South Africa

key figures

• Land area, thousands of km²	1 221
• Population, thousands (2005)	47 432
• GDP per capita, $ PPP valuation (2005)	11 470
• Life expectancy (2000-2005)	49
• Illiteracy rate (2005)	12.9

African Economic Outlook 2005-2006 www.oecd.org/dev/publications/africanoutlook

All tables and graphs in this section are available in Excel format at:
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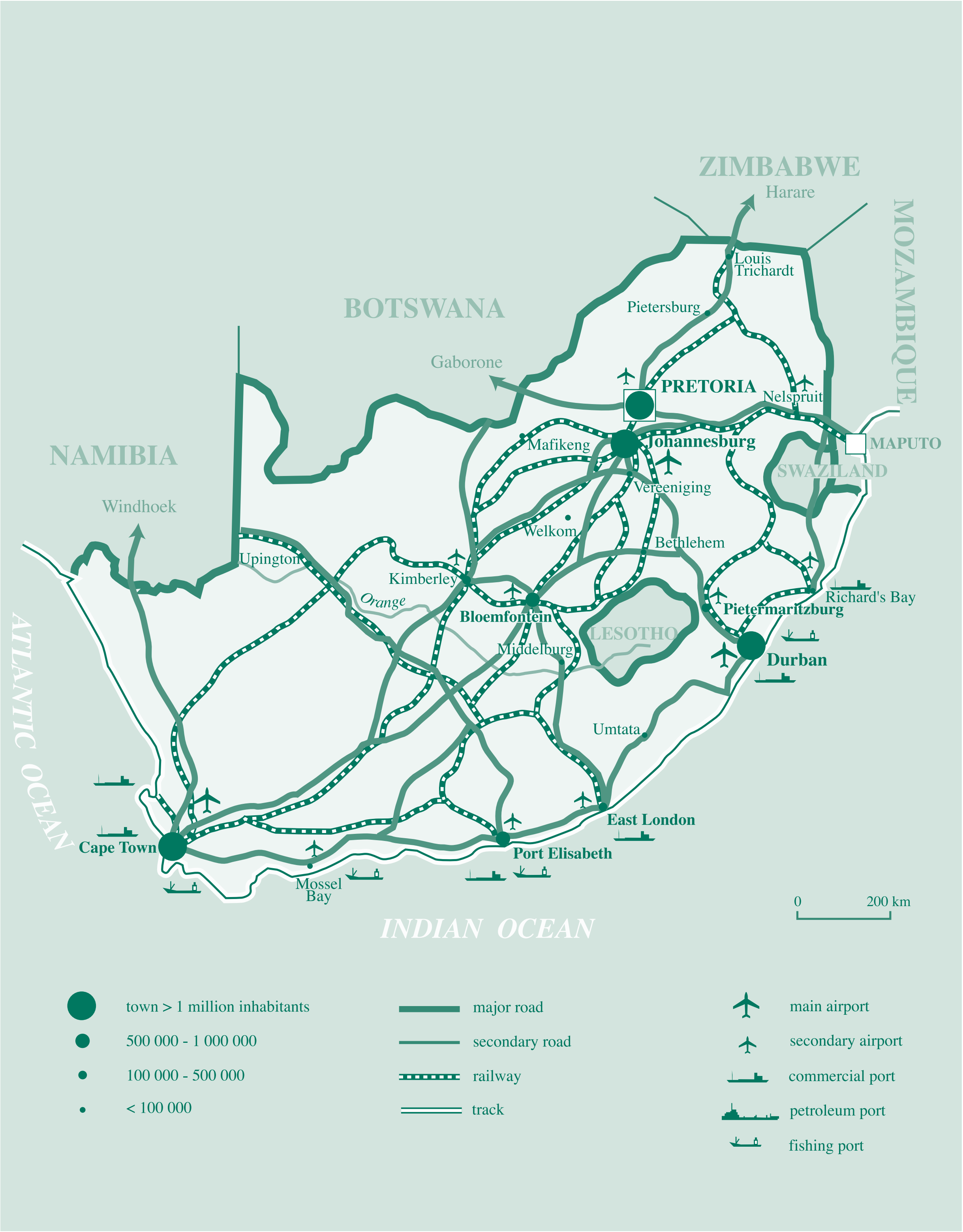
South Africa



South Africa

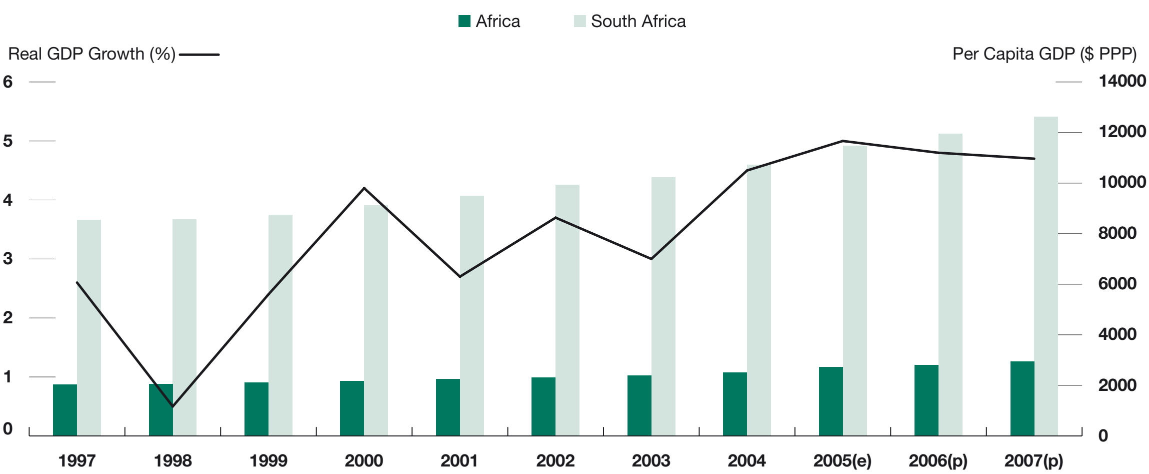
IN 2005, THE SOUTH AFRICAN economy experienced GDP growth of 5 per cent, its highest since the end of apartheid, and strong GDP growth, estimated at 4.8 per cent, is forecast for 2006. Although this good performance is due in part to a favourable international environment, it also reflects the sound economic policies that have been carried out since 1996 in accordance with the Growth and Employment and Redistribution (GEAR) strategy. Responsible monetary policy has paid off in the form of stable inflation, just 4.5 per cent in 2004, and low short-term interest rates. Similarly, the government's conservative fiscal strategy has controlled the deficit, which is now expected to amount to only 0.5 per cent of GDP for the 2005/06 fiscal year. These sustained responsible monetary and fiscal policies have entailed substantial increases in international reserves and raised the confidence of foreign investors in the economy and the rand. Several credit-rating agencies upgraded South African ratings in 2005, decreasing the cost of capital for South African borrowers by reducing sovereign spreads to historic lows. The falling cost of capital and sustained economic growth have allowed the South African government to increase development expenditure and easily finance a domestic demand-driven and widening current-account deficit, which reached 3.3 per cent of GDP in 2004.

