2

Economic policy and outlook

The world economy is emerging from a deep and synchronised recession precipitated by the financial crisis in developed countries. Recovery is likely to be slow and uneven, with modest global growth projected in 2010. South Africa is also recovering, but at a slower rate. While positive fourth-quarter growth is projected, the economy is expected to contract by 1.9 per cent overall in 2009. Gradual recovery will see the economy realise growth of 1.5 per cent in 2010, rising to 3.2 per cent by 2012.

Government and the Reserve Bank have adjusted fiscal and monetary policies to support domestic demand, while public expenditure on key social priorities and infrastructure investment has been maintained. The recovery will strengthen as business confidence improves, employment stabilises and household incomes start to rise.

Over the next few years, the best-performing emerging-market economies will boost their efforts to increase productivity and competitiveness, and South Africa must do the same or risk being left behind. The crisis provides us with an opportunity to improve the efficiency of public spending, expand investment opportunities for the private sector, and reorient the economy onto a more labour-intensive growth path.

The outlook for growth

The global recession has sharply curtailed trade, investment and employment

The most far-reaching economic crisis since the 1930s was set in motion by the collapse of the "subprime" housing market in the United States. When the bubble burst, the massive exposure of the financial system to bad debt led to a seizure in global credit markets. A systemic collapse of banking systems in developed economies was only averted through large-scale, coordinated government intervention during the fourth quarter of 2008. These events brought on a global recession, sharply curtailing trade, investment and employment.

Financial stabilisation and economic recovery are starting to take root

There are, however, growing signs that financial stabilisation and economic recovery are taking root. The International Monetary Fund (IMF) expects world growth of 3.1 per cent in 2010, after a projected contraction of 1.1 per cent this year.

In South Africa, the global downturn led to the first recession in 17 years. Following a decade of uninterrupted growth, real GDP growth contracted by 2 per cent in the first half of 2009. The world recession coincided with a range of negative domestic developments that contributed to the depth of the present downturn. These included a debt-fuelled consumption boom, followed by a surge in inflation during 2007 and 2008, which reduced competitiveness and pushed up interest rates. In addition, key infrastructure such as electricity generation could not keep up with demand.

Nearly half a million South Africans have been retrenched over the past year

The recession has had a severe impact, with increased hardship felt by millions of South Africans. Nearly half a million people employed before the crisis struck are now without a job, and a growing number have been squeezed between falling incomes and high levels of debt.

Domestic fiscal and monetary policies have been eased substantially over the past year to support communities and bolster demand. The fiscal deficit has increased to 7.6 per cent of GDP, while the repurchase rate has declined by five percentage points since December 2008 to 7 per cent, leaving real interest rates close to zero.

After an estimated contraction of 1.9 per cent in 2009 as a whole, the economy will recover gradually over the medium term, driven by positive investment growth, more stable inventories and slower, but still positive, growth in government consumption. Spending on stadiums and transport associated with the 2010 FIFA World Cup has already boosted growth, and the main event next year will further benefit tourism and tax revenues.

Public-sector investment programme supports growth and medium-term recovery

Real GDP growth of 1.5 per cent is projected in 2010, rising to 3.2 per cent by 2012. In the period ahead, South African producers will benefit from a recovery in global demand and high commodity prices, largely as a result of growth in China and India. Renewed capital flows to emerging markets will also reduce the cost of capital and finance fixed investment. Continuing public-sector investment in economic infrastructure provides crucial support to the recovery and is essential to reduce bottlenecks and draw in private-sector investment. Real fixed investment by public enterprises is projected to grow by about 17 per cent per year over the medium term.

CPI inflation, at 7.1 per cent in 2009, is expected to trend downwards

Low inflation, a more competitive real exchange rate, and rising private-sector investment and employment are important for a stronger recovery. CPI inflation declined gradually to 6.4 per cent in August 2009 as food and petrol prices moderated, but core inflation remains above 8 per cent. CPI inflation is projected to average 7.1 per cent in 2009, trending downward to 6.3 per cent in 2010 and reaching 5.7 per cent by 2012. The primary factors driving inflation next year will be higher electricity tariffs and efforts by producers to recoup profits as demand recovers.

