2

Economic policy and outlook

South African economic conditions are buoyant, and the outlook for robust growth to 2009 remains positive. The economy has strengthened steadily since 1999, with non-agricultural GDP growing by 5 per cent a year since the first quarter of 2004. Growth in income per capita has increased from 1,4 per cent in 2003 to 3,5 per cent in 2005.

Low interest rates, strong investment and rising house, asset and commodity prices contributed to rapid growth in most sectors. This has provided additional employment to more than 1 million South Africans over the past three years, broadening access to work and skills opportunities, reducing poverty and steadily drawing previously excluded people into the mainstream economy.

Growth is expected to strengthen over the medium term as large-scale public and private infrastructure and investment spending intensifies, and as structural transformation accelerates. Construction and refurbishment of stadiums in preparation for the 2010 FIFA World Cup, the Gautrain and a series of local transport, commercial and residential projects will generate wide-ranging economic spin-offs and opportunities. Investment in freight, roads and public transport will help to lower costs in the economy and expand capacity.

South Africa's growth path has been underpinned by prudent fiscal and monetary policies. Yet volatility in international financial markets and in capital flows remains a feature of the economic environment. In the period ahead, government's accelerated and shared growth initiative will contribute to removing constraints to more rapid, broad-based growth, while also addressing the challenges presented by the balance of payments position. Moderating oil prices, a competitive currency, productive infrastructure investment and a more export-oriented policy environment will support sustainable growth.

Introduction and overview

Economic growth is expected to rise to 5,3 per cent in 2009

Building on estimated growth of 4,4 per cent in 2006, the economy is expected to strengthen over the medium term, with growth rising to 5,3 per cent in 2009.[1] A pattern of higher tax revenues is evidence of vibrant conditions across a range of sectors, and suggests that growth may be stronger than reflected in the preliminary data.

[1] Unless otherwise indicated, growth rates presented in this chapter are year-on-year changes.

Over seven years investment in productive capacity totalled R1,4 trillion

The pace of the economic expansion has been strengthened by robust investment, which has grown at nearly 10 per cent annually over the past three years. According to the Reserve Bank, over the past seven years combined public and private-sector investment in productive capacity has totalled R1,4 trillion. By mid-2006, the ratio of fixed investment to GDP exceeded 18 per cent, up from 15 per cent in 2002.

Low interest rates and employment gains have broadened the consumer base and fed into strong growth in household spending, with consumption rising by well over 6 per cent in 2004, 2005 and in the first half of 2006. This is expected to remain strong, averaging 4,6 per cent over the three-year period. The long-term development of new housing and commercial buildings, and the renewal of existing stock, supports a broader economic expansion.

Evidence of a pick-up in manufacturing, while mining and agriculture should rebound next year

Growth has been strongest in the construction, financial services, and wholesale and retail trade sectors. In recent months the manufacturing sector has also picked up. Contractions in mining and agriculture, however, marred the overall picture for the first half of 2006. Performance in these sectors is volatile and is expected to rebound in the period ahead.

Rapid growth in response to domestic demand and nascent improvements in more export-oriented sectors will continue to shift the economy onto a more labour-absorbing growth path. The Labour Force Survey indicates an increase in total employment from about 11,2 million jobs in September 2001 to 12,4 million jobs in March 2006.

The current account deficit widened during the first half of 2006

More rapid economic growth and rising prices for oil and certain agricultural products have resulted in a surge in the value of imports. Until recently, growth in export volumes has been disappointing, even as export prices have increased. As a result, the current account deficit widened from 4,5 per cent in the second half of 2005 to above 6 per cent in the first half of 2006.

Somewhat slower household spending, declining oil prices, a rise in government savings and a more competitive currency are expected to moderate the current account deficit over the short and medium term. A more export-oriented approach to the manufacturing and other downstream sectors of the economy will help to boost exports in a more sustained way over the next several years.

South Africa's foreign exchange reserves continue to grow

A relatively benign global climate since 2003 has been marked by strong capital flows to the developing world, including South Africa, and this trend enabled the Reserve Bank to raise the level of reserves to US$24,7 billion by September 2006. Nevertheless, a pattern of rising interest rates in major world economies has resulted in some selling of rand assets and a consequent depreciation of the currency against the US dollar and euro.

Average CPIX inflation to remain within target band over medium term

Producer prices have increased sharply due to a spike in food and transport prices. While monthly variations may test the limits of the target band, annual average CPIX inflation is projected to remain within the 3-6 per cent range over the medium term. The recent decline in oil prices will reduce petrol and transport prices in coming months. Moderate interest rate increases announced by the Reserve Bank during the course of 2006 will help to contain inflationary pressures.

Economic policy takes into account short-term risks

Economic policy takes into account the short-term risks associated with the current account deficit, inflationary pressures and the volatility of capital flows. Bearing these in mind government will, over the medium term, focus on supporting sustainable levels of growth, opening channels to more rapid economic expansion by fostering an environment that encourages investment and employment, and reducing poverty and inequality. Continued investment in public infrastructure, driven by major capital expenditure programmes at Eskom, Transnet and other public companies, and by the private sector, will help to propel growth over the medium term.

Global developments

World growth is expected to increase to 5,1 per cent in 2006

Strong growth in the world economy continues to reinforce South Africa's own growth path. A healthy decline in oil prices will support a rise in world growth of 5,1 per cent in 2006, up from the 4,9 per cent realised in 2005.

Developing countries are setting the pace of the global expansion, growing at 7,3 per cent in 2006 – more than twice the rate of industrialised countries – and accounting for more than two-thirds of global growth. Accompanying these strong growth rates, however, is a relatively volatile pattern of capital flows to the developing world.

Rising interest rates and a slower housing market moderate US growth

In the United States growth is expected to accelerate marginally, to an estimated 3,4 per cent in 2006 compared to 3,2 per cent in 2005, although serious risks of a slowdown have appeared in the housing market. Since 2004, US consumption and residential investment growth have cooled alongside rising short-term interest rates.

