South Africa

key figures

• Land area, thousands of km²	1 221
• Population, thousands (2004)	45 214
• GDP per capita, $ (2003)	3 674
• Life expectancy (2000-2005)	47.7
• Illiteracy rate (2004)	13.3

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NOTWITHSTANDING APARTHEID'S LEGACIES of inequality and poverty, the South African government's fiscal and monetary policies have been remarkably restrained. With low inflation, little indebtedness and a strong currency, the country is now in a favourable position to move more aggressively towards tackling its profound social ills, most crucially the pervasive unemployment. The government is increasing social spending and public works programmes while continuing to foster investment in physical and human capital. Weaknesses in government capacity, lack of skills and the AIDS pandemic remain major obstacles to accelerating economic growth to levels sufficient to absorb unemployment.

The South African economy appears to have adjusted to the strong rand. After slowing down to 2.8 per cent in 2003, owing to the adverse impact of the rand appreciation on exports, growth picked up again in 2004, at 3.8 per cent, spurred by buoyant domestic demand and a low interest rate environment, coupled with robust consumer and business confidence. Strong domestic demand and a favourable external environment are expected to bring growth to an average of 4 per cent over the next two years.

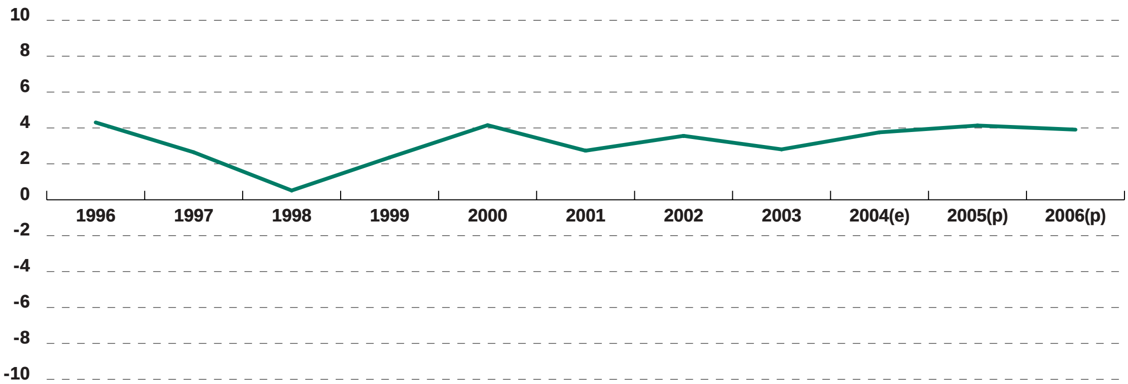
Despite a positive outlook, both investment and output growth are still below the levels necessary to reduce unemployment – which stood at 28 per cent in 2004 – and to achieve more equitable income distribution. Moreover, the country is faced with major social challenges, including a poverty level exceeding 50 per cent, a high prevalence of HIV/AIDS infection (20 per cent of the adult population), and an exodus of skills from an already inefficient health and education sector.

A successful macroeconomic stabilisation policy has provided room for more ambitious fiscal expansion.

Reducing poverty has moved to the top of the policy agenda. The 2004-2007 Medium Term Expenditure Framework has allocated increasing expenditures on infrastructure, public works programmes and income support schemes. This ambitious expenditure plan is confronted, however, with weak local government capacity and inadequate monitoring of budget execution, as highlighted by the 2004/05 overruns in social grants, mainly due to administrative failures.

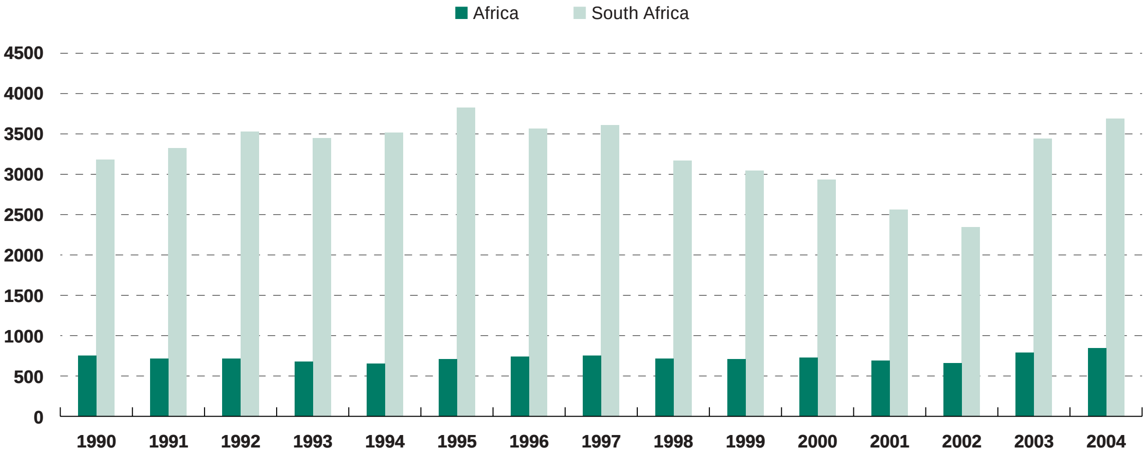
Securing a two-thirds majority in the 2004 local elections, ANC consolidated its control over all the nine provinces. The dominant position of the ANC reflects the lack of a strong parliamentary opposition which was further reduced during 2004.

Figure 1 - Real GDP Growth



Source: South African Reserve Bank data; estimates (e) and projections (p) based on authors' calculations.

Figure 2 - GDP Per Capita in South Africa and in Africa (current $)



Source: IMF.

Recent Economic Developments

A highly competitive exchange rate boosted growth performance to 3.6 per cent in 2002. However, the strong appreciation of the rand experienced since the end of 2002 coupled with a sharp decline in agricultural production contributed to a slowdown to 2.8 per cent in 2003. The adverse impact on domestic exports was mitigated by a resilient retail sector.