Household consumption will recover gradually. There is limited appetite for new debt and the labour market will remain weak until growth strengthens. Household consumption is projected to grow by 0.9 per cent in 2010 and 2.3 per cent in 2011.

Household consumption recovery will be slow given limited appetite for new debt

The current account deficit will decline to an estimated 4.9 per cent of GDP in 2009 from 7.4 per cent last year. However, the deficit is expected to rise to 5.7 per cent in 2010 and 6.1 per cent in 2011, reflecting stronger growth in domestic expenditure and international investment in domestic markets.

Table 2.1 Macroeconomic projections, 2009 – 2012

	2006	2007	2008	2009	2010	2011	2012
Calendar year		**Actual**		**Estimate**		**Forecast**	
Percentage change unless otherwise indicated							
Final household consumption	8.3	6.6	2.3	-3.1	0.9	2.3	2.5
Final government consumption	5.1	4.8	5.0	5.4	4.7	3.6	4.2
Gross fixed capital formation	13.2	16.3	10.2	3.5	4.4	7.1	6.6
Gross domestic expenditure	9.1	6.0	3.1	-3.4	1.7	3.3	3.8
Exports	6.0	7.5	1.7	-19.8	3.8	4.5	5.6
Imports	18.9	10.0	2.2	-20.3	4.2	6.2	7.3
Real GDP growth	**5.3**	**5.1**	**3.1**	**-1.9**	**1.5**	**2.7**	**3.2**
GDP inflation	7.3	9.0	10.9	6.0	6.3	6.4	5.7
GDP at current prices (R billion)	**1 745.2**	**1 999.1**	**2 283.8**	**2 373.8**	**2 560.5**	**2 798.9**	**3 050.0**
CPI inflation	3.2	6.1	9.9	7.1	6.3	6.0	5.7
Current account balance (percentage of GDP)	-6.3	-7.3	-7.4	-4.9	-5.7	-6.1	-6.9

Table 2.2 Macroeconomic projections, 2009/10 – 2012/13

	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
Fiscal year		**Actual**		**Estimate**		**Forecast**	
Percentage change unless otherwise indicated							
GDP at current prices (R billion)	**1 810.7**	**2 067.9**	**2 321.2**	**2 405.1**	**2 620.1**	**2 868.7**	**3 111.3**
Real GDP growth	5.5	4.6	1.8	-1.6	2.0	3.0	3.0
GDP inflation	8.2	9.1	10.2	5.3	6.8	6.3	5.3
CPI inflation	4.0	6.9	9.9	6.5	6.4	5.9	5.7

Prospects and risks in the global recovery

The events of the past year illustrate the dangers of laissez-faire economics, in which financial systems are allowed to operate without prudential supervision and regulation. This leads to boom-bust cycles that do great harm to ordinary people, their livelihoods and savings.

Boom-bust economic cycles do great harm to ordinary people

The world economy contracted by 3.2 per cent in the six months to March 2009, leading to millions of job losses and sharp declines in asset prices. Governments responded with extraordinary measures to stimulate demand by slashing interest rates, expanding money supply and increasing public spending. Although the worst of the crisis appears to be behind us, the world economy is unlikely to return quickly to the preceding period of 5 per cent-plus growth. Soaring household and company debt levels will take considerable time to unwind. The boxes on the following two pages provide a snapshot of the recovery internationally and in South Africa.

The world economy: recovery and risks

The global economy is responding to large-scale stimulus measures and coordinated policy action across major economies. Volatility in equity markets has declined and capital flows to emerging markets have resumed.

Emerging markets and developing countries were drawn into the crisis by the collapse in global trade volumes and a reversal of capital flows. Many emerging markets, particularly China, India and Brazil, are exiting the crisis more quickly. Some major economies, such as Germany and France, have seen output stabilise.