Japan's economic recovery is continuing, with growth rising to 2,6 per cent in 2005, and picking up to 2,7 per cent in 2006. Growth prospects in the euro-zone continue to improve, with expected growth of 2,4 per cent in 2006, up from 1,3 per cent in 2005. A stronger Japanese economy, and an upswing in Europe, will play an important role in balancing global economic growth.

Table 2.1 Trends and projections of global growth and inflation, selected countries, 2005 – 2007

Country/region	2005*	2006	2007	2005*	2006	2007
	Growth projections			CPI projections		
World	**4,9**	**5,1**	**4,9**	**3,7**	**3,8**	**3,7**
US	3,2	3,4	2,9	3,4	3,6	2,9
Euro zone	1,3	2,4	2,0	2,2	2,3	2,4
UK	1,9	2,7	2,7	2,0	2,3	2,4
Japan	2,6	2,7	2,1	-0,6	0,3	0,7
Emerging markets and developing countries	**7,4**	**7,3**	**7,2**	**5,3**	**5,2**	**5,0**
Developing Asia	**9,0**	**8,7**	**8,6**	**3,5**	**3,8**	**3,6**
China	10,2	10,0	10,0	1,8	1,5	2,2
India	8,5	8,3	7,3	4,0	5,6	5,3
Africa	**5,3**	**5,4**	**5,9**	**8,5**	**9,9**	**10,6**
Sub-Saharan Africa	**5,8**	**5,2**	**6,3**	**10,7**	**11,7**	**12,6**
South Africa**	4,9	4,4	4,4	3,9	4,6	5,5

Source: IMF, World Economic Outlook, September 2006

**Estimates*

***National Treasury Forecast*

China and India continue to set the pace of global growth

Chinese growth is expected to remain strong at about 10 per cent in 2006 and 2007, with renewed acceleration in investment and surging net exports. In India, growth is expected to remain robust at 8,3 per cent in 2006, down only slightly from 8,5 per cent in 2005.

High commodity prices and improved macroeconomic policies continue to support economic growth in sub-Saharan Africa. The 5,2 per cent growth rate expected in 2006 will mark the third consecutive year that regional growth has exceeded 5 per cent. Indications are that growth will accelerate to 6,3 per cent in 2007 as oil output recovers in Nigeria and new oilfields in Angola and Equatorial Guinea come on stream.

Recent trends in international financial flows

Investor interest in emerging markets grew sharply at the outset of this decade, when declining interest rates in major world economies and rising commodity prices stimulated a pattern of large capital flows. Net private flows reached US$481 billion in 2005, up from US$188 billion in 2000. These broad-based capital flows included bond issuances, bank lending, foreign direct investment and portfolio equity. Emerging market debt issuance reached an estimated US$130,9 billion in 2005 and foreign direct investment to emerging markets increased to US$399 billion, with inflows to China alone reaching US$79,1 billion. Portfolio equity investments outpaced other asset classes.

Since mid-2006, international investors have developed an increased risk aversion towards emerging markets. This is evident in the yield differential of the JP Morgan Emerging Markets Bond Index (EMBI+), which increased from a low of 178 basis points in April 2006, to 221 basis points in June, before improving to 194 basis points in August. The EMBI+ tracks the total returns for external-currency denominated debt instruments of emerging markets.

Economic growth in the region plays an important role in South Africa's economic prospects. Southern Africa is expected to grow by nearly 6 per cent annually between 2005 and 2007. This underlines the importance of regional economic linkages, diversified economies and enhancing the gains made from regional trade. Due in part to the low density of infrastructure, Africa's growth rates have the potential to rise rapidly for many years, while countries in the region work towards improved economic governance. These factors point to the importance of regional economic development and advances in regional trade and investment regimes in the years ahead.

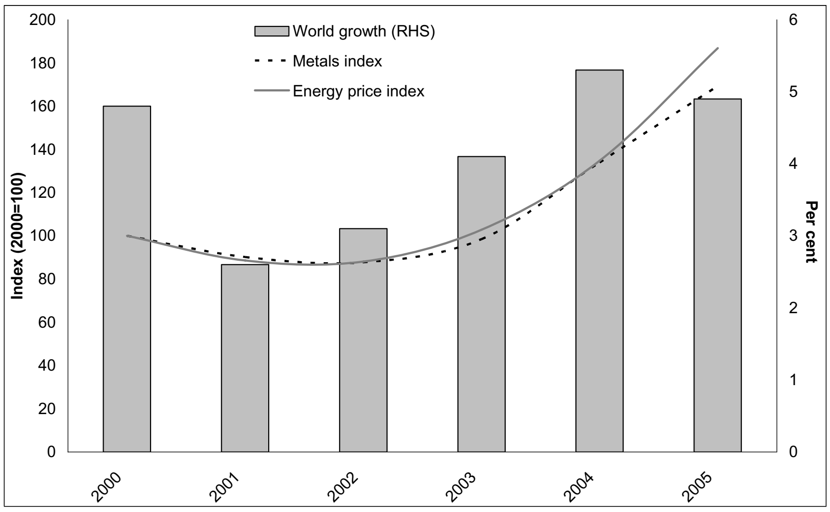
Africa's growth rates have the potential to rise rapidly for many years

Commodity prices

Strong global growth, particularly in China and India, continues to support relatively high commodity prices. In May 2006, gold and platinum reached record prices of US$722/oz and US$1 328/oz respectively. By 1 October, prices for both metals had fallen, with gold below US$600/oz and platinum below US$1 100/oz. Oil and other commodity prices have also decreased appreciably during the first three quarters. While oil prices are likely to remain volatile, the price of Brent crude oil for immediate delivery averaged US$63/barrel in September, down from the record peak of US$79/barrel realised in August.

