

SECTION FOUR: Macro Economic Overview

4.1. INTRODUCTION

For a study of this nature, it is regarded as imperative to provide a concise overview of the state-of-the-economy. The demand for labour (within a multitude of skills categories) is in all cases a derived demand and unless the demand patterns for particular goods and services demonstrate upward trends, skills development initiatives will be thwarted (except for the ever-present need to adapt to new technologies).

It is important to recognise that South Africa's successful transition to democracy in 1994 has been accompanied by a dramatic reversal of the country's economic fortunes. Between 1981 and 1993, the economy had experienced three extended periods of recession and living standards declined throughout this period.

The real value of the country's fixed capital formation in 1993 was 30% lower than the figure for 1982 and inflation persisted at levels of between 10% and 20% for most of the 1980s and the early 1990s. During the period 1985 to 1993, South Africa was forced to maintain a surplus on the current account of its balance of payments, due to the capital flight instigated by the debt standstill agreements with foreign creditors. It had become clear by the end of the 1980s that domestic socio-political unrest, combined with international embargoes on trade with South Africa was destabilising the country.

Democracy, attained in 1994, signalled an abrupt end to negative trends in virtually all of the major economic indicators. The changes in these trends are, by and large, dramatic, both in terms of directional shifts and sustainability, a fact that is not fully appreciated by the broad business community. The extent of structural change in the economy will be briefly discussed.

4.2. SUSTAINED ECONOMIC GROWTH

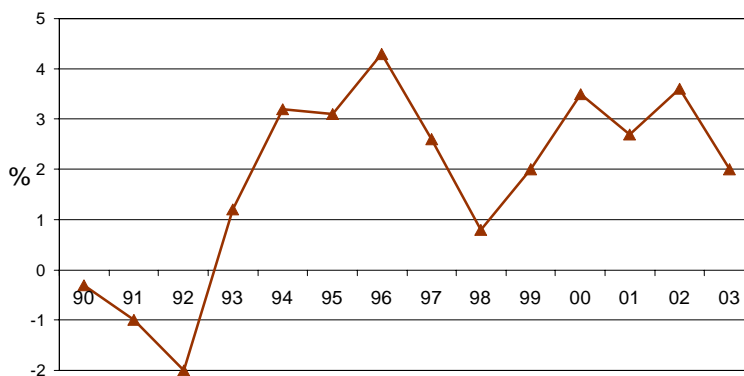
Between 1988 and 1992, real GDP in South Africa contracted by an average annual rate of 0.3%. Between 1993 and 2003 the South African economy has managed an average annual rate of real economic growth of 2.6%. To place this change into perspective, this sustained growth performance has witnessed a three-fold increase in the nominal GDP (from R370 billion in 1992 to R1.2 trillion in 2003).



The South African economy has, in fact, not witnessed a technical recession (two successive quarters of negative GDP growth) since the advent of democracy, and growth rates of between 3% and 4%, respectively, are being forecast for 2004 and 2005 by most economists.

One of the key implications of the return to sustained output growth is that a large degree of certainty now exists that cyclical economic patterns will be relatively smooth and are likely to continue with a growth path in the 3% to 4% range or higher for several years to come.

Real GDP growth



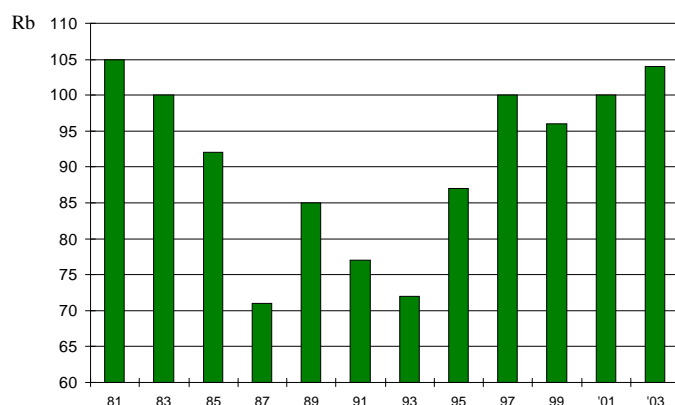
4.3. SUSTAINED AND STRONG FIXED CAPITAL FORMATION

In the area of fixed investment in infrastructure and new productive capacity, the change over the past decade has been even more pronounced. An annual average decline in gross fixed capital formation of almost 4% per annum over the 1989 to 1993 period was turned around into average annual positive growth of 4.6% (in real terms) between 1993 and 2003.

