The Current and Future South African Economic Context and Labour Productivity

Nontle Kabanyane
Economist
Absa Group Economic Research
22 September 2005

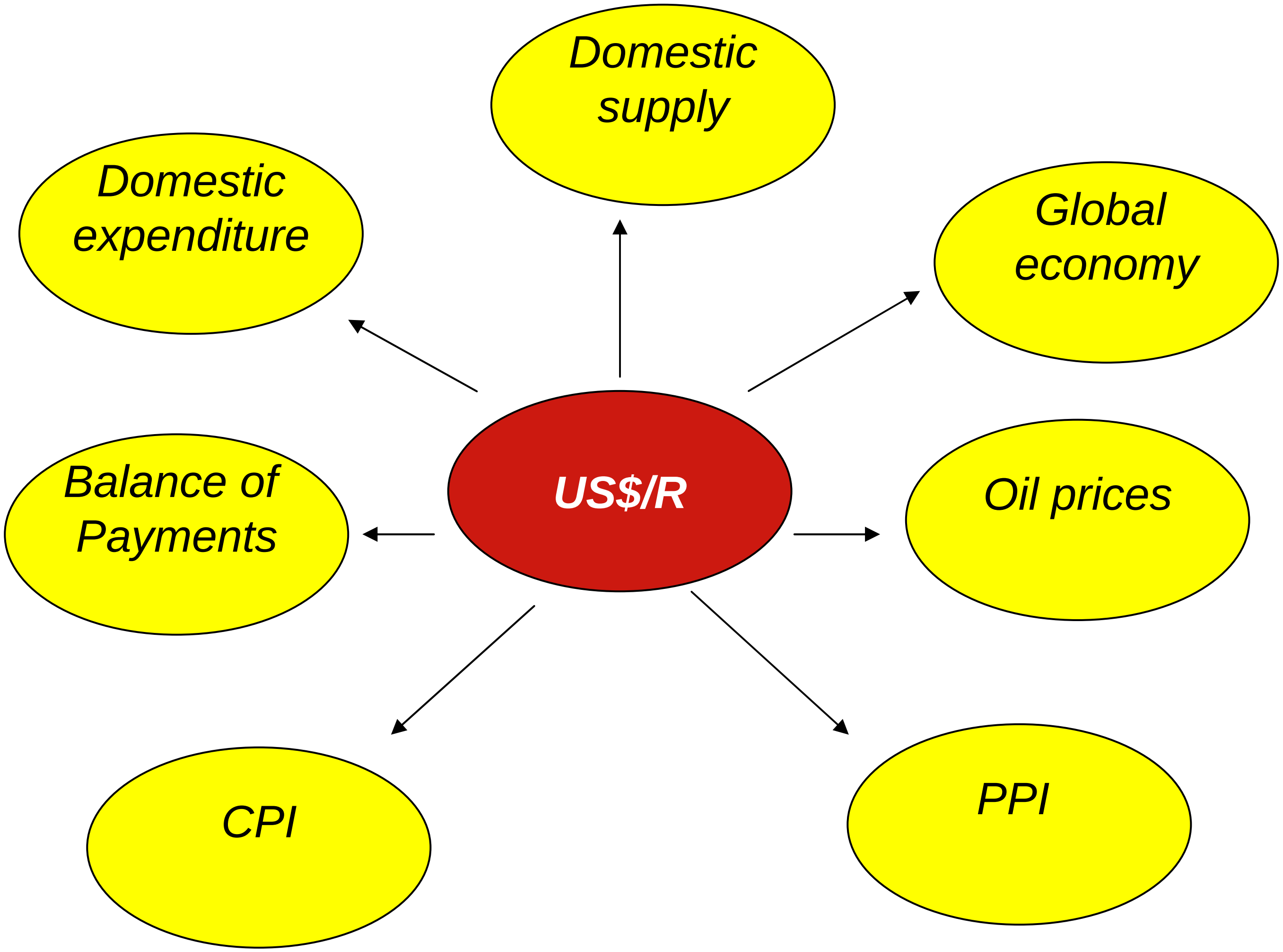
Group Economic Research

ABSA
Today, tomorrow, together.

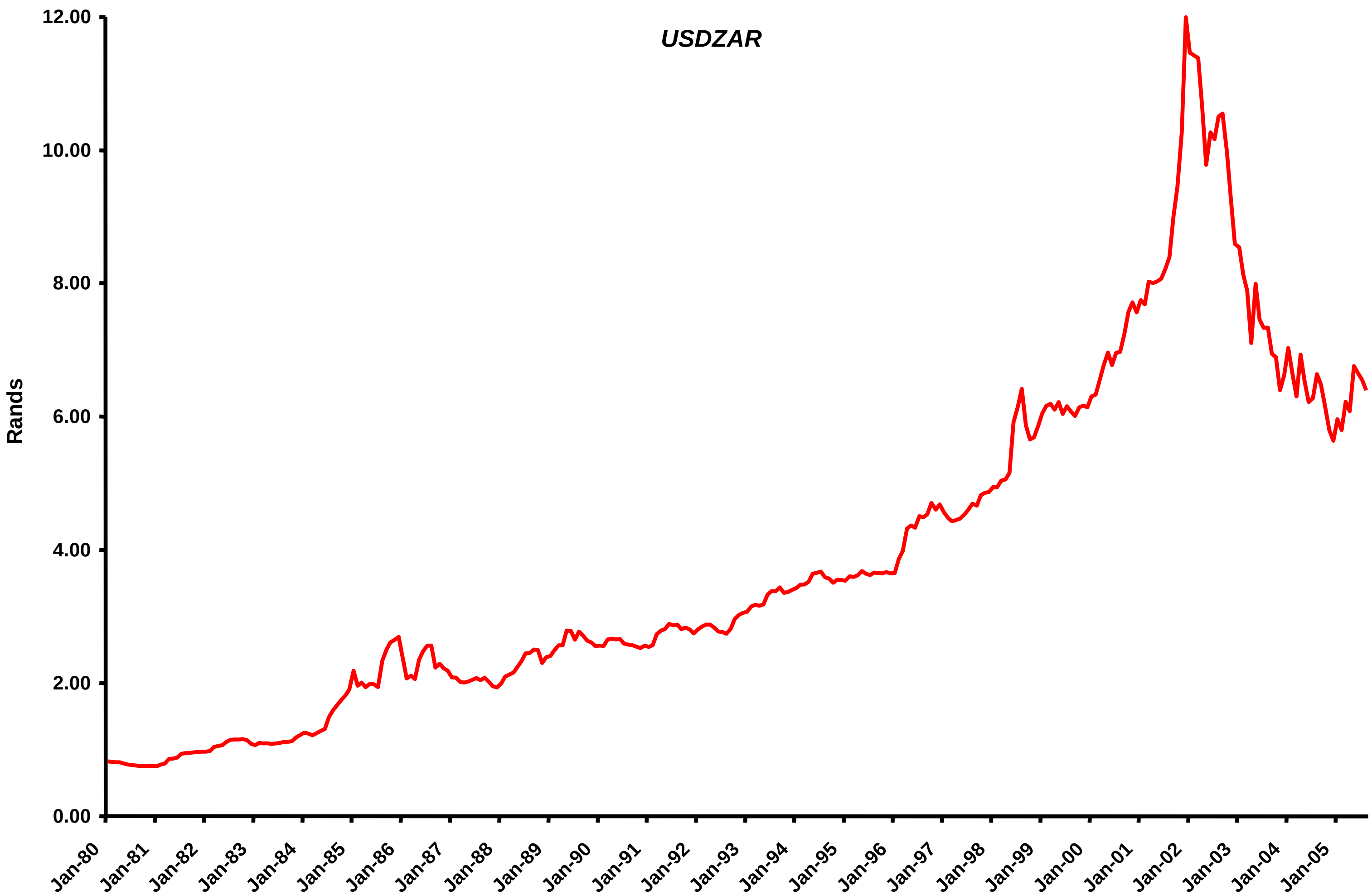
Outline

- **Economic Overview**
  - Rand direction
  - Economic prospects for 2006
- **Economic growth now and beyond 2010**
  - Tourism-led growth
  - Export-led growth
  - Labour reforms
- **Pension fund reforms**
- **Summary**

Economic overview



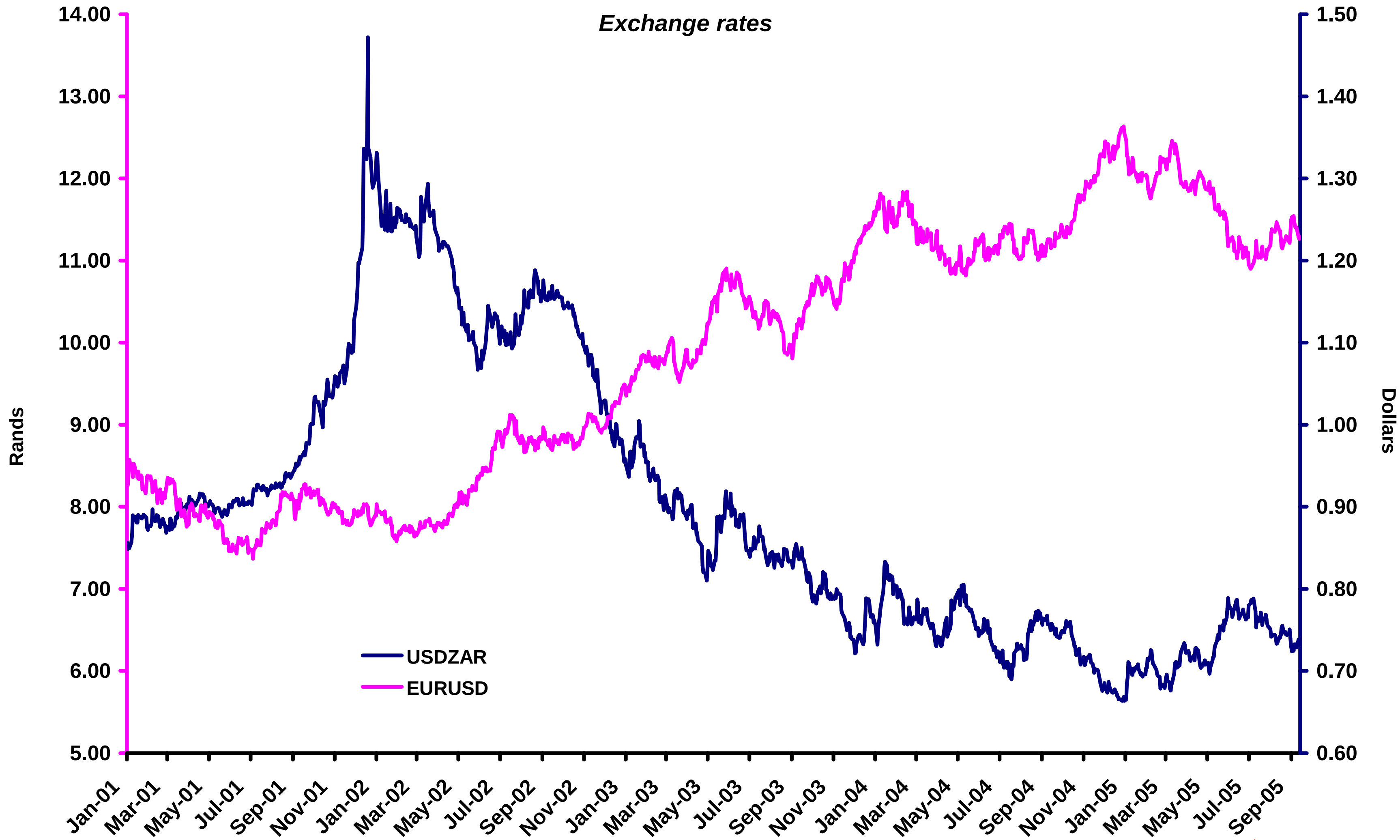
Rand: long-term trend change



Rand: short-term trend to move sideways between R6,30 and R6,80 trading range

Resistance levels: (1) R6,00 to the dollar for the upside – more interest rate cuts; (2) R6,90 – R7,00 to the dollar, increased inflationary pressures – interest hikes

EURUSD vs. USDZAR relationship

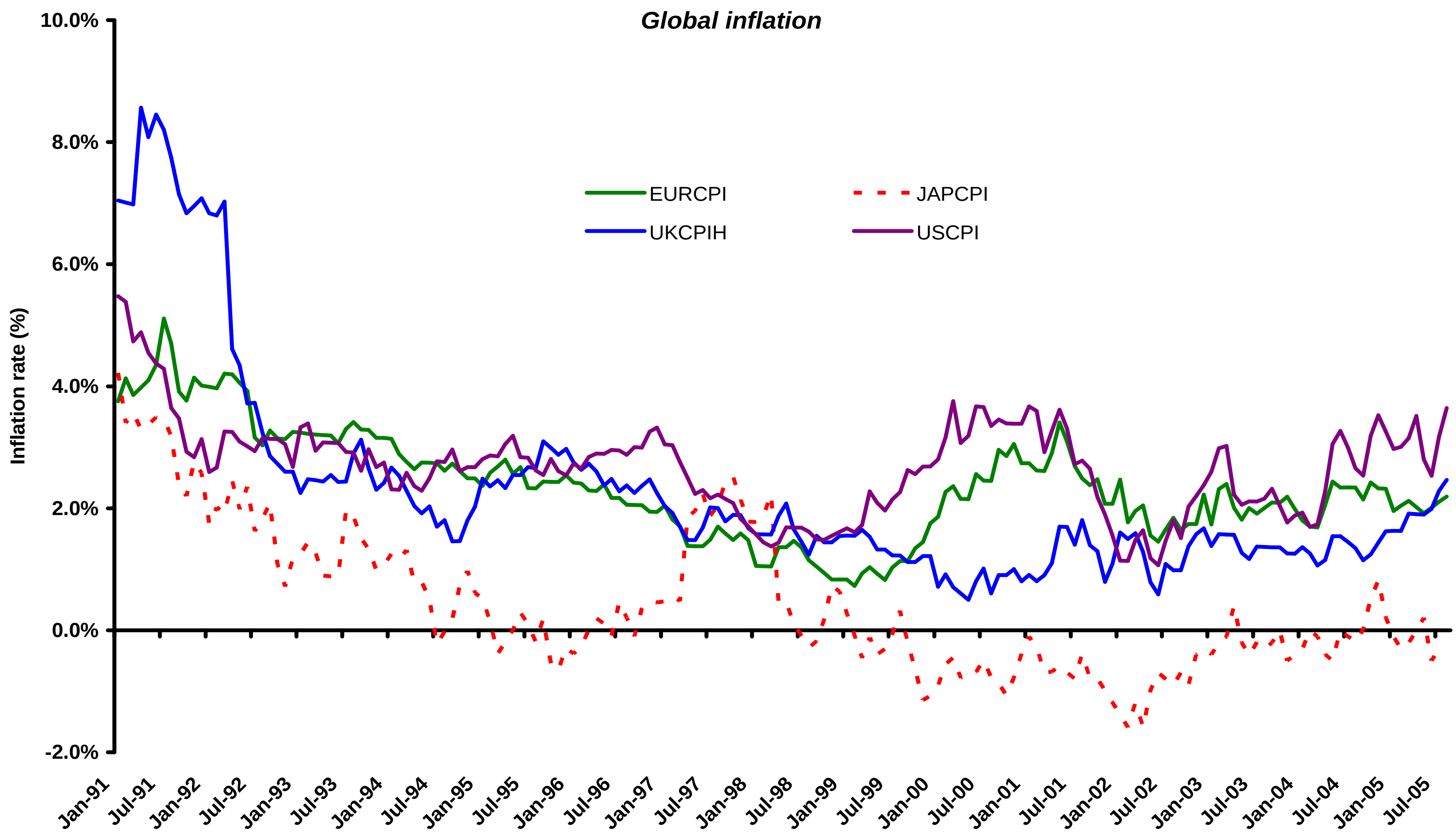


Group Economic Research

ABSA

Today, tomorrow, together.