Despite this generally positive picture, however, South Africa is still characterised by sharp economic dualism. While much of the white population and a growing black middle class benefit from a "first world" economy, large sections of the population still live in poverty. So far, the African National Congress (ANC) government has been able to maintain austere macroeconomic policies while retaining the support of the black majority. Nevertheless, impatience regarding the unequal distribution of the benefits of growth appears to be building and could lead to political and social instability that would jeopardise these hard-won macroeconomic achievements.

Growth is picking up and the authorities have unveiled an ambitious Accelerated and Shared Growth Initiative.

While growth in the post-apartheid era has been respectable and is now accelerating, it has been slow

Figure 1 - **Real GDP Growth and Per Capita GDP**
($ PPP at current prices)



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

in comparison with a number of other emerging economies. Moreover, the growth that has occurred has not substantially reduced the high rate of unemployment. This poor performance of growth and employment has resulted from several factors, notably from the lack of domestic and foreign investment, a deficient infrastructure, the lack of competition and the shortage of skilled workers. Accordingly, the government is now focusing on these microeconomic impediments, with a goal of 6 per cent growth in the coming years. Taking advantage of the country's strong fiscal position, President Mbeki plans to unveil an ambitious Accelerated and Shared Growth Initiative (ASGI) in his address to the nation in February 2006. The ASGI calls for reduced taxation, significant investments in the infrastructure, assistance to strategic economic sectors, and increased resources for education and training. The programme's success will hinge crucially on improving the government's implementation capacity as, in recent years, weaknesses in this area have severely hindered progress in areas such as infrastructure, education, poverty alleviation and health.

Recent Economic Developments

GDP growth is expected to be in the area of 5 per cent in 2005 after reaching 4.5 per cent in 2004, the acceleration in growth being broadly based across sectors.

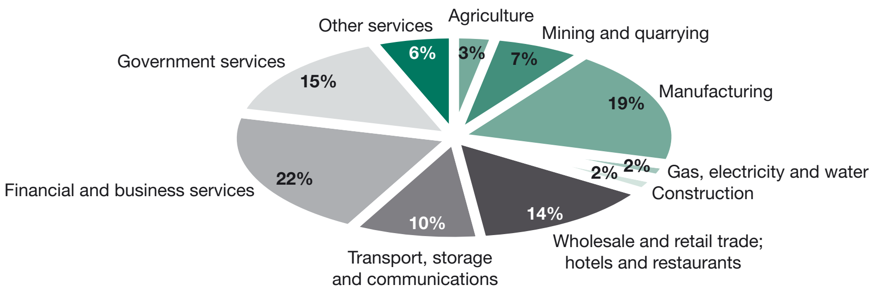
The primary sector, which accounts for 10 per cent of GDP, experienced 3.9 per cent growth during the first three-quarters of 2005 with respect to the same period in 2004. Agriculture, representing 3 per cent of GDP, delivered a 4.9 per cent growth rate, largely thanks to a bumper maize crop in 2004/05 and strong livestock production. The horticulture and fruit industries also turned in robust performances. Nevertheless, the strong rand and the inadequate infrastructure affected the agricultural sector adversely. In particular, the surplus maize could not be fully exported, resulting in a collapse in maize prices and leading many small producers to the brink of bankruptcy. South Africa's leading position in exports of off-season citrus fruits, wine and other produce to the Northern Hemisphere was also affected by these factors. In short, both small-scale farmers and large export-oriented agribusiness would benefit from improved transport infrastructure and more generally, from a more favourable business climate.

The mining sector, which accounted for 7 per cent of GDP in 2004, strongly benefited from vigorous global demand and high prices, growing 3.6 per cent in the first nine months of 2005. With the notable exception of gold, all major sub-sectors (platinum, copper, nickel, iron ore and steel) have grown at a brisk pace. Platinum, in particular, benefited from rising world prices. Despite rapidly rising prices, gold output, after falling by 21 per cent between 2000 and 2004, shrank a further 12 per cent during the first nine months of 2005. This poor performance reflects the exhaustion of easily accessible ore and the impact of the strong rand. Nonetheless, the rising rand-denominated prices of gold in late 2005 bode well for greater future profitability and thus for increased production in 2006, provided that local companies retain their focus on cost cutting and restructuring.

The secondary sector, accounting for 23 per cent of GDP, recorded 4.9 per cent growth during the first three-quarters of 2005. The manufacturing sector, which accounts for 19 per cent of GDP, grew 4.6 per cent despite the strong rand. In fact, the strength of the rand may be a blessing in disguise, insofar as it has enabled the monetary authorities to maintain low interest rates. The Investec Purchasing Managers Index (PMI), a leading indicator of manufacturing activity, posted an overall upward trend in 2005.

