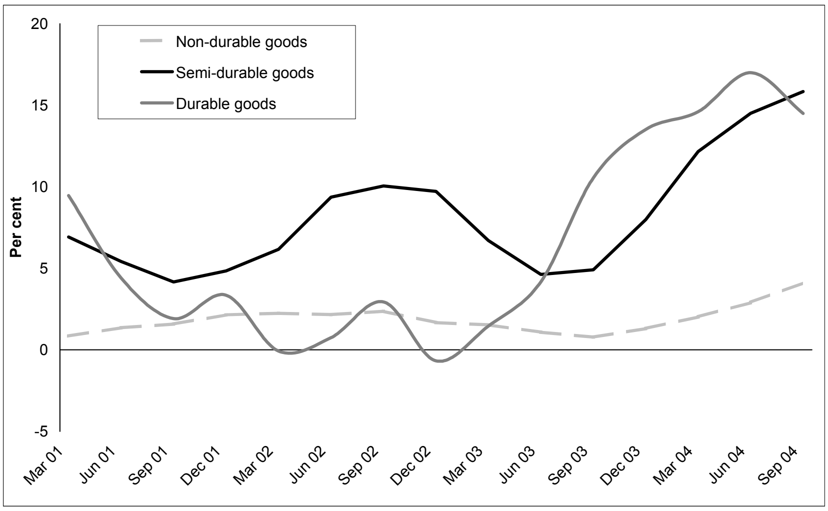
Household expenditure supported by wealth effects, employment growth

During 2004, real household consumption expenditure expanded at an estimated year on year rate of 5,9 per cent. This buoyant growth in household consumption was supported by the wealth effects of rising property and share prices relative to debt exposure, positive employment growth, and accelerated welfare spending by Government. Substantial disposable income was released for spending by the 6 percentage point reduction in short term interest rates since mid-2003.

Strong growth in durables and semi-durables

Consumer confidence remains high. At constant prices, sales of durable and semi-durable goods sales soared by an estimated 15,3 per cent and 13,7 per cent in 2004, respectively, while non-durable goods grew more moderately. The highest growth was recorded in motor vehicles and furniture sales in the durables category and in clothing, footwear and household textiles in the semi-durables category.

Figure 2.12 Consumption expenditure by type of good

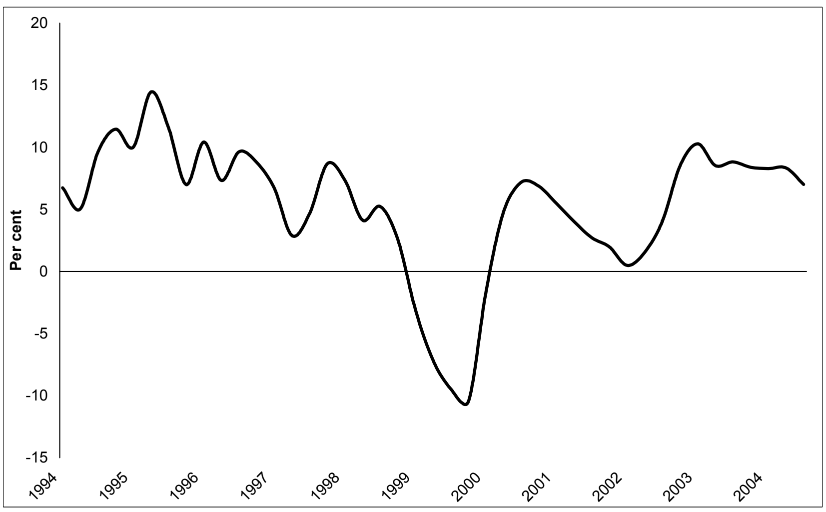


Savings and investment

Gross fixed capital formation

Improvements in business cash flow, lower interest rates and improving economic growth in domestic and international markets during 2004 contributed to a marked rise in business confidence. Expectations of continued strong growth are reflected in the expansion of production capacity.