Global growth continues to support high commodity price levels

Figure 2.1 World growth and commodity prices, 2000 – 2005

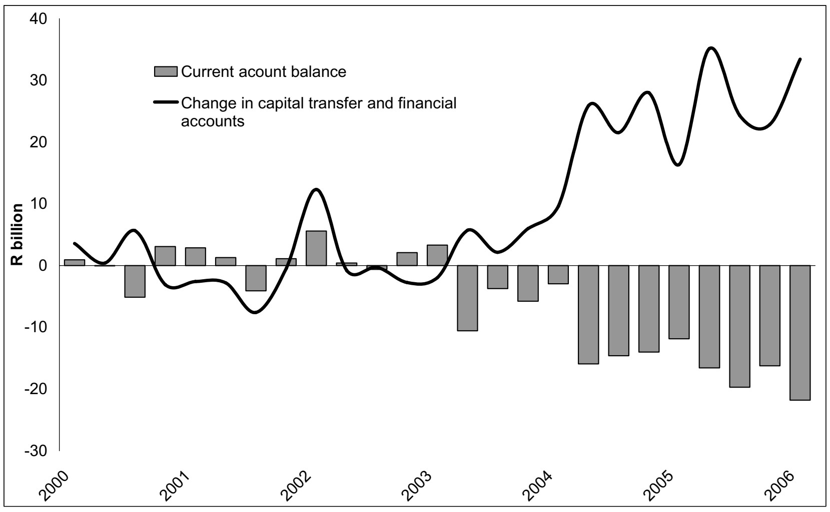


Balance of payments

Capital flows to emerging markets have strengthened in recent years in response to better returns relative to those in developed economies. South Africa has benefited, reflected in the surplus on the financial account in the first half of 2006. That comfortably offset the shortfall on the current account, and kept the overall balance of payments position stable.

Financial account position comfortably covers shortfall on current account

Figure 2.2 Overall balance of payments, 2000 - 2006



Current account

More competitive currency and tighter monetary conditions should reduce current account deficit

The current account deficit widened from 4,5 per cent of GDP in the second half of 2005 to above 6 per cent of GDP during the first half of this year. This was largely due to an increase in the trade deficit from 1 per cent in the second half of 2005 to 2,5 per cent of GDP in the first half of 2006. The current account also includes the income, services and transfer account, which incorporates transfers under the Southern African Customs Union (SACU).

While the deficit on the income and services account shrank during the first two quarters of 2006, there was a sharp increase in SACU payments, which rose from 0,7 per cent of GDP in the first quarter of 2006 to 1,1 per cent of GDP in the second quarter.

Import growth strongly influenced by oil price effects

Global economic growth and high commodity prices have increased the value of South African exports, which grew at an annual rate of 8 per cent in the first half of 2006. The value of merchandise imports rose by an annual rate of 21,2 per cent during the first half of 2006 due to robust domestic expenditure growth and a higher rand price of oil. While crude oil imports added nearly one percentage point to the current account deficit in the first half of 2006, moderating oil prices will directly lower the value of imports over the short term.

A more competitive currency, tighter monetary conditions and moderation in the consumption spending trend over the years ahead should also contribute to a smaller current account deficit in the balance of payments.

Trade policy and growth

Economic reforms since 1994 have contributed to significant growth in South Africa's international trade in goods and services – and to a stronger, more resilient economy.

Total export growth between 1990 and 2005 has been moderate, averaging 3,9 per cent annual growth. Non-gold, non-commodity manufactures exports grew by 5,2 and 9,0 per cent respectively in the same period. Services have been quite strong, rising from 0,4 per cent growth between 1970 and 1990 to 7,8 per cent growth between 1990 and 2005. By comparison, world trade grew at about 6 per cent between 1990 and 2004.

An international panel composed of experts from Harvard University and other academic institutions has been studying the constraints to and opportunities for accelerated growth in the South African economy as part of government's accelerated and shared growth initiative. The work of the panel indicates that exports, particularly of manufactured goods, are constrained by a relatively protected economy that keeps prices of inputs and capital goods high. To meet this challenge and to improve South Africa's export performance, attention needs to be paid to trade policy reform, encouraging innovation, improving transport logistics, reducing the regulatory burden and deepening competition. The panel emphasised that international trade is one of the most effective means of directly improving economic growth rates.

Export volumes, 1970 – 2005

Export volumes (percentage change)	1970-1990	1990-2005
Total	1,2	3,9
gold	*-3,3*	*-5,6*
Total non-gold	3,7	5,2
Manufacturing	2,9	6,7
non-commodity manufactures	*2,7*	*9,0*
Services	0,4	7,8

Source: Lawrence Edwards and Robert Lawrence, 2006. "South African Trade Policy Matters: Trade Performance and Trade Policy". Center for International Development, Harvard University

Financial account

Financial surplus rises to 7,9 per cent of GDP as foreign demand for South African assets continues

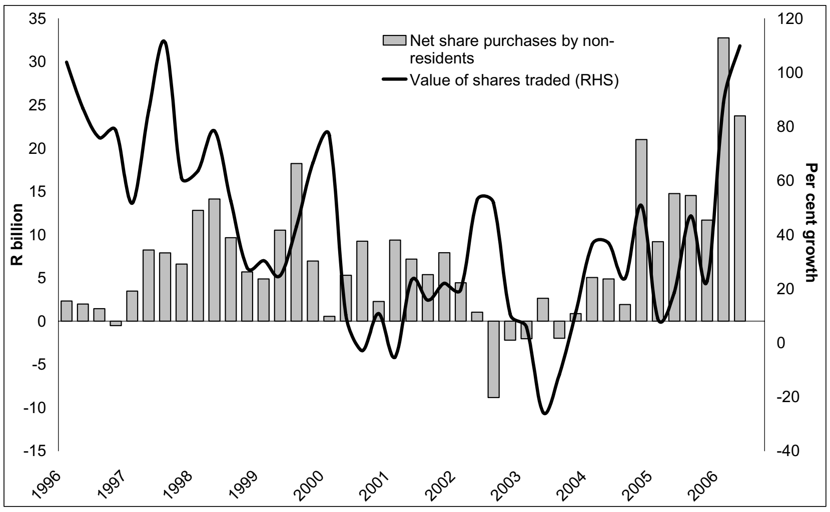
Strong domestic growth, high commodity prices and sound macroeconomic fundamentals have stimulated foreign demand for South African bonds and equities. As a result, the surplus on the financial account rose to 7,9 per cent of GDP in the first half of 2006 compared to 7,0 per cent for the same period in 2005.