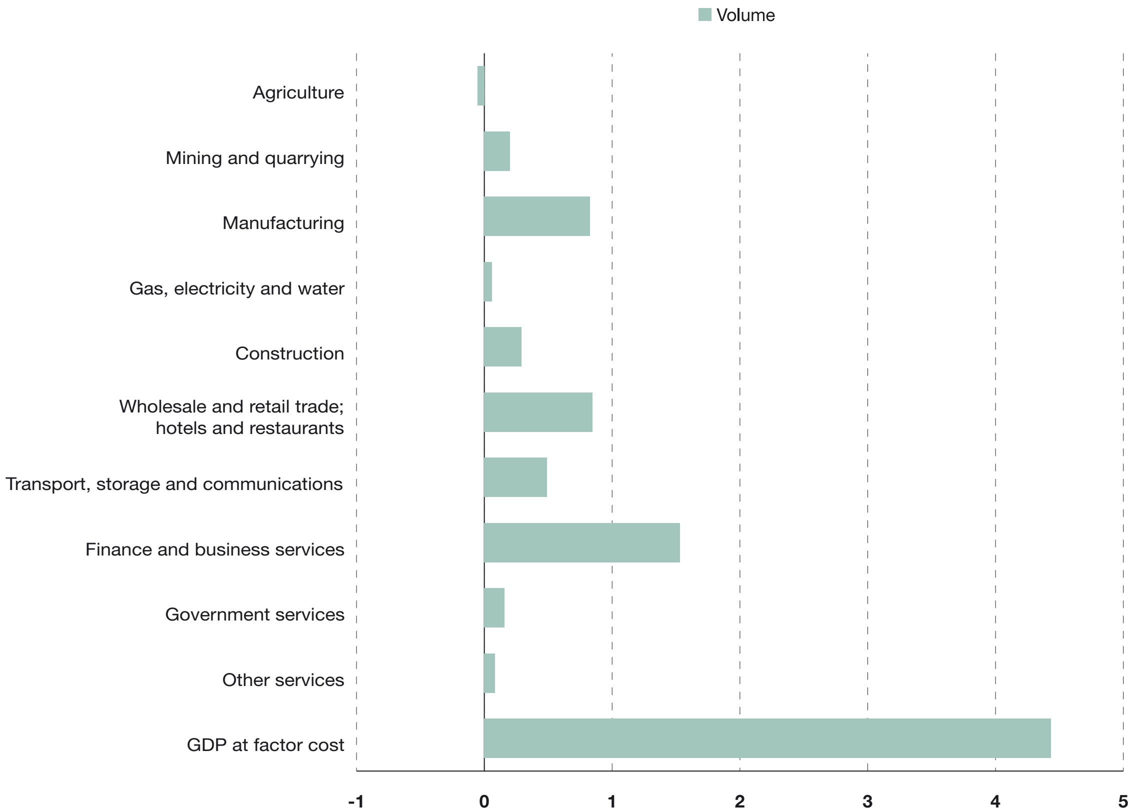
Some export-oriented manufacturing sub-sectors are nonetheless facing difficulties. The textile industry is a case in point. While the strong rand and increased Asian competition since the end of the Multi-Fibre Agreement (MFA) are certainly important local factors, notably labour-market rigidities, also loom large. Despite high tariffs – greater than 40 per cent on some products – other forms of government assistance in the course of the last decade and preferential access to the United States (US) market under the African Growth and Opportunity Act (AGOA), textile and

Figure 2 - **GDP by Sector in 2004** (percentage)



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

Figure 3 - **Sectoral Contribution to GDP Growth in 2004** (percentage)



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

clothing employment declined 7.5 per cent between 2000 and 2004. The government is reluctant to raise protection even more, so the industry will have to either increase efficiency or shrink further[1]. The situation of the important South African automotive industry, representing 6.4 per cent of GDP and the employment of 32 000 workers in 2004, although not as dire as that of the textile industry, also provides cause for concern. Compared with other developing countries, the sector displays low productivity and high labour costs, which to date have been partially offset by the low costs of electricity and raw materials and, decisively, by a system

1. See *Submission to the Portfolio Committee on Trade and Industry - Clothing, Textile & Footwear Sector,* http://www.dti.gov.za/clothing/submission.pdf

of export subsidies and import tariffs afforded by the Motor Industry Development Programme. Export subsidies do not, however, appear to be compatible with World Trade Organisation (WTO) rules and may have to be scaled back, if not completely phased out, intensifying the challenges that the industry is facing.

The construction sector, constituting 2 per cent of GDP, expanded at a brisk 9.6 per cent rate in the first three-quarters of 2005 thanks to a buoyant property market driven by low interest rates, rising household disposable income and rising public expenditure on infrastructure.

Tertiary activities, representing 66.1 per cent of GDP, were those that most benefited from vigorous domestic demand in 2005 with 5.3 per cent growth in the first three-quarters of the year. The financial industry led the way, growing at a rate of 8.4 per cent, largely thanks to the expansion of real-estate finance and retail banking supported by the Mzansi bank-accounts initiative, aimed at enlarging the access of the poorest to banking services. Real estate, civil engineering (associated to major infrastructure projects), telecommunications (the cell-phone industry in particular), distribution and transport also expanded strongly. As well, the South African tourism sector withstood the strength of the rand in 2005, with a 10 per cent increase in foreign tourists in the first nine months of 2005 following the record 6.7 million tourists in 2004. The World Cup in 2010 will provide a further impetus to tourism.

Output growth has been primarily driven by domestic demand, which increased by 6.5 per cent in 2005. Private consumption recorded a strong increase of 6 per cent, while government consumption posted an increase in real growth of 7.8 per cent. Several factors have contributed to the rapid pace of private-consumption growth during the last two years. First, the real income of households has been increasing, especially for the less well-off, who have benefited from rising wages, employment and transfer payments. Nominal remuneration per worker rose by 12.7 per cent year-on-year in the fourth quarter of 2004, while inflation remained around 4 per cent. The March 2005 Labour Force Survey indicates a 6.5 per cent increase in formal employment between September 2001 and March 2005 and a corresponding decline in the official unemployment rate, from 29.4 per cent to 26.5 per cent in the same period. Second, increased consumer borrowing, driven by low interest rates and expanded collateral based on rising housing prices, has also increased demand, especially among the emerging black middle class. As a result, household debt rose sharply to 62 per cent of household disposable income in the second quarter of 2005. Despite this increase, debt service remains manageable at 6.5 per cent of disposable income. Third, the most well-off have also experienced a wealth effect on consumption, induced by the strong performance of the Johannesburg Stock Exchange, which gained 35 per cent between April and September 2005.

This favourable context improved business prospects and spurred private investment, with the First National

Table 1 - **Demand Composition** (percentage of GDP)

	1997	2002	2003	2004	2005(e)	2006(p)	2007(p)
Gross capital formation	**16.7**	**16.1**	**16.6**	**17.9**	**18.6**	**18.4**	**18.6**
Public	4.8	4.1	4.3	4.7	4.7	5.2	5.4
Private	11.9	12.0	12.2	13.2	13.7	13.2	13.3
Consumption	**82.2**	**80.2**	**81.5**	**82.8**	**80.7**	**81.2**	**80.6**
Public	19.2	18.4	19.1	19.9	20.8	21.3	21.7
Private	62.9	61.8	62.3	63.0	59.9	59.9	58.9
External sector	**1.2**	**3.7**	**1.9**	**0.7**	**0.6**	**0.4**	**0.7**
Exports	24.6	32.7	27.9	26.6	26.6	24.5	25.3
Imports	23.4	29.1	26.0	27.3	26.0	24.1	24.6

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

Bank and Bureau for Economic Research (FNB/BER) Consumer Confidence Index revealing business and consumer confidence to be surging in 2005. Public investment also rose sharply in 2005, by 8 per cent in real terms, contributing to a total fixed investment growth of 6.5 per cent. Export volume stagnated, however, with only 0.3 per cent growth, while import volume, boosted by domestic demand, grew by 6 per cent.