Figure 2.13 Year on year change in gross fixed capital formation



Gross fixed capital formation increased by an estimated 7,5 per cent

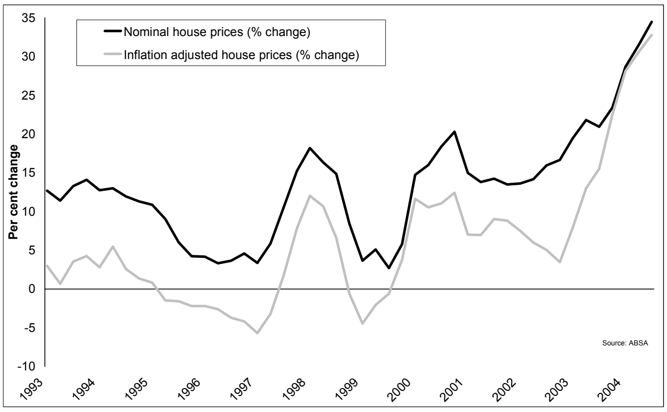
Real gross fixed capital formation expanded at an estimated rate of 7,5 per cent in 2004. During this period, private sector investment increased at an estimated rate of 7,7 per cent, while investment by general government and public corporations increased by an estimated 6,3 and 8,1 per cent respectively. The sustained rise in private sector investment since 2002 suggests a turnaround in expectations about future economic growth.

Rising capital investment throughout the economy

Real fixed investment in the manufacturing sector continued to grow, driven by manufacturers of beverages and refined petroleum products. Extensive investments were also made in mining, transport and telecommunications as well as the electricity, water and gas sector. The planned investments projects of state owned enterprises from 2005 will support this trend and crowd in further private sector investment.

Property prices – boom or bubble?

South African house prices rose 32,1 per cent in 2004 – the highest percentage increase since the gold boom of the early 1980's. Although the rate at which South African property prices are rising is expected to slow from current levels, most analysts expect house prices to increase in real terms during 2005.



Rapid price increases in housing have provoked discussion of whether the sector is experiencing a property boom or a bubble. The key feature of a bubble is that prices are bid up by speculative anticipation of further price rises, rather than underlying demand and supply conditions.

Ultimately, over the long run, house prices should be a function of affordability, which measures the relationship between household income and spending on mortgages. For example, as house prices rise, the proportion of a household's income being spent on mortgage repayments will increase, assuming no rise in household income and no change in interest rates.

Even though home prices have doubled over the last three years, the average cost to South African families remains moderate due to:

- Significant reduction in interest rates
- Growing real disposable income supported by net employment creation, productivity improvements and income tax relief
- Economic empowerment of the previously disadvantaged.

House prices have generally risen in line with decreasing mortgage interest rates and increases in average family income. Although there may be signs of speculative activity in some parts of the market, the overall property market trend does not display signs of speculative excess.

Principles of pension fund reform

South Africa has a large and established private contractual savings sector that compares well with developed countries. At the same time, however, the South African retirement fund industry has been heavily influenced by a racially divided past and economic exclusion. A large proportion of the population reaches retirement age without a funded pension benefit and hence relies on Government's social assistance grant programme.

Against this backdrop, Government has proposed reforms that seek to build on the strengths of the established retirement funding environment, while progressively addressing its deficiencies. Government's retirement reform agenda seeks among other objectives, to:

- Encourage individuals to provide adequately for their own retirement and the needs of their dependants
- Encourage employers and employees to provide for retirement funding as part of the remuneration contract
- Ensure that retirement funding arrangements are cost-efficient, prudently managed, transparent and fair
- Promote the retention of the purchasing power of pensions through protection against the effects of inflation, within the resource constraints of the fund
- Improve standards of fund governance, including trustee knowledge and conduct, protection of members' interest, accountability, and disclosure of material information to members.