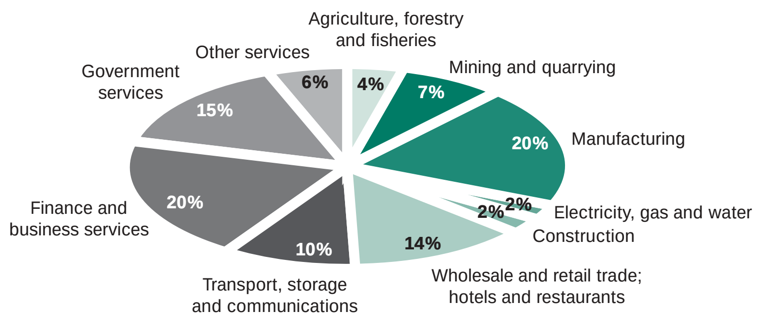
Growth regained momentum in 2004. The services sector continued to remain the main source of growth, especially transport and communication, while manufacturing and mining started to adjust to a more stable exchange rate.

Agriculture's share of total output is only about 4 per cent but it provides 10 per cent of the country's jobs. Agricultural production is extremely volatile, fluctuating with market prices and weather conditions. After a 5.9 per cent contraction in 2003 owing to poor weather conditions, agricultural output picked up in the second quarter of 2004, at an estimated pace of 7.4 per cent. Improved volume in the horticultural sector and animal products were the main contributors, while field crop production slowed in the face of declining prices. In the 2004/05 budget, the government set aside R1 billion ($168 million) to re-establish an Agricultural Credit Scheme, focused on the needs of new farmers and small-scale producers. The scheme aims at providing grants and loans for land acquisition and expansion as well as capacity building of small farmers.

As a result of the stronger rand, South Africa failed to gain much from the global commodities boom in 2003. Despite real growth in output and higher dollar prices, the strong appreciation of the rand translated into reduced rand revenues. The mining sector started to recover in 2004, growing by 4.1 per cent during the first nine months, as buoyant commodity prices partially offset the strength of the rand. The continued slow decline in gold production was balanced by robust growth in platinum, coal and diamond output. In particular, platinum output volume increased by 14.9 per cent in 2004, driven by automotive industry demand for use in catalytic converters. However, the development of the mining sector is constrained by inefficient infrastructure and by increasing operating costs (water prices and rail charges increased by 18 per cent and 16.5 per cent respectively in 2004, after increases of 8.5 per cent and 35 per cent respectively in 2003). Industry and government representatives are investigating ways of encouraging greater flexibility and lowering input costs.

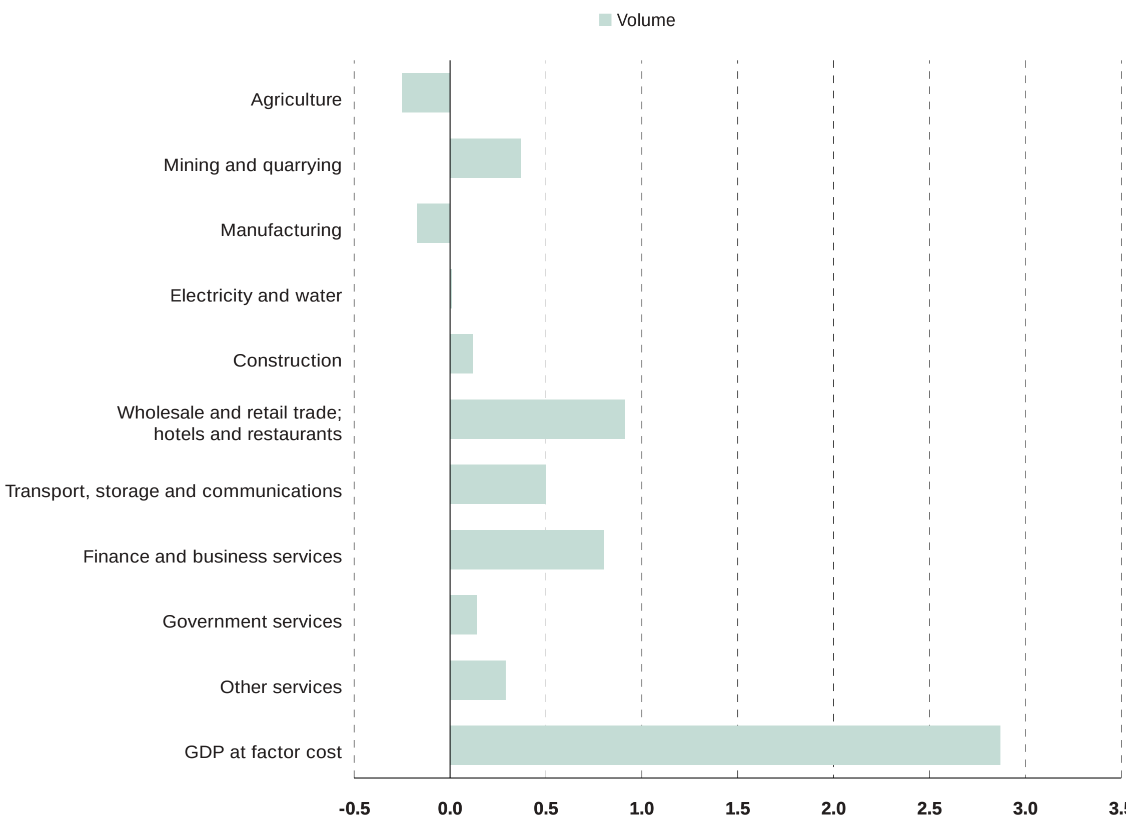
The pending Mineral and Petroleum Royalty Bill will further raise the industry's costs by R5 billion ($843 million), as it effectively raises taxes by 2-8 per

Figure 3 - GDP by Sector in 2003 (percentage)



Source: Authors' estimates based on South African Reserve Bank data.

Figure 4 - Sectoral Contribution to GDP Growth in 2003 (percentage)



Source: Authors' estimates based on South African Reserve Bank data.

cent of revenues on various minerals. Mining companies strongly oppose the proposed bill, arguing that royalties should be charged on profits rather than turnover.