The implications of this trend are, firstly, that South Africa's fixed capital stock has been significantly expanded, particularly in the areas of manufacturing; trade and catering; financial and business services; community services; and transport and communication. Secondly, the capital formation has been accompanied by a large degree of new technology transfer, which has raised the levels of competitiveness in the domestic economy and also expanded the capability for exports.



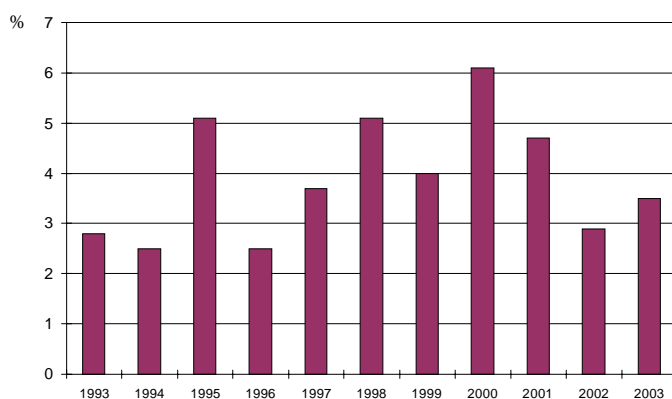
Real capital formation in the SA economy: pre- and post-democracy



4.4. INCREASED LABOUR PRODUCTIVITY

Between 1988 and 1992, South Africa's total labour productivity index increased by only 0.6% per annum (on average), whilst the average annual figure for person-days lost in labour stoppages amounted to more than two million during the 1987 to 1994 period. Since 1993, labour productivity in the South African economy has grown by an average annual rate of more than 4%.

Labour productivity growth



The conclusion drawn from these trends is that the transition to democracy has obviated the need for human resource inputs to be channelled to resistance efforts aimed at ending an unjust constitutional dispensation. More and more, productive energy is now finding its way into free enterprise activity. Unfortunately however, a degree of volatility still exists in the trend of this



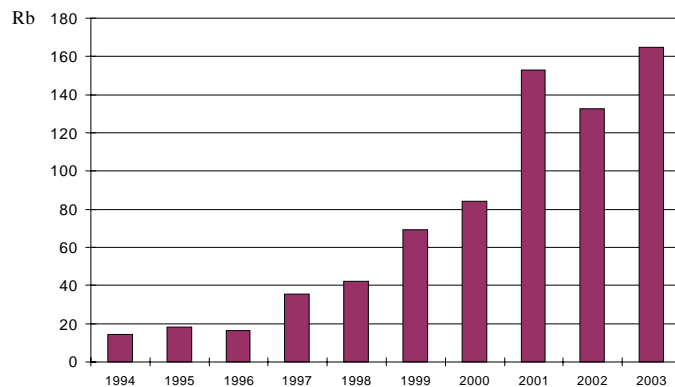
indicator, as illustrated by the above figure. During the run up to the 1999 elections, labour unrest increased again and labour productivity declined.

4.5. BALANCE OF PAYMENTS STABILITY

One of the most remarkable demonstrations of the reversal of South Africa's economic fortunes is found in the pre-election and post-election balance of payments flows. South Africa managed to attract a net inflow of foreign capital of R170.7 billion between 1995 and 2003. This figure was considerably more than the cumulative current account deficit of R56 billion over this period.

The capital inflow since the elections has averaged more than R17 billion per annum, which is more than three times the average annual capital outflow recorded between 1987 and 1993. In this process, the country's gross gold and foreign exchange reserves have reached new record highs virtually every single year. This trend was only halted temporarily in 2002 as a result of the strong recovery of the rand exchange rate.