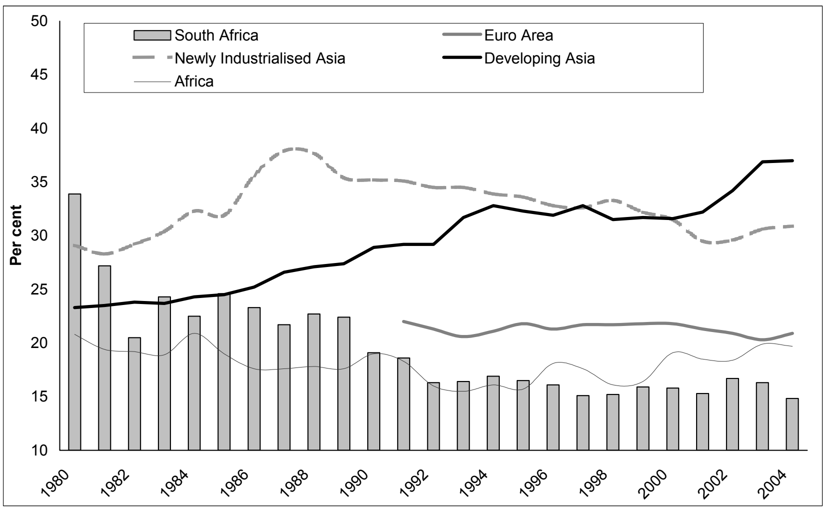
Specific proposals on the means to achieve these broad principles are contained in a discussion document released by the National Treasury in December 2004. Comments on the document are invited from all interested parties by the end of March 2005. Such comments will be taken into account when drafting a revised Pension Funds Act during the course of 2005.

Savings

South Africa's savings rate remains low

South Africa's savings rate continues to be among the lowest in the world, having declined from 16,2 per cent of GDP in the third quarter of 2003 to 14,7 per cent of GDP in the third quarter of 2004. Household savings have remained at about of 2,5 per cent of GDP since the beginning of 2004, while corporate saving increased to 12 per cent of GDP in the third quarter of 2004 from 11,7 per cent in the third quarter of 2003. Government's contribution to gross savings remained at about 0,2 per cent of GDP.

Figure 2.14 Gross national savings as a percentage of GDP



R1,2 billion invested in the government retail bond since May 2004

On 24 May 2004, Government launched a retail bond as a risk-free and no cost savings vehicle for households. At the end of January 2005, R1,2 billion had been invested in the retail bond. Of the 15 261 investments made, twenty per cent are in bonds that cost between R1 000 and R5 000. Subsequent to the launch of the government retail bond, commercial banks have launched more innovative savings vehicles with higher interest rates similar to the retail bond.

Prices and money market developments

Inflation

Inflation remained within target range

During 2004, lower inflation expectations and appreciation of the currency placed downward pressure on consumer and producer inflation, offsetting the upward pressure created by rising international oil prices.

Low producer prices passed on to consumers

Production prices of imported goods declined by 3,8 per cent year on year in 2004. Combined with moderate increases in the prices of domestically produced goods, the overall increase in production prices was a mere 0,7 per cent. This moderate increase in production prices had positive pass through effects to CPIX goods price inflation, which remained on average below 3 per cent. The CPIX inflation rate is expected to stay within the 3-6 per cent target range over the forecast period.

Figure 2.15 Components of CPIX inflation

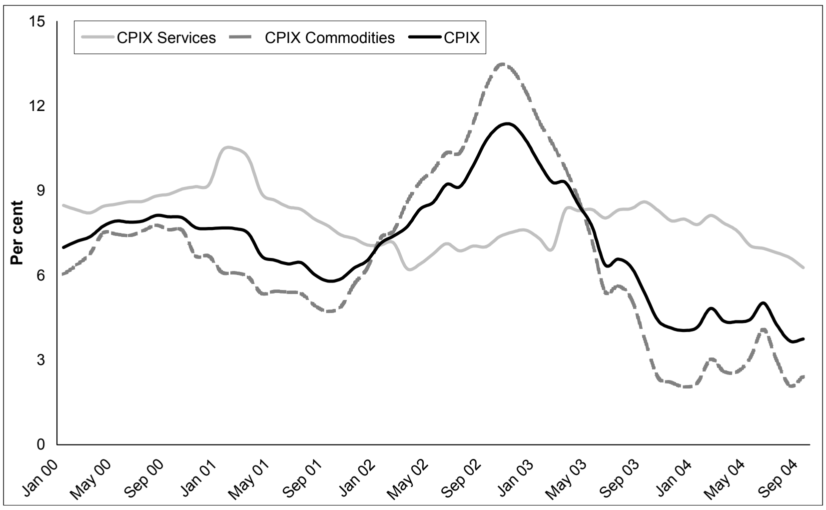
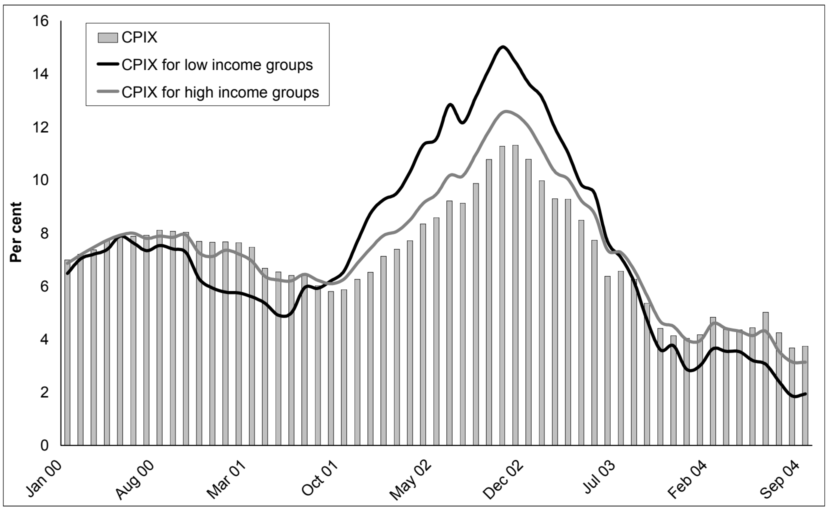