Global economy- inflationary pressure from higher oil prices



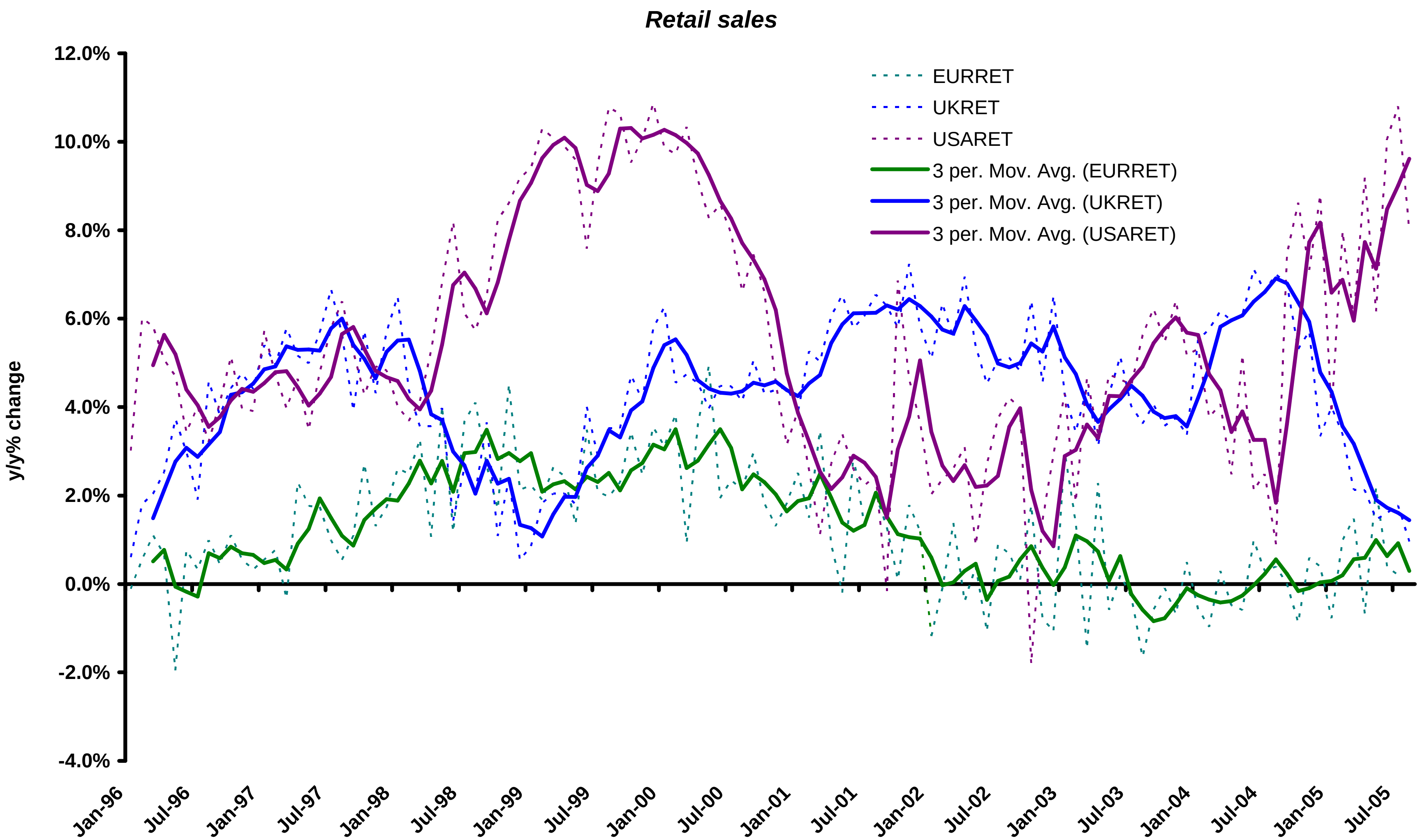
Higher US unit labour costs contributing to higher inflation.
Japan's deflationary pressures easing.

Group Economic Research

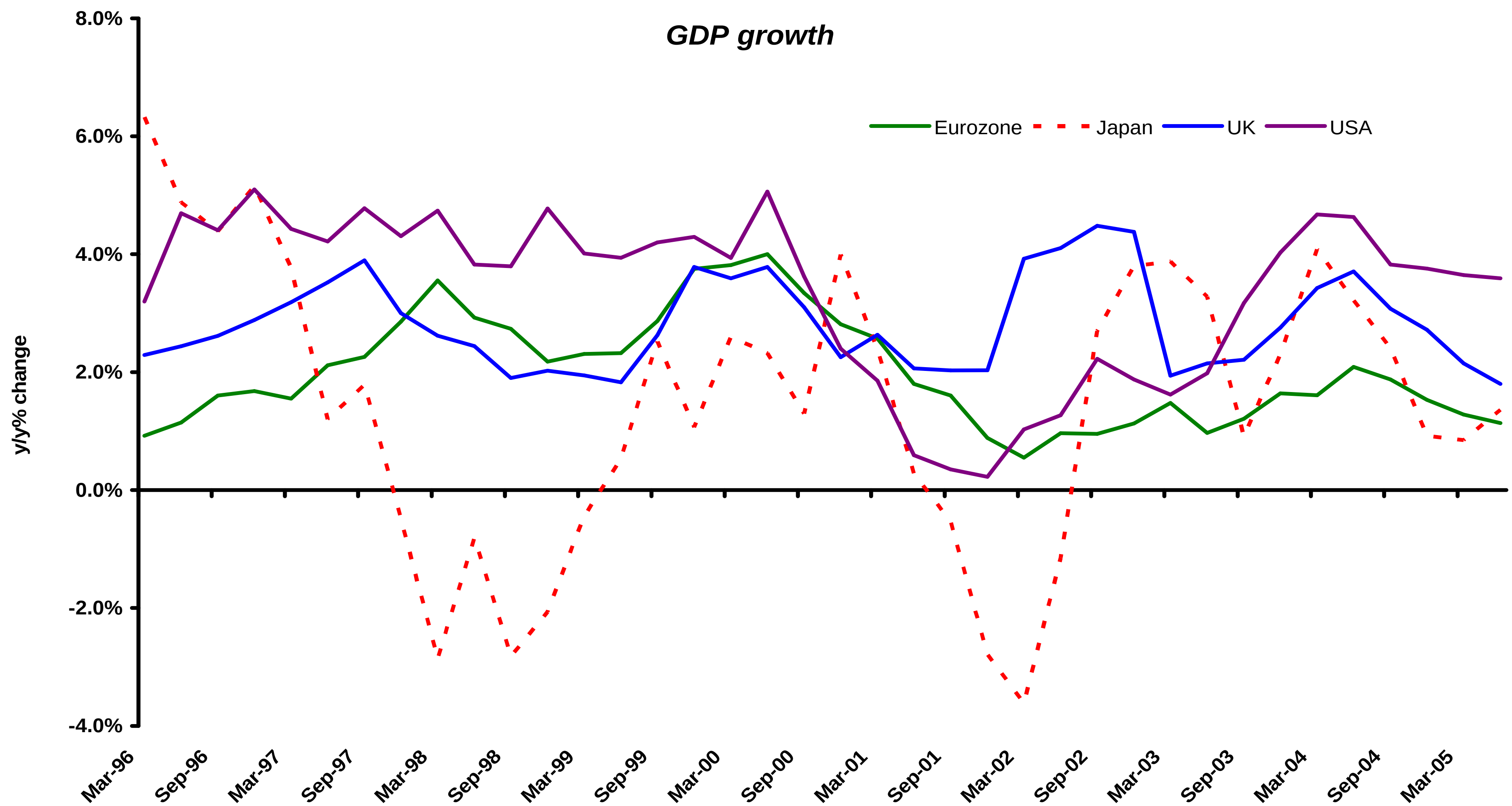
ABSA

Today, tomorrow, together.

Global economy: retail sales growth declining in Europe

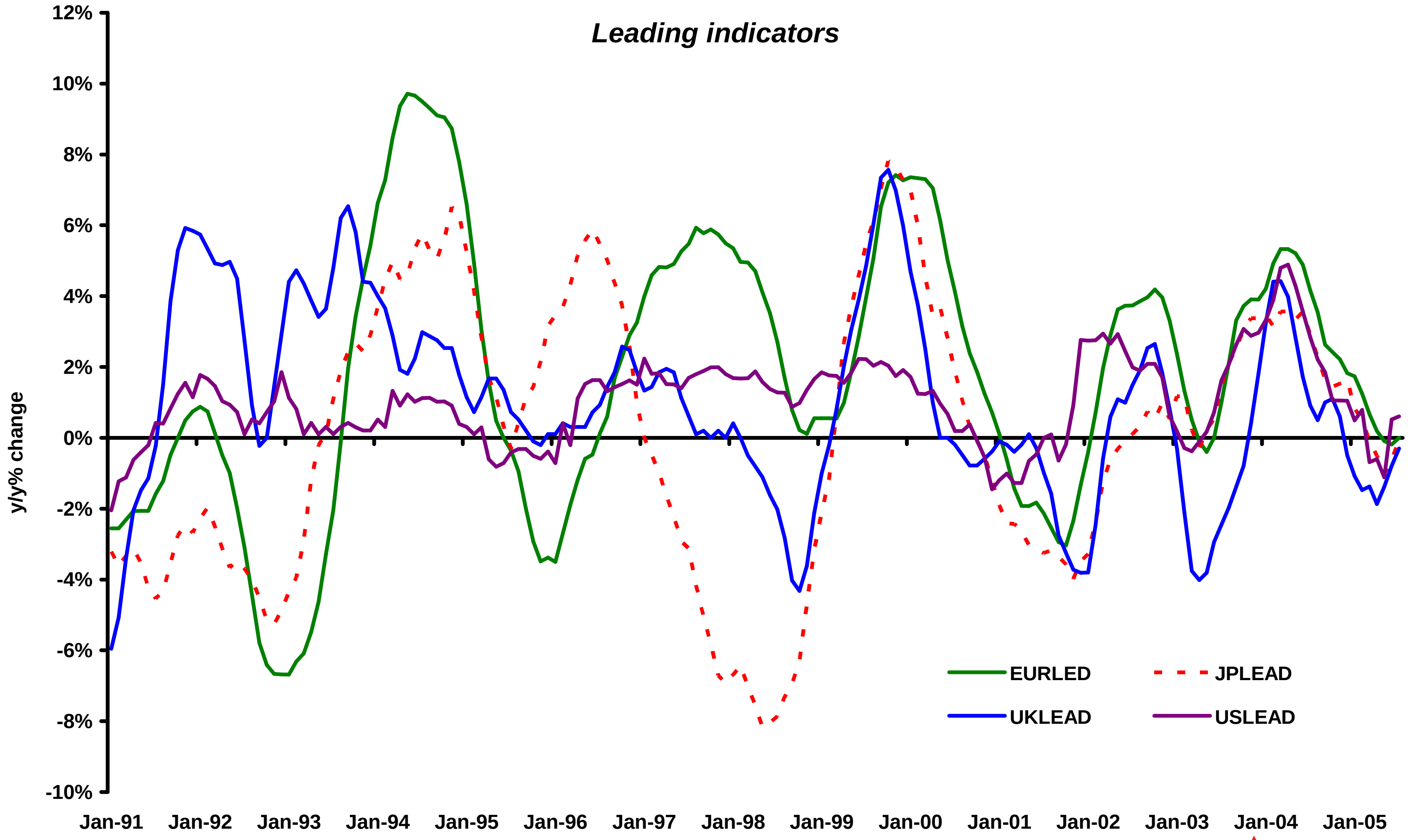


Global economy – slow recovery



Japan only one with rising growth momentum with growth in consumer demand at healthy levels

Global economy: Leading indicators showing signs of potential recovery

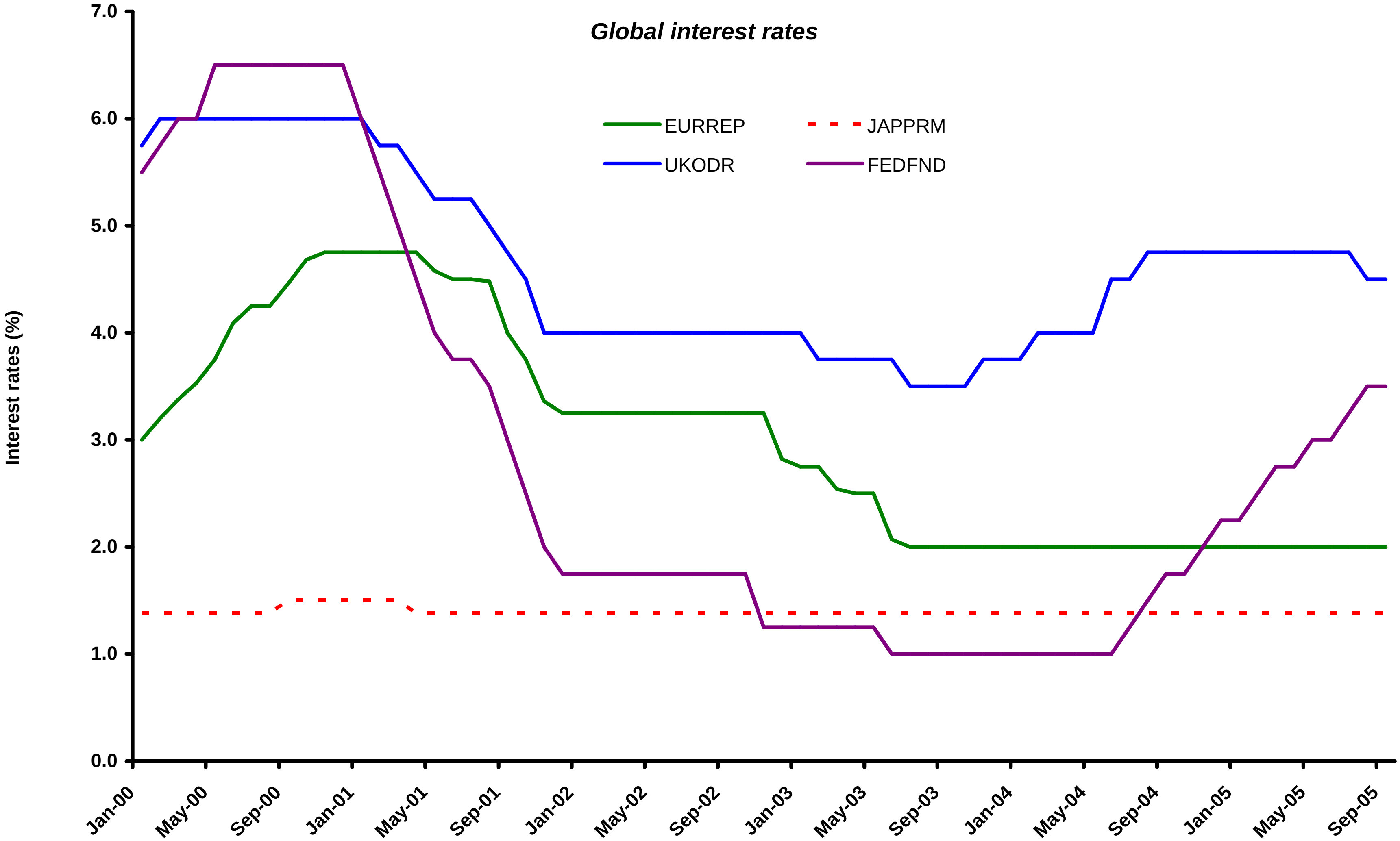


Group Economic Research

ABSA

Today, tomorrow, together.

Global economy: US hiking interest rates steadily



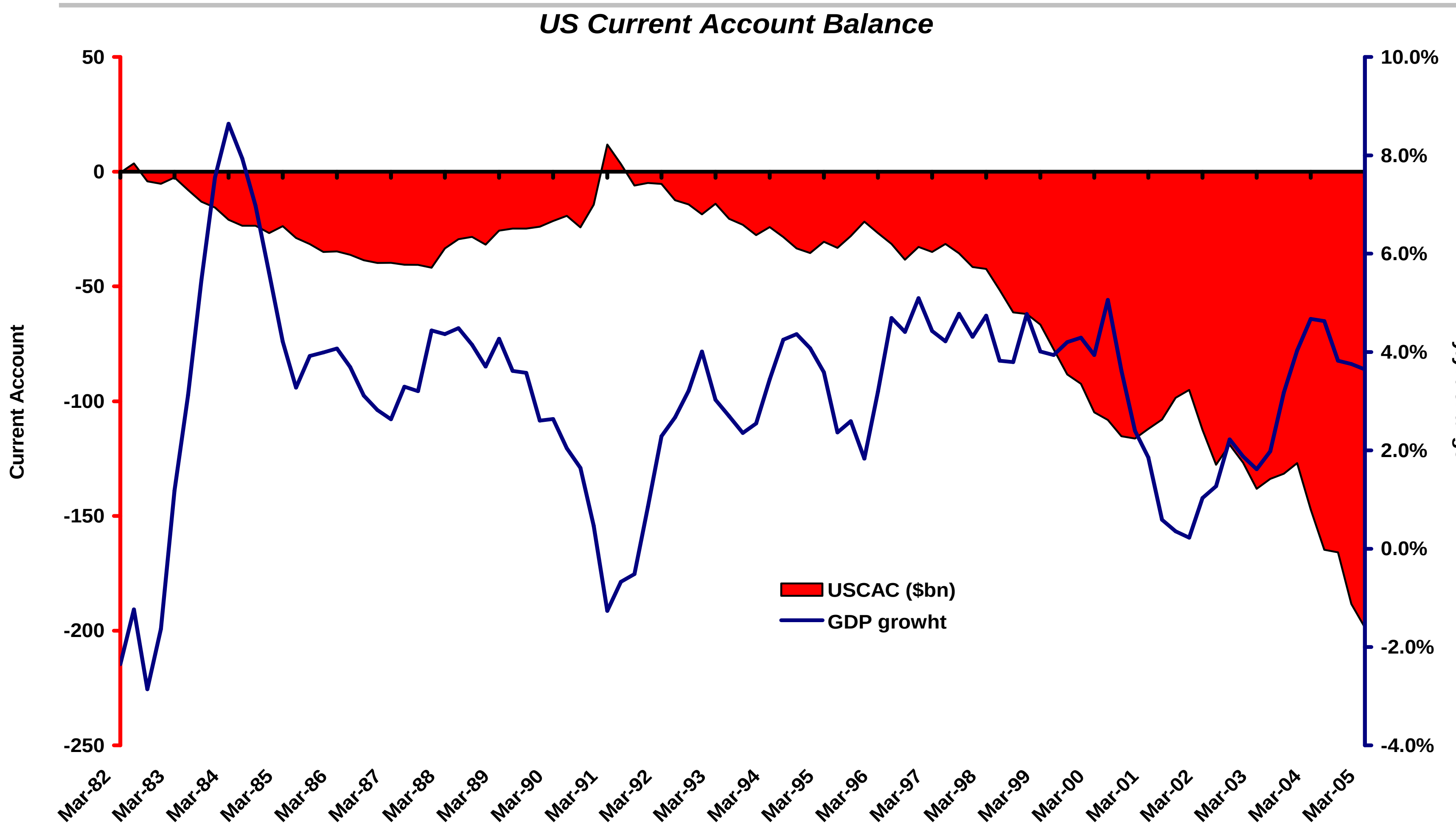
ECB has ignored political pressure and left interest rates unchanged for a 26th consecutive month

Group Economic Research

ABSA

Today, tomorrow, together.