Net foreign direct investment into South Africa remained firm at R4,8 billion in the first six months of 2006. South African firms also continued to expand their presence abroad, as reflected in outward foreign direct investment of R6,9 billion. In particular, telecommunications, media and petrochemical firms have expanded their operations as far afield as Brazil, Uganda, Côte d'Ivoire, Congo, Qatar, Liberia and Iran.

Net portfolio inflows of R82,5 billion were recorded in the first half of 2006, compared to R30,4 billion for 2005 as a whole. Non-residents were net purchasers of R56,4 billion worth of shares and R7,7 billion of bonds over the same period. [2]

[2] The remaining amount is classified as part of unrecorded transactions.

Figure 2.3 Non-resident participation in the share market, 1996 - 2006

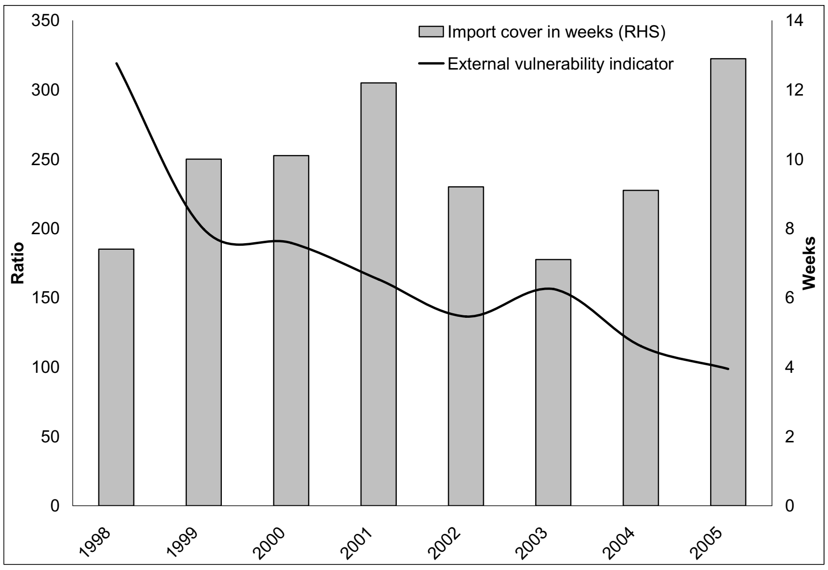


Exchange rate and international reserves

Rand depreciation due to a strong US dollar and softer commodity prices

A narrowing of the interest rate differential between South Africa and developed-country markets, along with softer commodity prices, contributed to a moderation in the value of the rand during the first three quarters of 2006. Achieving a more sustainable and competitive level, the exchange rate depreciated by about 13 per cent during the first nine months of 2006 on a real trade-weighted basis.

Figure 2.4 Reserves and external vulnerability, 1998 - 2005[3]



[3] The external vulnerability indicator is defined as the current account deficit plus short-term debt, plus longer-term debt maturing within the next 12 months, divided by gross reserves.

The Reserve Bank continued to accumulate foreign reserves during the first half of 2006. Gross gold and other foreign exchange reserves reached US$24,7 billion at the end of September, an increase of US$4 billion since the end of 2005. The international liquidity position has also improved substantially, rising from US$17,2 billion in December 2005 to US$21,2 billion in September 2006. Import cover rose from nine weeks at the end of 2004 to 15 weeks at the end of June 2006. South Africa's vulnerability to external shocks declined, as shown in Figure 2.5.

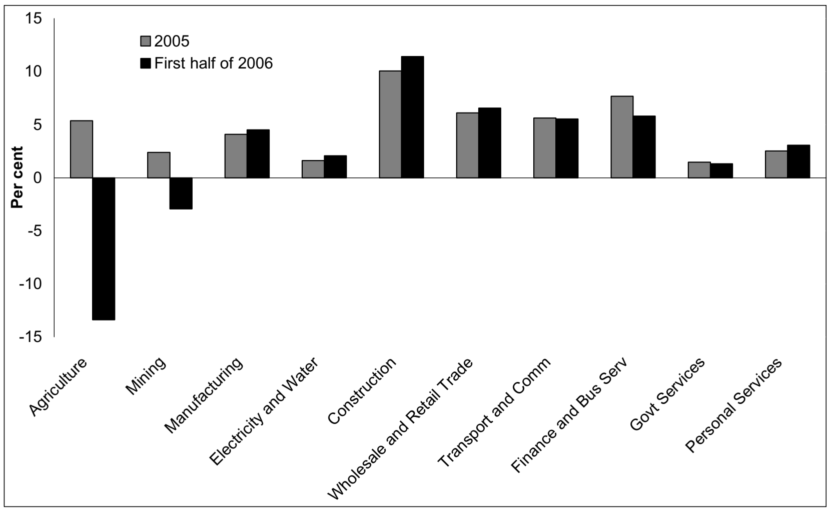
South Africa's international liquidity position continues to improve

Real output trends

During the first half of 2006, the South African economy grew by 3,8 per cent compared with 5,2 per cent during the first half of 2005. A contraction in the agriculture and mining sectors weighed on overall growth. On a seasonally adjusted and annualised basis, growth picked up from a revised 4 per cent in the first quarter of 2006 to 4,9 per cent in the second, with improved growth in mining and manufacturing. Non-agricultural output growth has averaged 5 per cent a year since the final quarter of 2004.