In 2006, GDP growth should remain vibrant at about 4.8 per cent. Private consumption should decelerate to 3.4 per cent growth due to a slower rise in labour compensation and housing prices. It is investment that is forecasted to take over as the main driver of growth at 7.6 per cent, boosted by the ambitious ASGI investment plans in energy, transport[2] and industrial development zones (IDZs). These public-investment projects might in turn catalyse increased private investment. For example, the Coega IDZ is designed to host the Coega Smelter Project, which is expected to produce up to 660 000 tonnes of aluminium annually after a $2.2 to $2.5 billion investment. This project is the subject of negotiations between the South African authorities and the international aluminium group Alcan. A decision is expected in 2006. The Coega IDZ is intended to be a focal point for other foreign investment as well.

Macroeconomic Policies

Fiscal Policy

Unexpectedly strong growth in 2005 is expected to bring down the 2005/06 fiscal deficit to 0.5 per cent of GDP instead of the 3.5 per cent of GDP anticipated in the February 2005 budget. In 2004, the budget deficit of 1.5 per cent of GDP also came under the targeted 3.1 per cent. The decline in the projected 2005 deficit was essentially due to unexpected revenues of ZAR41 billion (South African rands) and debt-service costs that were ZAR1.9 billion less than anticipated, while expenditures were only ZAR1.2 billion higher than budgeted.

The higher-than-expected revenues originated in value-added taxes (ZAR9 billion), corporate income taxes (ZAR16.2 billion), personal income taxes (ZAR8.8 billion), taxes on property transactions (ZAR1.2 billion) and import taxes (ZAR5.8 billion). Although much of this bonanza is attributable to the unexpectedly vigorous economic activity, it also resulted from enhanced efficiency in tax collection by the South Africa Revenue Service (SARS) and a broadening of the tax base. Tax revenues rose from 24.5 per cent of GDP in 2000/01 to 26.1 per cent of GDP in 2005/06. The improving fiscal situation made room for income-tax relief for both individuals and companies. In 2006, greater exemptions for medical contributions and employer-provided health services will provide additional relief to lower-income taxpayers. The 2006/07 budget should also provide substantial relief for taxpayers through inflation adjustments to tax brackets.

The government's sustained fiscal discipline is manifested in a total gross debt of only 35 per cent of GDP in 2005. Moreover, 86 per cent of the total stock of public debt is rand-denominated, thus largely shielding the budget from currency risk. The country's sound fiscal policies have been recognised in the form of better credit ratings. South Africa's rating was upgraded in January by Moody's from Baa2 to Baa1, and in August by both S&P and Fitch from BBB to BBB+, putting it in the same range as countries such as Poland, Thailand, Mexico and Chile. South African bond spreads have declined correspondingly.

The government's sound fiscal position provides room for the greater spending embodied in the ASGI, as well as the previously mentioned tax cuts. The budget released in February 2006 sets out the South African fiscal strategy for 2006/07 and revises the Medium Term Expenditure Framework (MTEF) through 2008/09. Based on assumptions of a continued annual average GDP growth of 5 per cent and associated revenue growth, the MTEF allows for a substantial increase of expenditures of ZAR160 billion between 2005 and 2008. Non-interest expenditure is set to

2. Eskom and Transnet are planning to spend ZAR134 billion in the next five to seven years, 26.1 billion of which in 2006.

grow approximately 7 per cent a year, increasing as a share of GDP from 22.8 per cent in 2004 to 24.8 per cent in 2007. Between 2005 and 2008, expenditures on social services – including education, health, welfare, housing and community development – are expected to increase by 36 per cent to ZAR305 billion while expenditures on transport and telecommunications are expected to double during the same period to ZAR30 billion.

At the same time, the government is maintaining a prudent fiscal stance. Expenditures on education, health and social security services as a share of GDP will remain kept in check through 2008/09. Although capital expenditure, notably for infrastructure, is a high priority for the government and is slated to grow faster than current expenditure, the share of capital expenditure in total expenditure will remain low, increasing from 4.1 per cent in 2004/05 to only 4.8 per cent in 2008/09. Most significantly, public deficits are expected to average only 2.1 per cent of GDP in the next three years.

The implementation of ambitious spending plans remains constrained by the limited administrative capacity of the government, especially at the provincial and municipal levels. Nevertheless, more resources will be channelled through regional and municipal governments, requiring efforts to upgrade their capacities. The government plans two major efforts to address this problem. First, it is to expand the Project Consolidate initiative, in which teams of financial experts as well as project-management and -planning specialists provide training to local officials. This programme will be extended to 136 municipalities in the next three years. Second, municipalities will receive ZAR1.1 billion in capacity-building and restructuring grants during the same period.

Monetary Policy

The South African Reserve Bank (SARB) maintains a policy of inflation targeting (IT) aimed at keeping inflation, as measured by the CPIX[3], in a range of 3 to 6 per cent. Monetary authorities have no official exchange-rate target, but they nevertheless take into consideration potential pass-through effects of currency depreciation on domestic prices. During 2005, the SARB reduced interest rates once, in April, from 7.5 per cent to 7 per cent, but otherwise kept them steady.

Inflation has remained in the SARB's inflation target range since September 2003 and stood at 3.9 per cent in 2005. The strong rand largely offset the effects of rising world oil-price increases on the overall price level, and the CPIX, excluding petrol and diesel, showed little change in 2005. Unit labour costs increased at a 4.2 per cent annual rate in the first half of 2005

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

	1997/98	2002/03	2003/04	2004/05	2005/06(e)	2006/07(p)	2007/08(p)
Total revenue and grants[b]	**23.4**	**24.0**	**23.5**	**24.8**	**26.5**	**25.9**	**25.8**
Tax revenue	22.9	23.6	22.9	24.3	26.1	25.5	25.4
Total expenditure and net lending[b]	**26.4**	**25.1**	**25.7**	**26.3**	**27.0**	**27.8**	**27.8**
Current expenditure	25.8	24.5	26.0	26.3	26.3	26.9	27.3
Excluding interest	*20.2*	*20.6*	*22.4*	*22.8*	*23.2*	*23.9*	*24.5*
Wages and salaries	10.5	9.3	9.5	9.2	9.4	9.8	9.9
Interest	5.5	4.0	3.6	3.5	3.2	3.0	2.8
Capital expenditure	1.1	1.1	1.2	1.1	1.2	1.3	1.3
Primary balance	**2.5**	**2.9**	**1.4**	**2.0**	**2.7**	**1.1**	**0.8**
Overall balance	**3.1**	**1.1**	**2.3**	**1.5**	**0.5**	**1.9**	**2.0**

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

3. Consumer price index, excluding mortgage-interest costs for metropolitan and other urban areas.

compared to 7.2 per cent in 2004. Apparently, the credibility of the SARB's anti-inflationary monetary policy and the strong rand have held down inflationary expectations. According to the Bureau of Economic Research survey, the expected rate of CPIX inflation is 5.2 per cent in 2006 and 5.4 per cent in 2007, well within the SARB's target range. Furthermore, capacity utilisation in the manufacturing sector is unchanged from 2004 at a moderate 83.9 per cent, providing little indication of inflationary pressure.

