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Economic policy: beyond the storm

The world economy has entered a period of extraordinary uncertainty. Following several years of persistent imbalances in global trade and finance flows, a banking and credit crisis has emerged in developed economies. While South Africa is well positioned to weather this storm, international and domestic factors will dampen economic growth in the short term. Weaker global conditions will lead to slower export growth, softer commodity prices, reduced investor risk appetite and greater currency volatility.

Sound fiscal and monetary policies enable government to respond flexibly to support the economy in times of stress. South African financial institutions have limited exposure to the underlying sources of the credit seizure, and gradual capital account liberalisation has encouraged companies to diversify offshore while retaining prudent checks on exposure to financial risk.

GDP growth is expected to average 3.8 per cent over the medium term. Despite tougher conditions ahead, the long-term drivers of growth remain intact. Strong public-sector investment will boost productive capacity and reduce growth constraints. Further microeconomic reforms are required to support a higher sustainable rate of growth and to raise employment.

Overview

Government will work to reduce short-term risks to the economy while investing for the future

To build a prosperous and equitable society, government seeks to reduce poverty, create employment and expand opportunity for millions of disadvantaged South Africans. The past five years of strong economic growth have contributed to these goals by increasing employment and financing an expansion of public services. The period ahead, however, is likely to be considerably tougher as international financial and economic conditions weaken. Government will continue to work to reduce short-term risks to the economy, while making investments that can raise future growth rates and improve the lives of all South Africans.

IMF forecasts global growth of 3 per cent in 2009

The present banking and credit crisis, which began in the United States and spread rapidly to Europe and beyond, will have far-reaching repercussions that will play havoc with long-term economic forecasts for all countries. The most recent forecast by the International Monetary Fund (IMF) projects a significant deterioration in global growth to 3.0 per cent in 2009, down from 5.0 per cent in 2007.

Global financial crisis will have implications for domestic economy

How the financial crisis is managed – and the implications for trade and commodity prices – will affect the trajectory of the South African economy.

A possible scenario is that a deep recession and lingering financial uncertainty in the developed economies will result in a reduction in international trade, with a concomitant decline in economic growth in emerging markets and continuing financial volatility. In such an environment, South Africa could expect a prolonged period of much slower growth. Our monetary and fiscal policy framework, strong financial position and appropriate economic policy responses might allow output and employment growth to be maintained, but real income and corporate profits would come under pressure.

In a second and more hopeful scenario, greater international policy coordination and improved regulatory capacity to intervene in poorly performing markets will result in a period of global economic adjustments over the medium term, followed by more balanced growth. While South Africa's fiscal stance and budget proposals are framed to allow for a wide range of possible global trajectories, our current economic forecast reflects this more benign set of assumptions.

GDP forecast and current trends

GDP projected to grow by about 3.8 per cent over medium term

Taking into account South Africa's policy frameworks and the relatively diversified character of the domestic economy, GDP is projected to grow by about 3.7 per cent in 2008 and 3.0 per cent in 2009, before rising to 4.0 per cent in 2010 and 4.3 per cent in 2011. This forecast factors in trends that have emerged during the robust economic performance of recent years, in particular the strong capital expenditure plans of the public sector and private-sector investment momentum.

Since 2004, South Africa has benefited from a stable financial environment and much-improved terms of trade in an expanding world economy. GDP growth averaged 5.1 per cent a year between 2004 and 2007, up from 3.2 per cent in the previous three years.

Rebalancing of domestic growth is taking place as consumption slows

Domestic expenditure in recent years has been robust, but some rebalancing is now taking place. Household consumption has slowed considerably in response to higher interest rates and inflation has eroded consumer purchasing power. Disruptions to electricity supply in the first quarter of 2008 also cut mining and manufacturing output temporarily, dampening GDP growth.

Strong investment supports continued growth over medium term

Strong investment will continue to underpin growth over the next few years. Investment has risen from about 15 per cent of GDP in 2002 to 22 per cent in the first half of 2008. Real growth in fixed investment is expected to remain high, averaging about 9 per cent a year over the medium term, well in excess of overall GDP growth. Household consumption is expected to grow at a slower pace of 1.6 per cent in 2009 before rising to 3.7 per cent in 2011.

Decreasing debt, rising foreign exchange reserves

Fiscal policy has aimed to reduce South Africa's exposure to negative international developments by decreasing government debt and increasing foreign exchange reserves. Over the medium term, the fiscal stance will help to moderate the slowdown in GDP growth by maintaining strong growth in public investment and social spending. A small budget deficit is projected over the next few years.

Rapid growth in domestic expenditure has contributed to an expansion of the current account deficit, which increased from 4.0 per cent of GDP in 2005 to a projected 7.6 per cent of GDP in 2008. This deficit is expected to remain relatively high over the medium term as a result of the projected performance of the economy and lower commodity prices.