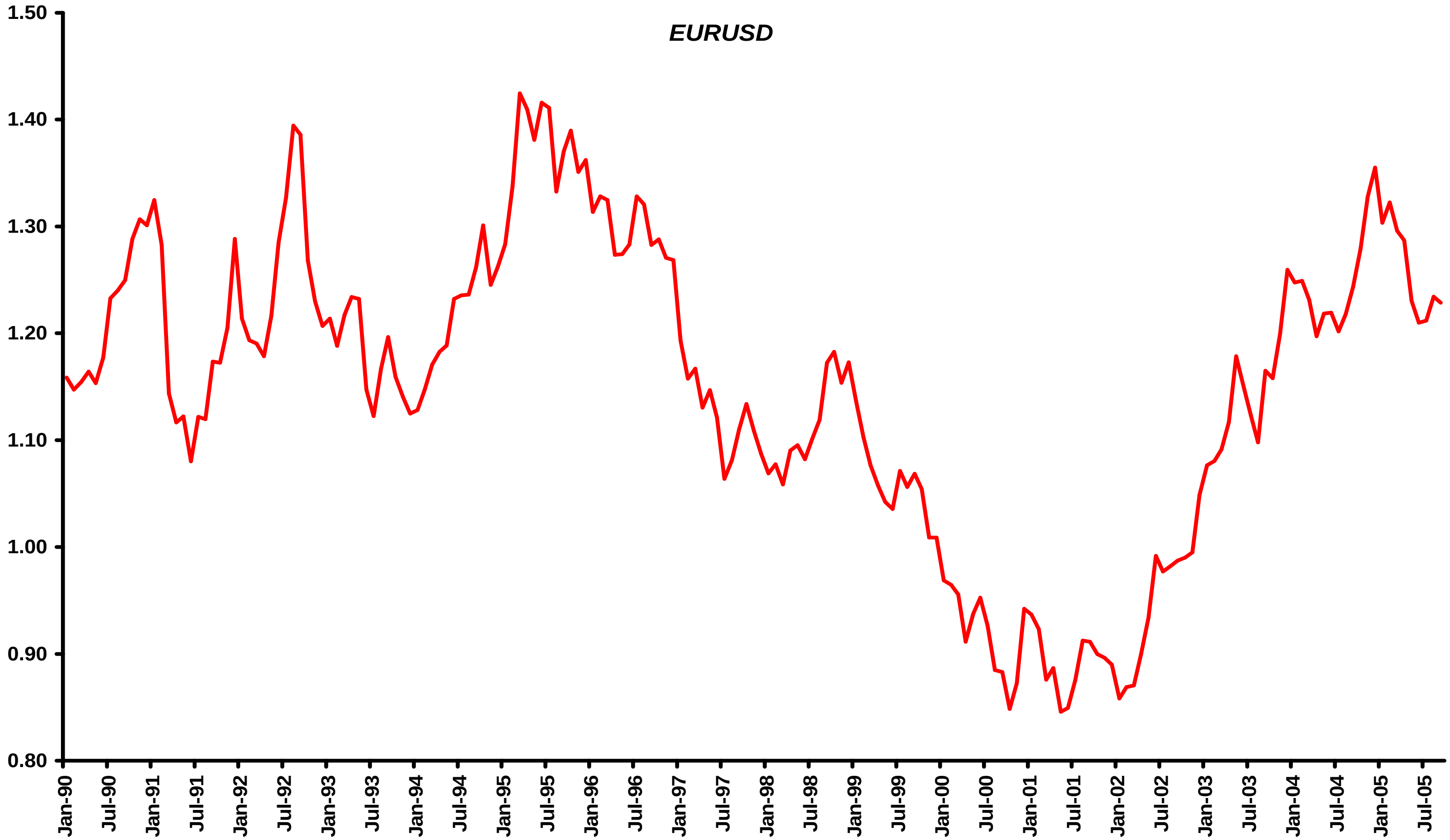
Global economy – US current account deficit deteriorating



US current account – structural problem rather than cyclical

Dollar needs to weaken further for export > imports

Global economy: strengthening trend in support of the dollar in short to medium-term

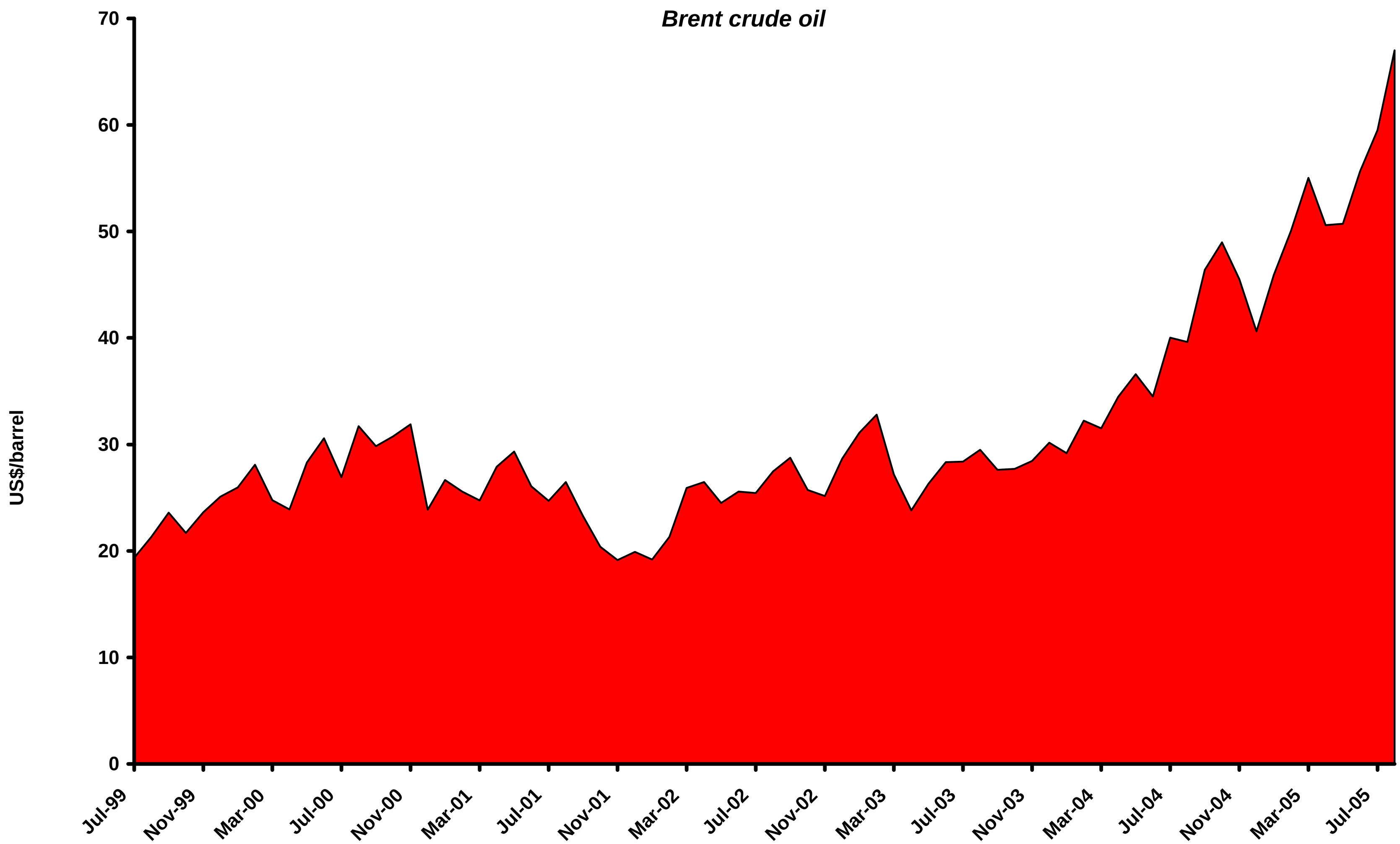


EU could be facing economic and political stagnation – euro seems unattractive to global investors, dollar strength not sustainable

Global economy: interest rates and exchange rate implications

- US Fed is set to hike interest rates at a measured pace to curb inflation
- Forecast US interest to peak at 4% - room for two more interest rate hikes
- BOE could leave rates unchanged till year-end, given rising inflation
- BOE should start considering cutting interest rates in 1Q2006 to:
  - Boost stagnating consumer demand
  - Decrease consumer debt burden – debt-to-income ratio over 150%
- ECB to keep interest rates at 2%
- Uncertainty over euro:
  - Stability pact undermined
  - Economic reforms necessary to fuel growth
- Interest rate differentials between dollar and euro and pound to widen further
- Euro and pound weakness
- Dollar strength expected to prevail in the short to medium-term

Oil prices – speculative demand driving higher oil prices



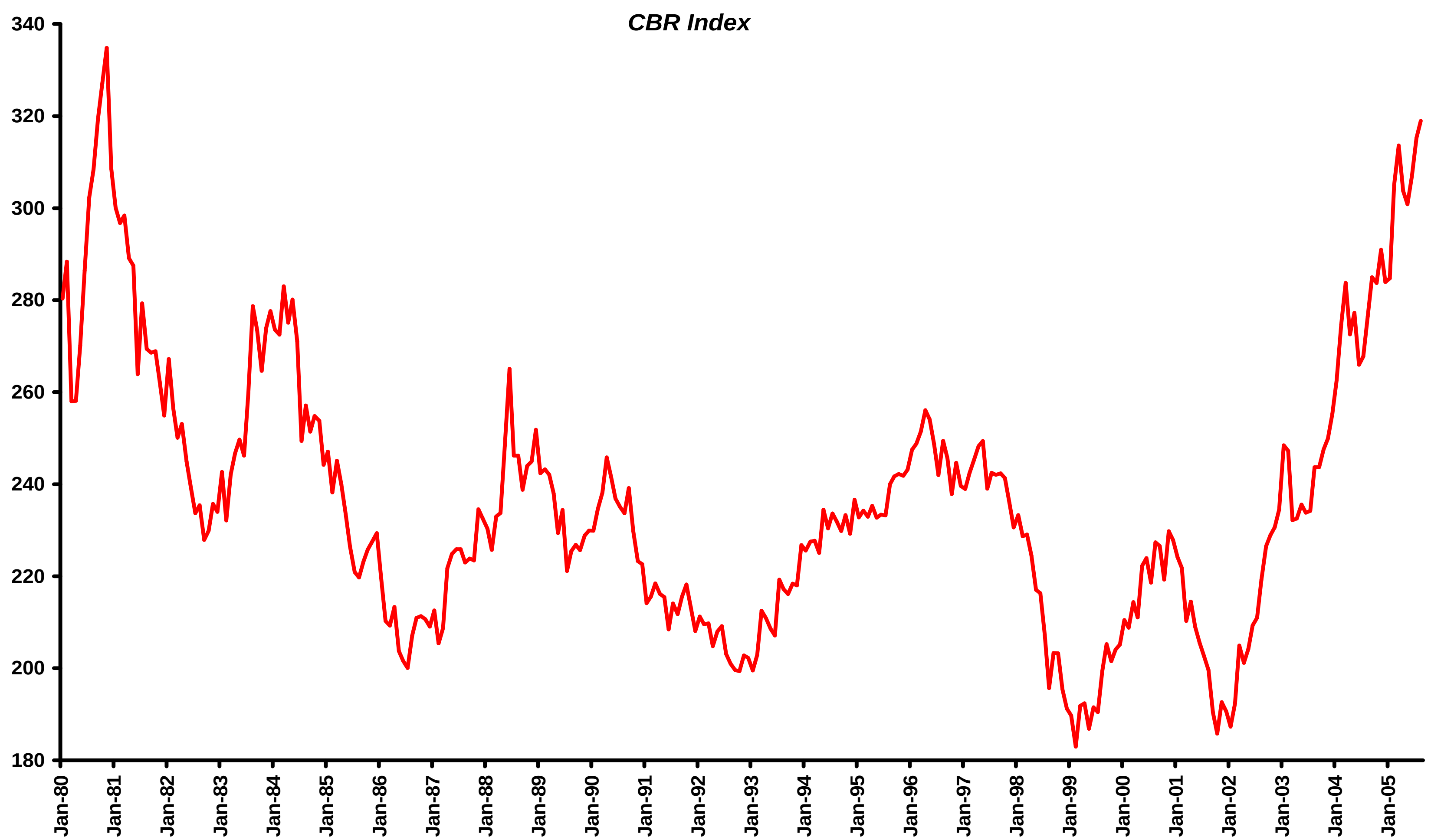
Second round inflationary effects expected – higher global inflation

Group Economic Research

ABSA

Today, tomorrow, together.

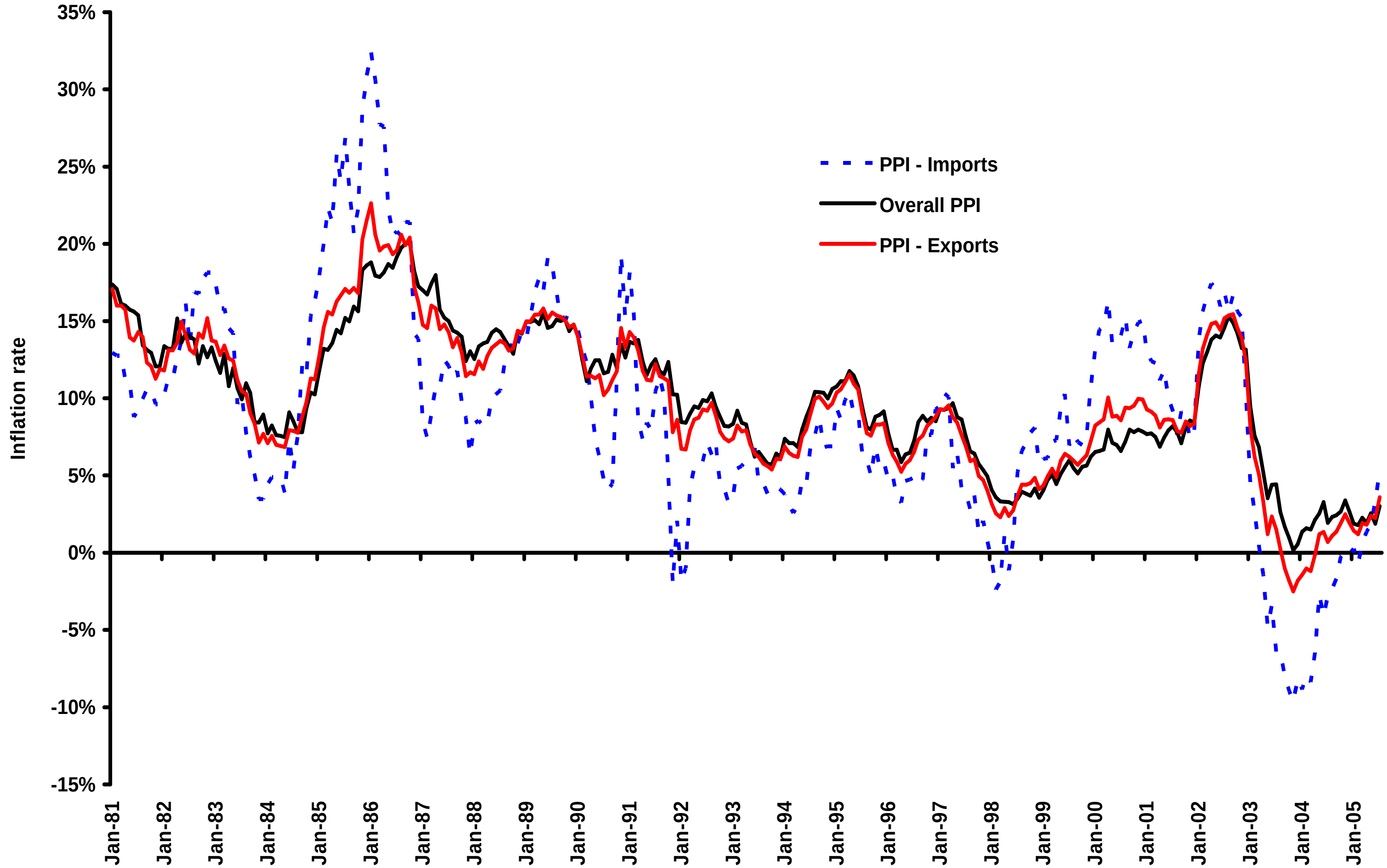
Commodity prices to rise further driven by higher oil prices