Gross gold & foreign exchange reserves



The return to balance of payments stability means that South Africa's external economic relations have provided the country with an additional platform for growth. The capital account surplus is acting as a financing mechanism for imports of technologically advanced capital equipment and intermediate components, with the current account deficit/GDP ratio remaining in a stable range of under 1%. South Africa's capital account performance since 1994 is an unequivocal stamp of international approval of both constitutional change and economic development potential.



4.6. FISCAL STABILITY

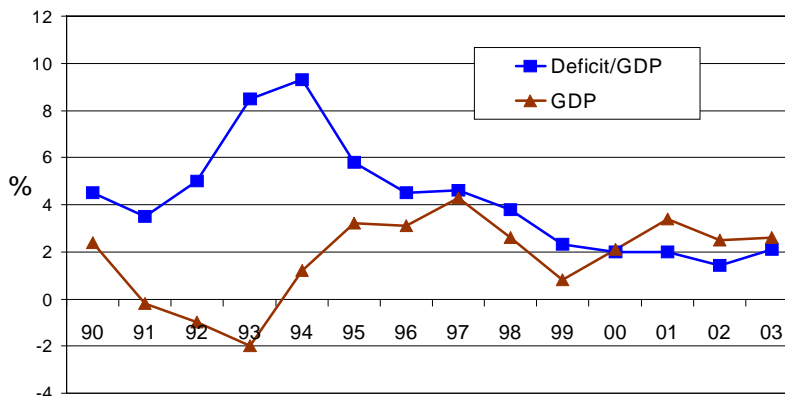
South Africa's public finances are in considerably better shape than prior to the 1994 elections, with the budget deficit/GDP ratio having been lowered from 9.1% in the 1993/94 fiscal year to a budgeted figure of less than 2% for 2003/2004. An outstanding feature of the 2004/2005 budget is the reversal of this decade-long declining trend in the deficit/GDP ratio. In the new budget, the deficit will move to above 3% of GDP.

Fiscal policy in South Africa has been applauded for its ability to maintain a large degree of discipline whilst also providing tax relief and maintaining the shift in expenditure priorities towards social services.

A further welcome development has been the positive result of government's financial management improvement programme, which has witnessed a fairly dramatic resuscitation of provincial finances (from a consolidated budget deficit of R5,9 billion in 1998 to a surplus in subsequent budgets).

Arguably the most notable catch phrase in the 2004 budget speech was the promise to spend R1 trillion on improving services over the next three years. Government's promises to speed up expenditure on the provision of infrastructure should also be seen against the reality of its neglect of capital expenditure over the past decade. Between 1995 and 2002, public sector capital expenditure declined from a ratio of 1.6% of GDP to below 1%, which is paltry compared to the levels of between 3% and 7% that exist in most emerging market economies (including South Korea, Chile, Egypt and Malaysia).

Growth leads to fiscal stability



Fortunately, the return to fiscal stability will make it possible for government to increase its capital expenditures from 2004 onwards. In this process, much-needed socio-economic infrastructure creation can be accelerated. The Department of Public Works is committed to preferential treatment of labour-

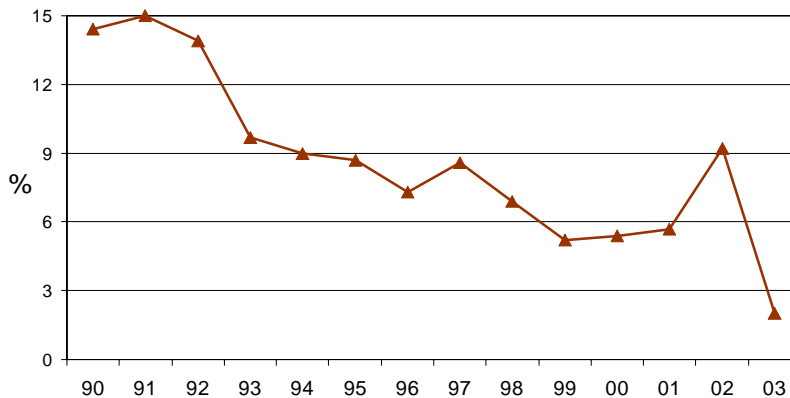


intensive projects, and the fiscus is now in a position to complement the objective of employment creation through increase expenditure allocations to community-based public works programmes.