Table 2.1 Macroeconomic projections

Calendar year	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**
		Actual		**Estimate**		**Forecast**	
Percentage change unless otherwise indicated							
Final household consumption	6.9	8.2	7.0	2.8	1.6	3.2	3.7
Final government consumption	4.8	5.2	5.0	4.5	4.0	4.0	4.0
Gross fixed capital formation	8.9	13.8	14.8	12.6	8.7	8.8	9.3
Gross domestic expenditure	5.7	9.2	6.0	3.6	3.0	5.5	5.2
Exports	8.0	5.6	8.3	2.6	2.9	4.4	6.0
Imports	10.3	18.8	10.4	2.6	3.2	8.9	8.2
Real GDP growth	**5.0**	**5.4**	**5.1**	**3.7**	**3.0**	**4.0**	**4.3**
GDP inflation	5.2	7.2	9.1	11.3	7.0	6.2	6.0
GDP at current prices (R billion)	**1 541.1**	**1 741.1**	**1 996.9**	**2 303.6**	**2 538.4**	**2 802.4**	**3 098.2**
CPIX inflation	3.9	4.6	6.5	11.6	–	–	–
Headline CPI inflation	–	–	–	–	6.2	5.3	4.7
Current account balance (percentage of GDP)	-4.0	-6.5	-7.3	-7.6	-7.8	-8.9	-8.8
Fiscal year	**2005/06**	**2006/07**	**2007/08**	**2008/09**	**2009/10**	**2010/11**	**2011/12**
		Actual		**Estimate**		**Forecast**	
GDP at current prices (R billion)	**1 584.7**	**1 808.3**	**2 061.9**	**2 366.7**	**2 598.6**	**2 870.2**	**3 170.3**
Real GDP growth	**4.8**	**5.6**	**4.7**	**3.5**	**3.0**	**4.2**	**4.3**
GDP deflator	5.9	8.0	9.0	10.9	6.6	6.0	5.9
CPI inflation (Metropolitan & urban)	3.5	5.2	8.1	11.6	5.2	5.2	4.7

CPIX inflation rose strongly in the first half of 2008, reaching 13.6 per cent in August 2008, raising inflation expectations and putting upward pressure on wage settlements. Exchange rate volatility may result in higher inflation in the short term, but falling oil prices and lower food costs will help to bring inflation back towards the 3-6 per cent target range. Slower GDP growth will also exert a moderating effect on inflation and the current account deficit.

Interest rate increases have helped to moderate demand

Cumulative interest rate hikes by the Reserve Bank, totalling five percentage points since 2006, have dampened domestic demand and helped to stabilise long-term inflation expectations.

From January 2009, CPIX inflation will be replaced by a new inflation target measure, headline CPI, which is expected to average 6.2 per cent next year and decline gradually over the next three years.

A new target measure of inflation

In 2005, Statistics South Africa (Stats SA) began an extensive review of inflation statistics. The last rebasing of the consumer price index (CPI) occurred in January 2002 and no significant changes were made at that time. A periodic updating of such measures is needed to ensure that the primary measures of consumer price inflation adjust with changes to consumption patterns.

The changes will take effect on 25 February 2009 with the release of the January 2009 CPI statistics. The new CPI series will differ from the old series in the following ways:

- The old CPI series was based on the International Trade Classification. The new series is based on the internationally accepted and widely used Classification of Individual Consumption by Purpose.
- Mortgage interest rates as a measure of housing costs in headline CPI will be replaced with a measure of owner's equivalent rent.
- The CPI will be reweighted based on the Household Income and Expenditure survey of 2005/06.
- The new CPI basket contains 416 indicator products (previously 1 200) broadly classified under commodities (e.g. food, petrol, clothing) and services (e.g. water services, insurance, medical care).

Replacement of mortgage interest rates with owner's equivalent rent is in line with international best practice. Mortgage interest costs were previously excluded from the target measure of inflation (CPIX) because changes in interest rates directly affected that measure of housing costs, resulting in a perverse relationship between headline CPI and monetary policy. The new measure solves that problem, enabling the cost of housing to be represented in the target measure of inflation.

Headline CPI (CPI for all urban areas) will replace CPIX inflation for metropolitan and other urban areas as the official targeted measure of inflation when the changes are implemented in February next year. The Minister of Finance and the Governor of the Reserve Bank have agreed that the target band for headline CPI will remain unchanged at 3-6 per cent.

It is expected that the reweighted and rebased CPI will indicate a somewhat lower rate of inflation in 2008 than the present index, partly due to lower expenditure weights for food and petrol. The extent of the bias will depend on the level of inflation for food, petrol and other components in January 2009.

The current CPI weights reflect expenditure patterns observed in 2000. Significant shifts in spending have occurred since then. The weight of food in headline CPI will fall from 25.7 per cent to 14.3 per cent and the weight for petrol will drop from 5.1 per cent to 3.9 per cent.

Developments in the real economy

About 2 million jobs have been created since 2003

Robust growth in the real economy over the past several years has brought about increased investment and job creation in most sectors. About 2 million jobs were created between March 2003 and March 2008, reducing unemployment from 29.3 per cent to 23.5 per cent. While job creation has been strong, a more rapid reduction in unemployment is required to reduce high levels of poverty. The key economic challenge is to achieve higher sustainable rates of growth that result in increased job creation, broadening economic activity and rising real incomes for all households.