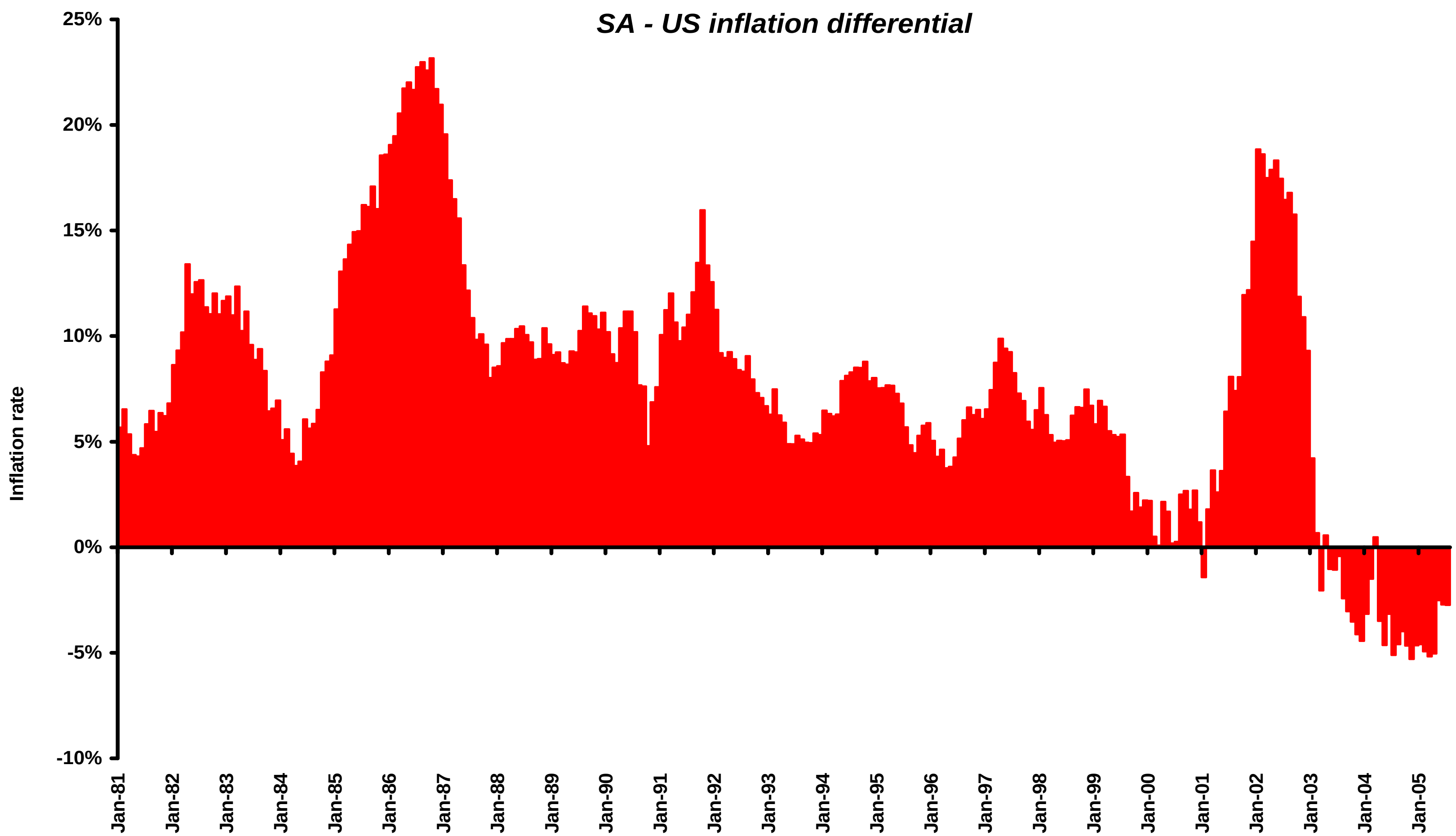
High oil prices have negative implication for the rand

Saving grace – higher gold and platinum prices

Producer price inflation: rising inflation driven by higher oil prices



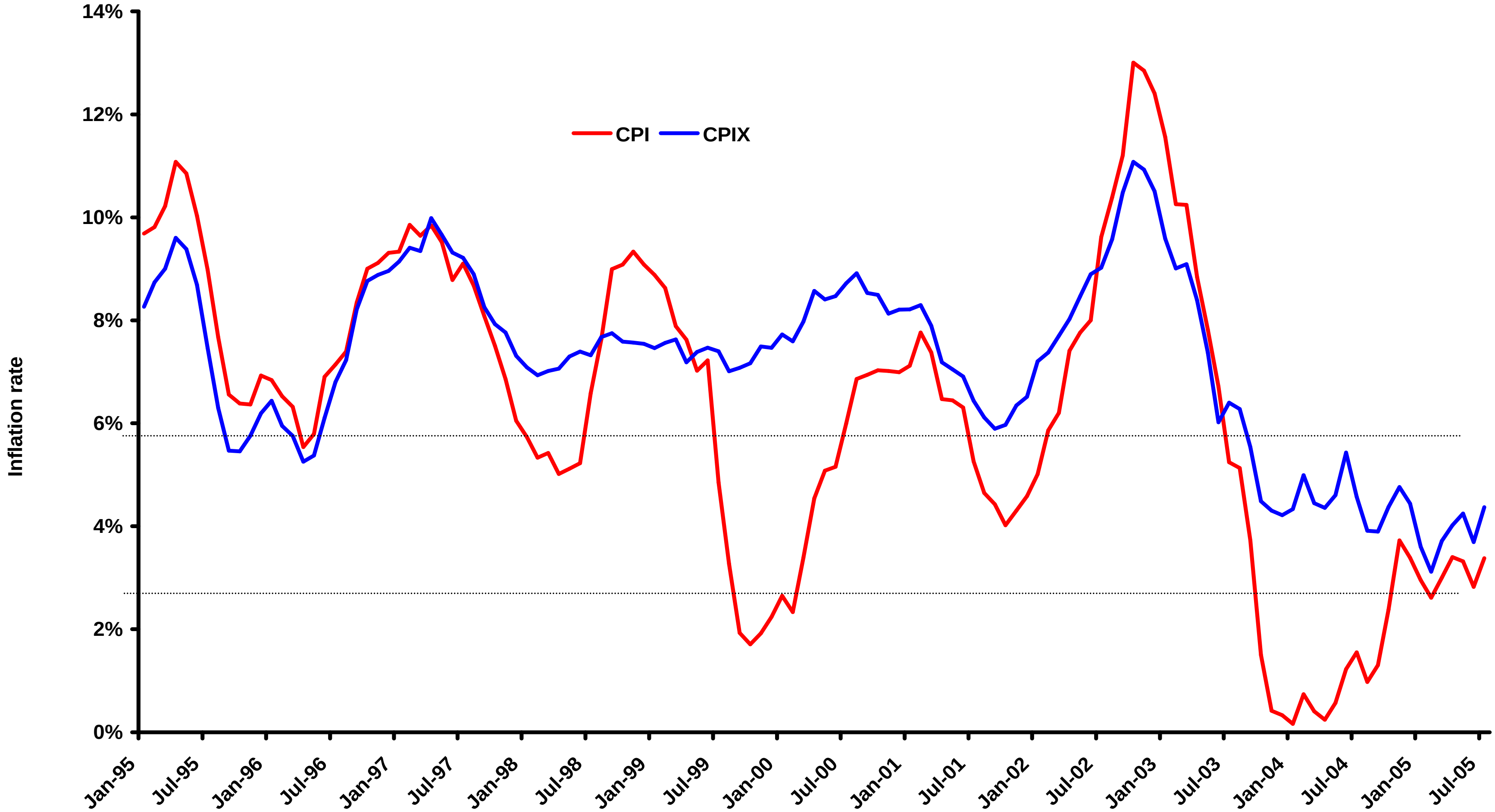
SA – US Producer inflation differential



Inflation differential closing

SA inflation lower than US for the last 27 months

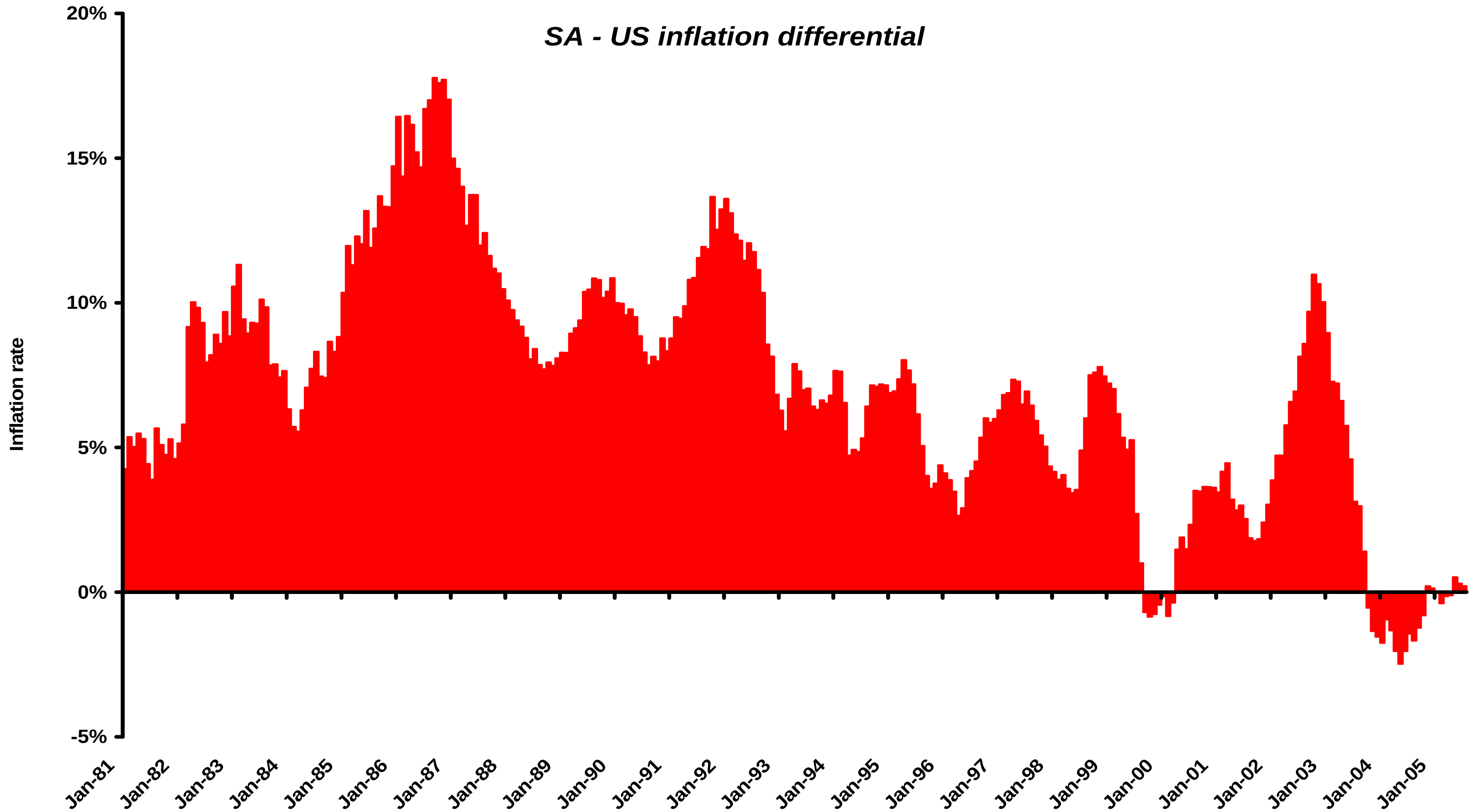
Consumer price inflation: rising but currently not a threat to monetary policy



Group Economic Research

ABSA
Today, tomorrow, together.

SA – US consumer inflation differential



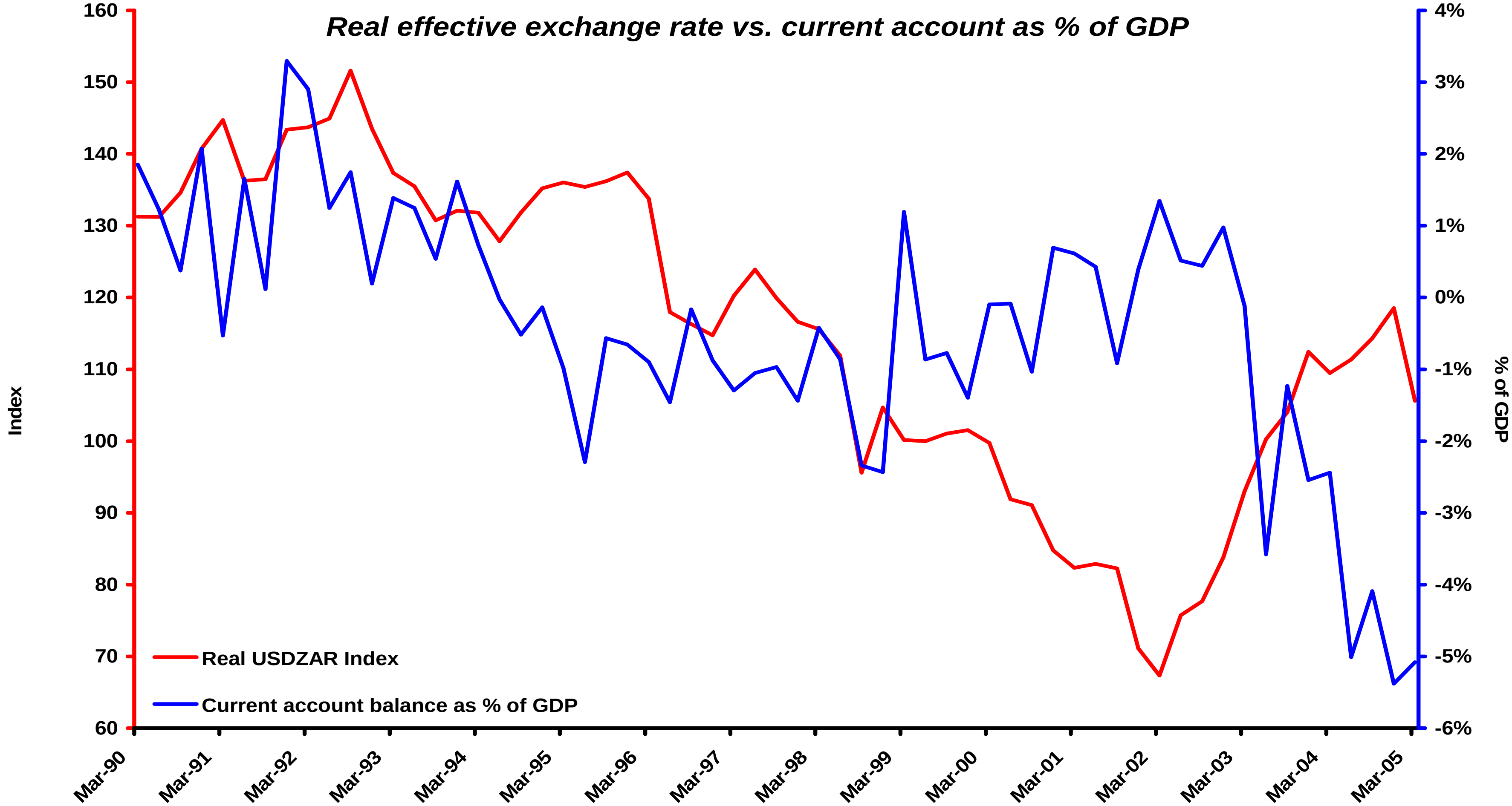
SA inflation marginally higher than US inflation, if the trend continues, this could lend to some rand weakness

Group Economic Research

ABSA

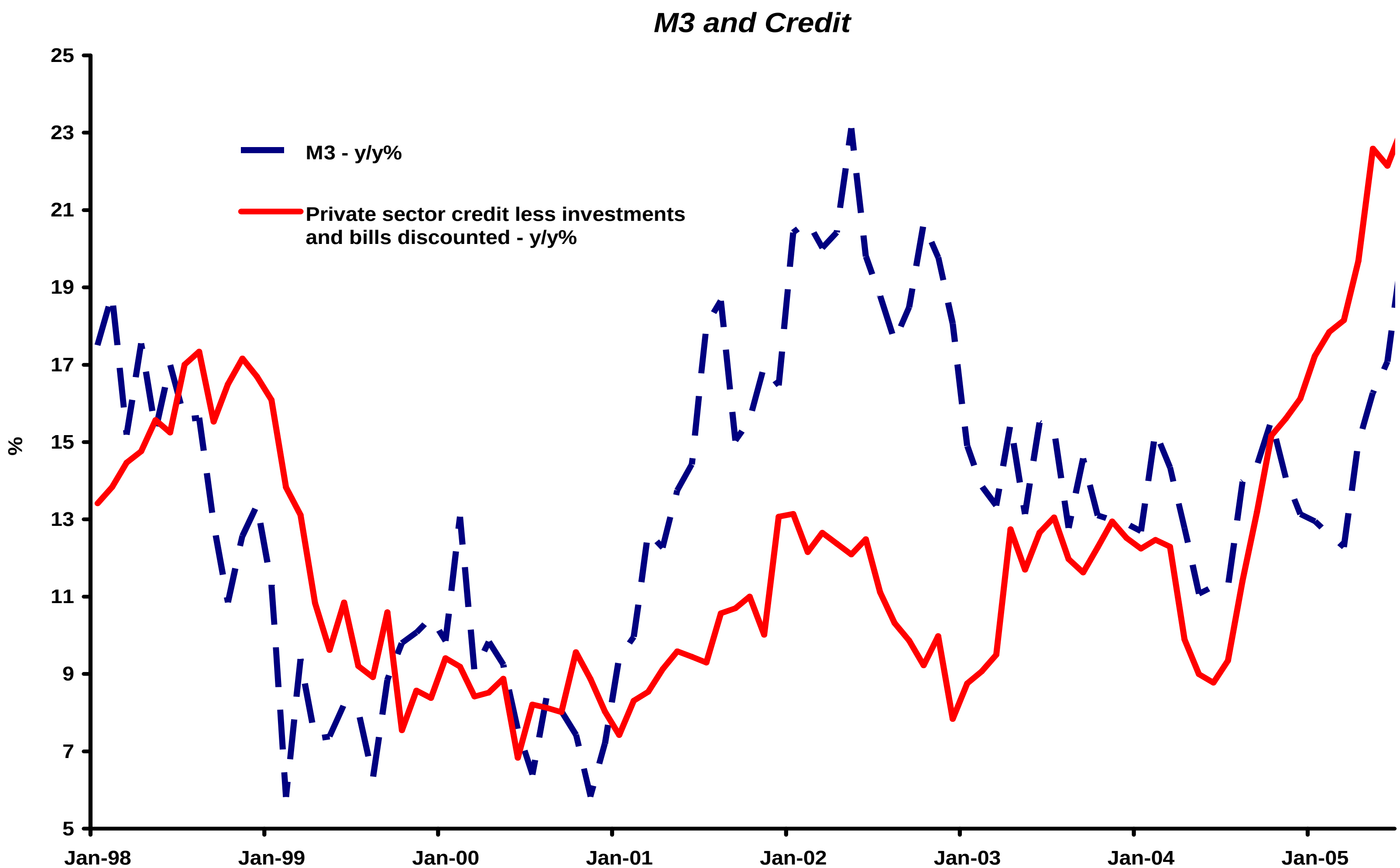
Today, tomorrow, together.