4.7. PRICE STABILITY

South Africa has finally managed to tame the domestic inflation tiger. Both consumer inflation and producer inflation are at their lowest levels in almost 40 years. The average increase in the Consumer Price Index (CPI) during the third quarter of 2003 amounted to 0.7%, down from a level of 8.6% in 1997, and 14.7% in 1989. Towards the end of the previous millennium, it seemed that inflationary trends had been restricted to the South African Reserve Bank's target range of 3% to 6%.

Inflation (CPI)



Unfortunately, however, a combination of external factors placed upward pressure on inflation between the end of 2001 and the beginning of 2003. This so-called “peak” in domestic prices was caused mainly by high oil prices, the strong US dollar (prior to 2002), the international grain and wheat shortage of 2002, and higher administered prices.

A subsequent easing of oil prices, a recovery of grain and wheat harvests, and government's commitment to strict monetary policy and fiscal discipline has resulted in a return to significantly lower inflation in 2004.

South Africa's long awaited return to price stability will have a profound effect on certain behavioural patterns in the economy. In the case of individual investors, a downward revision will be required of anticipated returns. The days of double-digit nominal rates of return on certain investments may well be something of the past.



Trade unions will also have to realise that historical bargaining positions which demanded wage increases of 10% and above are becoming unrealistic in the presence of deflationary trends. Costing procedures are therefore likely to become simpler in future, with regular and sharp cost revisions rapidly becoming unnecessary.

From a macro-economic perspective, low inflation means that monetary policy can be more readily relaxed, and the combination of low inflation and lower money market rates provides a sound platform for strong economic growth in the future.

4.8. A RETURN TO EXCHANGE RATE STABILITY

The emerging market turmoil of 1998 and 2001 took its toll on the South African currency, which depreciated significantly against the euro during these two calendar years. The latter is the major barometer of the rand's international exchange rate, as Europe is, by far, South Africa's major trading block. This volatility has obscured the fact that the rand has been fairly stable since 1991. Between 1991 and 1996, the average annual rate of depreciation against the euro (then named the European Currency Unit - ECU) amounted to 8.7%, which approximated the inflation differentials between South Africa and Europe.

Between 1996 and June 1999 the rand depreciated at an average annual rate of 6.2% against the euro, which also represents a stable pattern in terms of purchasing power parity. This performance is indeed remarkable when viewed against the volatility of 1998, which was not induced by fundamental flaws in the South African economy, but rather by a temporary and speculative mood swing on the part of international portfolio investors and overvalued equity markets in certain South-east Asian economies.

Unfortunately, it transpired that the monetary authorities had overreacted in their attempts to shore up the value of the rand through forward market transactions. In the process the so-called net open forward position (NOFP) of the SA Reserve Bank reached a level of more than \$20 billion at the end of 1998, which was destined to place continuing downward pressure on the domestic currency. During the next three years, a number of other factors conspired to also place downward pressure on the rand exchange rate. They included subjective issues, such as the 1999 elections, which renewed fears of a more populist policy stance by the ruling ANC, particularly in the event of the South African government becoming a de facto one party state and the human rights violations which had become a trademark of the Zimbabwean government.

Other factors were more technical, such as net bond sales by international portfolio investors, lower demand for South African exports as a result of a world economic slowdown, and negative leads and lags in trade payments.



From the beginning of 2004 the rand started a sustained recovery phase, particularly against the US dollar. During most of 2002, the rand's recovery was mainly due to dollar weakness, with the local currency gaining a modest 8% against the US dollar between February and September 2002.

Thereafter, however, the rand demonstrated its mettle through a significant strengthening against all major currencies. Relative to the US dollar, the rand gained 83% between January 2002 and December 2003, which meant that the local currency has largely eliminated the real depreciation recorded over the past decade.