Table 2.2 Key labour market indicators, 2003 – 2008

Thousands	Mar-03*	Mar-07	Mar-08	Jun-08
Employed	11 666	13 326	13 623	13 729
Unemployed	4 843	4 119	4 191	4 114
Total economically active	16 509	17 445	17 814	17 844
Not economically active	11 819	12 763	12 794	12 861
Total aged 15-64 years	28 327	30 208	30 608	30 705
Unemployment rate [1]	29.3	23.6	23.5	23.1
Labour force participation rate [1]	58.3	57.7	58.2	58.1
Labour absorption rate [1]	41.2	44.1	44.5	44.7

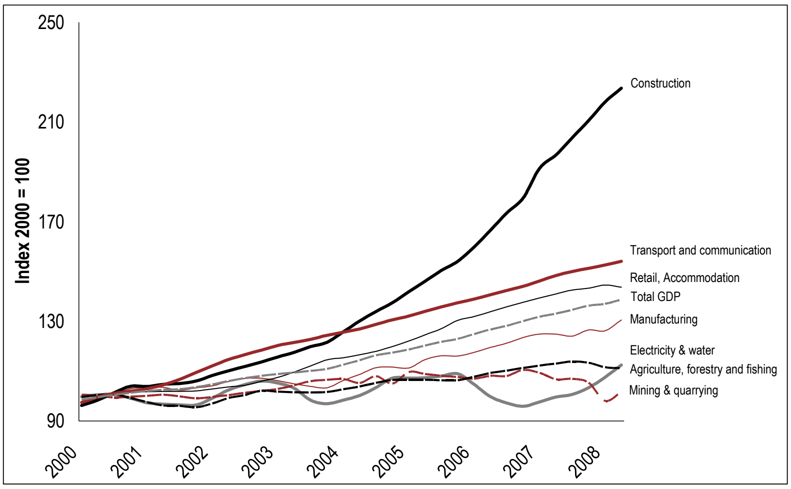
1. Unit is per cent.

** Revised series to make the LFS estimate comparable with the Quarterly Labour Force Survey (QLFS) Q1 data starting 2008*

In the recent period most new jobs have been created in the construction, retail and financial services sectors. In contrast, employment growth in mining, manufacturing and agriculture has been slow.

Job creation has been strongest in construction, retail and financial services

Figure 2.1 Sectoral drivers of GDP growth, 2000 – 2008



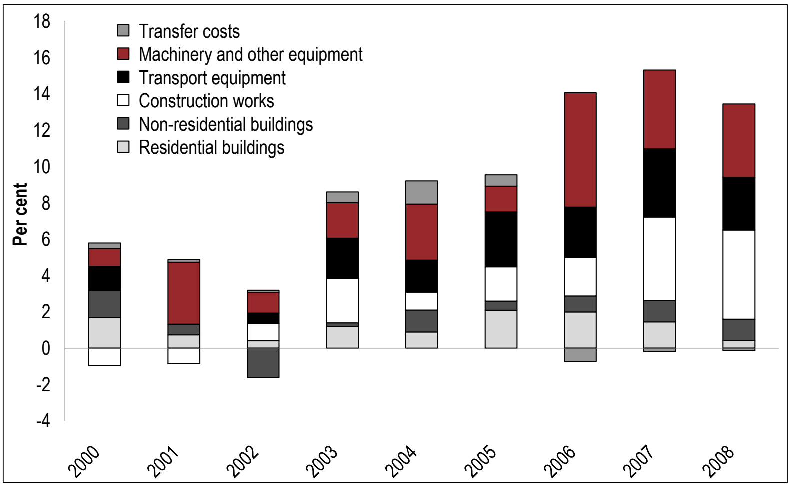
Data for 2008 is for the first half of the year.

Strong investment in machinery, transport equipment and construction should continue to raise productive capacity and long-term potential growth. Real growth in gross fixed capital formation has averaged 11.1 per cent a year since 2003, driven by capacity expansion in manufacturing, electricity and transport. The financial sector invested heavily in information technology expansion. By the end of the second quarter, fixed investment accounted for 22.4 per cent of GDP, the highest level since 1985.

Robust investment will raise productive capacity and long-term potential growth

Investment growth in 2008 has been strongest in the public sector, with the share of investment by public corporations rising to 15.3 per cent in the first half of the year from 11.3 per cent in 2003. The private sector accounted for about 72 per cent of total investment in the first half of 2008.

Figure 2.2 Gross fixed capital formation, 2000 – 2008

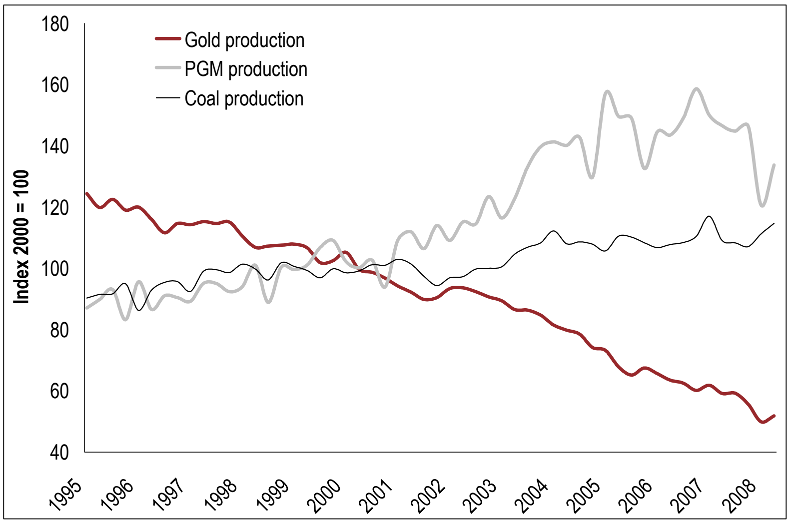


Data for 2008 is for the first half of the year.