Balance of payments: current account deficit recovered marginally as imports fell in Q1



From the monthly trade balance figures, imports > exports, current account deficit expected to widen further for the year as a whole

Demand: consumers still willing to take more debt to finance spending

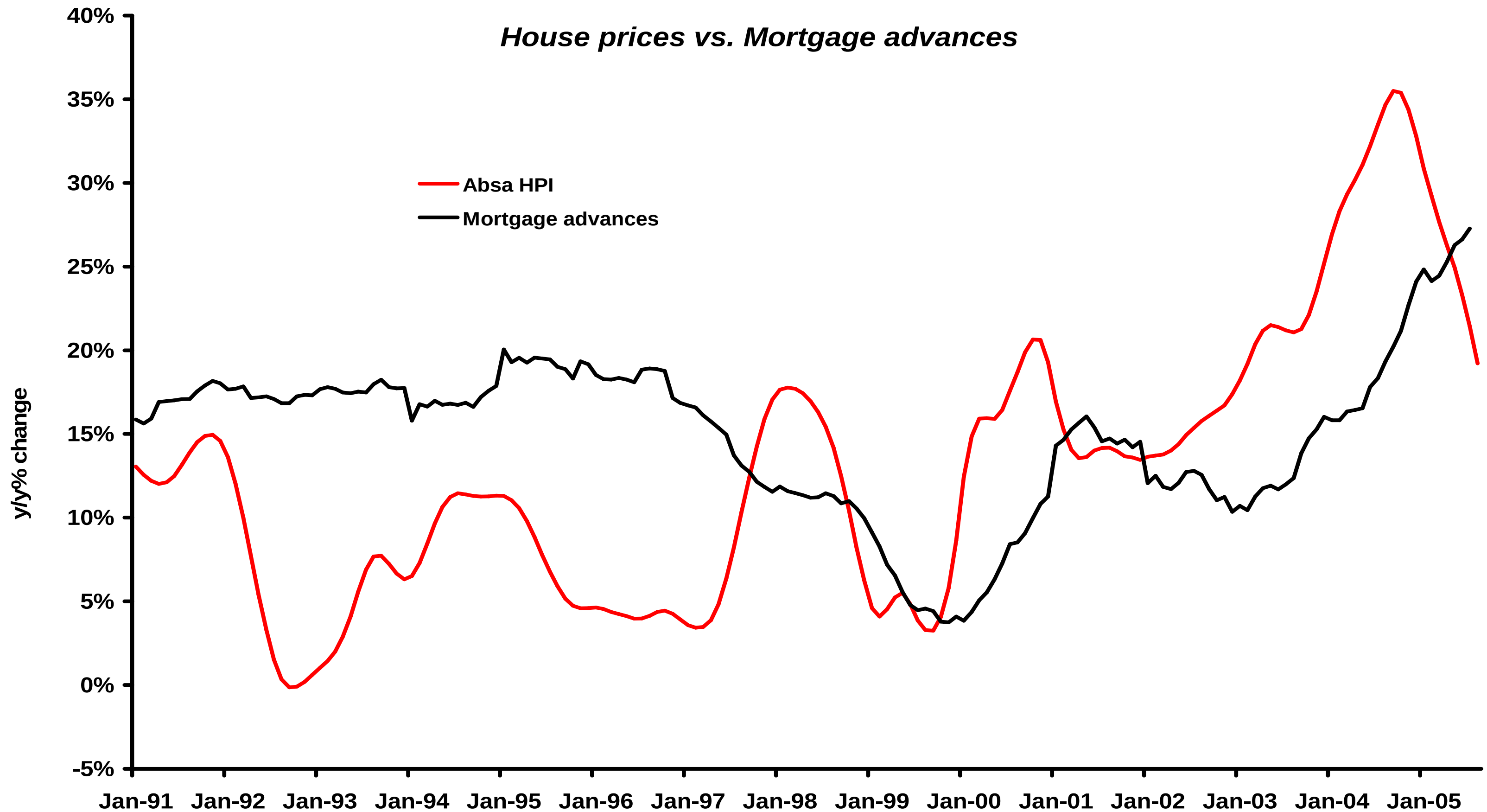


Group Economic Research

ABSA

Today, tomorrow, together.

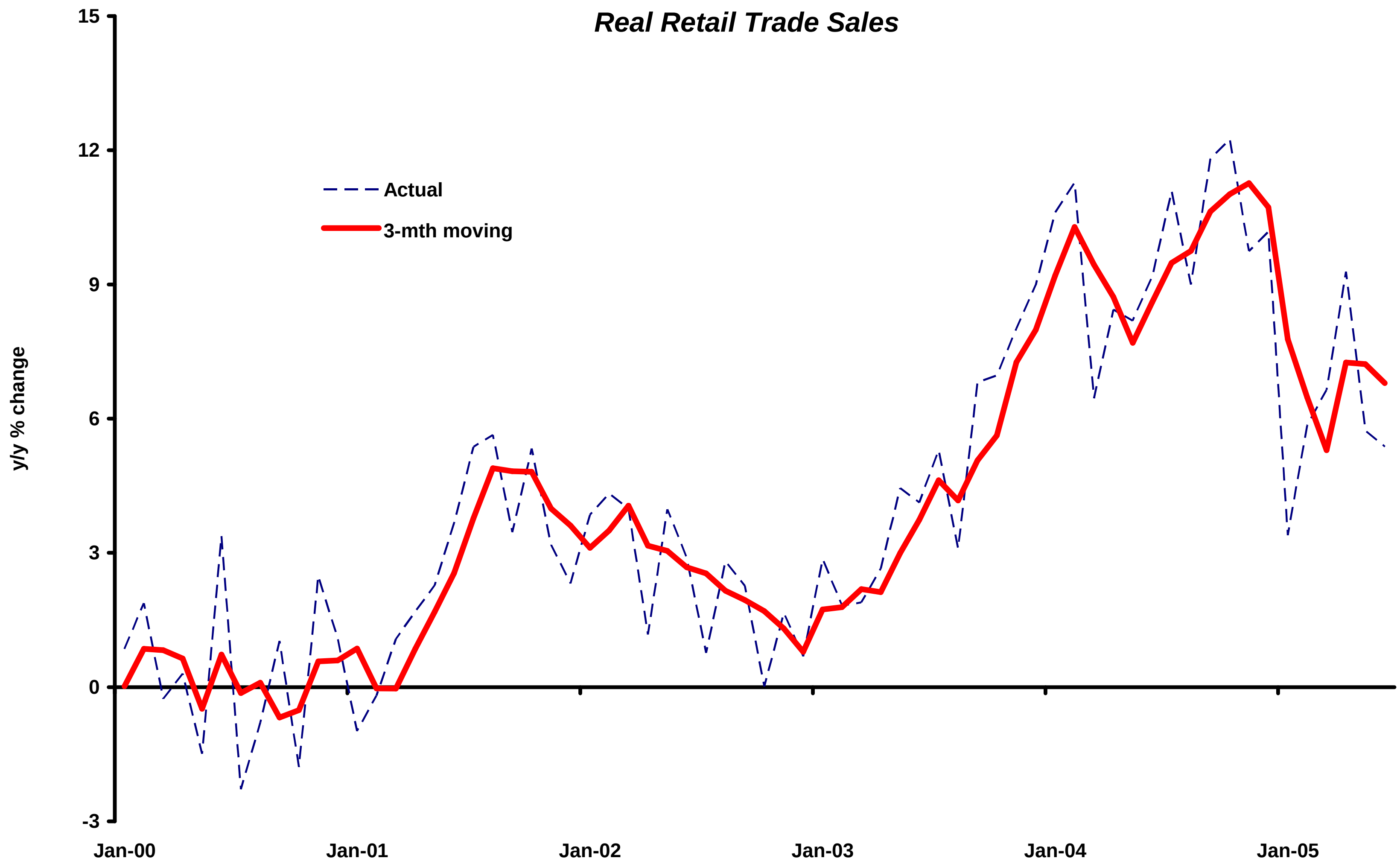
Demand: house prices and mortgage advances growth



Rates of increases in house prices tapering off, mortgage advances growth still strong

Residential market experiencing a boom trend fuelled by strong economic fundamentals

Demand: retail sales growth moderating, affected by high base effects

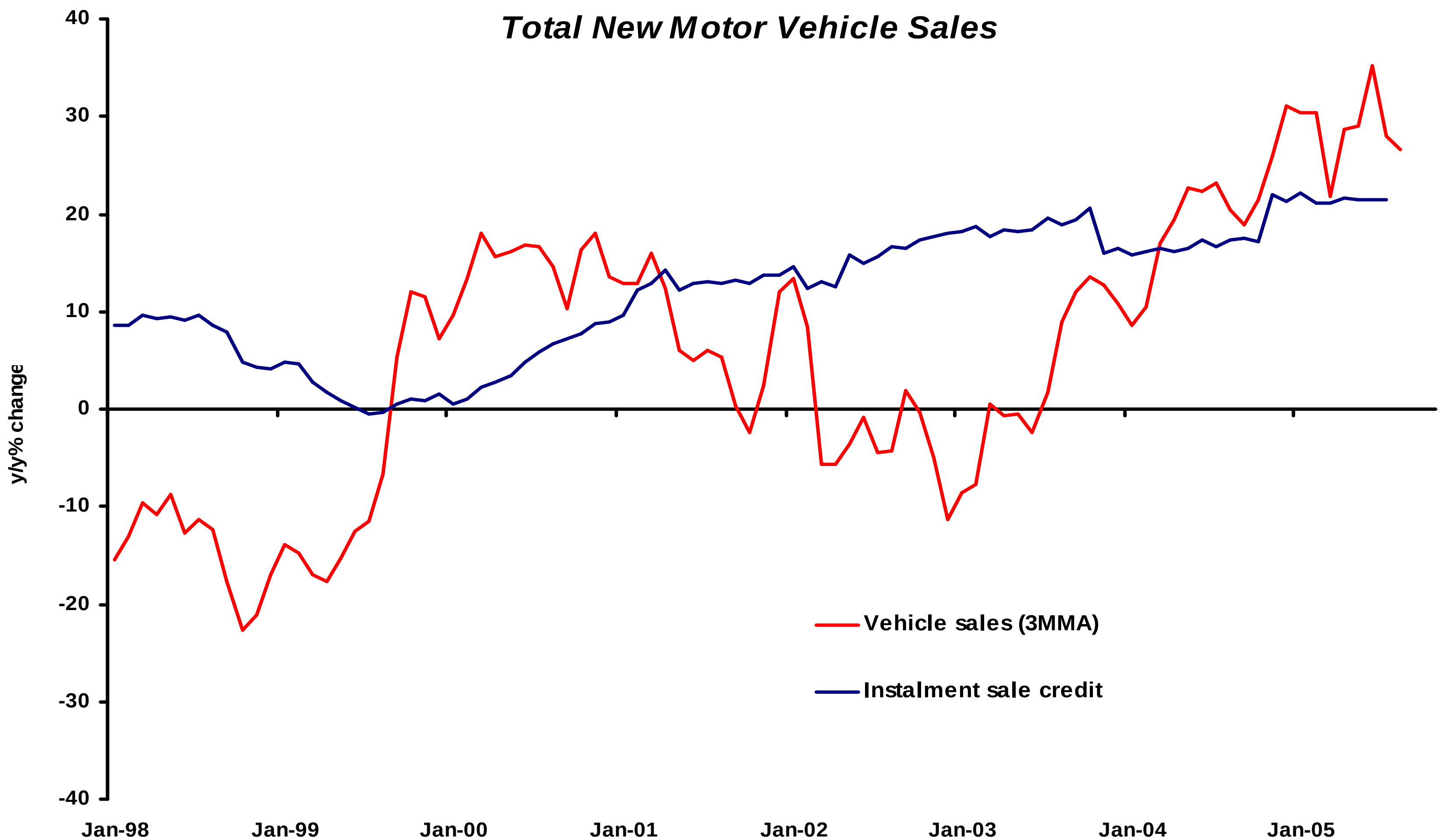


Group Economic Research

ABSA

Today, tomorrow, together.

Demand: vehicle sales and installment finance



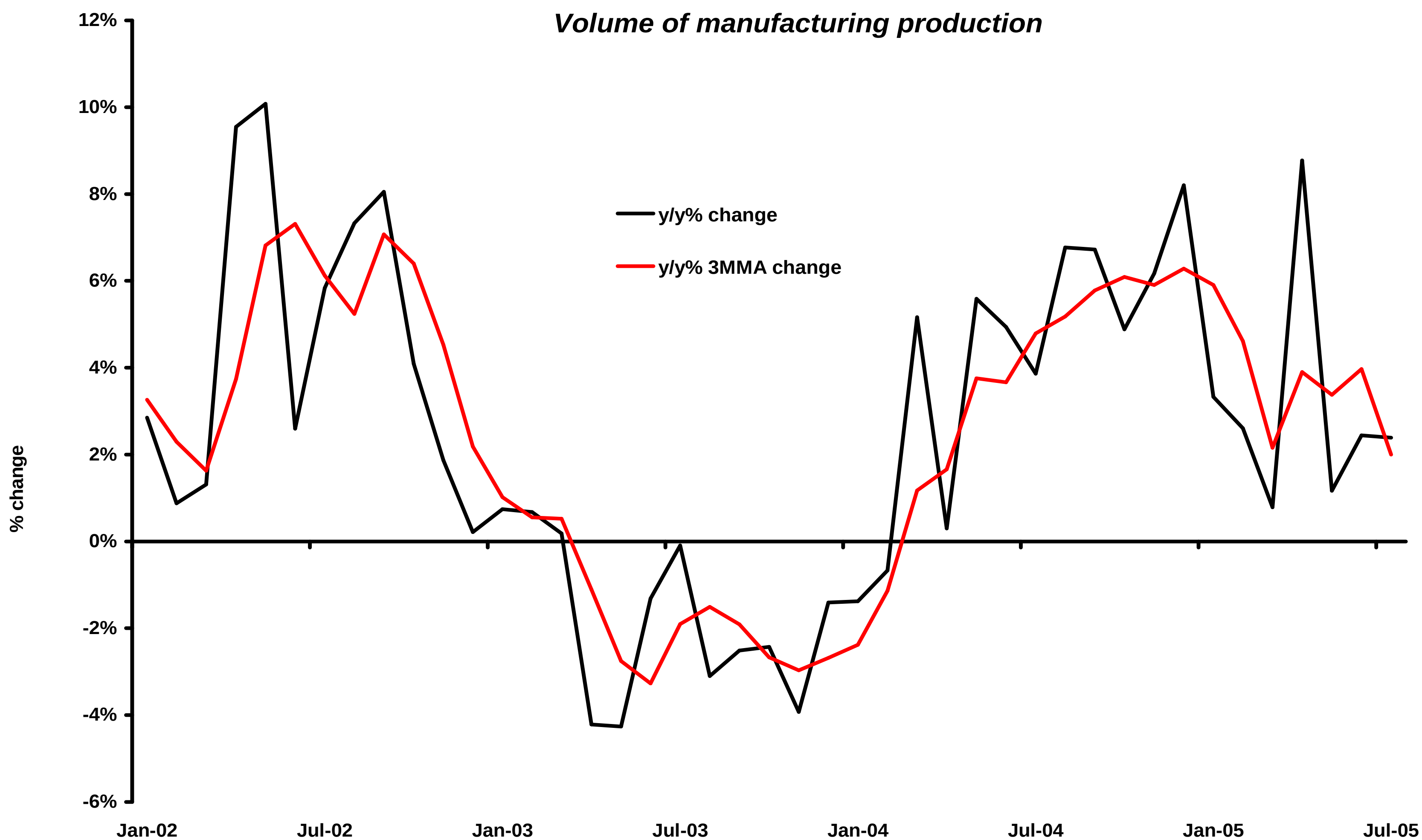
Demand for new vehicles remarkably strong but showing signs of petering out

Group Economic Research

ABSA

Today, tomorrow, together.