Real output growth is robust, with indications of growing momentum

Figure 2.5 Sectoral growth



Agriculture

The agriculture sector contracted by 13,4 per cent in the first half of 2006 due to a decline in the production of field crops. This subsector includes maize and wheat, and accounts for just over a quarter of agricultural gross value added. Production of field crops fell following lower prices in the previous season.

Agriculture sector contracted as production of field crops declined

Table 2.2 Area planted and intentions to plant, September 2006

	Area planted 2004/05	Area planted 2005/06	First intentions to plant 2006/07	Percent change 2004/05 to 2005/06	Percent change 2005/06 to 2006/07
Maize	3 223 440	1 600 200	2 635 000	-50,4	64,7
Sorghum	86 500	37 150	71 000	-57,1	91,1
Groundnuts	40 000	48 550	48 000	21,4	-1,1
Sunflower seed	460 000	472 480	371 000	2,7	-21,5
Soya bean	150 000	240 570	217 000	60,4	-9,8
Dry beans	49 300	54 880	55 000	11,3	0,2

Source: National Department of Agriculture crop estimate

Recent data on intentions to plant and rising agriculture prices suggest that maize production will rebound. The trade balance for the sector remained positive, with exports led by maize, wheat and horticulture.

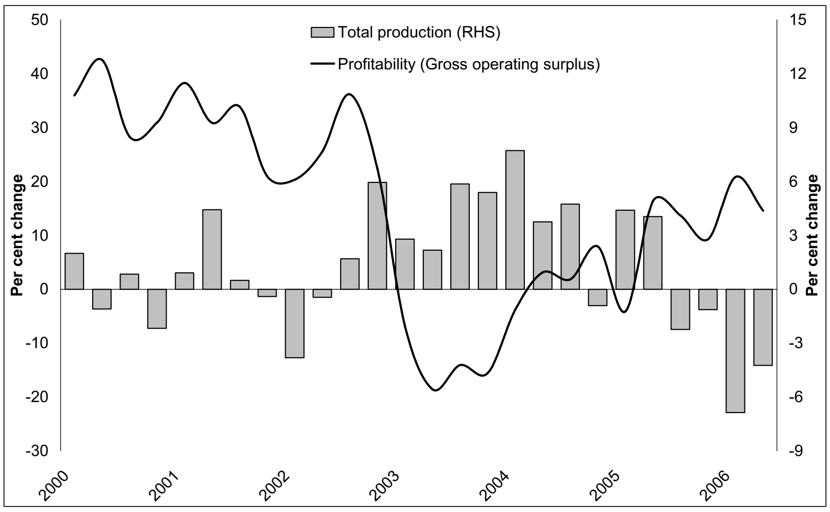
Mining

Mining sector contracted in the first half of 2006, but production is expected to rebound

The mining sector contracted by 2,9 per cent in the first six months of 2006. The contraction was due to a decline in production across all subsectors with the exceptions of manganese and iron ore. The production of platinum group metals declined by 5,7 per cent due to unforeseen production challenges during the first quarter, including difficult conditions on the Merensky reef and the shutdown of a platinum refinery due to a fire. Production picked up during the second quarter and is expected to rebound during the second half of the year.

A significant increase in the profitability of mining companies and greater certainty in the regulatory frameworks affecting the industry are expected to result in new investments in coming years.

Figure 2.6 Production and profitability in the mining sector, 2000 - 2006

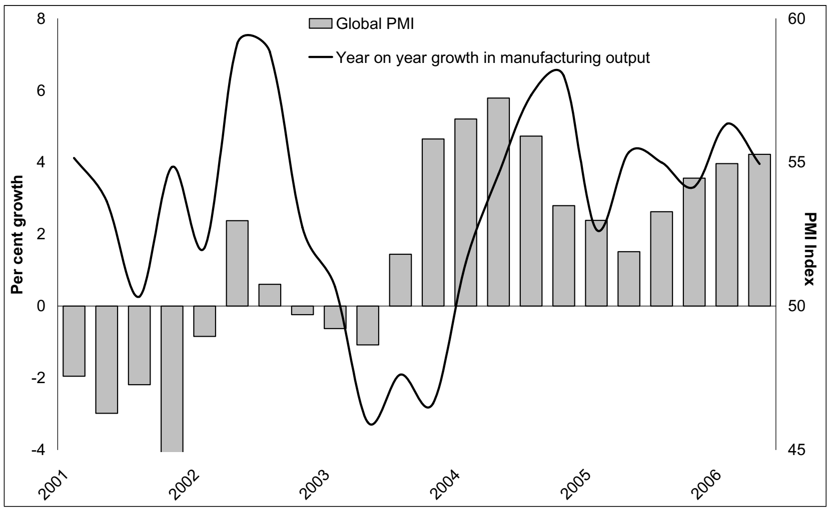


Manufacturing

Strong domestic and global demand supported growth in the manufacturing sector. Gross value added rose by 4,5 per cent in the first half of 2006, led by transport goods, furniture and non-metallic minerals, which consists of mainly the glass and cement industries. Manufacturing output growth has been positive for 10 consecutive quarters, exceeding 4 per cent since mid-2005. The sector continues to invest heavily, with investment growth reaching 7 per cent during the first half of 2006.

Manufacturing output growth has been positive for 10 consecutive quarters

Figure 2.7 Manufacturing output and global PMI*, 2001 – 2006



** Global purchasing managers' index series courtesy of JP Morgan*

Exports of manufactured goods have improved in 2006, rising by 4,4 per cent in real terms. The proportion of exports in total manufacturing sales has increased from 17,6 per cent in 1998 to 24,8 per cent in the first half of 2006. Sustained investment in productive capacity, improved global conditions and more competitive businesses are expected to contribute to better export growth rates over the medium term.