Over the past two years, some progress has been achieved in promoting black economic participation in the mining sector, in line with the sector's empowerment charter, which calls for 15 per cent black ownership of mining companies' local assets within five years, increasing to 26 per cent in ten years. In 2004, a number of important mining empowerment deals were finalised, including the sale of 15 per cent of Gold

Fields' South African gold sector to Mvelaphanda Resources, and the creation of Incwala platinum company, with 52.8 per cent of black shareholding. In addition, in compliance with the Mineral and Petroleum Resources Act approved in May 2004, progress has also been made in terms of employment equity, procurement from historically disadvantaged companies, and development of skills.

While the manufacturing sector strongly benefited from the depreciation of the rand in 2001 and 2002, the rebound of the currency constrained both export-oriented industries and the import-competing sector in 2003. The global economic slowdown also contributed to the poor performance of the manufacturing sector. The sector partly recovered in 2004, expanding by 2 per cent during the first nine months of the year, helped by the strength of domestic demand and export demand from Asia. Investment in manufacturing has increased despite subdued prices of manufactured products. The automotive industry was the best performing sub sector. According to the National Association of Automobile Manufacturers of South Africa, total domestic vehicles sales increased by 18.7 per cent in 2004, benefiting from the launch of the Toyota's exports to Europe and the commencement of Ford's export regime. These positive developments are mainly attributed to the Motor Industry Development Programme (MIDP) introduced in 1995, granting duty rebates on the components of exported vehicles. Vehicle producers can also obtain import duty credits through capital investment geared to export production. The programme has been extended until 2012.

The construction sector continued to grow at a rapid pace of 6.1 per cent in the first nine months of 2004. The expansion is due to the boom in construction of new residential buildings and shopping centres, supported by rising disposable incomes and growing consumer confidence. Favourable tax allowances for inner city property development and greater investment in township renewal are expected to support this sector further. Additional impetus in the medium term will come from planned investment in infrastructure by government and public corporations, including the extensions to the Johannesburg and Cape Town Airports and harbours of Durban and Richard bay. Moreover, South Africa's successful bid to host the 2010 World Cup will certainly provide a further important boost to the sector.

Over the same period, the service sector, which has been the backbone of growth in South Africa in recent years, also continued to perform well. Transport, storage and communications grew by an estimated 5.5 per cent. Growth was spurred by continued expansion in the telecommunications industry, notably with the introduction of a third cellular telephone operator – Cell C – in 2001. After some delay, the government is now in the process of negotiating with investors for a second fixed-line operator and is committed to ensuring effective competition by allowing mobile operators open and non-discriminatory access to all fixed-line networks. Strong demand for residential property resulted in increased activities in expansion of real estate and business services of 3.6 per cent in 2004.

Table 1 - Demand Composition (percentage of GDP)

	1996	2001	2002	2003	2004(e)	2005(p)	2006(p)
Gross capital formation	**17.2**	**15.3**	**16.1**	**16.8**	**17.1**	**18.8**	**20.4**
Public	4.5	4.0	4.1	4.7	5.2	6.1	6.8
Private	12.7	11.3	12.0	12.1	11.9	12.7	13.6
Consumption	**81.3**	**81.0**	**80.2**	**81.6**	**80.6**	**79.1**	**77.5**
Public	19.1	18.3	18.3	18.9	19.1	19.0	18.8
Private	62.2	62.7	62.0	62.6	61.5	60.1	58.7
External sector	**1.5**	**3.7**	**3.6**	**1.6**	**2.3**	**2.1**	**2.1**
Exports	24.7	29.8	32.5	27.2	25.7	26.5	26.9
Imports	-23.2	-26.1	-28.9	-25.5	-23.3	-24.5	-24.8

Source: South African Reserve Bank data; estimates (e) and projections (p) based on authors' calculations.

Sustained by real wage increases and a reduction in income taxes, private consumption remained buoyant in 2004. Spurred by lower interest rates and the falling prices of imports owing to appreciation of the rand, household debt increased and real outlays on durable and semi-durable goods rose by 5 per cent in 2004. Real government consumption also increased over the same period, in line with the moderately expansionary stance of the 2004/05 budget.

Although still low when compared to other emerging economies, investment growth accelerated in 2004. Private sector capital formation has been spurred by several factors: low costs of imported capital goods, reduced borrowing costs, rising commodity prices, and control of inflation. Investment by public corporations, mainly in the form of purchase of new aircraft for the South African Airways fleet, contributed to the increase in investment.

Expansion in investment is expected to continue over the medium term as the government envisages investment in new electricity supply capacity, several major water schemes, and road and rail network rehabilitation. Major investment is also expected ahead of the 2010 soccer World Cup that will be financed through public-private partnership. According to the November 2004 Medium Term Expenditure Framework, the government foresees an increase in the overall investment-to-GDP ratio from the current 16 per cent to 25 per cent in 2014.

Relatively favourable global economic conditions accompanied by buoyant commodity prices suggest a gradual recovery of export performance. On the other hand, rising imports will accompany the acceleration in spending on capital goods.

Macroeconomic Policies

Fiscal and Monetary Policy

Since the start of the democratisation process, South Africa's macroeconomic policy has been aimed at enhancing the government's credibility by demonstrating to the international community its commitment to macroeconomic stability. Over the past ten years, South Africa has made significant progress in stabilising macroeconomic fundamentals. Public finances have been consolidated significantly, inflation has been brought under control, real interest rates have dropped and the external position has improved.

However, enormous social needs remain unmet and a large segment of the population is excluded from the formal economy and has limited access to services. The gravest problem continues to be the high unemployment rate, officially about 28 per cent in 2004, but as much as 40 per cent if disguised unemployment is included.

Since 2001, South African fiscal policy has edged away from fiscal austerity towards stimulus. However, despite growing emphasis on reducing poverty and increasing social spending, the fiscal stance has remained conservative. Deficit ratios in the past three fiscal years have been below target, reflecting shortfalls in social spending and the limited absorptive capacity of the provinces and local governments, to which about 60 per cent of expenditure is channelled.