Mining exports have stagnated but high prices boosted earnings

The mining sector has faced a number of difficulties in expanding production in 2008, including a period of sharply lower output due to electricity shortages and concerns over mine safety. Some recovery was seen in the second quarter, but total production was still 8.8 per cent lower in the first eight months compared with the same period in 2007. Mining export volumes stagnated in the first half of the year, but export earnings between January and August were 33.7 per cent higher compared with 2007 due to higher commodity prices.

Figure 2.3 Mining production by commodity, 1995 – 2008



Data for 2008 is for the first half of the year.

Agricultural production has responded positively to higher prices

The agricultural sector benefited from a bumper crop and rising food prices during the first half of 2008. Favourable weather conditions and increased plantings raised production of summer crops by at least 47 per cent in 2008. Maize production is likely to be 69 per cent higher in 2008 than in 2007.

Manufacturing output is an important driver of GDP, exports and employment, but the sector's contribution to growth remains uneven. Manufacturing gross value added lagged behind overall GDP growth in the first two quarters of 2008, expanding at an average rate of 3 per cent compared with 2007. Electricity failures in the first quarter of the year constrained output in some subsectors, but the slowdown in global demand has been a more prominent factor in recent months.

Table 2.3 Composition of manufacturing sector growth

	Weights*	Per cent growth (Ave Jan-Aug)	Growth contribution	
			Percentage points	Per cent
Petrochemicals	22.5%	10.5	2.4	71.9
Basic iron and steel	22.4%	-1.4	-0.3	-9.7
Food and beverages	16.4%	3.0	0.5	14.8
Wood and paper	11.0%	1.0	0.1	3.5
Motor vehicles and accessories	8.6%	-1.6	-0.1	-4.1
Furniture	5.8%	4.2	0.2	7.4
Textiles, clothing, leather and footwear	5.4%	1.8	0.1	2.9
Glass and non-metallic mineral products	3.9%	1.1	0.0	1.3
Electrical machinery	2.7%	13.3	0.4	10.9
Radio and TV	1.3%	2.5	0.0	1.0
Total**	**100.0%**	**3.1**	**3.1**	**100.0**

** Weights are based on the large sample manufacturing survey of 2001*

***Columns may not add up due to rounding*

Export imbalance leaves South Africa exposed to developed-country demand

A more competitive real exchange rate will make South African goods cheaper in international markets, although these gains may be offset by weaker global demand and rising production costs. About 36 per cent of South Africa's manufactured goods exports are sold to the Group of Seven (G7) industrialised countries. In contrast, only about 5 per cent of such exports go to Brazil, Russia, India and China. This export imbalance leaves producers sharply exposed to a reduction in developed-country demand.

The global economic environment

Trends in the world economy

Financial crisis is likely to impact on real growth in most developed countries

The world economy is slowing rapidly and many developed countries – including the United States, United Kingdom and Eurozone member states – face a downturn. Global growth is forecast at 3.9 per cent in 2008 and 3 per cent in 2009, down considerably from 5 per cent in 2007.

The deflation of the US housing market bubble, which began in August 2007 in the subprime mortgage market, has developed into a full-blown global crisis, severely undermining confidence in the banking systems of many developed economies and precipitating massive losses in financial markets. The erosion of bank balance sheets due to falling asset prices, combined with reduced market liquidity, has led to a number of high-profile bank failures in the US and Europe, with an associated loss of confidence and a drying up of credit.

Table 2.4 Annual percentage change in GDP and consumer price inflation, selected regions/countries, 2007 – 2009[1]

Region/ Country	2007	2008	2009	2007	2008	2009
Percentage	GDP projections			CPI projections[2]		
World	**5.0**	**3.9**	**3.0**	**4.0**	**6.2**	**4.6**
US	2.0	1.6	0.1	2.9	4.2	1.8
Euro area	2.6	1.3	0.2	2.1	3.5	1.9
UK	3.0	1.0	-0.1	2.3	3.8	2.9
Japan	2.1	0.7	0.5	0.0	1.6	0.9
Emerging markets and developing countries	**8.0**	**6.9**	**6.1**	**6.4**	**9.4**	**7.8**
Emerging Asia	**9.3**	**7.7**	**7.1**	**4.9**	**7.3**	**5.8**
China	11.9	9.7	9.3	4.8	6.4	4.3
India	9.3	7.9	6.9	6.4	7.9	6.7
Africa	**6.3**	**5.9**	**6.0**	**6.2**	**10.2**	**8.3**
Sub-Saharan Africa	**6.8**	**6.1**	**6.3**	**7.1**	**11.9**	**9.5**
South Africa[3]	5.1	3.7	3.0	6.5	11.6	6.2

1. IMF, World Economic Outlook, September 2008 for GDP growth and CPI inflation projections.
2. For South Africa, CPIX inflation in 2007 and 2008, and headline CPI in 2009.
3. National Treasury, October 2008.

While it is too early to judge the success of bailout and recapitalisation programmes using public funds, such steps will impose considerable pressure on governments, whose balance sheets may be subject to fiscal deterioration as expenditure rises and debt increases.