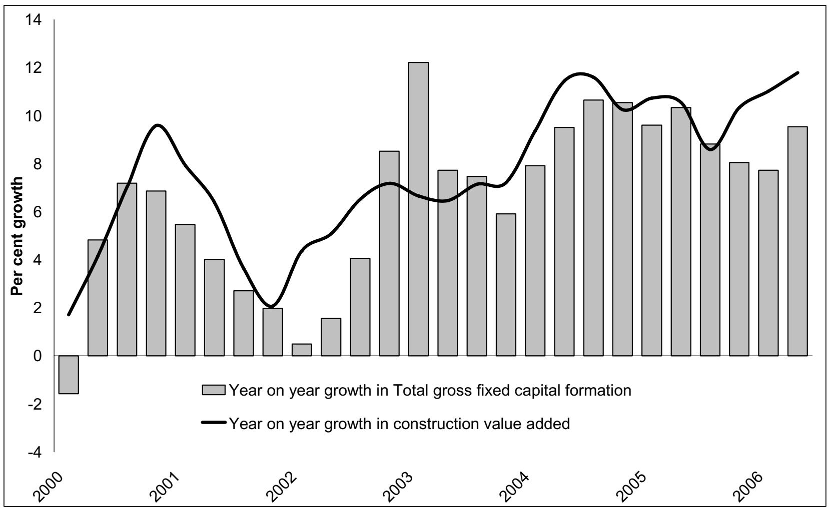
Improved export growth expected over medium term

Construction

Construction grew by 11,4 per cent in the first half of 2006, driven by strong levels of investment across the economy, and employment within this sector grew by 14,3 per cent. The strong performance is expected to continue, with a shift in momentum from residential to non-residential construction and civil works. The value of non-residential building plans passed grew by 29,2 per cent during the first half of 2006. Civil construction is expected to grow by 9 per cent in 2006 as major projects such as Gautrain and stadium construction and refurbishment get under way.

Investment activity supports strong continued growth in construction sector

Figure 2.8 Investment and construction sector growth, 2000 - 2006



As a share of the economy, construction activity (2006: 2,6 per cent of GDP) remains well below the high achieved in 1974 (5,5 per cent) suggesting that the recovery in economic growth will see further acceleration in this sector.

Transport and communications

Transport and communications benefits from rapid growth and new technologies

Rapid economic growth has increased the demand for distribution and logistics services. The transport, storage and communications sector grew at 5,5 per cent in the first half of 2006, compared to average growth of 6,2 per cent from 2001 to 2005. Significant improvements continue to be made in transport infrastructure to lower the overall cost of logistics. Transnet investments amounting to R64,5 billion will be spread across the five years to 2011.[4] Approximately 50 per cent of the investment will be in rolling stock and port infrastructure.

The cellular services sector has driven growth in communications. In the coming years fixed-line communications is expected to grow more rapidly as a result of regulatory adjustments and the second national operator beginning to compete with Telkom.

Financial services

Financial services sector supported by increased banking activity and strong property market

The finance, real estate and business services sector continues to perform well, growing by 5,8 per cent in the first half of 2006. Low interest rates, improved employment, and rising real

[4] Spoornet will acquire 374 new locomotives over the next five years at a cost of R8,5bn. The rail utility also intends to upgrade a further 514 locomotives over the same period.

income levels have boosted demand for banking and other financial services. Exceptional growth in the number of Mzansi accounts for low-income individuals – rising to more than 3,3 million in the first half of this year – reflects the growth potential for financial services in the economy.

Banking sector benefits from increasing credit extension, especially mortgages

The banking sector has benefited from continued increases in credit extension, particularly mortgages. The average amount per outstanding mortgage rose from R247 000 to R307 000 between June 2005 and June 2006, while the value of the average medium-sized home[5] increased from R693 600 to R792 600.

Quality of debt continues to improve. By July 2006, overdue accounts constituted 2,3 per cent of total loans and advances, compared with 2,4 per cent in December 2005. This compares to 4,9 per cent at the end of 2002.

Expanded financial services in Africa

The sector has also benefited from an expansion of South African financial services firms internationally, particularly throughout Africa, and this should support growth in the years ahead.

Employment and remuneration

Strong job creation since 2001 has reduced the unemployment rate

Strong, broad-based economic growth continues to deliver employment opportunities. The economy generated about 1,2 million jobs between September 2001 and March 2006, with the pace of job creation accelerating after 2004. In March 2006, the official unemployment rate fell to 25,6 per cent, a decline of 3,8 percentage points compared to September 2001.

Table 2.3 Key labour market indicators, September 2001 – March 2006 (Official definition of unemployment)

Labour market category Thousands	September 2001[1]	March 2006
Total employment	**11 181**	**12 451**
Employed (formal sector)	*7 793*	*8 666*
Unemployed (official definition)	4 655	4 275
Total economically active	**15 836**	**16 726**
Not economically active	12 281	13 126
Total aged 15 - 65 years	**28 117**	**29 852**
Unemployment rate	29,4%	25,6%
Labour force participation rate	56,3%	56,0%
Labour absorption rate	39,8%	41,7%

1. Revised on the basis of the new population estimates.
Source: Labour Force Survey, Historical Series, September 2000 to March 2005: Revised Estimates; March 2006

[5] Homes of between 80 and 120 square metres.

Productivity and economic growth

South Africa's labour productivity has grown by an annual average of 2 per cent since 1994. Growth in productivity is an important determinant of the pace at which the economy can grow over the long term. Increased productivity raises potential GDP growth and holds down inflation.

The rate at which productivity rises in any economy is affected by the regulatory framework, the use and management of inputs to production processes, incentives to innovation, new technologies, skills levels and the competitive dynamics of particular markets, including barriers to entry.