Major economic trends include the following:

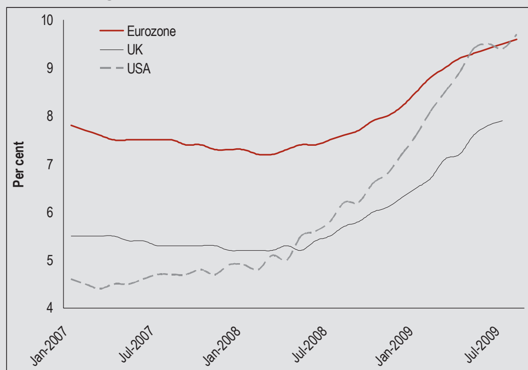
- A contraction in the US economy of 2.7 per cent in 2009 and growth of 1.5 per cent in 2010.
- Real GDP in the Eurozone is expected to contract by 4.2 per cent in 2009 and grow by 0.3 per cent in 2010.
- China is expected to grow by 8.5 per cent in 2009 and 9.0 per cent in 2010. India is expected to grow by 5.4 per cent in 2009 and 6.4 per cent in 2010.
- Emerging markets and developing countries are forecast to grow by 5.1 per cent in 2010, from 1.7 per cent in 2009.
- Growth in sub-Saharan Africa will fall to 1.3 per cent in 2009, rising to 4.1 per cent in 2010.

Much of the present policy stimulus is temporary in nature, and it remains to be seen whether enough has been done to facilitate a lasting recovery. For the recovery to take hold it will require rising real incomes, increasing equity prices, cheaper credit and more stable house prices to outweigh high levels of indebtedness and weak labour markets. The aggregate unemployment rate in advanced economies, which stood at 5.4 per cent in 2007, is projected to be 9.3 per cent in 2010.

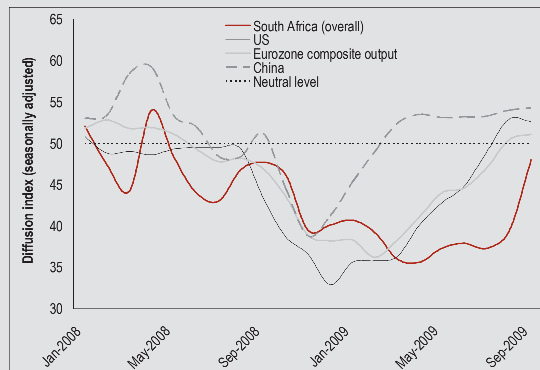
In the longer term, the recovery will be constrained by deteriorating fiscal balances, limiting room for additional stimuli. Higher interest rates could become a factor in the world economy in coming years. The IMF estimates that global fiscal balances will deteriorate by an average of six percentage points in 2009 relative to pre-crisis levels. Debt ratios in advanced economies are projected to rise to 110 per cent of GDP by 2014 from 80 per cent before the crisis.

Short-term efforts to support growth need to be balanced with long-term improvement in fiscal positions and reduced debt.