A period of slower global growth lies ahead

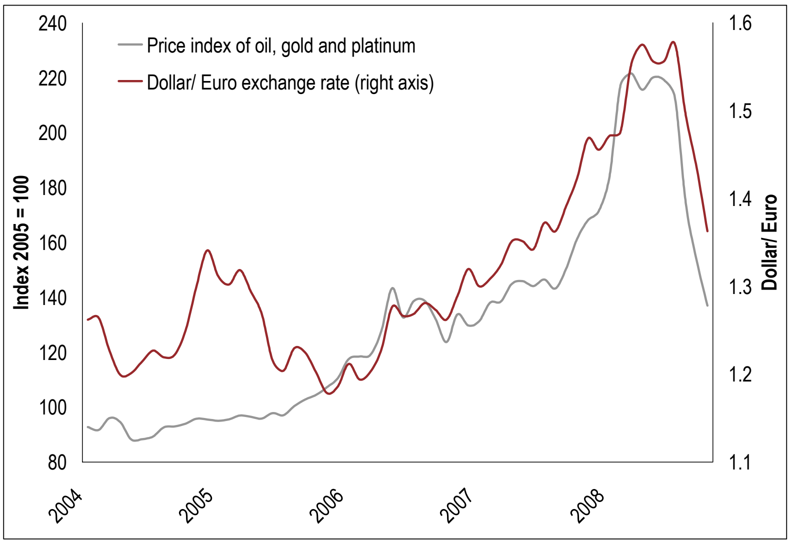
Emerging markets are not immune from this financial and economic imbroglio. Capital flows into equities and bonds have dropped sharply, contributing to declining share prices and more volatile exchange rates. Developing economies will continue to grow, but at generally lower levels.

Key trends in the global economy include the following:

- US economic performance has deteriorated significantly and is expected to grow by 1.6 per cent in 2008 and 0.1 per cent in 2009. The unemployment rate rose to 6.1 per cent in September from 5.0 per cent at the end of 2007. House prices have fallen by 16.3 per cent over the past 12 months.
- The Eurozone is expected to grow by 1.3 per cent in 2008 and 0.2 per cent in 2009.
- The UK is likely to endure a period of slower growth, characterised by a contracting housing market and high inflation.
- China's economic growth, which registered almost 12 per cent in 2007, is expected to slow to 9.7 per cent in 2008 and 9.3 per cent in 2009, as exports to the US, Europe and Japan weaken.
- Economic growth in Sub-Saharan Africa remains strong. While falling commodity prices may pose risks to current projections, commodities have not been the only sources of growth. In much of the continent, greater economic activity has been supported by improved governance and the opening up of undeveloped markets. Sub-Saharan Africa is expected to grow by 6.1 per cent in 2008 and 6.3 per cent in 2009.

- After soaring to record levels in the first half of 2008, commodity prices declined substantially in anticipation of slowing global demand. Gold and platinum prices reached highs of US$1 003/oz and US$2 254/oz respectively in March 2008, but subsequently fell back sharply to current levels of about US$820 and US$900. Investor demand for gold surged in September as global markets deteriorated and investors sought refuge.
- The price of oil, which peaked at US$145 a barrel in early July, fell below US$70 in October. The decline was driven by a sharp appreciation of the dollar exchange rate and declining demand, especially in developed markets. The fall in commodity prices is illustrated in Figure 2.4.

Figure 2.4 Commodity prices and the dollar, 2004 – 2008



2008 represents data up to and including the first half of October 2008.

South Africa and the world financial crisis

Sound banking regulation, gradual capital account liberalisation bolster resilience of economy

While the endpoint of the global credit crisis does not lend itself to accurate predictions, South Africa appears set to avoid the worst consequences of these developments. The domestic financial sector has been relatively unscathed because it has limited exposure to subprime assets and the frenetic round of deleveraging in major economies. Banking sector regulation has been sound and gradual capital account liberalisation has encouraged companies to expand offshore in a responsible manner that has minimised the build-up of risky investments.

Government, together with the Reserve Bank, continuously monitors the domestic banking and financial system. While there are no signs of stress in the domestic financial sector, the authorities will remain alert to any undue strains and take appropriate action should the need arise.

Prudent macroeconomic decisions taken over the past 14 years will stand South Africa in good stead in the tougher times ahead and provide a platform for accelerated growth in the future.

The global financial crisis and the real economy

The international financial crisis now unfolding is of a scale not seen since the 1930s. Global financial and banking systems have been undermined as financial institutions with large exposures to high-risk assets are unable to raise sufficient capital to offset the loss in value of those assets. While the upheaval has been concentrated in the US and Europe, the inclusion of subprime mortgage-backed securities and derivatives in investment vehicles sold across the world has led to a global contagion.

Since early September the financial market landscape has been irrevocably changed as large financial institutions have failed and governments intervened on an unprecedented scale, attempting to bail out large insurance companies and banks, and to unblock credit markets.

Uncertainty regarding the solvency of individual banks has paralysed the interbank lending market and raised overnight and short-term lending rates to prohibitive levels. Central banks have coordinated action to stabilise markets by injecting billions of dollars, euros, pounds and yen into short-term money markets and cutting interest rates. While this has helped to alleviate liquidity constraints, interbank lending remains severely constrained as banks continue to hoard cash. A number of governments have announced plans to take direct stakes in major banks.

Financial distress affects the real economy through channels such as falling asset prices (house prices and equities) and reduced confidence. An insolvent banking system will provide less credit to the economy, which will ultimately lower investment, consumption and economic growth, leading to businesses closing and rising unemployment.