According to *Doing Business* (a World Bank publication), barriers to entry in South Africa are low when compared to other developing countries and above those of the Organisation for Economic Cooperation and Development. A study* by the international panel of experts from Harvard University and other academic institutions found that in the South African case the positive effects of low administrative barriers to entry are offset by high markups in manufacturing and concentration (the number of companies in each sector), which weigh on productivity and employment by limiting competition and investment.

Other regulatory factors are also important for productivity, including constraints arising from labour regulations that affect the adoption of new technologies and work practices, and the shortage of skills in the workforce.

*Aghion, Braun and Fedderke. 2006. "Competition and Productivity Growth in South Africa." Center for International Development, Harvard University.

The services and trade sectors are important sources of job creation. Employment growth increased by 6,1 per cent between March 2005 and March 2006. Over the same period, employment in manufacturing grew by 4,5 per cent.

Domestic expenditure

Growth in real domestic expenditure accelerated to 7,7 per cent in the first half of 2006, due to strong household expenditure growth and strong growth in investment spending.

Gross fixed capital formation

Investment growth is creating new productive capacity

Between 2003 and 2005, investment grew at an average rate of nearly 10 per cent a year. Investment in new productive capacity and upgrading of existing capacity continues to rise, with gross fixed capital formation growing by 8,6 per cent during the first half of 2006.

The highest investment-to-GDP ratio since 1991

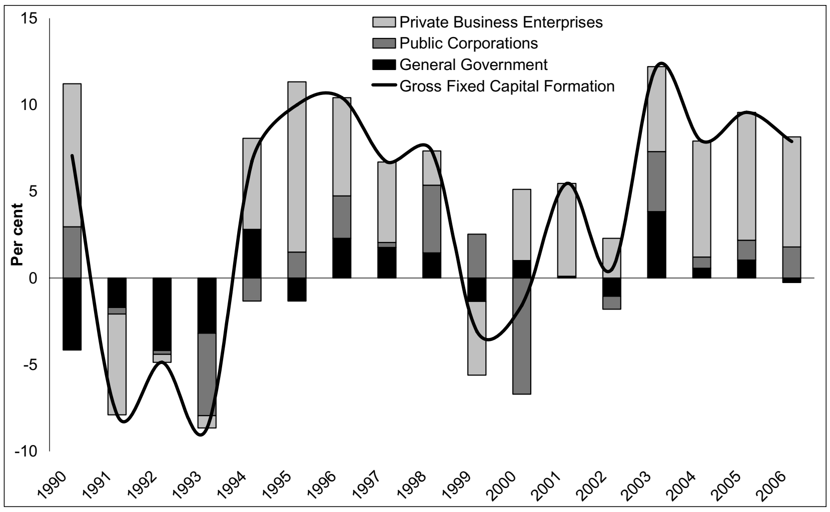
During the first half of 2006, investment by public corporations rose 15,8 per cent, investment by private enterprises grew 9,4 per cent and government fixed investment contracted slightly. The ratio of investment to GDP continues to trend upwards, reaching 18,4 per cent. This is the highest ratio since 1991, and a significant improvement on the all-time low of 14,7 per cent of GDP, recorded in 1993.

Growth in residential buildings was particularly strong during the first half of 2006, growing by 20,2 per cent compared to the same period in 2005. The continued demand for housing, particularly at the lower end of the market, will support residential investment in coming years.

Investment in machinery accounts for nearly half of all investment. Growth in this category continues to be strong, reflecting high rates of capacity utilisation and expansion of capacity, robust levels of economic activity and increased business confidence.

Investment in machinery reflects increased business confidence

Figure 2.9 Investment growth, weighted by share, 1990 - 2006



Household consumption expenditure

Household consumption expenditure remains strong due to low interest rates and higher real wages, rising by 6,8 per cent in the first half of 2006 compared to 7 per cent in the first half of 2005. Growth in household consumption has averaged 4,9 per cent a year since 2001.

Household consumption growth has averaged 4,9 per cent a year since 2001

The durable and semi-durable goods categories continue to post the strongest gains, rising 16 and 16,8 per cent respectively in the first half of the year. Spending on durable goods has primarily comprised sales of motor vehicles and household appliances. Semi-durable goods rose, supported by relatively low import prices for clothes and household furnishings.

Monetary developments, inflation and interest rates

Money supply and credit extension

Growth in broadly defined money supply (M3) has eased from the peak growth rate of 27 per cent realised in March 2006 to 21,4 per cent in August. Money supply growth has been supported by rising asset values (holdings of equities and real estate), buoyant economic activity, increased employment and deepening access to financial services.

Money supply growth is supported by rising asset values and economic activity

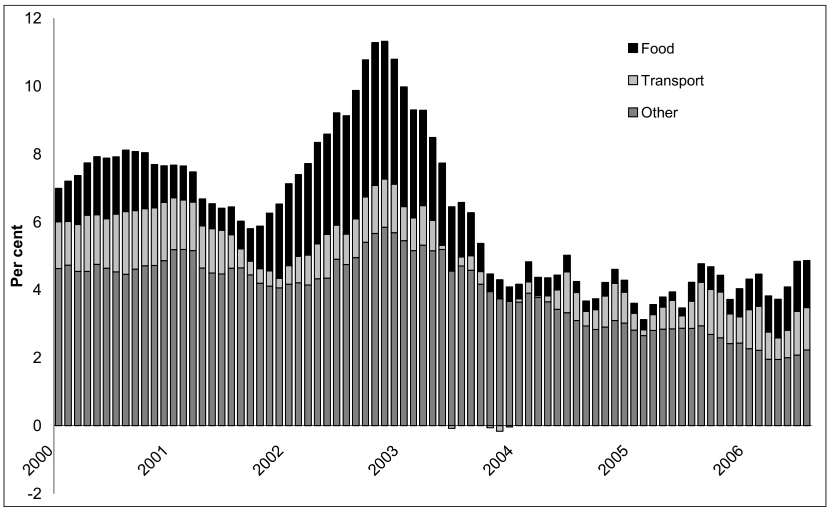
The extension of private sector credit reached new heights during the first eight months of 2006, rising by an average of 23,3 per cent from an average annual growth of 20,4 per cent during 2005. Private sector credit extension has remained strong due to continuing increases in asset-backed credit, particularly mortgage advances. Mortgage advances rose 30,3 per cent between August 2005 and August 2006, accounting for just over half of the increase in private sector credit extension.