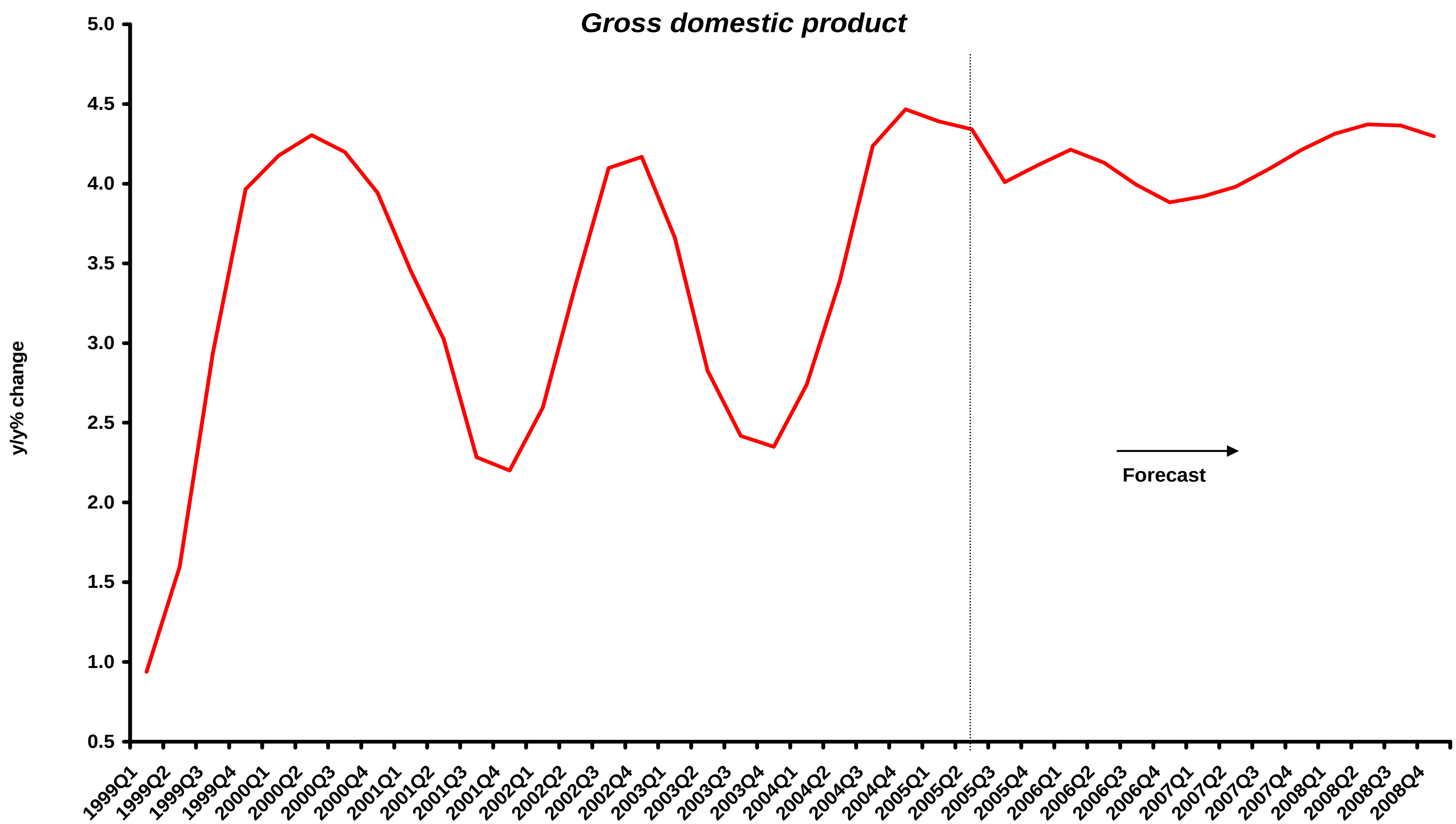
Supply: Manufacturing activity slowing down yet again after short-lived recovery



Implications for the rand and domestic interest rates

- Consumer spending and demand to remain an important driver for domestic economic growth
- Easier access and affordability of credit – consumers to finance spending with credit
- Manufacturing activity affected by strong rand and inefficiencies in some industries
- Cheaper imports still greater than exports, expected to drive current account deficit
- Financial account surplus aided by the R30bn FDI investment by Barclays
- Higher oil prices, through secondary effects, should push inflation higher
- No threat of inflation breaching the 6% upper band of the inflation target
- Hawkish stance from SARB – no interest cut for the rest of the year
- Narrowing inflation and interest rate differentials between SA and US
- Weaker rand in the short to medium-term, on the back of stronger dollar

Prospects for 2006: real GDP growth expected to move sideways



Consumer spending will remain an important driver of economic growth

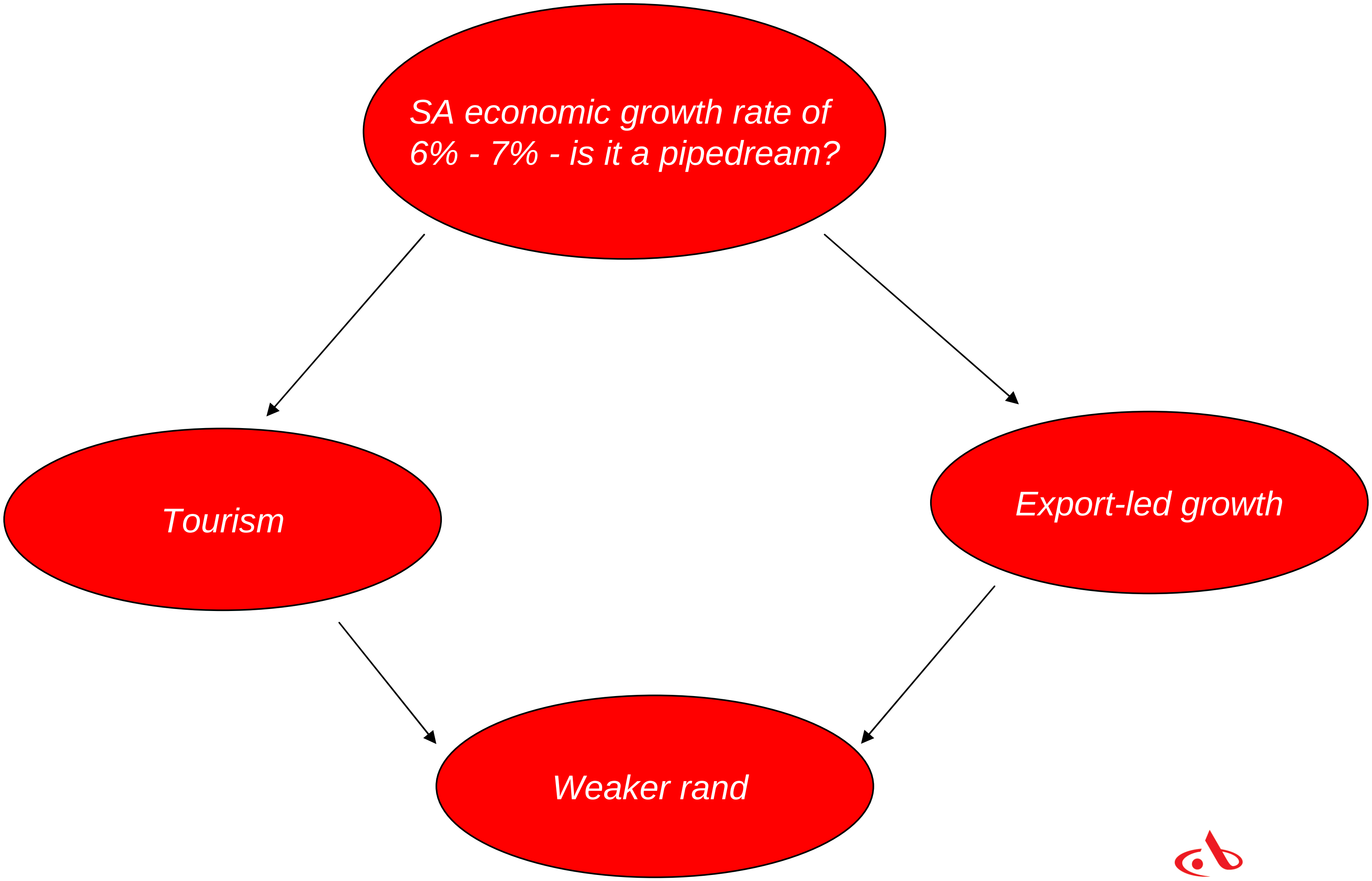
Growth momentum will moderate further towards year-end

Group Economic Research

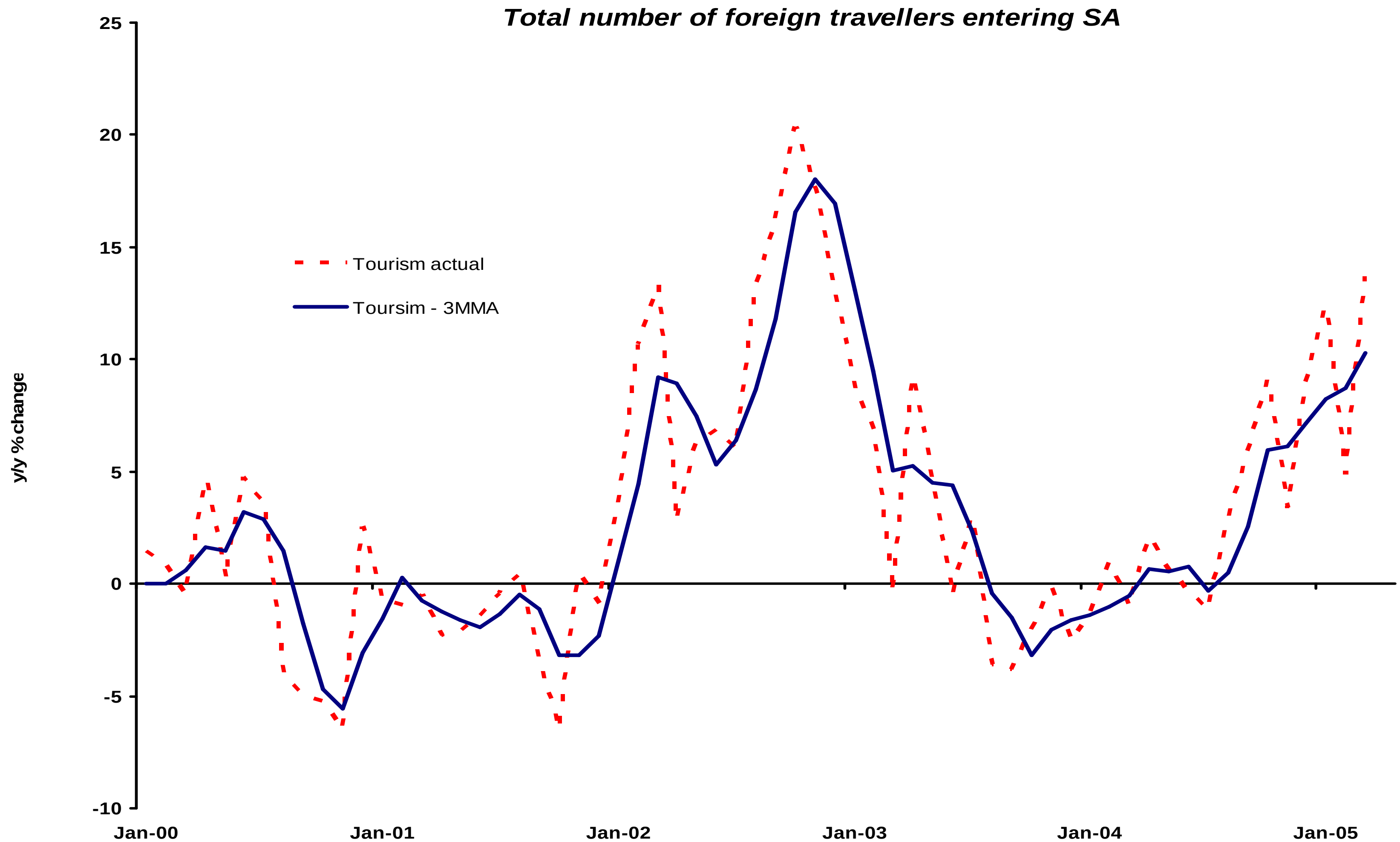
ABSA

Today, tomorrow, together.

Economic growth: now and beyond 2010



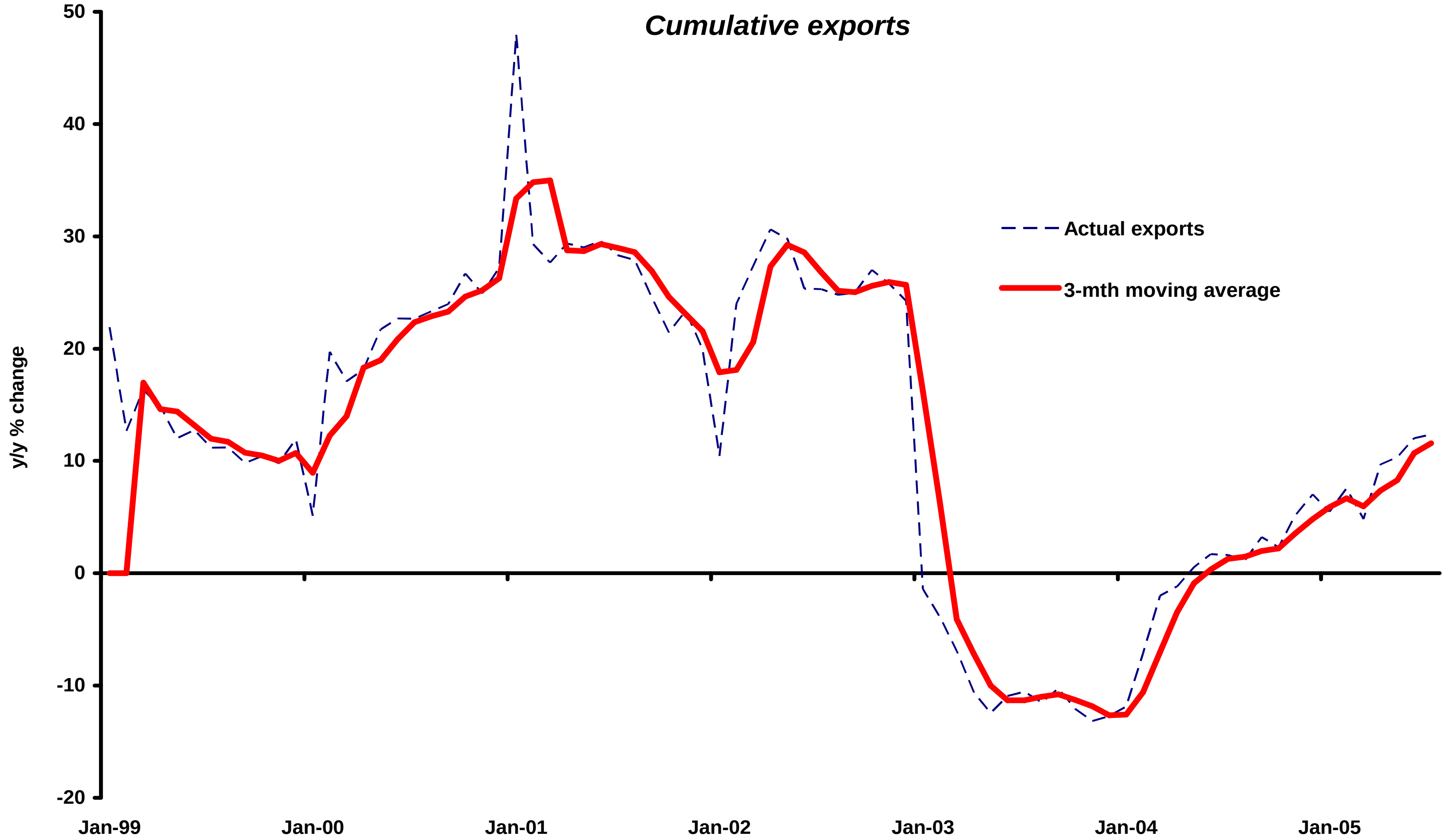
Tourism: recovering from the negative impact of the strong rand



Weak rand required to attract foreign visitors

Investment in infrastructure

Export led growth: buoyant growth in some segments despite strong rand



Base metals, vehicles, vehicle parts and cement are the main contributors to growth

Group Economic Research

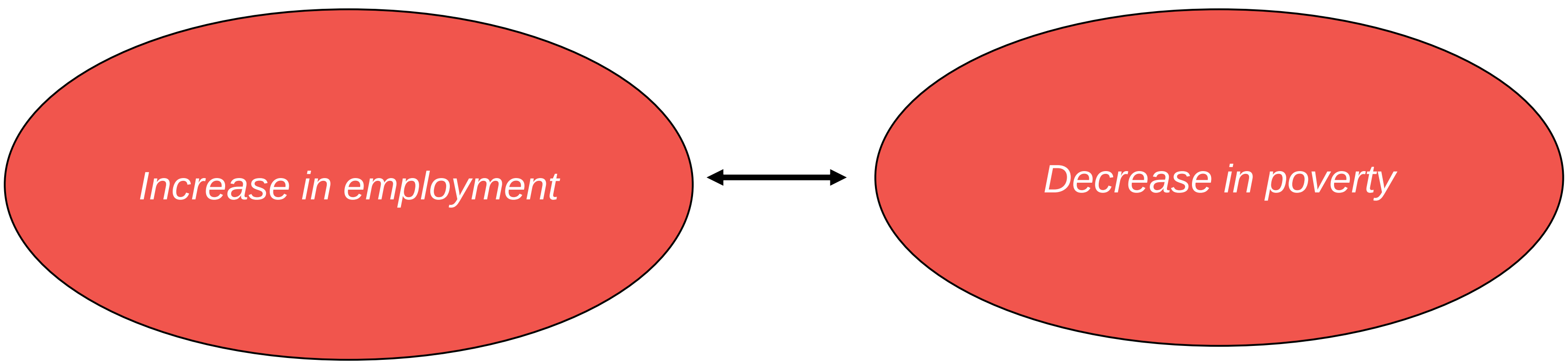
ABSA

Today, tomorrow, together.