In order to address pressing social challenges and improve the poverty impact of spending, the Medium Term Expenditures Framework (MTEF) for the period 2004/05 to 2006/07 proposes a more ambitious fiscal expansion. Increased emphasis has been placed on the role of the state in providing social services for the poor, increasing capital spending on economic infrastructure and social services, and providing tax incentives for investment. More specifically, the authorities are pursuing a two-pronged strategy focused in the short term on income support schemes and public works programmes, and in the long term on investment in social and transport infrastructure, and a more effective competition policy.

To this end, the 2004 budget targeted poverty reduction in the form of further extension of social grants for children in need, universal provision of antiretrovirals, labour-intensive public works programmes, and training for the unemployed.

Additional outlays were allocated for the black economic empowerment programmes, land restitution, and the provision of free basic services to poor households.

In contrast with previous years, preliminary estimates of the 2004/05 budget suggest that, despite higher than expected business-tax receipts, overruns in social grants resulted in a deficit slightly higher than targeted at about 3.2 per cent of GDP.

Social grants were provided to close to 9 million people by the end of September 2004. This represents an increase of more than 2 million beneficiaries since April 2004. Disability grants for adults and children have been growing much faster than other grants. There are concerns that a significant part of this growth arises from fraud. The government opened an inquiry into the source of this unexpected increase, which might include the impact of HIV/AIDS, abuse, and unclear guidelines about how to treat conditions – especially chronic illness such as TB.

Concerns remain over the affordability and sustainability of these social services and income supports, as they could eventually crowd out development and education expenditure as well as threaten the hard-won fiscal stability.

The Medium Term Budget Policy Statement, presented in October 2004, proposes further increases in social spending as well as salary increases for teachers and police personnel. Investment in infrastructure – partly through public-private partnerships – is expected to reach 6 per cent of GDP, with the focus on improving railways, ports, electrification, schools and housing. These ambitious government plans are confronted however with weak local government capacity originating from an increasing shortage of skilled staff, as well as management deficiencies and inadequate systems for monitoring and evaluating performance.

On the revenue side, the government is proposing tax relief for investments from other countries within the Common Monetary Area (namely: Namibia, Swaziland and Lesotho), encouraging broad based employee equity participation and simplifying tax compliance for small enterprises.

Taking into account overruns in social grants programmes and the expected increase in capital expenditure, the overall budget deficits are expected to widen to 3.5 per cent of GDP in 2005/06 and to 3.7 per cent in 2006/07.

Over the past year, monetary policy has remained focused on containing the CPIX[1] inflation within the rolling monthly target range of 3-6 per cent. Since the peak of 11.3 per cent in November 2002, propelled by the lagged effect of the collapse of the rand in the latter

Table 2 - Public Finances[a] (percentage of GDP)

	1996/97	2001/02	2002/03	2003/04	2004/05(e)	2005/06(p)	2006/07(p)
Total revenue and grants[b]	**22.5**	**24.6**	**24.8**	**24.3**	**24.8**	**24.4**	**24.1**
Tax revenue	21.9	24.2	24.4	23.8	24.2	23.9	23.6
Total expenditure and net lending[b]	**26.9**	**26.1**	**25.9**	**26.7**	**27.9**	**27.9**	**27.8**
Current expenditure	24.9	25.2	25.3	27.0	27.9	27.9	27.6
Excluding Interest	*19.8*	*20.5*	*21.1*	*23.2*	*24.2*	*24.3*	*24.1*
Wages and salaries	10.3	9.8	9.9	9.8	9.9	9.7	9.5
Interest	5.1	4.7	4.2	3.8	3.7	3.6	3.6
Capital expenditure	2.2	1.8	1.2	1.3	1.5	1.7	1.9
Primary balance	**0.7**	**3.2**	**3.0**	**1.4**	**0.6**	**0.1**	**0.0**
Overall balance	**-4.4**	**-1.5**	**-1.2**	**-2.4**	**-3.2**	**-3.5**	**-3.7**

a: Fiscal year begins 1 April.
b: Only major items are reported.
Source: South African National Treasury Statistics; estimates (e) and projections (p) based on authors' calculations.

1. The CPIX is defined as the consumer price index for metropolitan and other urban areas excluding the interest cost of mortgage bonds.

part of 2001 and the poor performance of the agricultural sector, inflation decreased dramatically and has been within the target range since September 2003, averaging 4.3 per cent in 2004. The appreciation of the rand since end-2002, fiscal discipline, and slower rates of increase in food prices contributed to bringing inflation down. Despite high international oil prices and buoyant domestic demand in the course of 2004, there was little evidence of significant inflationary pressures as the negative impact of higher international oil prices was offset in part by the appreciation of the rand. A surge in petrol prices led inflation to reach 5 per cent in June, but it subsided to 4.2 per cent in July and 3.7 per cent in August and September.

In turn, the favourable inflation outlook has allowed the Monetary Policy Committee to reduce the repo rate by as much as 600 basis points between June 2003 and August 2004.

Inflation is expected to remain in the range over the forecast period, at 5.7 and 5.1 per cent in 2005 and 2006, respectively. Though positive, the outlook for inflation still bears some risks, stemming from oil price developments and the continued rise in domestic expenditures.

After depreciating by 34 per cent between the end of 2000 and the end of 2001, the rand rebounded strongly against the dollar, appreciating by 24.2 per cent in 2002 and 16.2 per cent in 2003. The rand also appreciated against the euro, but to a lesser extent. In 2004, the exchange rate remained relatively steady after appreciating by 8.2 per cent in the first half of the year. Following an interest rate cut by the South African Reserve Bank (SARB) in August it slipped back to R6.50 per dollar. However, it stabilised quickly, and strengthened in the last quarter of 2004, ending the year at R5.7 per dollar.