Inflation and interest rates

Food and transport prices remain the most important drivers of CPIX inflation

CPIX inflation remains within the target band of 3-6 per cent. The CPIX inflation rate rose to 5 per cent in August 2006, from a low of 3,7 per cent in April 2006. Food and transport remain the most important drivers of CPIX inflation. Food prices rose from 4,3 per cent at the beginning of the year to 7,2 per cent in August 2006 due to higher prices for meat, fish and vegetables.

Figure 2.10 Components of CPIX inflation, weighted by share, 2000 - 2006



Transport inflation up sharply due to petrol price increases

In August, transport inflation rose to 8,7 per cent year-on-year due to an increase in the running costs subcategory, mainly due to a 4,6 per cent month-on-month or 24,4 per cent year-on-year rise in the petrol price.

Producer price inflation has risen rapidly since February 2006, increasing from 5,5 per cent to 9,2 per cent in August. This acceleration is mainly due to increases in the prices of petrol, non-ferrous metals – such as aluminium and copper – electrical machinery and food products.

Consumer price inflation is expected to rise moderately in coming months, possibly breaching the 6 per cent level in early 2007, before declining over the MTEF period in response to lower oil prices and recent interest rate increases.

Domestic outlook

Growth expected to average about 5 per cent a year over medium term

With a healthy global economy, buoyant domestic demand and relatively high commodity prices, economic growth continues to be robust. Over the medium term, measured GDP growth is expected to average about 5 per cent a year, largely due to continuing investment and an improved export performance.

Domestic demand has been strong as a result of rising income levels

Domestic demand has been exceptionally strong in recent years, largely as a consequence of households adjusting consumption patterns to match changes in income and wealth levels. This was brought about by improved economic fundamentals, including lower interest rates, increased access to credit, rising asset prices and increases in real wages. With this adjustment slowing somewhat, consumption is expected to grow at a more sustainable pace of 4-5 per cent over the forecast period.

Capital expenditure projects drive strong investment spending trend

Investment spending is expected to remain strong over the medium term, driven by major capital expenditure projects by government and the state-owned enterprises. Growth in investment is expected to accelerate to 10 per cent a year by the end of the three-year period.

Over the next three years a more competitive currency will support increased exports, as will the continued relative strength in commodity prices and international growth. Export growth is projected to average 6,4 per cent over the period. Although growth in import volumes is expected to slow somewhat in 2007 as domestic demand eases, it is expected to remain in line with higher investment growth and sustainable levels of domestic demand.

Table 2.4 Macroeconomic projections, 2003 – 2009

Calendar year	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**
		Actual		**Estimate**		**Forecast**	
Percentage change unless otherwise indicated							
Final Household consumption	3,5	6,5	6,9	6,6	4,4	4,5	4,7
Final Government consumption	6,5	6,9	5,6	5,6	4,5	4,6	4,6
Gross fixed capital formation	8,3	9,7	9,2	9,5	9,0	9,3	10,0
Gross domestic expenditure	5,2	7,5	5,9	7,2	4,3	5,2	5,7
Exports	0,3	2,5	6,7	2,7	6,5	6,3	6,4
Imports	8,8	14,1	10,1	13,0	5,7	7,4	7,6
Real GDP growth	**3,0**	**4,5**	**4,9**	**4,4**	**4,4**	**4,8**	**5,3**
GDP deflator	4,4	5,6	4,7	6,5	6,6	4,8	4,5
GDP at current prices (R billion)	**1 257,0**	**1 386,7**	**1 523,3**	**1 693,4**	**1 885,0**	**2 069,6**	**2 277,2**
CPIX (Metropolitan & urban, average for year)	6,8	4,3	3,9	4,6	5,5	4,4	4,5
Current account balance (% of GDP)	-1,3	-3,4	-4,2	-5,7	-5,3	-5,6	-5,8

Overall growth during the first half of 2006 was slower than anticipated at the time of the 2006 Budget due to a disappointing performance by agriculture and mining. As a result, overall growth for the year has been revised downwards from the projected 4,9 per cent to 4,4 per cent.

Current account deficit is expected to narrow as oil prices ease and exports pick up

A narrowing of the current account deficit is expected over the remainder of 2006 as oil prices and import volumes ease, and as export volumes pick up. A deficit of 5,7 per cent of GDP is expected in the current year, and the deficit is projected to average about 5,6 per cent over the medium term.

CPIX inflation may briefly exceed 6 per cent in early 2007 but is projected to remain within the target band thereafter. Domestic and external price pressures are expected to lead to the inflation rate trending upwards during the remainder of 2006 and into early 2007, before decreasing again. CPIX inflation is projected to average 4,6 per cent in the current year and to average 4,8 per cent over the medium term.

Table 2.5 Macroeconomic projections, 2005/06 – 2009/10

Fiscal year	2005/06	2006/07	2007/08	2008/09	2009/10
	Actual	Estimate		Forecast	
GDP at current prices (R billion)	**1 562,8**	**1 745,8**	**1 928,3**	**2 119,9**	**2 330,5**
Real GDP growth	**4,5**	**4,5**	**4,3**	**5,0**	**5,2**
GDP deflator	5,3	6,9	5,9	4,7	4,5
CPIX (Metropolitan & urban, average for year)	4,1	5,1	5,1	4,3	4,5