The real-economy impact of the current financial crisis is evident in a range of recent economic data releases in G7 countries portraying weak manufacturing output, low business and consumer confidence, reduced spending and rising job losses – all of which points to recessionary conditions in developed economies and slower growth in emerging markets. Commodity prices have declined sharply due to fears of a global recession. Exchange rates have also been volatile, with the global funding squeeze benefiting the dollar and emerging-market currencies falling due to increased risk aversion.

Fiscal stance maintains strong growth in investment and social spending

Inflation targeting helps to manage long-term inflation expectations by providing an appropriate anchor for monetary policy. In recent years fiscal policy has worked to reduce South Africa's exposure to negative international developments by decreasing government debt and increasing foreign exchange reserves. Over the medium term, the fiscal stance will help to moderate the slowdown in GDP growth by maintaining strong growth in public investment and social spending. A small budget deficit is projected over the next few years.

Government is steadily building foreign reserves

Government's policy stance of building foreign reserves has reduced the vulnerability of the economy to external shocks. While a period of general risk reduction by global investors will reduce capital flows to emerging markets, countries such as South Africa, with strong financial systems and growth-oriented policies, are better placed to retain investor confidence. Over the short-term a growing interest rate differential between South Africa and developed economies will be another factor supporting capital inflows.

Financing the current account deficit

South Africa's mismatch between savings and investment is reflected in the deficit on the current account, which rose to 8.1 per cent of GDP in the first half of 2008 compared with 6.7 per cent in the same period in 2007. Although the gap between savings and investment was adequately financed in the first half of the year, capital inflows slowed considerably in the third quarter as investors liquidated asset holdings in emerging markets, resulting in a weaker rand exchange rate.

Table 2.5 Summary of South Africa's current account, 2004 – 2008

Percentage of GDP	2004	2005	2006	2007	2008*
Trade balance	-0.1	-0.4	-2.4	-2.0	-2.1
Net service receipts	-0.3	-0.4	-0.9	-1.1	-1.6
Net income receipts	-2.0	-2.0	-2.1	-3.1	-3.3
Net dividend receipts	*-1.3*	*-1.6*	*-1.6*	*-2.9*	*-2.6*
SACU transfers	-0.8	-1.2	-1.1	-1.0	-1.1
Net services, income and transfer receipts	-3.1	-3.6	-4.0	-5.3	-6.0
Total current account	**-3.2**	**-4.0**	**-6.5**	**-7.2**	**-8.1**
Current ex SACU transfers	-2.4	-2.9	-5.4	-6.2	-7.0
Financial account balance	3.2	5.1	6.0	8.1	7.9
Unrecorded transactions	2.6	1.2	2.2	1.5	0.5
Change in net reserves due to BoP transactions	**2.7**	**2.2**	**1.7**	**2.4**	**1.1**
Total current account (R million)	**-44 631**	**-62 179**	**-112 346**	**-145 016**	**-179 553**

** First half of 2008, annualised*

Surplus capital inflows fully financed current account during first half of 2008

The trade deficit has stabilised at about 2 per cent of GDP over the past year as returns to commodity-based exports have outweighed the impact of rising oil prices. But the increase in foreign capital required to finance the current account deficit since 2003 has contributed to deterioration in the income account due to rising dividend, service and interest payments to international investors. The deficit on the income account explains a large part of the rise in the current account deficit. Some moderation in dividend payments can be expected in the period ahead as economic activity slows.

Depth of South Africa's capital markets is a significant advantage

As state-owned enterprises increase capital investment spending, they are likely to require additional domestic and international borrowing. The cost of borrowing abroad has risen significantly in the past month due to tight credit conditions in developed-country capital markets. A year ago, South Africa was able to borrow at a spread of 0.65 percentage points above the rate of the US government, but today the spread has increased to more than four percentage points. The depth and resilience of the rand-denominated capital market, and government support for the borrowing programmes of state-owned enterprises, are therefore significant advantages in present circumstances.

South Africa's flexible exchange rate helps to reduce the impact of commodity and capital flow shocks on the real economy. Public and private-sector liabilities are mostly rand-denominated, which means less potential adjustment costs from a weaker exchange rate and a generally more resilient economy. The nominal effective rand exchange rate declined by about 18 per cent between January and the first half of October, while the real effective exchange rate was 3.7 per cent weaker between January and July.

Foreign exchange reserves reached US$34.4 billion in September 2008

Higher foreign exchange reserves also provide an important buffer. Gross gold and other foreign exchange reserves reached US$34.4 billion at the end of September 2008 from US$30.5 billion at the end of September 2007. This was US$26.7 billion higher than the level of foreign exchange reserves at the end of 2000. In the first half of 2008, foreign exchange reserves almost fully covered the value of South Africa's short-term liabilities, including the current account deficit, with the external vulnerability ratio standing at 115 per cent down from 136 per cent in 2000. A lower ratio suggests that South Africa has become less vulnerable to external shocks.

Policy challenges: driving higher growth

Reducing poverty and unemployment remain key goals of economic policy

The unforgiving global economic climate highlights the need for South Africa to address its primary economic policy challenges – reducing unemployment and poverty – in a more concerted way.

Declining foreign demand, weaker commodity prices and potentially lower portfolio investment from abroad suggest that to sustain a more rapid economic expansion, South Africa requires consistently stronger growth in productivity, and more efficient and lower-cost logistics and communications. Innovation and competition are essential to sustain a long-term rise in productivity, along with investments in human capital, plant and equipment, and infrastructure. Alongside continued efforts to reduce the vulnerability of the economy to global contagion, these areas should be the primary targets of economic policy.