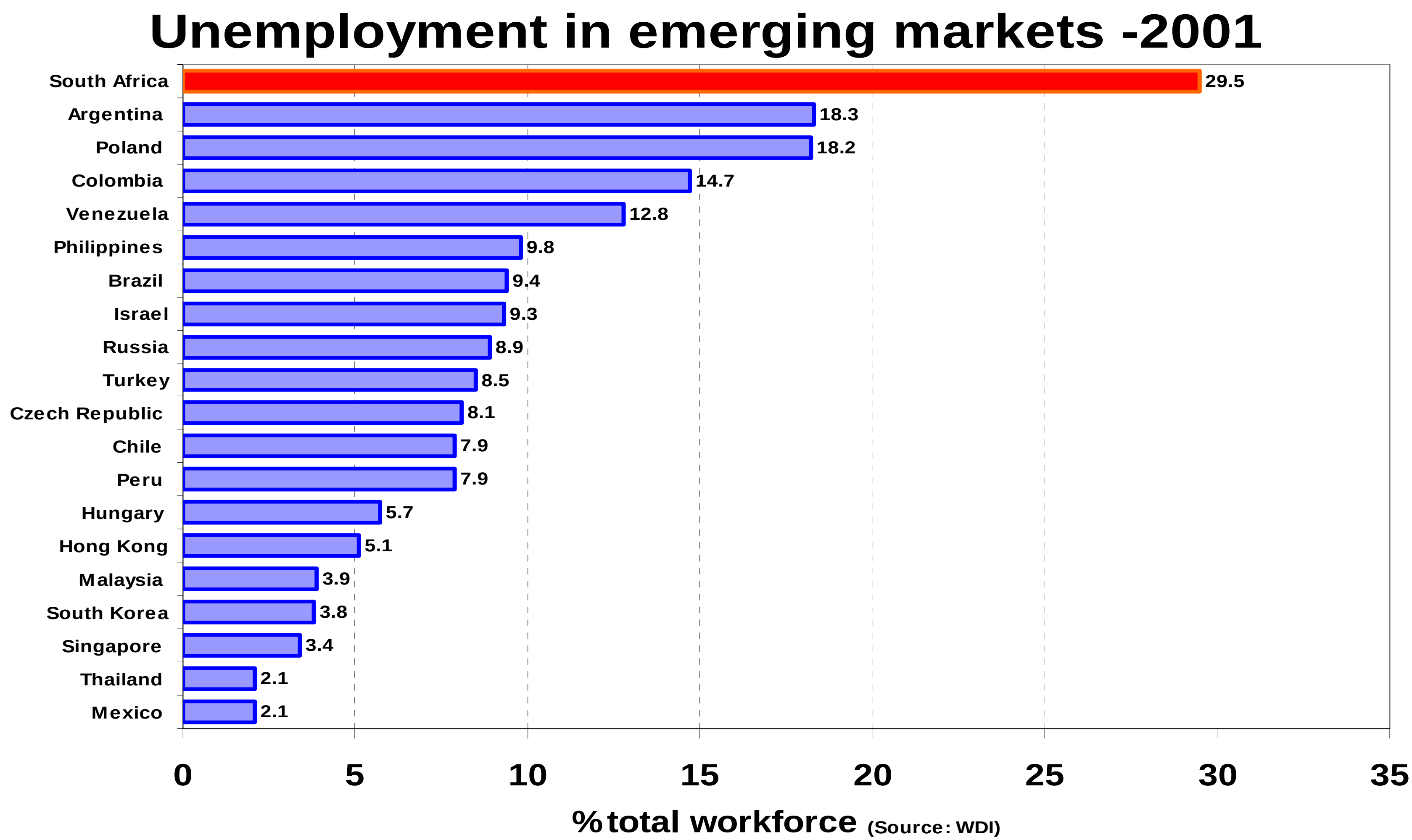
Export-led growth prospects

- Expenditure-switching policy
  - Devaluation or managed depreciation of the currency – question is to what level?
  - Promotion of domestic products – Proudly South African campaign
  - Benefits:
    - Exports become cheaper and competitive
    - Imports become more expensive, decrease in demand
    - Positive trade balance and current account surplus
    - Long-run strength of the rand
  - Disadvantages:
    - Decrease in capital inflows and increase in capital outflows
    - Increase in inflationary pressure from (1) increased demand for domestic goods and (2) increased imported inflation
    - Devaluation of the currency will not guarantee efficiency in manufacturing process
    - Increase in government in domestic currency terms – this is not a major threat as SA foreign debt = 34,9% to GDP (down from 45% in 2000), interest payments = 4,0% to GDP (down from 6% in 2000)

Implications of 6% - 7% economic growth

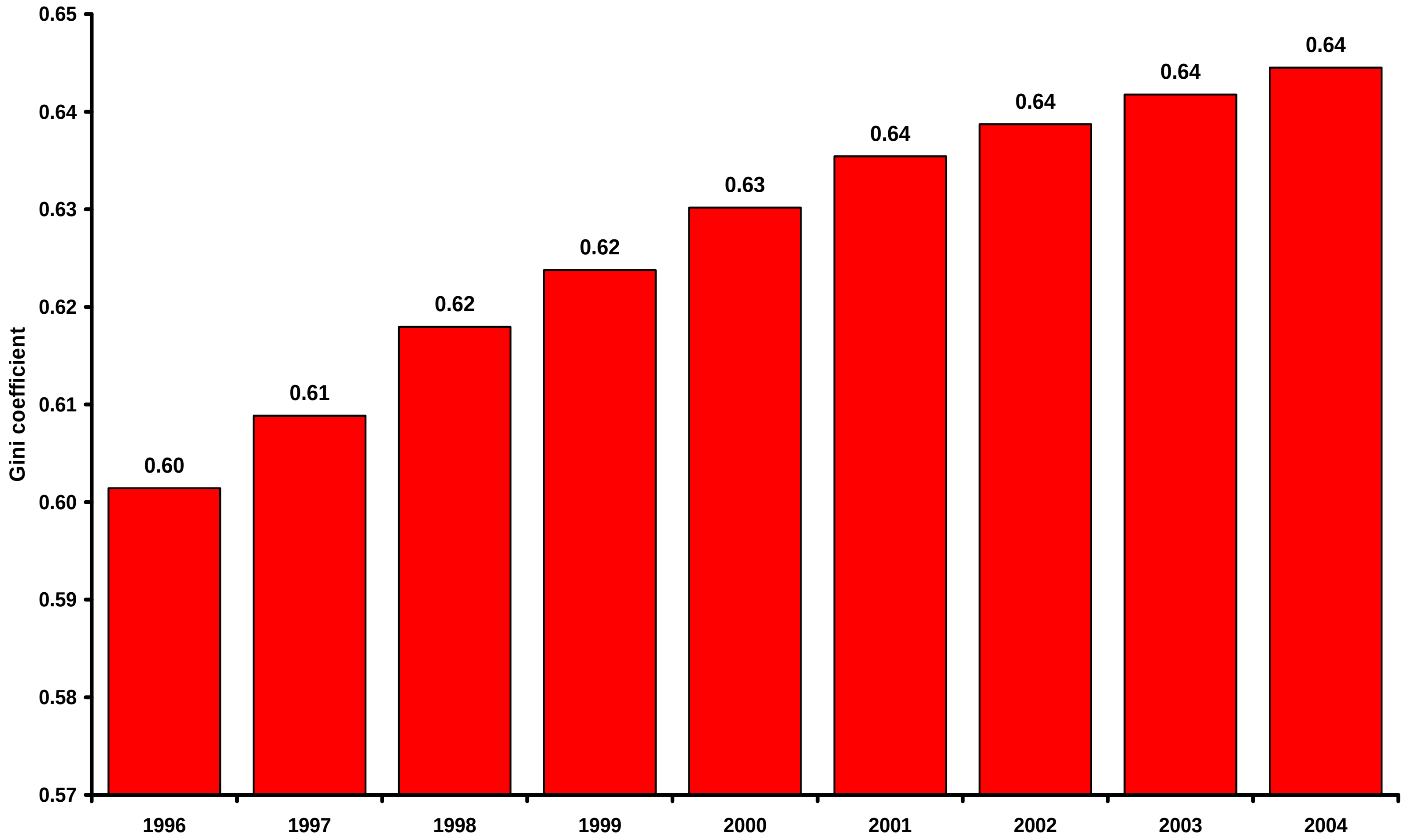


SA unemployment figures: a contentious issue, highest among emerging markets

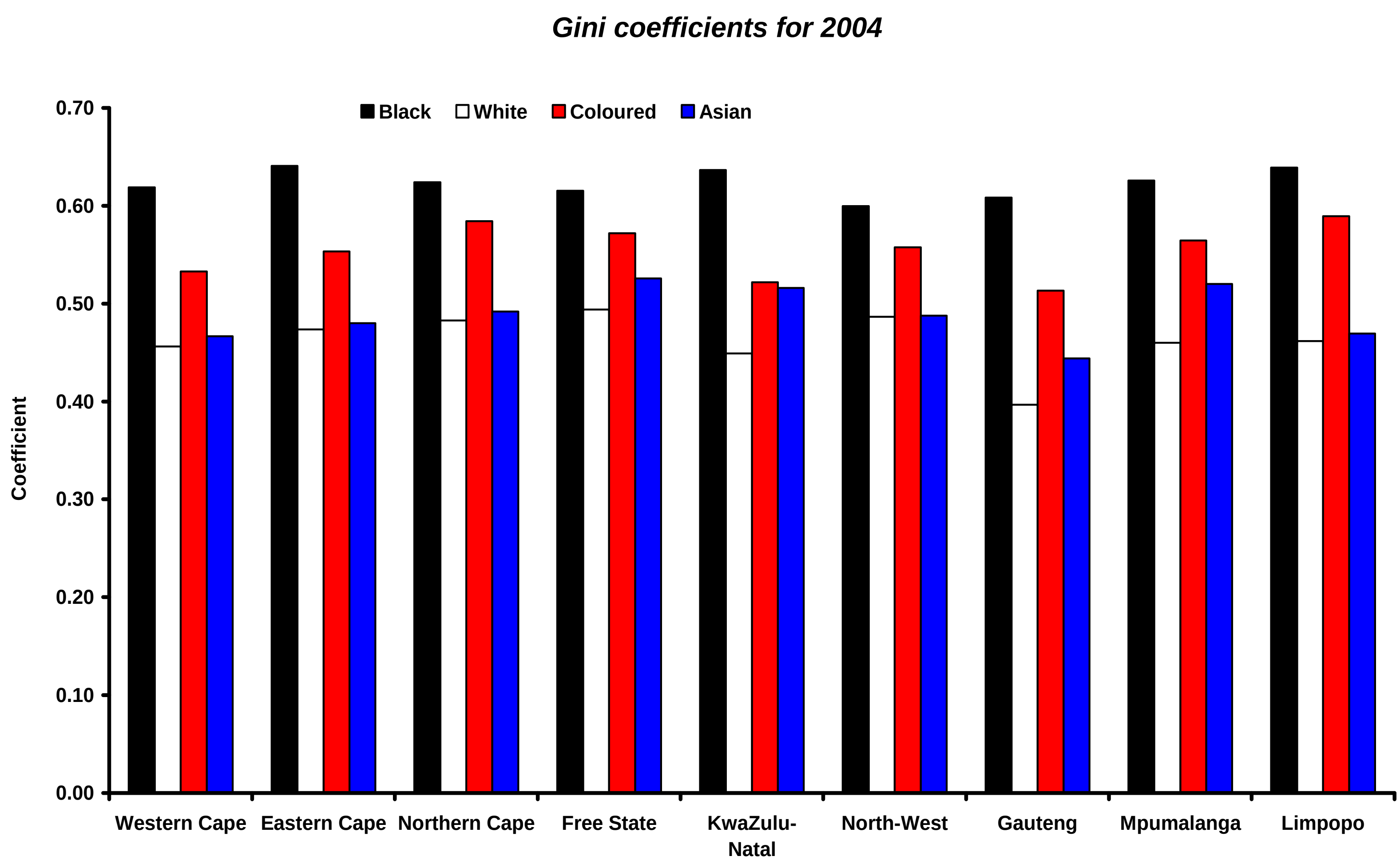


Official unemployment rate: 26,5% in 1Q05

Income distribution: 1996 – 2004, increasing inequality



Income distribution by province – high inequality between the race and provinces



Proposed labour reforms

- High level of unemployment
- Unequal distribution of income
- Government's resolution:
  - Freedom Charter lays the foundation
    - "The state shall recognise the right and duty of all to work…" and
    - "Miners, domestic workers, farm workers and civil servants shall have the same rights as all others who work"
  - ANC's National General Council proposals:
    - Exemption of small businesses from bargaining agreements
    - Increasing the limit of the size of companies that comply with certain aspects of the labour legislation from 50 to 200 employees
    - Reducing the compliance burden
    - Dual labour market model – existing laws to be used to govern one set of employees , flexible laws to govern another set (the youth).

Why labour reforms are important?

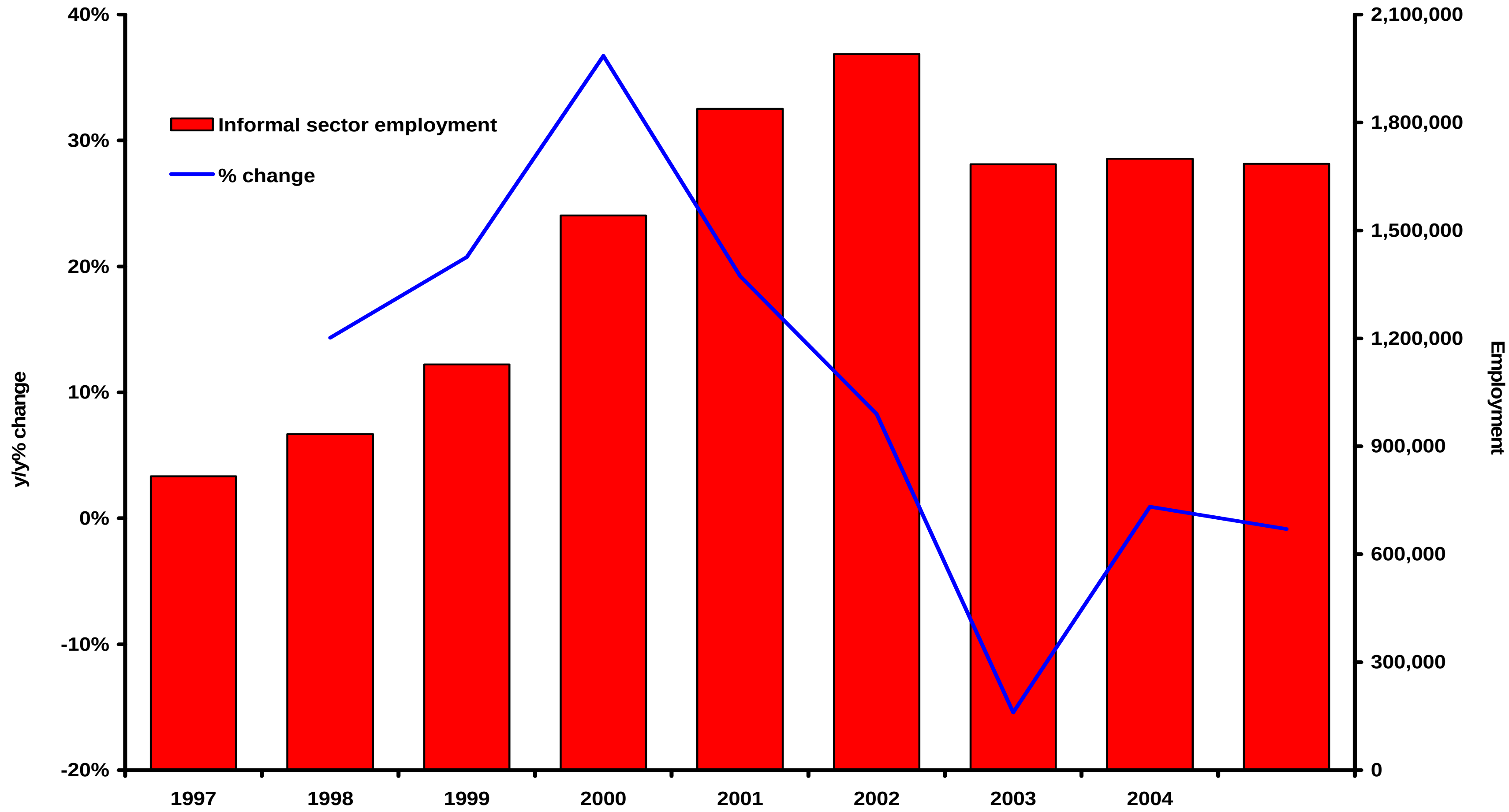
- Comprehensive and pro-competitive reforms can generate substantial gains
  - Study conducted in OECD countries by the IMF reveals that after labour reforms were implemented, output gains were 5% and unemployment decreased by 3%
- When labour markets are competitive , the economy reacts more quickly and smoothly to changes in interest rates – essential for inflation-targeting