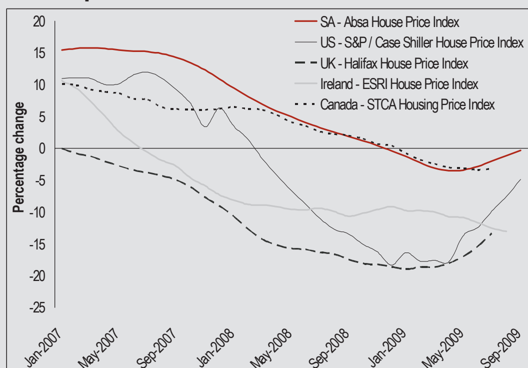
Unemployment rates



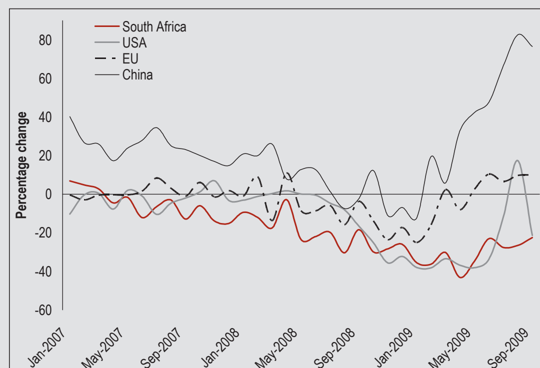
Global purchasing managers' indices



House prices



Vehicle sales



South Africa begins to show signs of a turnaround

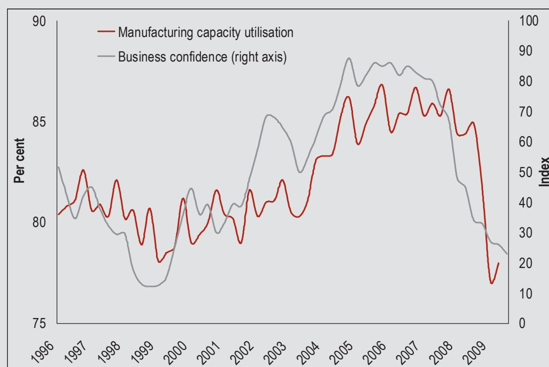
There is mounting evidence that South Africa's economy turned the corner during the third quarter of 2009 in response to improving global conditions, expansionary fiscal and monetary policies, lower inflation and resilient commodity prices.

The composite index of leading business cycle indicators has displayed a gradual upward trend since its lowest point in March 2009. Capacity utilisation by large manufacturers has bottomed out and forward-looking indicators of expectations in the Purchasing Managers Index (PMI) are also more positive.

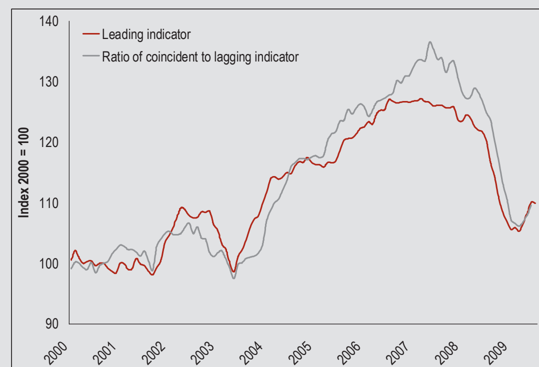
Growth in mining and manufacturing production improved in the three months to August, suggesting benefits from positive global developments, especially high commodity prices. However, competitiveness has been constrained by the appreciating real exchange rate and strong growth in unit labour costs.

South Africa's export prices rose faster than import prices, leading to an improvement in the terms of trade between the fourth quarter of 2008 and the second quarter of 2009, supported by commodity-intensive growth in large emerging economies such as China and India, and gold's reputation as a store of value. Combined with platinum's role in energy-efficient technologies, these factors should provide support to commodity prices over the medium to long term, with positive benefits for mining and minerals exporters. The oil price, however, remains high, with an impact on consumers and businesses.

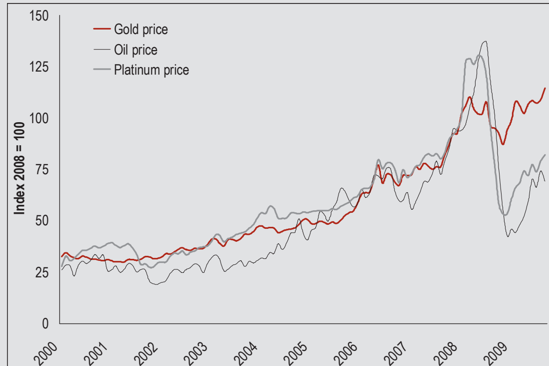
Business confidence and capacity utilisation