The rand remained largely stable despite a widening current-account deficit. The currency has been supported by high commodity prices, upgraded credit ratings and capital inflows, which more than cover the current-account deficit, with resulting increases in international reserves. While local manufacturers continue to decry the strength of the rand, the real effective exchange rate has returned to the average 1996-2000 level.

In short, fiscal policy remains prudent despite expenditure increases, and inflation is under control thanks to credibly but not unduly restrictive monetary policy.

External Position

Along with higher world oil prices, strong domestic demand – both consumption and investment – brought about a 10 per cent increase in the value of imports (in rands) during the first three-quarters of 2005. Exports grew at an estimated 2.5 per cent in value, mainly thanks to the previously mentioned strength of demand for South Africa's natural-resource-based products, notably platinum and diamonds. Gold exports, second to platinum as a source of export revenues, dropped by 17.2 per cent, however. Despite a strong rand, manufacturing exports have fared well, growing at a rate of 17.6 per cent. The two main manufacturing products exported by South Africa, steel and motor vehicles, recorded 19.2 per cent and 11 per cent growth, respectively.

The trade deficits in both the oil and non-oil merchandise rose to about 1.7 per cent of GDP in 2005. At the same time, the service and investment income balance is estimated to have posted a deficit of about 2.5 per cent of GDP. As a result, the current-account deficit is estimated to have reached 4.2 per cent of GDP in 2005.

In December 2004, South Africa concluded a preferential trade agreement with the Mercado Común del Sur (Mercosur). Negotiations to reach a similar arrangement with India started in the second half of 2005. The government is also committed to negotiate a trade arrangement with China, but this may be some time in coming.

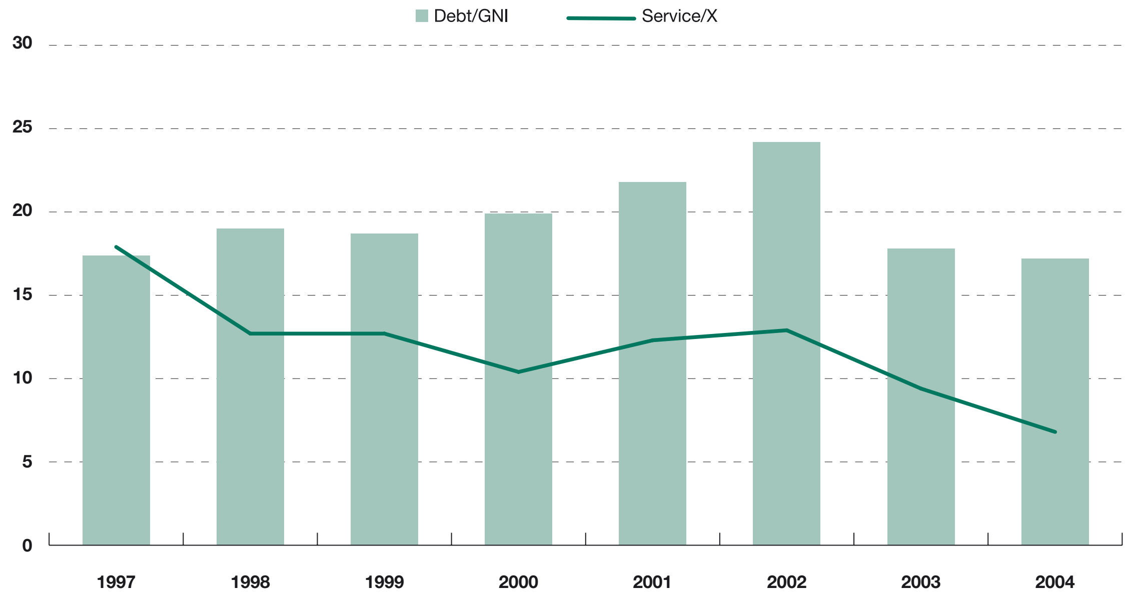
Though flows of foreign direct investment (FDI) remain small by the standards of emerging markets, inflows were unusually large in 2005, at an estimated 2.8 per cent of GDP. The surge in 1995 was due in part to several major transactions, including Vodaphone's bid for more Vodacom assets in the telecommunications sector and the Barclays-Absa deal in the banking sector. Substantial additional inward FDI is on the way. Tata Steel and Mita Steel have embarked on negotiations with Anglo American to acquire a 79 per cent stake in

Table 3 - **Current Account** (percentage of GDP)

	1997	2002	2003	2004	2005(e)	2006(p)	2007(p)
Trade balance	1.6	4.3	2.1	0.1	1.7	2.1	2.0
Exports of goods (f.o.b.)	21.0	28.5	23.2	22.4	19.8	18.0	18.4
Imports of goods (f.o.b.)	-19.4	-24.2	-21.1	-22.5	-21.5	-20.0	-20.4
Services	0.4	0.6	0.3	0.5			
Factor income	2.2	2.5	2.8	2.0			
Current transfers	0.5	0.5	0.5	0.7			
Current account balance	**1.5**	**0.7**	**1.4**	**3.3**			

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

Figure 4 - **Stock of Total External Debt** (percentage of GNI) **and Debt Service** (percentage of exports of goods and services)



Source: IMF and World Bank.

Highveld Steel & Vanadium Corp Ltd., the second largest steelmaker in South Africa. Additional FDI may be forthcoming in: telecommunications, where the French cellular operator Orange may be interested in acquiring the local operator MTN; retail, where Wal-Mart has shown interest; and in the tourism industry. From a balance-of-payments viewpoint, however, these expected FDI inflows are likely to be partly offset by growing outflows, to some extent to other African countries.

Despite the surge in FDI in 2005, the main source of current-account financing in 2005 has remained foreign portfolio investments, spurred by growing confidence in South Africa and its currency, as noted above.

With a current-account deficit more than financed by capital inflows, the SARB's international liquidity position increased by $7 billion between January 2005 and January 2006. As a result, reserve coverage of imports rose from 7 weeks at the end of 2003 to 15 weeks in June 2005, while the ratio of net foreign exchange reserves to gross external short-term debt stood at 120 per cent in September 2005 up from 51 per cent in December 2003. Furthermore, South Africa's foreign debt was just 20.2 per cent of GDP at the end of 2005, 38.5 per cent of which was rand-denominated, while interest payments were limited to 3.6 per cent of export revenues. Capitalising on the country's strengthened external position, the government is planning further liberalisation of capital controls. In particular, limits on holdings of foreign assets by South African banks will be raised in 2006.