Increasing employment and enhancing competition

International reports underline importance of exports for South Africa

During 2007 and 2008 the country's economic policies were subject to two international assessments. The International Growth Advisory Panel and the Organisation for Economic Cooperation and Development (OECD) both released their reports and recommendations on South Africa.

The International Growth Advisory Panel identified the creation of employment through higher exports as the central challenge, pointing out that export industries tend be more labour intensive than industries focused on domestic consumption. The panel's proposed policy measures included:

- Increasing support for export-oriented manufacturing sectors
- Raising domestic savings
- Introducing a targeted wage subsidy for school leavers
- Reducing barriers to employment creation.

Labour productivity gains are essential to open up new job opportunities

The OECD summarised the key economic challenge as follows: "Although in the long-run sustained increases in living standards and convergence to the levels enjoyed by advanced countries will only be achieved via growth in labour productivity … the near-term priority should be given to creating jobs for the millions of primarily low-skilled South Africans currently wanting work".

Addressing this dual challenge requires removing impediments to higher levels of investment and innovation, especially those arising from the dominance of several key economic sectors by a small number of companies. It is difficult for new firms to break into these sectors, where the incumbents enjoy high profit margins. This can be addressed in part by more effective competition policy and reducing external barriers to trade.

Linking education to the world of work is one area that deserves attention. Practical steps could include designing curricula for better alignment with market requirements, practical work experience, improving the employability of graduates and providing career paths for young people leaving the system. This includes greater attention to vocational training, and improved alignment between companies and Sector Education and Training Authorities.

To reduce unemployment, education should be more linked to the world of work

Raising investment

Over the past six years, strong economic activity has exposed the consequences of historic underinvestment in critical infrastructure. While the electricity crisis was the most glaring example, constraints to faster growth can be seen in the ports and rail sector, on the roads and in the refining of petroleum.

Government, often in partnership with the private sector, has embarked on a significant expansion of economic infrastructure. Public-sector capital investment of more than R600 billion is planned over the next three years. Over the medium term, capital formation is on average forecast to add about one percentage point to GDP growth.

Public-sector investments to exceed R600 billion over next three years

In addition to capital investments by Eskom, Transnet and the Airports Company of South Africa, which are well under way, the Gauteng freeway improvement programme and investments by several municipalities in bus rapid transit systems are raising spending on infrastructure. These investments in municipalities complement 2010 FIFA World Cup projects.

Financing these needs during a period of reduced access to global credit is a challenge. South Africa's well-developed domestic capital markets will be important sources of finance. Through targeted guarantees and support for borrowing programmes, government assists several state-owned enterprises to access capital markets at a lower cost. Government is also exploring ways of using its development finance institutions, such as the Development Bank of Southern Africa, to support public investment.

The budget framework provides considerable support to Eskom to finance its large investments. However, the correct pricing of services is crucial to balancing supply and demand, and generating the resources required for higher investment. The realignment of electricity tariffs will encourage more efficient consumption of energy by residential and business users, and provide an incentive for investment in new production capacity.

Correct pricing of services will help balance supply and demand

Public investment in economic infrastructure crowds in private-sector investment, with significant expansion plans in agriculture, mining and manufacturing in anticipation of greater capacity in the key utilities. For example, construction of the De Hoop Dam unlocks new mining opportunities; new power stations generate both demand for coal supplies and greater opportunities for industrial development; and improvements in transport networks contribute to export growth and the mobility of goods and workers.

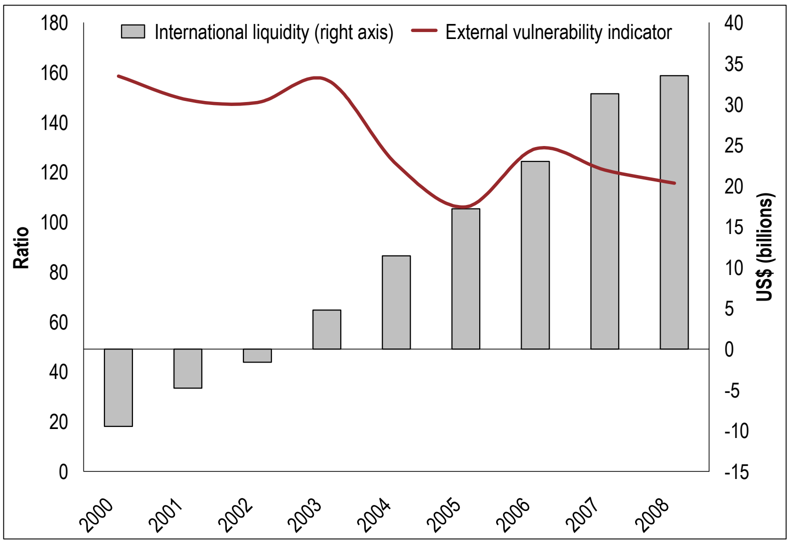
Public investment serves to crowd in private investment

Reducing external vulnerability

Policies and institutions act to cushion economy in a period of global volatility

South Africa has maintained a range of policies and institutions that help to cushion the economy against global volatility. The inflation-targeting framework allows the currency to absorb changes in the prices of commodities and key imports while limiting the impact of these fluctuations on the real economy.