The US dollar's weakness and high commodity prices have been fundamental drivers of rand behaviour. Other factors contributing to the recovery of the rand include a positive, albeit narrowing, interest rate differential with the rest of the world, and a continued positive market sentiment towards South Africa, in

Figure 5 - Rand Performance versus the US dollar and the Euro

Source: South African Reserve Bank.

part as a result of a turnaround in the international reserve position of the SARB. Indeed, South Africa's reserve position has continued to improve significantly over the past months. Having stood at around $23 billion in 1998, the Net Open Forward Position (NOFP) was eliminated in May 2003 and the oversold book of the bank was closed out in February 2004. Since then, the Bank has continued to purchase foreign exchange with the objective of building up reserves in a prudent manner. At the end of September 2004, gross reserves amounted to $12.4 billion.

If the removal of NOFP has contributed to reducing a source of vulnerability for the currency, the question of the durability of the rand's present strength remains open. Much of the strength of the rand might actually be driven largely by a surge in offshore transactions in rand derivatives (especially swaps), as reflected by the high level of unrecorded transactions in the financial account of the balance of payments.

External Position

After the failure of the international trade negotiations in Cancún in September 2003, where South Africa proved to be a vocal and effective participant, South Africa's focus moved in 2004 towards various bilateral trading arrangements.

A major development was the establishment of the Southern African Customs Union (SACU) Secretariat in Windhoek (Namibia) in July 2004. With the creation of a new more democratic institution and a new formula for the distribution of customs and excise duties, attention is turning to harmonization of trade and industrial policies. The new SACU Secretariat will enhance the participation of the smaller member countries.

The most advanced bilateral negotiations are between SACU and the USA, originally slated to start at the end of 2004. However, the date has been postponed to end-2005, on account of negotiations concerning the United States Africa Growth and Opportunity Act (AGOA) preferences. These preferences are especially generous to some BLNS (Botswana, Lesotho, Namibia, Swaziland) countries such as Lesotho, for which quotas and onerous rules of origin have been waved for textile inputs used in clothing destined for the US market. Some studies of the US-SA agreement, however, suggest that the United States will gain more in terms of market access than South Africa, given the much higher South African tariff levels.

South Africa is also considering a trade deal with China. South Africa exports almost $1 billion of goods to China, mainly primary or lightly processed commodities, while it imports from China more than $2 billion worth of higher value added and labour intensive goods in the clothing, glassware and electronics sectors. On the surface, it would therefore appear that South Africa will gain less than China from a bilateral FTA. However, South Africa could potentially sell a large number of manufactured goods to China, including chemicals, metal products and motor vehicles, that currently find their way to the rest of the world, in particular the EU. The competition from regional suppliers in the ASEAN countries may however be stiffer for South African exporters. Another promising avenue would be to encourage Chinese investment to South Africa, accompanied by Chinese entrepreneurship.

Despite its modest growth in the last five years, Europe remains South Africa's largest trading partner. In 2004, trade with Europe accounted for 35 per cent of total exports and 42 per cent of imports, while China accounted for 2.5 per cent of total exports. Trade with other African countries is still low but the recovery of the rand led to increased imports from the region. In June 2004, Africa accounted for 13 per cent of total South African exports and 4.5 per cent of imports. The bulk of exports to Africa goes to the SADC region and consists predominantly of manufactured goods, followed by agriculture and mining products.

After recording a surplus of 4.2 per cent of GDP in 2002, South Africa's trade balance narrowed to 2.2 per cent of GDP in 2003 as the skyrocketing rand seriously affected export earnings. Although in 2004 exports regained some lost ground, the trade balance

Table 3 - Current Account (percentage of GDP)

	1996	2001	2002	2003	2004(e)	2005(p)	2006(p)
Trade balance	2.0	4.2	4.2	2.2	0.1	-0.1	0.0
Exports of goods (f.o.b.)	21.2	25.9	28.3	23.2	19.4	20.2	20.5
Imports of goods (f.o.b.)	-19.2	-21.7	-24.1	-21.0	-19.3	-20.3	-20.5
Services	-0.5	-0.5	-0.6	-0.6			
Factor income	-2.2	-3.2	-2.5	-2.0			
Current transfers	-0.5	-0.6	-0.5	-0.5			
Current account balance	**-1.2**	**-0.03**	**0.6**	**-0.9**			

Source: South African Reserve Bank data; estimates (e) and projections (p) based on authors' calculations.

has deteriorated considerably owing to a sharp rise in demand for imported goods.

In the first half of 2004, exports rose by 1.9 per cent, well behind import growth of 13.5 per cent. In rand terms, these numbers translate into a trade deficit of R2.5 billion ($421 million), against a surplus of R14.5 billion ($2.4 billion) over the same period in 2003. Imports of capital goods, such as machinery, vehicles and transport equipment have dominated the surge, accounting for over three-quarters of total imports. Motor vehicles increased their share from 11 per cent to 14 per cent and fuels from 12 per cent to 15 per cent.

Within manufacturing, chemicals and metal products and machinery appear to have suffered marked declines in real exports during 2004. On the other hand, as noted earlier, thanks to increased platinum volumes and sustained commodity prices, basic metals and transport equipment recorded a moderate improvement compared to 2003, when the decline in rand prices neutralised the increase in volumes of gold and platinum. Agriculture, food and beverages, clothing and furniture also recorded increases in exports compared to a decline the year before.