Structural Issues

Recent Developments

Restructuring of state-owned enterprises in the telecommunications, energy and transport sectors continued to receive significant attention from the government in 2005. Although the year saw some success in increasing competitiveness in the telecommunications sector, restructuring is still proving difficult in the others. In addition, although the business environment is largely satisfactory, efforts to lower the cost of doing business in South Africa and to make growth more job-intensive are critically in order.

The recent economic boom has led to increased energy demand, with growing pressure on the power grid. Although such energy shortages were not expected until 2010 and Eskom, the power utility, remains confident that it can meet increased demand and finance its capital expenditure programme, the government has had to revise its investment timetable. Real signs of stress are evident in some provinces. Cape Town, for example, experienced three blackouts in the autumn of 2005. Despite Eskom's claims that sufficient capacity is in place to avoid future blackouts, there is concern that the Western Cape province may face rolling blackouts until new power lines connecting the coal-fired power stations in Mpumalanga and Koeberg are completed in 2007.

Eskom was given the green light in 2004 to invest about ZAR92.9 billion in new power stations, transmission and distribution. To that end, five consortia have qualified to bid for the exclusive rights to build, own and operate two new power stations needed to meet South Africa's growing energy demands. These new plants in the Eastern Cape and KwaZulu-Natal should be fully operational by the end of 2008. The introduction of independent power producers will bring competition to Eskom, which currently produces 95 per cent of South Africa's electricity, and further reduce the cost of electricity, already among the cheapest in the world.

There has been some progress in bringing competition to the telecommunications market. In December 2005, after a three-year delay, the Independent Communications Authority of South Africa licensed a second national operator to operate a fixed-line telephone network in the public domain, providing some competition to Telkom starting in the second half of 2006. The six-group coalition included the black-empowerment group Nexus Connexion and the Indian group Tata. As in many African countries, the greatest growth has been in mobile telecommunications. There are over 18 million cell-phone subscribers compared with only 4.8 million fixed-line subscribers. In addition, as in other emerging markets, international mobile-phone companies are showing increased interest in investing in South Africa. The announcement in late 2005 of a joint venture between South Africa's Cell C and Branson's Virgin Mobile followed Vodafone's announcement that it planned to increase its stake in South Africa's Vodacom to 50 per cent, equalising its stake with Telkom's. Despite increased competition in telephony, Telkom retains substantial control over Internet access, and Internet-service providers continue to complain about Telkom's dominance and anti-competitive practices.

During 2005, the South African banking system remained sound and banks benefited from South Africa's strong growth. The average capital-adequacy ratio slightly receded from 13.2 per cent in December 2004 to 12.5 per cent in October 2005 but remains well over the minimum capital-adequacy ratio of 10 per cent; only one bank fell below the required threshold in 2004. In addition, overdue payments were less than 2 per cent of total loans and advances in October 2005. All the same, the South African banking sector suffers from low competition. The sector is dominated by the "big four" banks, which in December 2004 constituted 83.7 per cent of the banking-sector assets. It remains to be seen whether the Barclays-Absa deal will help alleviate this problem.

Business confidence is high in South Africa thanks to the efficient financial market and a largely friendly business environment. Nevertheless, problems remain. The South African Chamber of Business (SACOB) points to deficiencies in public services as impediments to business. Other pressing challenges include labour-force skills and education, labour-market regulation, exchange-rate instability and crime (South Africa Investment Climate Assessment, 2005). The lack of competition in industries producing intermediate goods such as steel and chemicals also produces inefficiencies and additional costs for downstream activities and consumers.

Many consider inflexible labour-market regulations to be a major obstacle to private investment, especially in labour-intensive activities. Indeed, South African firms have about twice as much capital per worker as firms in Lithuania, Brazil and in the most productive areas of China. Growth has consequently failed to be as labour-absorbing as in other emerging economies. Business organisations attribute the economy's low labour intensity to high labour costs and labour-market regulations, which inhibit employment. For instance, many claim that wage setting is too centralised, especially because bargaining council agreements are extended to non-unionised small firms. The evidence, however, is contested by unions and their supporters, who claim that labour-market regulations are not enforced strictly.

Regardless of the controversies concerning labour-market rigidities, there is a broad consensus that skill shortages, inequality in access to education for black South Africans and immobility of the working-force population, all legacies of the apartheid regime, are barriers to well-functioning labour markets. Shortage of skilled labour is a particularly important barrier to business development. Engineers, scientists and artisans are so scarce that many companies want to import people with these skills from abroad, which would require an amendment to the Immigration Act. Given the unemployment rate, such proposals are controversial. The government is also considering revision of the Employment Equity Act to remove obstacles to employing skilled white South Africans, notably engineers.

Several initiatives aim to improve the skill level of the working population. For example, the 2003 Skills Development Act and Learnership programmes use financial contributions from private companies to invest in training the South African workforce. These programmes have had limited success so far, not least because most skills-development programmes are targeted at the employed. The 23 Sector Education and Training Authorities (SETAs), responsible for designing sector-specific skill-development strategies and promoting learnerships, have also had uneven results.

The affirmative-action Black Economic Empowerment (BEE) programme also continues to provoke debate in South Africa. There are some encouraging signs that a black middle class is emerging, but broadening the breadth of empowerment remains crucial. More sectors are writing charters that provide a framework and scorecard for empowering historically disadvantaged individuals and communities. The Service Charter, which is particularly relevant to small and medium enterprises, should be published in 2006. The government is also currently proposing "codes of good practice in empowerment", to which all charters should conform. Some complain, however, that these codes would lead to too much central decision making in areas that would be better left for sector-by-sector level negotiations.

Transport Infrastructure

The provision of adequate transport infrastructure is one of the key elements of South Africa's strategy for growth. While South African transport is in stellar condition compared to other African countries, the quality of the various components of the system is uneven and higher growth of output and trade require new investments. Organisation and financing for roads is superior to that of the other transport systems. The railways and ports, in particular, function poorly and constitute obstacles to increased growth. Moreover, demand is increasing and the growth of freight traffic has surpassed most of the 20-year growth forecasts made by the Moving South Africa (MSA) strategy in 1999. Rapid urban development and migration to the cities, as well as the forthcoming soccer World Cup in 2010, provide additional pressure to strengthen urban transport infrastructure.

The Department of Transport (DOT) oversees overall co-ordination of transport policy, with particular responsibility for roads, aviation, and passenger and commuter rail, while the Department of Public Enterprise (DPE) is responsible for rail and ports, i.e. the parastatal Transnet and her subsidiaries Spoornet, South African Ports Operations (SAPO) and the National Ports Authority (NPA). Transport policy is built on the framework set out by the 1999 MSA strategy and the 2000 National Land Transport Transition Act. A National Roads Plan is currently being developed.