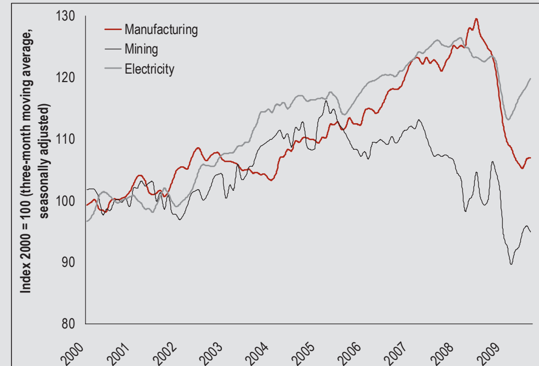
Business cycle indicators



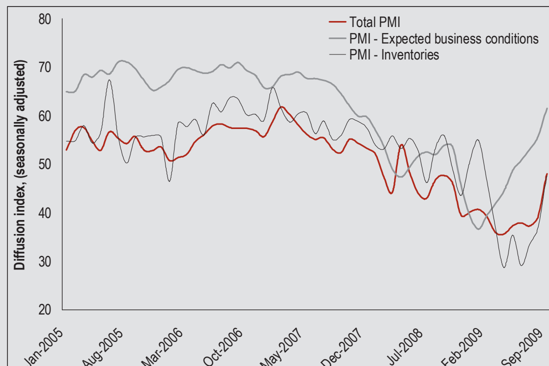
Indices of gold, platinum and oil prices



Mining, manufacturing and electricity output



Components of the PMI



Growth in retail and car sales

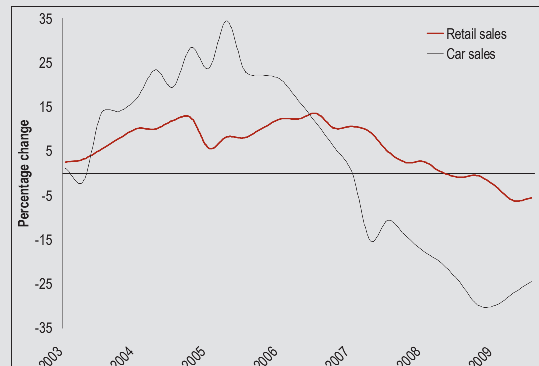


Table 2.3 Annual percentage change in GDP and consumer price inflation, selected regions/countries, 2008 – 2010[1]

Region/Country	2008	2009	2010	2008	2009	2010
Percentage	GDP projections			CPI projections		
World	**3.0**	**-1.1**	**3.1**	**6.0**	**2.5**	**2.9**
US	0.4	-2.7	1.5	3.8	-0.4	1.7
Euro area	0.7	-4.2	0.3	3.3	0.3	0.8
UK	0.7	-4.4	0.9	3.6	1.9	1.5
Japan	-0.7	-5.4	1.7	1.4	-1.1	-0.8
Emerging markets and developing countries	**6.0**	**1.7**	**5.1**	**9.3**	**5.5**	**4.9**
Emerging Asia	**7.6**	**6.2**	**7.3**	**7.5**	**3.0**	**3.4**
China	9.0	8.5	9.0	5.9	-0.1	0.6
India	7.3	5.4	6.4	8.3	8.7	8.4
Africa	**5.2**	**1.7**	**4.0**	**10.3**	**9.0**	**6.5**
Sub-Saharan Africa	**5.5**	**1.3**	**4.1**	**11.9**	**10.5**	**7.3**
South Africa[2]	3.1	-1.9	1.5	11.6	7.1	6.3

1. IMF, World Economic Outlook, October 2009

2. National Treasury, October 2009

Supporting the recovery and achieving more rapid growth

Fiscal and monetary measures to support recovery

Policy aims to encourage a recovery without burdening future generations with unsustainable debt

In the near term, economic policies need to encourage a recovery in the domestic economy without burdening future generations with large public debts, high inflation and interest rates, and low growth. For that reason, government has maintained prudent growth in spending on public services and infrastructure development.