Evidence of lack of competition in the labour market

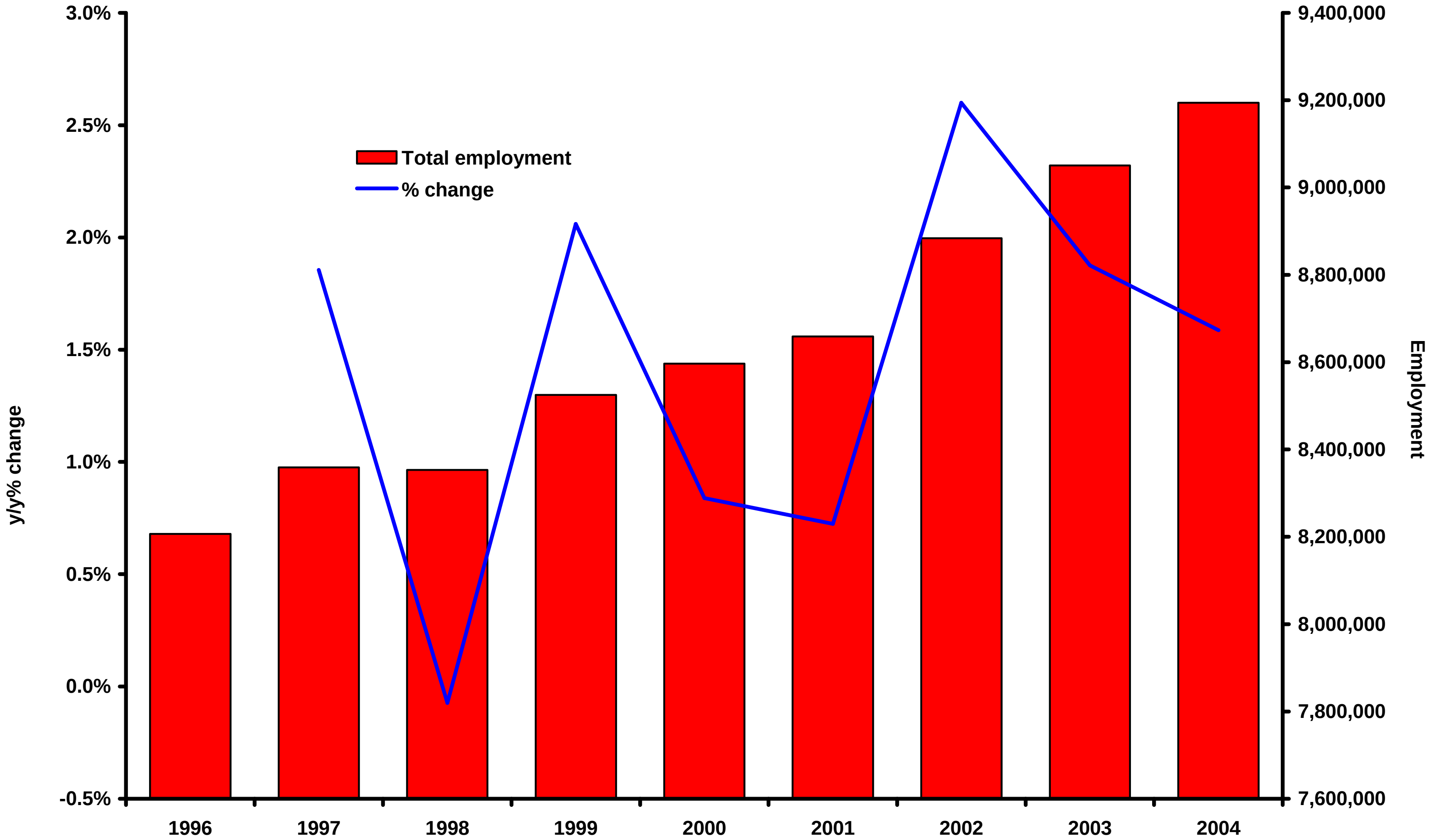
- High structural unemployment
  - Low levels of labour market participation
  - Length of time to find a new job is longer
  - Labour market participants leave the formal sector - increased participation in the informal sector
- Difficulty in matching unemployed individuals to existing vacancies
- Greater coordination in wage bargaining
  - Discourages competitive wage setting – upward pressure on real wages
- High unionisation – Cosatu claims it has 1,8m paid members (19,6% of formally employed population)
- Increased employment protection
  - Labour legislation – direct employment protection
  - Charters – direct employment protection

South African labour market = uncompetitive

Informal sector employment

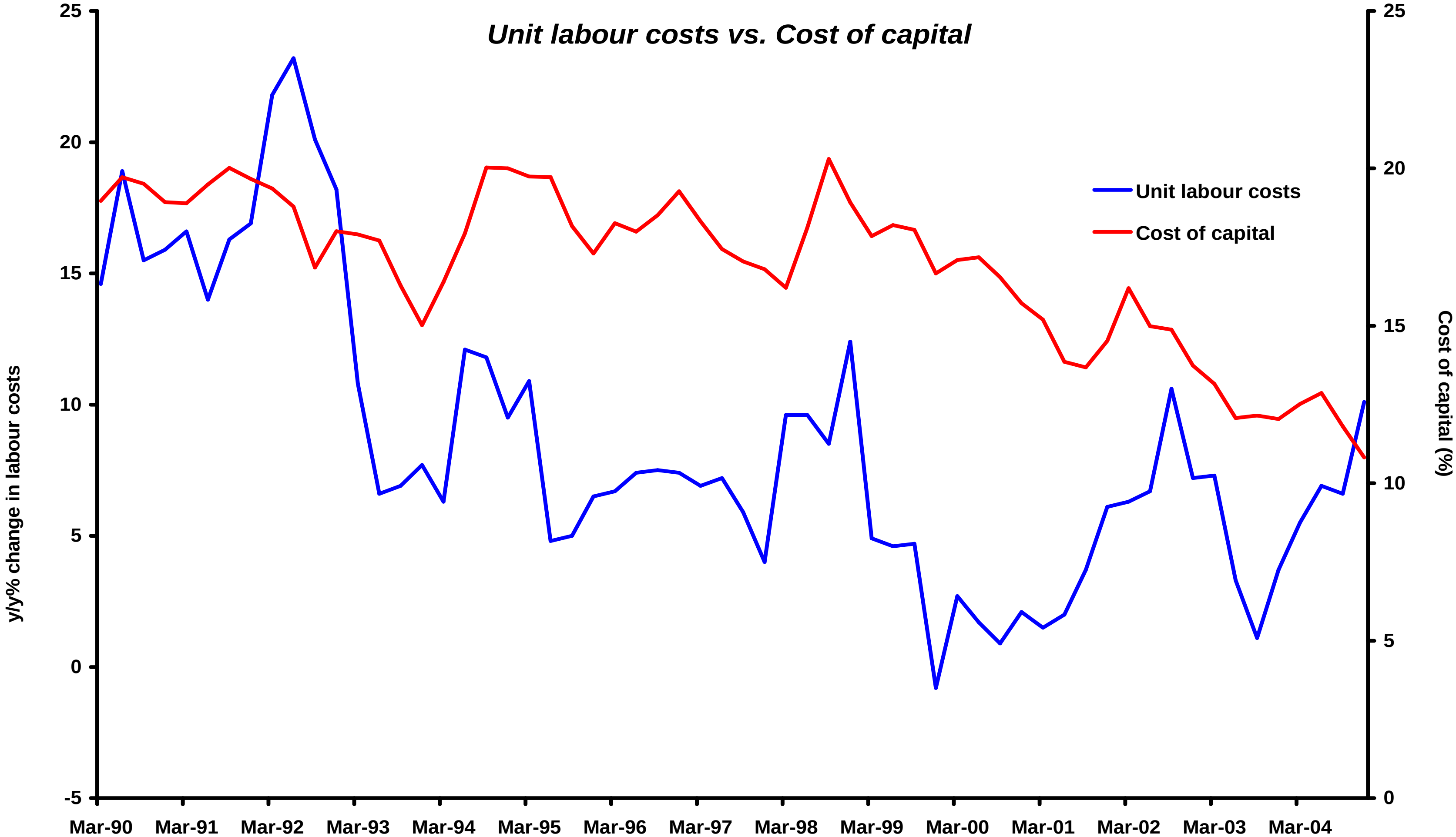


Formal sector employment



High labour costs = low labour productivity = low economic growth

Capital becoming cheaper, labour costs rising



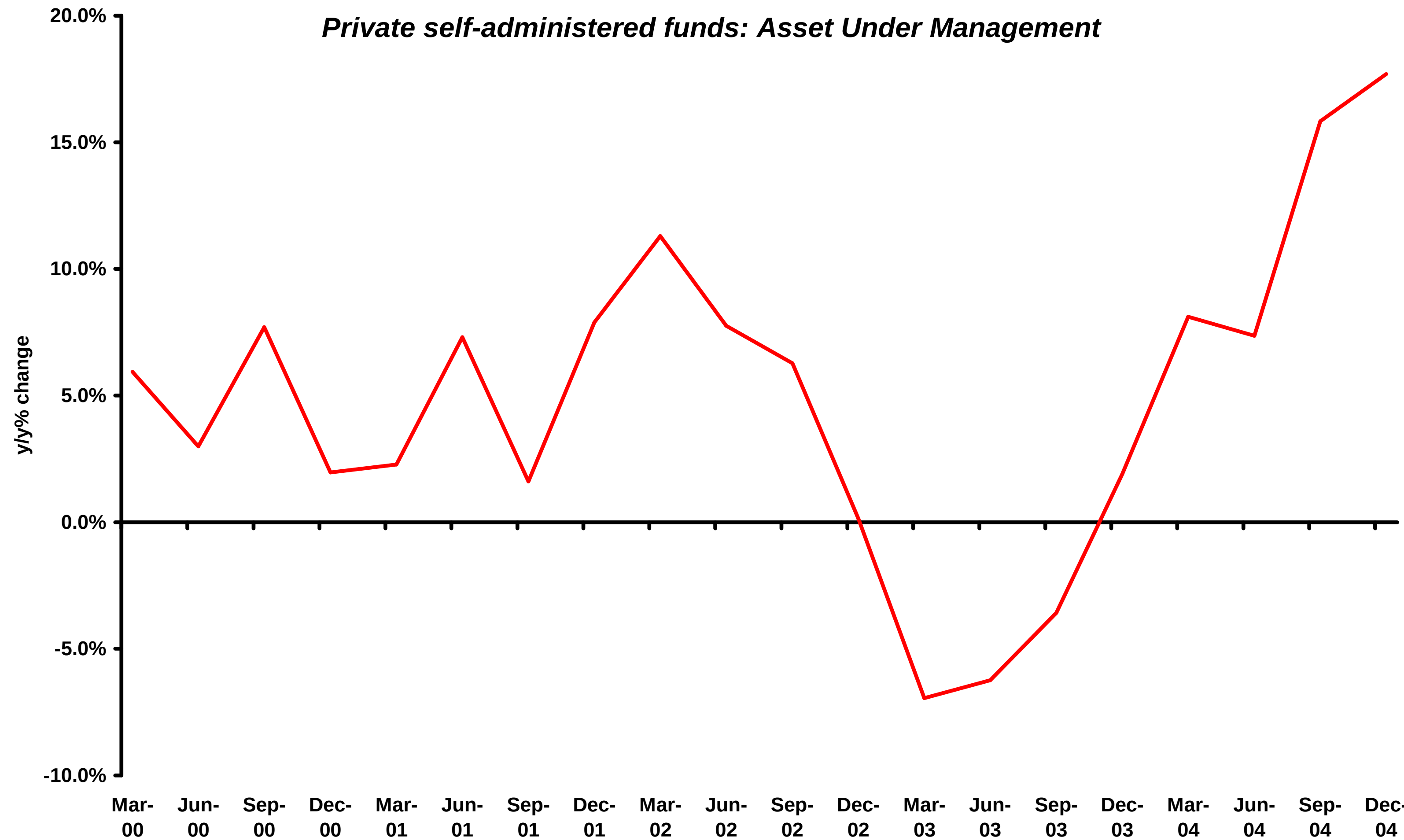
Firms will start substituting labour for capital (machinery, new technology) - exacerbate unemployment rate

Group Economic Research

ABSA

Today, tomorrow, together.

Pension fund industry: assets under management growing steadily

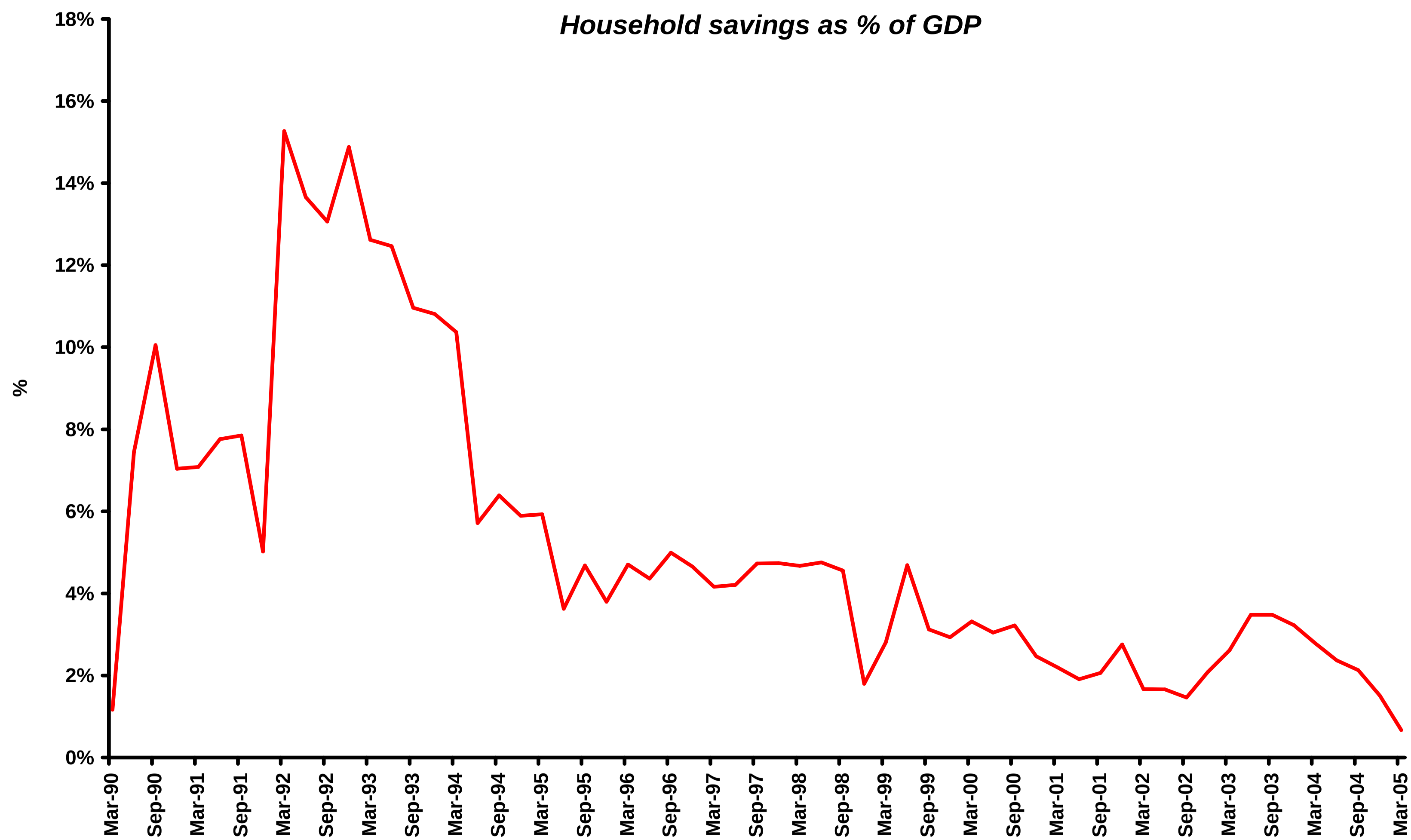


Boom in equity markets aiding growth

Pension fund reforms

- Seen an increase in the rulings by the Pension Fund Adjudicator
- Amendment of the Pension Funds Act of 1943
  - Need for clear definition of the relationship between the client, life assurer and retirement fund managers
- Proper disclosure and transparency of management fees
  - Allow proper comparison with products offered by other life assurers
- Disclosure of penalties charged in early surrender or termination
- Change in the payment of commission
  - No longer upfront but ongoing
- Advantages of reforms:
  - Build trust and confidence of the industry
  - Improved transparency
  - Increased long-term savings in the economy
  - Protection of retirement capital
  - Decrease the dependency on government pension

Savings culture dwindling



Summary

- 6%-7% increase in economic growth is feasible
- Labour reformations necessary
- To increase employment
  - Decrease in the power of labour unions
  - Flexibility of labour market
- Decrease in labour costs, hopefully increase in labour productivity
- Pension fund rulings will in the short-term have a negative impact on the reputations of life companies and fund managers
- Long-run prospects are positive
  - Increased confidence
  - Increase in household savings

Questions

Contact details:
011 350 7248
nontlek@absa.co.za