Figure 2.5 Net reserves and external vulnerability, 2000 – 2008

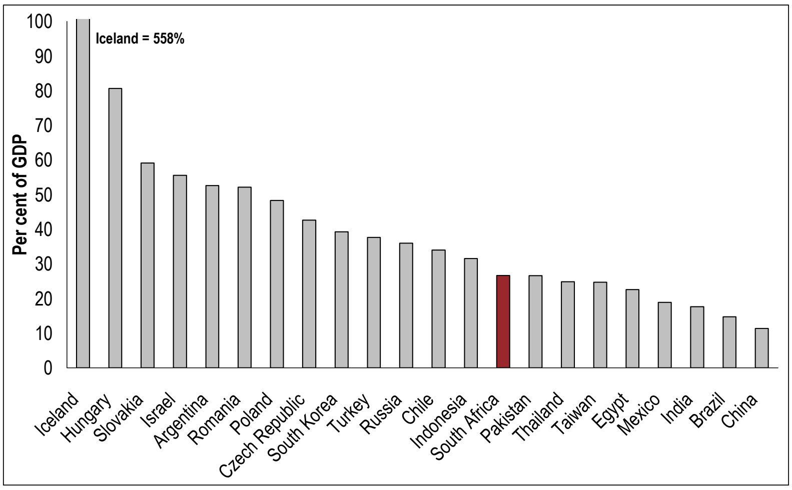


2008 represents data up to and including September 2008.

South Africa's external vulnerability has declined

Financial vulnerability has declined. The prudent fiscal stance has increased government savings and lowered debt (in particular foreign debt) and debt-servicing costs. Exchange controls, prudential regulations and banking supervision have allowed for a responsible expansion of South African financial institutions abroad. Rising foreign exchange reserves have provided further protection.

Figure 2.6 Country comparison of foreign debt levels, 2007



Includes domestic currency debt held by foreigners.

A degree of risk, however, is associated with the large current account deficit. The policy response to mitigating this is as follows:

- Strengthening supportive measures already in place, especially in relation to prudential supervision of the banking system
- Increasing domestic savings to reduce reliance on foreign savings
- Improving net trade performance to generate greater resources for investment.

Household savings are now on the increase

While the institutional capacity to do the first is well advanced, achieving the latter two is likely to be harder. A period of slowing consumption expenditure will help households improve their savings position. This has already begun, with household savings rising in the second quarter of 2008 for the first time in several years. The implementation of the National Credit Act has also served to limit excessive lending by the banking system.

Yet export growth remains sluggish. The ability of South African companies to compete internationally depends on greater productivity gains, cost reduction and innovation, as well as government programmes that promote skills development, reduce infrastructure bottlenecks and improve logistics affecting transport costs.

Table 2.6 Emerging markets export indicators, 2000 – 2007 average

	Goods exports	Services exports	Total trade	Change in share of world exports: goods	Change in share of world exports: services
		Percentage growth		Per cent	
South Africa	3.5	6.3	6.6	0.7	3.2
China	25.3	16.4	22.2	12.4	8.7
Turkey	15.9	5.1	11.3	5.6	-2.4
Poland	15.2	10.7	10.3	10.6	5.7
Hungary	13.5	7.8	11.7	6.4	6.0
South Korea	12.9	4.3	11.6	1.4	0.4
Brazil	9.9	11.3	8.2	5.0	5.6
India	9.2	18.6	11.5	6.4	14.0
Thailand	9.0	5.5	8.6	0.5	-2.1
Mexico	6.4	2.8	6.8	-2.3	-4.5
Argentina	4.9	16.8	5.6	0.2	-0.6

The bulk of South Africa's export earnings are still derived from commodities, and the mining sector has expanded investment rapidly over the past three years. Although commodity prices have fallen sharply in recent months, prices remain relatively high and are likely to receive continued support from economic growth in Asia. The potential for higher mining exports in the medium term remains strong.

Energy efficiency of the economy needs to be improved

South Africa's trade surplus in commodities has been significantly reduced by the economy's reliance on imported oil and petroleum products. While lower oil prices will help to shrink the import bill, over the longer term policy must focus on improving the energy efficiency of the economy, expanding domestic production of oil and gas, and shifting to greater use of other energy sources.

Expanding small-scale agriculture will boost food security and employment

Agricultural investment and production have increased in response to higher prices, and this will support the trade balance. In 2008 South Africa reverted to being a net exporter of maize, but much more needs to be done to boost small-scale agriculture to improve food security and ensure that producers can benefit from higher prices.

Industrial development depends on simplified import tariffs and a lower overall level of trade protection, together with improved coordination of sectoral strategies, skills development, logistics networks and industrial infrastructure investment. Significant tax incentives for the manufacturing sector – to be managed by the Department of Trade and Industry – will also contribute to industrial investment and employment growth over the period ahead.

Conclusion

Through its impact on world growth and appetite for risk, the global financial crisis poses a challenge for commodity-producing countries and those with external funding needs.

Sound macroeconomic management will stand South Africa in good stead in the period ahead, cushioning the economy and households against shocks and providing a platform for higher long-term growth.

The flexible exchange rate, a well-capitalised and prudently regulated banking system, low external debt, deep domestic capital markets, higher foreign exchange reserves, sustainable fiscal policy and ongoing commitment to inflation targeting provide key anchors for improved economic performance. A period of slower growth in consumption in the year ahead will help to replenish household savings. Public-sector investment and capacity additions, in combination with government’s efforts to reduce constraints to more rapid economic expansion, will support higher sustainable growth in the future.