Monetary policy adjusted sharply to the decline in demand and output to support growth, with real interest rates now just above zero per cent. However, greater coordination between government, labour and business is needed to mitigate persistent inflationary factors that have built up in recent years and undermined the competitiveness of the real exchange rate. Monetary policy needs to be strengthened and supported by fiscal policy to keep long-term interest rates low. Government will ensure that financial market regulation is appropriately calibrated to maintain macroeconomic stability.

Global lessons for growth

All countries were affected by the crisis, but some emerging markets are faring better than others

All countries were severely affected by the collapse of global trade and demand over the past year. Some emerging markets, however, have bounced back more quickly than others and are in a better position to benefit from the nascent global recovery. South Africa entered the global crisis with large domestic imbalances and relatively low savings, despite having built up a small fiscal surplus during the preceding economic boom. Asian and Latin American economies that enjoyed relatively high savings rates going into the crisis, as reflected in large fiscal and/or current account surpluses, have displayed more resilience. Brazil, which went into the crisis with high savings and low

inflation, has weathered the storm particularly well. Countries such as Australia and Korea, where prices and wages have adjusted more quickly to weak demand and rising unemployment, have been able to demonstrate a competitive edge, reflected in their real exchange rates and higher levels of investment.

An opportunity to forge a new growth path that promotes large-scale employment gains

South Africa has the opportunity to use this crisis as a catalyst to forge a new growth path that combines faster economic expansion with large-scale job creation to reduce high levels of poverty and inequality, along with an expansion of public services and a strong social safety net. Improved export performance, sustained investment and robust job creation are essential to those goals.

Over the medium term, government intends to play a greater role in drawing more South Africans into work that complements skills development and enhances service delivery. Measures to help young people make the transition from school to work are also necessary. A greater role for the state in the economy needs to be complemented by efforts to promote private-sector growth. South Africa's macroeconomic framework needs to promote stronger domestic investment, job creation and export activity.

Research has helped to identify core elements of a new growth path

Several recent studies have identified constraints to South Africa's growth. These studies included the work of the International Growth and Advisory Panel (2006-2008), the Organisation for Economic Cooperation and Development's *Economic Assessment of South Africa* (2008), and the Commission on Growth and Development's work on high-growth strategies in 13 economies in the post-World War II period (2008). The five broad lessons that emerge from these studies are summarised below.

Fiscal and monetary policies that promote balanced, sustainable growth

- Savings is the key driver of investment and growth. Countercyclical fiscal and monetary policies that prevent the build-up of large imbalances in the economy bolster savings. Initiatives to promote financial inclusion and literacy are also important to encourage households to save.

Shifting resources to labour-intensive sectors

- In addition to providing incentives to increase labour intensity in public works programmes, governments can boost job creation by facilitating the transition of workers from older, less-productive industries to new, faster-growing ones. Income-support for affected workers, and education and training programmes, are more desirable than efforts to save jobs in uncompetitive industries.

Increasing competitiveness, raising productivity, lowering costs

- Aligning input costs all along the production chain – from capital to labour to transport and finished goods – is necessary to support

export and import-competing industries in global and domestic markets.

- Skills development is crucial and reducing red tape is essential. Lowering the cost of hiring young people would improve social inclusion and reduce high rates of youth unemployment. Productivity is central to growth and employment.

Productivity: how South Africa compares

In the view of Nobel Laureate Paul Krugman: “Productivity isn’t everything, but in the long run it is almost everything. A country’s ability to improve its standard of living over time depends almost entirely on its ability to raise its output per worker.”

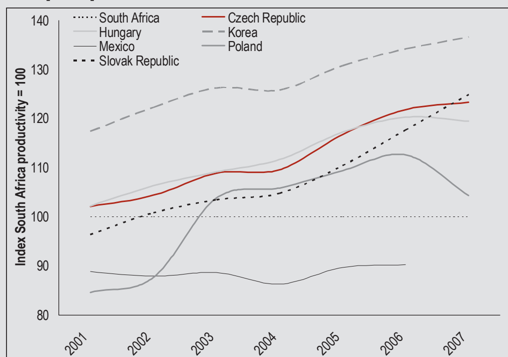
The gap in productivity between South Africa and its emerging-market competitors has grown, requiring us to take steps to raise productivity to support income growth.