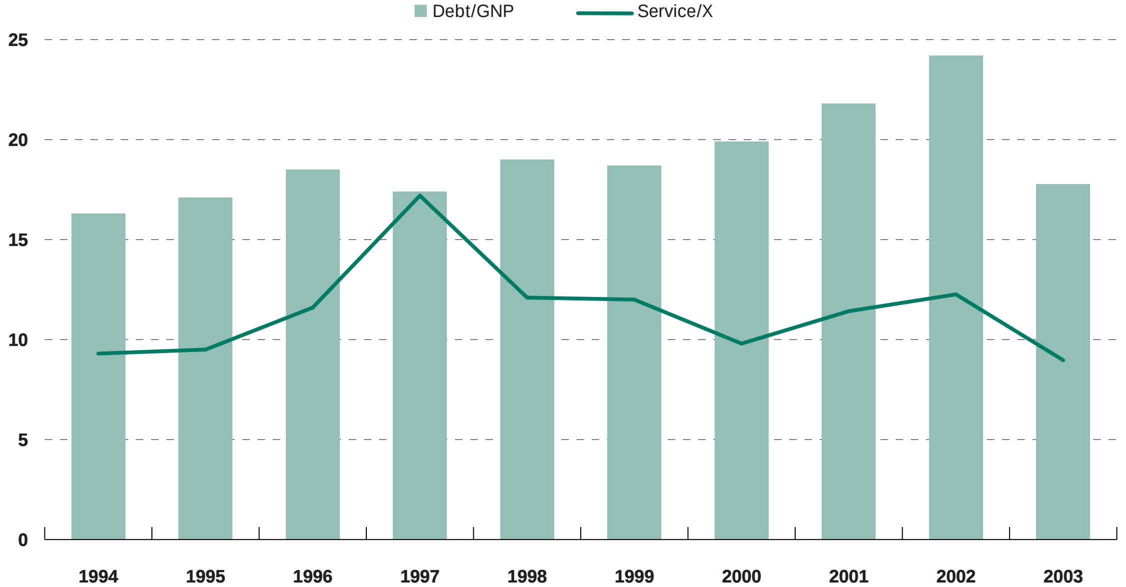
Export growth is likely to pick up in 2005 and 2006, helped by anticipated depreciation of the rand against the euro, boosting manufacturing exports to the euro zone. Firmer commodity prices will contribute to higher gold and platinum exports. On the other hand, imports are also expected to continue to rise, mirroring the increasing trend of private and public investment.

While foreign direct investments in the country remain disappointing, South Africa is the main source of outward FDI in Africa ($500 million in 2003). In order to further support the global expansion and international competitiveness of Southern African companies, the 2004 budget abolished exchange control limits on new outward foreign direct investments by South African companies. Application to the South African Reserve Bank's Exchange Control Department will still be required in terms of existing foreign direct investment criteria, including demonstrated benefit to South Africa. In addition, South African corporations will be allowed to retain foreign dividends offshore.

Major steps were also undertaken to promote foreign investment into South Africa and support the positioning of the country as a financial centre for Africa. The 2004 budget announced that foreign companies, governments and institutions may list on South Africa's bond and securities exchanges. The first foreign listing took place in November 2004 in the form of Aquarius Platinum, an Australian mining concern.

South Africa's foreign-currency denominated debt is around 10 per cent of GDP and it has been prudently managed by the authorities who intend to maintain it at this level in the future. In May 2004, South Africa issued an international bond of $1 billion that was heavily oversubscribed, highlighting the strong market confidence in the country's macroeconomic policies. In support of this positive sentiment, Moody's Investors Service upgraded South Africa's sovereign rating one notch to Baa1 in January 2005. In addition, Fitch has recently changed South Africa's sovereign rating outlook from stable to positive. South Africa has no programme

Figure 6 - Stock of Total External Debt (percentage of GNP) and Debt Service (percentage of exports)



Source: World Bank.

with the IMF and has eschewed borrowing from the World Bank.

Structural Issues

In September 2004, the authorities undertook a review of the reform strategy for the major public enterprises, aiming at accelerating efforts to improve management, accountability and efficiency of service provision. One of the pillars of the restructuring programme is also to foster black economic empowerment (BEE) through the sale of discounted shares and preferential procurement. The restructuring programme comprises various sectors, including defence, energy, telecommunications, forestry and transport. The intention is to promote greater investment by the public companies, attracting strategic equity partners or concessionaires.

To this end, the Department of Public Enterprises designed a R165 billion ($27.8 billion) five-year programme for expanding the power and transport systems. Over the medium term, the South African public enterprise for transport, Transnet, expects to expand the port, freight rolling stock, rail and pipeline infrastructure. Investment in the country's monopoly electricity provider, Eskom, includes major development of power generation, transmission and distribution.

The private sector laments the absence of government contributions in the R165 billion initial round of investment in electricity generation and transport capacity. Investors claim that initial public offering or sales of some of Transnet subsidiaries will require balance sheet restructuring that will not be possible to achieve without a new injection of funds.

The financial situation of Spoornet, the largest division of Transnet, responsible for rail freight and long-distance passenger services, is particularly weak and its restructuring will pose major challenges. The railways are estimated to have a 75 per cent deficit in capital spending (i.e. they are only investing 25 per cent of the capital required to maintain the existing fixed capital) with important negative implications for exports. The deterioration of the railway network's operating efficiency has indeed hampered South Africa's bulk commodity exporters' response to booming global demand, in particular from China.

The poor service of Spoornet also affects the South African Ports. Although the ports are highly profitable, the profits are used to compensate for losses in rail services, resulting in extensive inter-modal cross-subsidisation. Thus, port charges are higher than they need to be or investment expenditure is lower than it could be. The indirect impact of this policy choice is a tax on trade, reducing international competitiveness of South Africa's industries. This adds up to a general congestion of the ports, resulting in port delays and extra costs for exporters. Overall, the restructuring of Transnet will require a strong effort to reduce its operating costs, close loss-making lines, and deliver effective and competitive services. One option to attract private interest would be to sever the links between the infrastructure (ports) and monopoly service provider (rail and ports) controlled by Transnet. The existence of the cross-subsidisation mechanism poses, however, major challenges to this opportunity.

In the electricity sector, although Eskom's performance appears highly efficient when judged by African standards, a series of problems require attention. Chief among these is the imminent exhaustion of current capacity and the necessity of investing in new power plants. A "managed liberalisation" plan proposed in 2001 called for 10 per cent of Eskom's existing generation capacity to be sold under the BEE programme, followed shortly thereafter by the sale of an additional 20 per cent to a strategic foreign partner. In the medium term, transmission (wires, system and market operations) would remain an Eskom subsidiary before becoming an independent state-owned company. On the distribution side, six regional electricity distributors owned jointly by Eskom and the municipalities would be established. This unbundling programme was scheduled to commence in 2003, but has been postponed until 2006.

In terms of the public sector restructuring agenda, the authorities have put a strong emphasis on the importance of involving the local private sector, and in particular black business. To this end, the 2004 Medium Term Budget policy statement stressed the importance of fostering small micro- and medium-enterprises (SMMEs) development, especially through regulatory reforms, micro-credit initiatives and business support channelled through multipurpose community centres.