Figure 2.15 shows the contributions of goods and services to CPIX inflation during 2004. Inflation of the commodities component fell sharply as prices of imported goods declined. The dampening effect of the strong currency was most noticeable in the slower rate of increase in prices of furniture, clothing and footwear and vehicles. Services inflation also decreased, although it remains higher than the upper limit of the inflation target.

Lower price increases for low-income groups

Since June 2003, consumer price inflation for low-income groups has fallen to below that of the high-income groups. This is primarily attributable to a strong deceleration in food price inflation to 1,6 per cent in December 2004, while the rate of increase in prices of goods also moderated significantly.

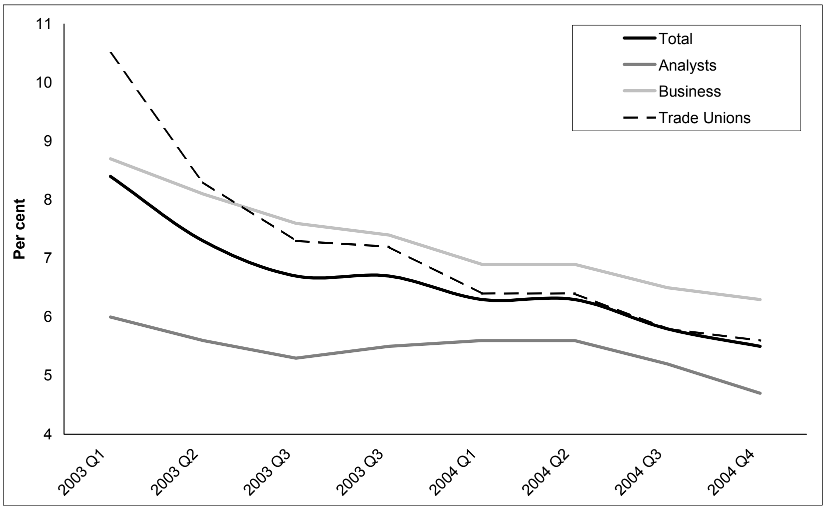
Figure 2.16 Inflation for low and high-income groups



Inflation expectations gravitate towards inflation target

Overall, inflation expectations fell to within the target band of 3-6 per cent for 2005. While business inflation expectations remain high, this has come down since early 2004, and expectations appear to be tracking moderating consumer price inflation.