The NOFP remains the crucial factor in understanding the reversal of fortunes experienced by the South African currency. While it stood at levels of above \$10 billion, no foreign exchange dealer would seriously have backed a stronger rand, simply because of the existence of a strong and visible demand for foreign exchange by the S A Reserve Bank. During a presentation to the Myburgh Commission in April 2002, the author predicted that the unwinding of the NOFP would be inversely correlated to the local currency's future performance, aided, of course, by significant export earnings during 2002.

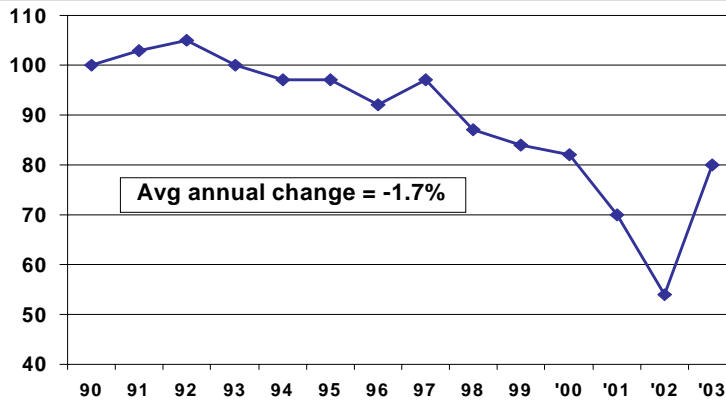
The NOFP had dwindled to below \$3 billion towards the end of 2002, and South Africa's 1.25 billion euro bond issue in May 2003 finally put paid to the NOFP. Other reasons for the resilience of the rand over the past two years include:

- A strong balance of payments, with both the current account and the financial account recording a surplus in 2002. This was followed by large financial account inflows in 2003, resulting in an increase in foreign exchange reserves of more than R32 billion.
- A series of upgrades in South Africa's international credit ratings.
- A widening of interest rates between South Africa and most other stable economies.
- The consistent application of sound fiscal policies.

Between 1990 and 2003, the real effective exchange rate of the rand depreciated by an annual average of only 1.7%. This depreciation is marginal when compared to the strength of the US dollar over most of this period and the fact that South Africa is classified as an emerging market, with unstable currencies characterising several of the world's developing countries. Between September 2002 and December 2003, the rand strengthened by 30% against the euro. Sound prospects exist for a large degree of future exchange rate stability, particularly as a result of improved GDP growth prospects, lower inflation, and balance of payments stability.



Real effective exchange rate of the rand Index: 1990 = 100



4.9. EMERGING MARKET LEADERSHIP

A little bit of history was made during the 1999 annual meetings of the International Monetary Fund and the World Bank with the formation of the "Group of Twenty Countries" (G20).

This organisation is the product of a growing realisation amongst the world's largest economies that emerging markets have an important role to play in the shaping of global economic strategies. Intensive lobbying by policy-makers not represented in the smaller G7-grouping has no doubt contributed to the formation of the world's newest international organisation. Compelling arguments and economic realities exist for the G20 concept, including the following:

- In terms of size of output, five of the top fifteen economies in the world are emerging markets.
- In terms of average annual GDP growth since 1990, emerging markets have dominated the scene, with 14 countries in the world's top fifteen ranking.
- Emerging markets also dominate the capital formation ranking since 1990 with 14 countries in the world's top fifteen ranking.
- Economic policy decisions by the high-income countries often contribute to the stabilisation or destabilisation of developing economies. A forum for discussion of issues related to monetary policies, gold reserves, and third world debt relief may prevent sharp cyclical movements in some developing countries.

South Africa has been included in the G20-grouping, together with the following emerging markets: Argentina, Brazil, China, India, Mexico, Russia, South Korea and Turkey.