According to the 2003 Department of Trade and Industry annual review of small business, the number of small businesses in South Africa ranges from between 1.8 and 2.5 million among which between 1.25 and 1.9 million are non-VAT-registered. More than three-quarters of small companies are involved in services which are less capital intensive than agriculture, manufacturing and construction. Black-controlled informal SMMEs tend to specialise in trade, while white formal ones are involved in financial and business services (engineering and IT). It is estimated that SMMEs account for three-quarters of employment in South Africa, of which micro enterprises account for about 40 per cent. SMMEs generate around 30 per cent of the country's GDP.

Although less unfavourable than in most African countries, the business climate in South Africa is hindered by lengthy administrative processes, inappropriate and underdeveloped financial instruments, and high levels of informality. According to the Regulatory Compound Cost Survey, smaller South African enterprises face regulatory costs as a ratio of sales 80 times higher than bigger enterprises.

In addition, business associations lament extensive state interference in the form of administered prices, labour-market regulations, and black economic empowerment requirements. Field interviews suggest, however, that many companies manage to circumvent the minimum wage rules, for instance. More than in the cumbersome regulation in itself, the major problem seems to lie in frequent changes in regulations.

The strong rand adds to the burden of small businesses, undermining their ability to export. Increased competition from Asia, which could worsen with the FTA with China, is also highly detrimental to SMMEs.

The commercial banks tend to restrict lending to large formal companies. SMMEs, which usually lack proper financial accounts and collateral, are in general unable to borrow from banks. Other financial instruments, such as factoring and leasing, are very little developed. Small businesses also cite a general lack of information about available financing facilities and substantial red tape in access to them, as well as physical distance from the support institutions. These constraints lead many SMMEs to seek financing through other channels.

Outside the formal banking sector, small scale and co-operative banking – via the so called Stokvels – is established in the black community and has taken on increasing importance. It is estimated that 60 per cent of Stokvel users already have bank accounts for various transactions but use stokvels for savings and loans. Most stokvels remain unregulated.

A three-pronged strategy seems to be pursued by the authorities to foster SMME development and their access to finance. On the one hand, the regulatory framework is being adapted to allow existing financial institutions to better serve the needs of the SMMEs. In addition, the development of SMMEs is encouraged through the development of franchising and subcontracting. Thirdly, in the framework of the Black Economic Empowerment initiative, specific charters are issued to assist small- and medium-sized black businesses.

Innovative Financial Solutions: Increasing Reputation, Franchising is a Successful Avenue for SMME Financing

Franchising developed in South Africa when the country was under embargo. Since its opening, the country has been spreading franchising technology to Southern and Eastern Africa, using its good knowledge of African markets and exporting South African brands. Franchised companies have a 90 per cent success rate. This reputation has allowed for greater access to finance. According to the Franchise Census 2004 conducted by ABSA, (a large bank group), the total number of outlets operated by franchised systems in South Africa is almost 23 000, mainly concentrated in retail and restaurants. The estimated annual turnover generated by the franchising system is 129 billion rand and its contribution to GDP was 6 per cent. The franchise sector employs a total of 232 500 staff, of whom 59 per cent are black employees.

Greenfield Venture Capital from Cape Town is currently launching a new fund that will provide equity capital and the intensive management support to franchising outlets. The fund would be subject to the following investment criteria: the business must have a trading history of at least one year, the investment range should be between R100 000 ($16 000) and R2 million ($337 000), the type of investment should consist of 25 per cent to 49 per cent equity. Since most of the franchise outlets do not by themselves generate the value creation that venture capital funds need to cover their cost of capital, Greenfield is asking the Western Cape government to support a pilot project in order to remunerate investors for their contribution to the transition of these enterprises to a formal and businesslike sector. This appears to be a promising new trend in the quest for SMME financing.

Business Partners (formerly the Small Business Development Corporation) support qualifying small business by providing investment of up to R.15 million ($2.5 million) using equity, shareholders' loan account, royalties and term loans. Applications for investment financing of below R250 000 ($42 150) are usually not considered; the average investment is between R500 000 ($84 300) and R.7 million ($1.2 million). Funding is granted based on the viability of the business, the expertise of the individuals involved in the structure and the financing requirements. Equity based investments account for 40 per cent of the total investment portfolio. Investments are spread over manufacturing, retailing, travel and tourism.

In late 2004, as a part of the recently launched activities to support SMMEs development, the authorities started a review of the regulatory framework for SMMEs focusing on lifting of lending limitations of microfinance institutions, the development of second tier banks (mortgage banks) and third tier banks (co-operatives) better suited to the needs of SMMEs, and the launch of credit registers to disseminate information available on SMMEs and improve their creditworthiness. Moreover, the authorities created a unified development agency, through the merger of Ntsika, the non-financial business support institution, with the National Manufacturing Advisory Centre. Although welcoming these initiatives, the business community laments the lack of a comprehensive entrepreneurial strategy and is sceptical about the capacity of the newly established agency to assist small business.

As shown in the box on the previous page, franchising has proved to be a successful avenue for SMMEs' development and has facilitated access to finance through formal channels, by providing information, access to markets, and capabilities. In particular, programmes have been launched to assist franchising outlets through management support and access to equity capital.

The Black Economic Empowerment (BEE) Act's provisions to give preference to black-owned enterprises in procurement bids is another potential way of favouring access to finance, through increased reputation. Although subcontracting arrangements between large companies and BEE SMMEs have developed rapidly since the approval of the act, they remain restricted to some unskilled functions. South African corporations have largely limited outsourcing to cleaning, basic construction and security, while retaining core activities, such as engineering and maintenance, ultimately limiting those firms' growth and development.

A major breakthrough in the government's black economic empowerment strategy was the issuance of the financial sector charter in the last quarter of 2003. The charter provides a framework and scorecard against which financial services providers can measure their progress in empowering historically disadvantaged individuals and communities. It requires financial institutions to increase financial services to the unbanked, support agricultural development, finance for low income housing, and assist small- and medium-sized black business. The charter also mandates significant increases in black ownership and control, management and skills development over the next 10 years. Financial institutions are also expected to procure services from BEE-compliant and black-owned businesses, reaching two-thirds of all purchased services within a decade.