Figure 2.17 Inflation expectations 2005



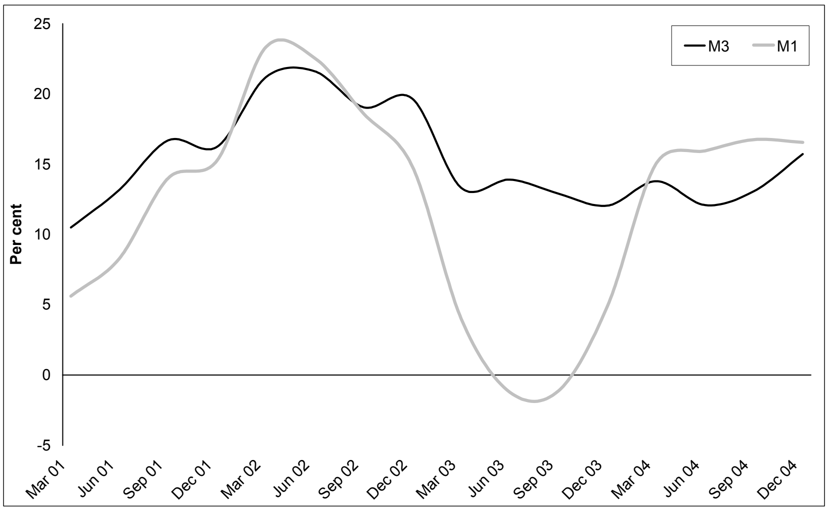
CPIX inflation is projected to average 4,0 per cent in 2005 and 5,1 per cent and 5,4 per cent in 2006 and 2007, respectively. Risks to this forecast include possible drought conditions, developments in the foreign exchange markets, oil prices and strong domestic demand, which may put upward pressure on existing capacity.

Money supply

Robust growth in money supply

Growth in M3 (broad money supply) remained robust in 2004, increasing by 12,8 per cent over the twelve months to December 2004. Growth in the narrow monetary aggregates (M1A and M1) also increased as the opportunity cost of holding money decreased in a low interest rate environment. This is in line with the easing of inflationary pressures in the economy following the tight monetary policy stance in 2002 and the recent robust growth in domestic production and expenditure.

Figure 2.18 Money supply growth



Strong growth in private sector credit extension

Total loans and advances to the private sector increased by 16,3 per cent in December 2004, compared with growth of 12,5 per cent in December 2003. This reflects the strong growth in all asset-backed finance classes, including instalment sale credit and leasing finance, on the back of underlying strength in the economy, a moderation in vehicle price inflation and enhanced price competitiveness of imported durable consumer and capital goods.

Mortgage advances remain the largest share of total loans and advances. Growth in this segment (18,7 per cent in 2004) was underpinned by the low interest rate environment, wealth effects emanating from increased property prices, growing numbers of middle and high income households and the attractiveness of fixed property as an investment asset.

Household debt as a percentage of disposable income remains moderate

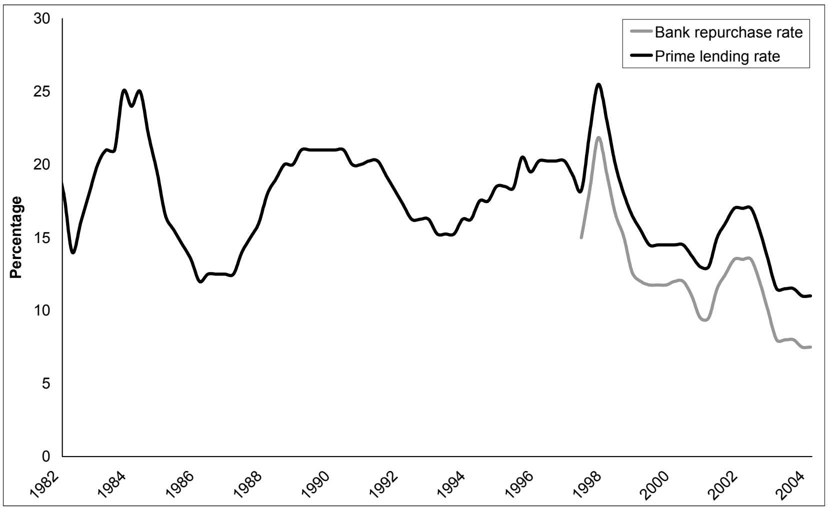
Although credit extension increased, the level of household debt as a percentage of disposable income remains moderate. Debt to disposable income increased from 51,5 per cent at the end of 2003 to 55,5 per cent in the third quarter of 2004, while debt servicing costs as a percentage of disposable income dropped from an average of 8 per cent in 2003 to about 6 per cent in 2004.

Interest rates

Interest rates are currently at their lowest levels in 24 years having receded from the record high of September 1998. This structural decline may be attributed to moderating inflationary pressures in line with the world trend towards greater price stability.