South Africa's presence in this elite grouping should not only be seen in the context of being the sole representative from the African continent, but rather

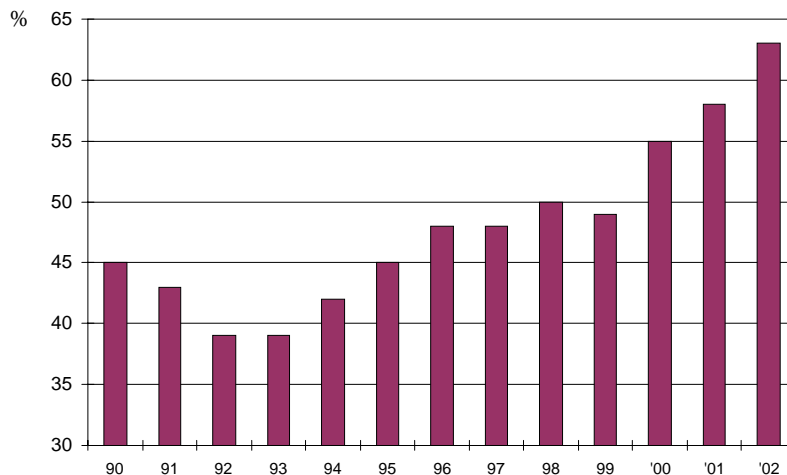


due to the country's fundamental economic recovery since its transition to democracy. South Africa's ranking as number five in a recent survey of transparency in emerging market financial information (covering the public and private sectors) also justifies its inclusion in the G20 countries.

4.10. CHANGING PATTERNS OF INTERNATIONAL TRADE

Since 1994, the ratio of total trade to GDP has risen fairly dramatically to even higher levels than existed prior to the sanctions era, reflecting South Africa's ability to join the international trend towards globalisation. Strong growth has occurred during the post-democracy period in a number of export categories associated with high-value added economic activity. These include furniture; aircraft; chemicals; mechanical machinery and equipment; electrical machinery and equipment; and beverages and vehicles.

Trade/GDP ratio



Investment in new productive capacity in the economy is the dominant characteristic of South Africa's imports by International Standard Industry Classification (ISIC) section. The three sections comprising machinery and equipment; transport equipment; and high-tech equipment account for 50% of South Africa's classified imports, and above-average growth rates have occurred since 1994 in the imports of products associated with technology improvements and capital formation.

Changing patterns of international trade are also discernible from an analysis of the destination of South Africa's exports and the origin of South Africa's imports.



Europe remains South Africa's major export trading region, accounting for approximately 40% of all exports (excluding precious metals and stones). This dominant position has been strengthened during the democratic era.

Table 4.1 - South Africa's top-ten export trading partners (R million at constant 2003 prices)

Country	1994	2003	Average annual growth	Ranking 1994	Ranking 2003
USA	8,026	28,890	15.3%	3	1
UK	10,888	24,046	9.2%	2	2
Japan	7,619	23,671	13.4%	4	3
Germany	6,794	18,353	11.7%	5	4
Netherlands	3,870	11,345	12.7%	8	5
Belgium	4,776	7,410	5.0%	6	6
Italy	3,234	6,868	8.7%	10	7
China	1,071	6,686	22.6%	23	8
Zimbabwe	4,508	6,457	4.1%	7	9
Spain	2,207	6,246	12.3%	14	10

Africa has also consolidated its importance as a major export destination since 1993. Four African countries are amongst the top five export destinations in terms of average annual growth since the elections, namely Nigeria, Ghana, Angola and Tanzania.

Table 4.2 - South Africa's top-ten import trading partners (R million at constant 2003 prices)

Country	1994	2003	Average annual growth	Ranking 1994	Ranking 2003
Germany	23,806	38,345	5.4%	1	1
USA	22,959	25,044	1.0%	2	2
UK	16,427	22,436	3.5%	3	3
Japan	14,470	18,193	2.6%	4	4
China	2,352	16,598	24.2%	12	5
France	4,979	15,416	13.4%	6	6
Italy	5,472	8,437	4.9%	5	7
Australia	1,967	5,961	13.1%	14	8
Brazil	1,349	5,339	16.5%	20	9
Taiwan	4,774	4,643	-0.3%	7	10

A number of countries that were at the forefront of trade embargoes and disinvestment during the apartheid era have taken a pro-active stance towards exporting to South Africa. India and Finland have increased their exports to South Africa by more than 50% per annum on average, since 1993.



A ranking of import growth performers since 1993 indicates the opening up of various new markets, especially in China, Africa, India, Australia and the Middle East. These trends are depicted by the accompanying tables.