Going forward, the government is working to ensure that different parts of the transport system work together effectively. To date, this goal has been undermined by the fact that the DOT and DPE have overlapping functions and powers, with resulting waste, confusion and turf battles. Addressing this problem of overlapping responsibilities is a large part of the newly approved 2005 National Freight Logistics Strategy. The strategy also seeks to open the ports and railroads to competition, as is already the case in the road and airfreight sectors.

Investment in the road network since 2001 has resulted in a doubling of the surfaced national toll and non-toll roads, with a further doubling targeted by 2010. There are 56 000 km of surfaced provincial roads, 301 000 km of unpaved (gravel) road network, 168 000 km of surfaced and unpaved urban roads, and 221 000 km of unpaved rural roads including access roads. The road system is the only part of the national transport system that receives regular investment, although even there, investment levels are well below the levels necessary to maintain all roads in good condition. Roads receive a fiscal allocation of 900 million rands per annum and 5.2 billion rands of private-sector funding through toll-road concessions.

In 2003, 74 per cent of domestic freight was carried by road and 26 per cent by rail. In the last decade, freight levels on roads have grown at an annual rate of 4 per cent, while rail freight traffic has shown a slight decline.

South Africa is expected to experience the highest growth in airfreight of any country in the world during the next decade. Johannesburg International Airport is a rapidly growing cargo hub that is likely to experience capacity constraints in the near future. There are two other international airports, in Cape Town and Durban, and seven regional airports.

The railways and ports are controlled by the state monopoly Transnet. They are the weakest links in the South African transport system. Spoornet, a Transnet subsidiary, has a near monopoly on commercial cargo transport by rail. South Africa is home to 26.6 per cent of the African continent's rail network with 22 300 km of rail. There are rail lines reserved for iron ore and coal, which account for most of the profits generated by Spoornet.

Rail infrastructure suffers from 15 years of deferred investment: 45 per cent of trains are late and 25 per cent do not show up; freight loads per wagon are at only half the international best-practice level; and the average age of locomotives is 25 years, compared with the international average of 16 years. Derailments have also been too frequent, with two just in October 2005. As a result of these efficiency problems, customers who use rail do so only for goods that are least time-sensitive, limiting Spoornet's ability to increase container traffic.

Ports are also owned by the state monopoly Transnet, though there are a few concessions run by private operators. Despite an increase in investment in the past few years, the ports are under growing pressure from rising demand. Container volume handled in South Africa's seven commercial ports has grown at a 7.25 per cent annual rate since 2000. In addition, the ports remain extremely inefficient by international standards. They move 17 container units per hour versus a best-practice standard of 35. One particular problem is the inefficient interface between railcars and ships, which causes regular, severe congestion problems. The lack of competition in port operations is an underlying source of these inefficiencies. Even compared with some other African countries, South African ports perform poorly. For example, the port of Dar es Salaam (Tanzania) averages 21 container moves per hour, the ports of Namibia 18 and those of Brazil 42.

Given that Transnet controls the port and rail systems, its restructuring strategy is crucial to improving the inefficient port and rail systems in South Africa. The restructuring strategy calls for Transnet to transform itself into a freight transport company. Transnet will narrow its focus on ports, rail and pipeline businesses, which are currently operated by its subsidiaries Spoornet, SAPO, the NPA and Petronet. Transnet will divest itself of other business, including passenger rail service, tourism and baggage handling, which have generally shown poor performance and required cross-subsidisation, using Spoornet and SAPO profits. In particular, South African Airways will be split off from Transnet and will report directly to the government as of the spring of 2006. These reforms are to be accompanied by ZAR40 billion in investment in freight infrastructure, which is essential to upgrade the system and satisfy the rising demands.

Substantial barriers to restructuring Transnet remain, however. First, despite the government's efforts to broker an agreement between the unions and Transnet through the Transnet Restructuring Committee (TRC), the unions are calling for strikes, claiming that Transnet breached the "letter and spirit" of the constitution of the TRC. Union leaders are particularly worried about the 25 000 jobs they claim will be lost. Second, the extensive cross-subsidisation between Transnet's various subsidiaries makes it difficult to identify which business units are performing well and should receive additional investment and which are performing poorly and should be eliminated.

Urban transport infrastructure is under increasing stress as well, as traffic volumes grow in cities such as Gauteng and Durban, impeding the flow of both persons and merchandise. Due in part to the rising public anger of commuters, the DOT has made it a high priority to improve commuter rail-service delivery. The DOT reform programme emphasises the institution of public-private partnerships that will secure increased public investment. One such example is the construction of the high-speed Gautrain rail line between Pretoria and Johannesburg. The 80-km connection is made up of two links, one from Pretoria and Johannesburg and another between Johannesburg International Airport and Sandton. The latter link is highly controversial because of its 750 million euros cost, the high level of subsidies guaranteed by the authorities to the private operator, its limited integration with the pre-existing rail system and the expected modest daily number of passengers of only 600. Nonetheless, at its last meeting in 2005, the South African Cabinet reiterated its support for the Gautrain Project. If finally endorsed by the government, it is expected to be ready when South Africa hosts the World Cup in 2010.

There is broad agreement that the transport infrastructure in South Africa needs substantial upgrading, and the government is committed to addressing this problem. It has increased the financial resources for transport to approximately ZAR14.3 billion over four years, starting in 2006. Transnet's investments of ZAR40.8 billion and state funding for future private-public partnership agreements of ZAR18.2 billion are expected to add to this total.

Political and Social Context

After an overwhelming victory in the 2004 general elections, the honeymoon period for the African National Congress (ANC) came to an abrupt end in 2005, when the popular Vice-President, Jakob Zuma, was charged with being in a "generally corrupt relationship" with his financial adviser. As a result of these revelations, President Mbeki dismissed Zuma from his position, a move that was unpopular with many members of the ANC. After his dismissal, Zuma was charged with rape in a separate case, which helped to temper the unhappiness over Mbeki's decision. Nonetheless, the "Zuma affair" has made 2005 the most difficult year for the ANC since it came to power in 1994.

In particular, the Zuma affair has brought to the fore the question of who will lead the ANC after President Mbeki's tenure ends in 2009. While Zuma had previously been seen as one of the strongest candidates for this position, the rape and corruption charges have severely weakened his standing. The result is a wide-open selection process that will sorely test ANC unity and thereby potentially threaten its continued dominance of South African politics.

On the other hand, the Zuma affair has enhanced the democratic credibility of South Africa by highlighting the independence of the judiciary branch and demonstrating that even high-profile public officials are not above the law. According to Transparency International, the government's response is a signal of South Africa's maturing democracy and sets an important precedent for the advancement of good governance.