Although some of the objectives appear ambitious, it is not expected that the financial soundness of South Africa's banking system will be jeopardised. Overall, the country's banking indicators are healthy and the sector received a strong vote of confidence in October 2004, when Barclays confirmed its intention to acquire ABSA, the biggest retail bank.

The five local banks that dominate 87 per cent of the market are starting to comply with the charter's targets. In 2004, ABSA was the first bank in South Africa to announce a black empowerment deal. Moreover, the launch of low-cost bank accounts for low-income earners is an important step forward. The "Mzansi" account, initiated jointly by the five banks in October 2004, had already reached 300 000 customers at the end of the year.

Political and Social Context

The African National Congress (ANC) won a resounding 69 per cent majority in the general elections of April 2004, with President Thabo Mbeki retaining the presidency of the country. The ANC obtained its first two-third majority in parliament, and appointed all nine provincial premiers, after previously having governing majorities in only seven provinces.

The dominant position of the ANC reflects the lack of a strong parliamentary opposition, also highlighted by the disappearance of the Zulu-based

InKatha Freedom Party from the new Cabinet. The fact that the ANC has such a broad constituency has made it difficult for opposition parties to establish an identity that is both credible and distinct from the ruling party, and some have been absorbed by the ANC. Observers interpret the ANC's increased supremacy as a further sign that the country is slowly becoming a one-party state. The ANC is faced with the difficult task of balancing the interests of the white and new black business community against the poor, in the context of a still fragile democracy and high levels of economic inequality.

While the ANC's prudent economic management over the past 10 years is widely recognised as a great achievement, much less progress has been achieved in reducing inequality and poverty. South Africa continues to face formidable challenges with unemployment at about 28 per cent, 20 per cent rates of HIV infection, and widening income inequality (the Gini coefficient is 0.59 per cent).

The persistent high unemployment rate is a huge challenge facing the government. Economic growth rates have so far been insufficient to absorb the growing pool of unemployed labour. Moreover, much of the unemployment is structural, reflecting the chronic skills imbalances inherited from the apartheid education system, as well as obstacles to labour market flexibility and high labour costs.

In his June 2004 State of the Nation speech, President Mbeki vowed to halve unemployment by 2014. He proposed a longer-term strategy based on investment and educational reform along with public works programmes to temporarily increase employment. Launched in May 2004, the Expanded Public Work Programme aims to create 1 million temporary jobs during the five-year term of the current government in a range of sectors including labour-intensive construction, and home- and community-based health care.

The acceleration of land redistribution represents another priority means to reduce poverty and promote rural employment. The willing buyer-seller land reform programme aims at transferring 30 per cent of white-owned farmland to black ownership by 2015. Although progress has recently been made in restoring land to owners dispossessed during apartheid, the pace of land redistribution is still disappointingly slow, owing to administrative constraints. To date, only 3 per cent has been restituted or redistributed and 80 per cent of commercial farmland is still owned by some 50 000 white producers.

By the end of 2003, an estimated 5.3 million South Africans were infected with HIV, the largest number of individuals living with the virus in a single country. Since the epidemic began, the government has been criticised for its failure to take effective action against AIDS. The lack of a comprehensive and co-ordinated response by the government and lack of co-operation between the government and NGOs have been exacerbated by President Mbeki's controversial stance. Despite a court ruling in July 2002 that requires the government to provide antiretrovirals for infected children, the government has been slow in meeting its obligations. Treatment and prevention measures have been primarily led by charity and international aid organisations, pressure groups and, increasingly, private-sector companies of which about 68 per cent currently have an internal HIV/AIDS strategy.

International and internal pressure, as well as the political imperative of the 2004 election compelled the government to act more decisively. In November 2003, the government approved a $1.7 billion Comprehensive National Plan on HIV and AIDS Care, Management and Treatment, which aims to provide access to antiretroviral treatment (ARVs) to more than 1.4 million South Africans by 2008. However, since the launch of the initiative, little progress has been made. In June 2004, only 20 000 people had access to ARV treatment out of 750 000 people in need. Access to ARVs has been very uneven across the country as provinces face different challenges, including insufficient human resources, lack of training of health care workers, lack of treatment literacy, delays in the procurement of the drugs, and the need for specialised equipment.

Further progress will depend on leadership at the provincial level. Questions remain about the extent of political commitment to the plan, given the reluctance in parts of the government to act on HIV/AIDS with appropriate urgency.

In the education sector, near-universal primary school enrolment has been achieved as suggested by the latest available education statistics. Gross primary school enrolment reached 105 per cent in 2002. Gross secondary school enrolment was 86 per cent in 2002, a 15 per cent increase from 1992. Classroom sizes fell from 43 in 1996 to 38 in 2001.

Despite these successes, the quality of education remains alarmingly low relative to the government's allocation to the sector (about 5.5 per cent of GDP per year from 2001 to 2004). This reflects the apartheid legacy of the very unequal access to learning resources in the country, as well as failure of some provinces to manage government's allocations properly. A major problem lies also in the teacher brain drain. A recent survey showed that a high number of South African teachers, including many of the best educated and trained leave the country after qualifying, attracted by higher foreign salaries. Up to 5 000 South Africans are teaching in London alone. This poses major challenges to the country's skill development.

The Growth and Development Summit which took place in June 2003 bringing together representatives from government, business, labour and local communities, was an important first step towards addressing the daunting skills problem. The agreements arising from this summit focused on promoting literacy, learnerships, strengthening the Sector Education and Training Authorities (SETAs) and broadening access to quality education and basic services. With funding from the SETAs and the National Skills fund, business and government have undertaken to draw up a register of least 72 000 unemployed learners by May 2004. However, despite the positive uptake, in the second half of the year, SETA underwent a profound funding crisis and failed to finance the promised skills development grants to its members. At the end of the year it declared a moratorium on new learnerships until at least July 2005.