4.11. ECONOMIC GROWTH PROSPECTS

It has become fairly easy to predict an improvement in the general economic welfare of South African society, particularly when viewed against the backdrop of substantial shifts that have occurred in a number of key indicators over the past couple of years.

Increased optimism over the prospects for higher and sustained growth in the short to medium term are mainly based on the following developments:

- Lower nominal interest rates

Money market rates in South Africa are currently at rates that are 32% lower than the first quarter of 2003. Even though interest rates have actually increased in real terms over the past two years (due to a sharp decline in the consumer price index), the decline in nominal terms has translated to a substantial increase in personal disposable income for a large proportion of households.

This effect operates mainly through lower mortgage bond repayments, which provides households that own mortgaged property to choose between increased consumption or increased savings. A key issue with regard to the role of interest rates in the economy is the prospect that now exists for money market rates to remain at relatively low levels for the foreseeable future. The reason for the prospects of interest rate stability is to be found in the absence of any significant threat of higher inflation.

- Low inflation

As indicated in section 7, the battle against inflation has more or less been won. The consumer price index (CPI) remained snugly within the Reserve Bank's target range of 3% to 6% for three calendar years in a row, before a series of external events combined with the huge net open forward position (NOPF) to create an "inflationary spike" in 2002.

It is important to appreciate the abnormal nature of the causes of this increase in inflation – an international wheat shortage; dramatic short-term increases in the price of oil; and a sharp depreciation of the exchange rate of the rand. It is unlikely that so many key drivers of local inflation will ever again simultaneously conspire to threaten price stability.

No sound reason exists therefore to believe that inflation will depart from the Reserve Bank's target range over the next year or two. In fact, hardly any prospect exists for the 2002 "inflation spike" to occur again.



In this environment, it is highly likely that the prime rate will remain at a level of between 11% and 12% for many years to come, bringing with it the likelihood of a large degree of predictability regarding the cost of capital – a phenomenon that would be welcomed by business and consumers.

▪ Infrastructure drive

Since the beginning of 2004, government has announced a series of programmes intended to upgrade existing infrastructure, create new infrastructure, alleviate poverty and create jobs. The most ambitious project is the R181 billion allocated to provincial governments and local municipalities during the 2004/2005 financial year. A special task team will be established to ensure that the implementation of this programme progresses smoothly.

One of the unit's immediate tasks will be to tackle the R26-billion debt owed to municipalities and to assist them in all areas of project management during the implementation of the R100-billion Expanded Public Works Programme which, government hopes, will create a million jobs over the next five years.

The treasury's contribution to increased investment and job creation would be boosted by transforming the Public Investment Commissioners (PIC) into a corporation that would pump more than R15 billion into new projects. Over the next three years, it would invest about R4 billion in public infrastructure and about R2 billion in small and medium enterprises.

Furthermore, Transnet is considering the sale of bonds to fund part of a R14.5 billion upgrade of the country's railway system. In the area of poverty alleviation, President Mbeki has promised that social grants would eventually reach 7.7 million beneficiaries. With R166-billion allocated over three years for social security, government has promised to have the necessary resources available for about 3.2 million children who will qualify for child-support grants over the next two years.

It has also been announced that the National Empowerment Fund (NEF) is up and running and has R2 billion to spend. Mr Alistair Ruiters, the director-general of the department of trade and industry, said the revamped NEF would assume greater risk than traditional sources of finance.

Employer organisations and economists have welcomed these initiatives, which are regarded as pragmatic and focused, whilst they will undoubtedly exert a positive impact on the country's economic growth performance.

▪ Improved international investment rating

South Africa's investment grade ratings from the three major agencies (Standard & Poor's, Moody's Investors Service and Fitch) has started to pay significant dividends in the form of an attractive yield allocated to the country's latest \$1



billion international bond offering. Strong interest from European and American investors resulted in the bond being fully subscribed within a matter of days.

The new international bond, which will mature in June 2014, was priced at 6.5 percent - only 1.95 percentage points above similar-dated US treasuries, giving South Africa its lowest-ever spread in the dollar bond market. The spread is the premium that investors demand to invest in a country's debt. This low spread, and the fact that there were no pricing concessions, demonstrated the attractiveness of South African credit despite recent volatility in the international bond market.