The government is acutely aware that there is growing impatience among many South Africans, especially among the poor majority, regarding the lack of improvement in living standards despite the economic growth of the past decade. President Mbeki is well aware of the importance of improving social services and infrastructure, and he has made this a priority for the rest of his term of office. Nevertheless, protests about poor service delivery, housing and unemployment have been increasing, and observers suggest that some of this frustration may affect the outcomes of the local-government elections planned for March 2006. Some members of civil society are already threatening to boycott the elections.

While the government has made progress in targeting aid to the poorest and most vulnerable, notably through the social-grants scheme described below, poverty has not diminished much since the democratic transition. Indeed, a debate is currently under way on the definition of poverty in South Africa. In 2000, according to the international poverty standards of $1 per day or $2 per day (the equivalent at that time of ZAR87 per month or ZAR174 per month), 11.3 per cent or 34.4 per cent of the population lived in poverty, respectively (South Africa United Nations MDG Report 2005). When the national poverty line of ZAR354 per month per adult is used, however, 57 per cent of the population lived in poverty in 2001. In any case, South Africa remains a very unequal society with a Gini coefficient of 0.59, although the latter drops to 0.35 when transfers are included, as explained below.

One of the government's main tools for addressing extreme poverty is cash transfers, the so-called "social grants". Expenditures on these grants increased 3.7-fold between 1994 and 2004 to ZAR37.1 billion as the number of beneficiaries grew from 2.6 million in 1994 to 7.9 million in 2004. In addition to the social-grants programme, the Expanded Public Works Programme (EPWP), the Agricultural Starter Pack Programme to provide food production start-up support and the Comprehensive Agricultural Support Programme providing post-settlement support to beneficiaries of the Land Reform processes also aim to alleviate poverty.

There is some controversy about the adequacy of the government's anti-poverty programmes. For example, the People's Budget Campaign, a coalition of civil-society organisations, is calling for the introduction of a universal Basic Income Grant of ZAR100 per person per month, indexed to inflation, and a National Health Insurance system. The government will surely resist these proposals, however, given the concerns about the cost of the present social-grants programme and its objective of preserving incentives to work. Overall, it appears that the current system of social grants works well, as demonstrated by the increase in expenditure on basic commodities such as food and fuel, as well as by school attendance in households receiving grants. The South African Social Security Agency, which began operating in April 2005, should increase the impact of social grants further by improving delivery and reducing fraud, which leads to an estimated ZAR1.5 billion in losses per year.

Official unemployment remains very high at 26 per cent but the rate rises to 41 per cent when a broad definition is used. Approximately 2.5 million people are employed in the informal sector (Labour Force Survey, 2005:12). The high level of unemployment is the main source of continued poverty and inequality. In what is clearly a lasting legacy of apartheid, poor households tend to be disconnected from the labour market. In particular, the lack of skills among the poor, due largely to the neglect of education for blacks during apartheid, make them difficult to employ. Only 9 per cent of working-age individuals in the bottom-income decile are employed, compared to 68 per cent in the top decile (United Nations Development Programme [UNDP], Development Bank of Southern Africa [DBSA], Human Sciences research Council of South Africa [HSRC] Development Report, 2005:6).

The EPWP, launched in 2004, seeks to provide public employment for the unskilled, particularly in government infrastructure projects. The EPWP has a target of creating jobs for one million people, with ZAR15 billion of the infrastructure funds allocated to provinces and municipalities earmarked for the EPWP. Unfortunately, the public's high expectations from the programme may be difficult to fulfil, as most of the jobs will be temporary and no more than 200 000 people are likely to be employed at any given time (DBSA Development Report, 2005).

Although more than 95 per cent of both boys and girls between the ages of 7 and 13 are reported to be attending school, school conditions are unfavourable in poorer areas. Some civil-society organisations decry the low level of expenditure in poorer provinces and the resulting inadequate education facilities. Currently, there is a shortage of about 57 000 classrooms (People's Budget: 28). In addition, although public education is funded primarily by taxes, most cash-strapped schools will continue to charge fees as long as there is no clear policy prohibiting the practice (People's Budget: 30). The Department of Education Costs Review found that most schools charge fees of up to ZAR100 a year, a substantial sum for people living in extreme poverty.

Access to water and electricity has been improving steadily since 2000 although there is still some backlog. The proportion of households with access to clean water increased to 85.5 per cent in 2003 from 60 per cent in 1995 and access to sanitation increased to 63 per cent in 2003 from 49 per cent in 1994. Nevertheless, many argue that the current allocation of 6 000 litres of water per household per month is inadequate, as it falls short of the World Health Organisation (WHO) recommendation of 100 litres per person per day. The share of people living in Reconstruction and Development Programme housing rose to 26 per cent in September 2003, but there is also continued backlog in housing.

Both the government and its critics agree that the pace of land redistribution remains too slow. Falling far short of a target of 30 per cent redistribution by 2014, only 3 per cent of land has been redistributed. There was general consensus at the National Land Summit held in July 2005 that relying on voluntary land sales is inadequate and that expropriation should be considered. The government, however, remains reluctant to follow this path for obvious reasons.

About 5 million South Africans are infected with HIV, the largest number in the world in one country. A recent report by the HSRC suggests that the rate of HIV infection may be flattening, with 21.5 per cent of 15- to 49-year-olds being HIV positive at the end of 2003 (UNAIDS 2004 Report on the global AIDS epidemic). The government's approach to HIV/AIDS prevention and treatment is improving, despite the Minister of Health's continued misleading statements about the disease. The 2005 budget allocated ZAR6.6 billion for the national integrated response to cover the health, education and other social-development sectors. Nevertheless, the fact that 77 per cent of the total HIV and AIDS budget are allocated to the provinces as conditional grants is cause for concern, given the provincial authorities' weak implementation capacity. Consequently, the Health Department will have to strengthen its monitoring, evaluation and support mechanisms.

Once again, a scarcity of workers with the proper skills is the largest barrier to a comprehensive treatment of AIDS. By 2009, South Africa will need approximately an additional 3 200 doctors, 2 400 nurses, 765 social workers, 765 dieticians, 112 pharmacists and 2 000 data recorders to fully implement treatment with antiretroviral (ARV) drugs. Migration of health workers to better-paying countries contributes to this shortage. Partly as a result of this latter, ARV therapy reached only 28 786 of the targeted 53 000 in 2004, but increased to an estimated 50 000 individuals in 2005 (South Africa MDG Report). Even with increased access to ARV drugs, however, mortality rates from AIDS are not expected to peak in South Africa until about 2010 (HSRC HIV and AIDS survey).

There are encouraging signs that South Africans are more aware of HIV/AIDS as well as the availability of ARV drugs. Unfortunately, public awareness on prevention is lagging and the public displays a false sense of security regarding their risk of infection. According to a survey by HSRC, half of the people diagnosed as HIV-positive did not think they were at risk of HIV infection. Awareness campaigns must address these misperceptions actively.