Interest rates at a 24 year low

Figure 2.19 Interest rate movements



Domestic outlook

Conditions for moderate improvements in growth and macroeconomic performance over the MTEF period ahead are favourable.

Household consumption is expected to remain above 4 per cent spurred by substantial gains in real disposable income and manageable debt levels. The lagged effect of the continued cuts in nominal interest rates since 2003, positive wealth effects (from increases in the prices of real estate, shares and bonds), accelerated welfare spending by Government, a stronger currency, and growth in real disposable income (boosted by both employment and real wages) in an environment of benign inflation will support consumption. Consumer surveys indicate that individuals are generally upbeat in their assessment of the economy's prospects and of their own circumstances. Government consumption growth will remain steady, reflecting continued expansion in health, education and security services.

Household and government consumption to remain strong

Investment growth is expected to increase briskly over the forecast period as domestic producers invest in new capacity to meet rising demand and benefit from favourable interest rates. Parastatal investment plans for the medium term entail sharp increases in investment toward the end of the forecast period. Private firms are also expected to increase capacity in anticipation of a rise in output. The strong property market should support residential investment.

Investment growth continues to be brisk

Export performance is expected to improve, as the global economic environment continues to exhibit good growth rates and the real trade-

Exports to improve as global growth picks up

weighted rand weakens moderately. Over the longer term, exports are also expected to benefit from continued investment in capacity.

Import volumes recorded exceptionally high growth in 2004 and are expected to increase moderately over the forecast period. Investment in new capacity by domestic producers as well as parastatal and government capital expenditure programs will continue to put upward pressure on imports.

Current account deficit to widen

The projected deficit on the current account is expected to widen to about 3,5 per cent of GDP, primarily as a result of the ongoing restructuring and investment needs of the economy.

Inflation to remain within target

CPIX inflation will remain comfortably within the target due to low prices of imported goods and moderating food prices. Modest wage increases coupled with further productivity gains will keep growth in unit labour costs moderate.

Table 2.6 Macroeconomic projections, 2004 – 2007

Calendar year	2001	2002	2003	2004	2005	2006	2007
		Actual		Estimate		Forecast	
Percentage change unless otherwise indicated							
Final household consumption	3,5	3,2	3,4	5,9	4,7	3,7	4,2
Final government consumption	3,1	4,4	6,4	6,7	4,0	3,5	3,1
Gross fixed capital formation	3,5	3,7	9,0	7,5	7,0	6,2	7,8
Gross domestic expenditure	2,6	4,6	5,3	5,7	4,7	4,3	4,4
Exports	1,1	0,4	-2,3	5,0	4,7	3,6	5,7
Imports	0,2	4,1	7,3	12,7	5,9	5,5	5,7
Real GDP growth	**2,7**	**3,6**	**2,8**	**3,7**	**4,3**	**3,8**	**4,4**
GDP deflator	7,7	10,3	4,5	5,9	4,4	5,3	5,6
GDP at current prices (R billion)	**1 020,0**	**1 649,9**	**1 251,5**	**1 374,5**	**1 497,1**	**1 636,2**	**1 803,3**
CPIX (Metropolitan and urban, average for year)	6,6	9,3	6,8	4,3	4,0	5,1	5,4
Current account balance (percentage of GDP)	0,0	0,6	-0,9	-2,3	-3,1	-3,6	-3,6

Table 2.7 Macroeconomic projections, 2004/05 – 2007/08

Fiscal year	2002/03	2003/04	2004/05		2005/06		2006/07		2007/08
R billion			2004 Budget	Revised	2004 Budget	Revised	2004 Budget	Revised	
GDP at current prices	**1 149,9**	**1 277,0**	**1 331,8**	**1 403,9**	**1 455,6**	**1 528,6**	**1 592,5**	**1 674,0**	**1 847,3**
Real GDP growth	3,4	2,7	3,3	4,2	3,6	4,1	4,0	3,9	4,4
GDP inflation	10,0	4,2	5,4	5,5	5,5	4,6	5,2	5,4	5,7
CPIX (Metropolitan and urban)	9,8	5,5	5,2	4,2	5,5	4,2	4,9	5,3	5,3