- The successful World Soccer Cup bid

Following South Africa's success in securing the right to host the 2010 World Soccer Cup, a number of studies have been undertaken to assess the likely impact of the event on the domestic economy. Whatever the figures eventually amount to, consensus exists that the economic impact on South Africa will manifest itself in a tourism showcase without parallel in the country's history.

Three million spectators are expected to arrive in the country for the event, which will lead to a substantial increase in consumption expenditure. In addition, the international television audience will probably amount to 40 million people. The event will also generate additional taxes for government, whilst more than 150 000 jobs are likely to be created. Sectors that will experience a surge in demand will include accommodation; food outlets; car rentals; communication; leisure; garments; and curios.

- High levels of business and consumer confidence

A variety of surveys on business and consumer confidence levels are indicating record levels of optimism, indicating most business leaders and consumers are optimistic about future economic and personal financial developments.

Factors underpinning the recent surge in confidence levels include the successful elections and statements by senior politicians committing government to an increase in economic growth and infrastructure spending. Positive output growth is also being recorded in virtually every sector of the economy, whilst high property prices are starting to exert a wealth-induced effect on durable consumption.

4.12 IMPLICATIONS FOR EMPLOYMENT AND SKILLS

The key conclusion of this brief economic overview is that South Africa's economy has experienced a decade-long process of structural adjustment, during which period virtually all of the major indicators has improved significantly in terms of their ability to facilitate higher output growth. The list is quite impressive and includes the following:



- Eleven successive years of positive real GDP growth
- The lowest inflation in 40 years
- A cumulative net inflow on the capital account of the balance of payments of more than R170 billion
- Average annual positive growth in capital formation of 4.6% (in real terms) between 1993 and 2003
- Average annual labour productivity growth of more than 4%
- A lowering of the budget deficit/GDP ratio from 9.1% in the 1993/94 fiscal year to 23% for 2004/2005
- A lowering of the public debt/GDP ratio from 50% to 40% over the past four years
- A decrease in the ratio of personal income and wealth taxes to gross salaries and wages
- An increase in the trade/GDP ratio from 38% to above 55%

A large degree of consensus exists amongst economists that South Africa has returned to a position of fundamental macroeconomic stability. Since 1998, every national budget prepared by the Department of Finance has provided measurable relief to low-income earners. The cost of mortgage credit is 30% lower today than during mid-2002 and interest rate levels are expected to remain at their current levels for many years to come.

It should be fairly obvious that such a state of affairs calls for renewed vigour in the quest to relieve poverty, particularly amongst rural communities. It is no surprise, therefore, that the State President himself has committed government to strict deadlines and ambitious targets with regard to projects aimed at large-scale job creation, expanding social welfare and establishing new infrastructure.

The link between infrastructure, on the one hand, and growth and development, on the other hand, is quite strong and transgresses direct effects via increased demand in the economy. Input-output table analysis shows that transport, telecommunications, electricity and water are used in the production processes of nearly all sectors of economic activity. Infrastructure services are not only demanded for direct consumption needs, but also indirectly, by reducing the costs associated with production or involvement in gainful employment.

Furthermore, the awarding of the 2010 soccer World Cup bid should be viewed as an event that promises to act as a catalyst for future economic growth. In addition to boosting the national morale, every sector of economic activity stands to gain from a host of activities that will surround the preparation for the World's largest single event of whatever nature. Construction activity will be in the foreground, but the preparations for the tournament will impact on a multitude of linked industries, particularly tourism and hospitality.

On a macro level, the key implication for skills development initiatives that the demand for skilled employment will increase at higher rates, on average, than has been the case during the adjustment process.



4.13. CONCLUSION

This section presented a macroeconomic overview of South Africa. The overview brings the study into perspective in terms of expected future trends regarding economic growth and labour prospects. The following two sections present an economic sectoral analysis. A labour demand model will be used to prioritise the economic sectors, which will be followed by a comprehensive discussion on the development potential of key sectors in the economy.