South Africa compares reasonably well on indicators of innovation and technology, but educational outcomes are poor, as illustrated by low scores in international tests of literacy, maths and science, which in turn contribute to low enrolment in tertiary education and a low proportion of researchers.

Investment in fixed capital has also lagged other countries. Over the period 1993-2007, our emerging-market competitors invested on average 9 per cent of GDP more each year than South Africa, equivalent to an investment shortfall of R1.3 trillion.

The productivity gap needs to close to boost growth and employment. Greater innovation, technological progress, and more efficient production processes need to be combined with increased investment, and reform of our educational and skills development systems.

Output per worker hour



Productivity indicators

	CEE Average	Korea	Mexico	South Africa
R&D expenditure as share of GDP	0.9	3.2	0.5	0.9
Number of researcher per million inhabitants	2 017	4 162	464	361
Public spending on education as share of GDP	4.8	4.4	5.5	5.4
Primary school enrolment**	98.7	105.0	112.7	103.2
Secondary school enrolment**	96.8	97.5	87.2	95.8
Tertiary school enrolment**	57.3	92.6	26.1	15.4
Rank in international literacy test (PIRLS)	21 out of 45	-	-	45 out of 45
Rank in international science test (TIMSS)	11 out of 45	3 out of 45	-	38 out of 45
Investment as share of GDP	24.5	29.0	23.0	20.0
Investment per worker (PPP US$, Million)	10.3	14.9	8.0	9.3
Manufacturing value added as share of GDP	23.7	29.0	15.8	14.6
Days to start a business	22.0	17.0	27.0	31.0

** Latest available figures unless stated otherwise*

*** As share of relevant school-age population*

Data sourced from the World Bank, UNESCO, UNIDO, WIPO, PIRLS, TIMSS and the Presidency
CEE refers to Central and Eastern Europe

Trade and industrial policies that lower costs and create jobs

- Fast-growing economies are open to trade and fully exploit the global economy by importing ideas, technology and know-how, and exporting goods and services. Foreign direct investment is an important conduit for the transfer of capital, skills and technology.

- In many countries, industrial policy was used successfully to diversify exports and to promote investment in new sectors through special export zones and tax incentives. Such measures should be temporary. “Any profit-seeking activity that needs permanent subsidies or price distortions to survive does not deserve to do so,” notes the Growth Commission. A proposed fund to support industrial development and job creation is discussed in Chapter 4.

- A more stable and competitive real exchange rate is important for growth. Foreign reserve accumulation limits the appreciation of the exchange rate. Reform of exchange controls can facilitate greater two-way flow of capital and help to reduce volatility.
- Government should promote efficient use of energy and water resources by producers and households, alongside measures to mitigate the effects of climate change. Prices that reflect cost and well-structured environmental taxes provide incentives for efficiency improvements and new investment.

Calibrating trade policy

Work on trade policy is focused on providing meaningful support to South Africa's industrial strategy and job-creation objectives. Tariff structures will be reviewed with these objectives in mind.

South Africa seeks a conclusion of the Doha Round based on the original developmental mandate. However, that mandate has been eroded over time, and may result in less ambitious reforms to tariff policies in agriculture that hold back developing-country producers.

At the same time, our status as a middle-income country implies tariff reductions in South African industrial products that we believe to be too large and could have negative effects on employment in some labour-intensive industries.

In line with the objective of building trade relations with key developing economies, South Africa and other members of the Southern African Customs Union (SACU) negotiated and concluded a preferential trade agreement with MERCOSUR in June 2008. The agreement, subject to parliamentary ratification in all signatory countries, provides a sound basis for expanding trade links between Southern Africa and South America.

Improving public-sector performance and service delivery

- Effective and capable public sectors are common to fast-growing economies around the world. Political leadership focused on growth, setting performance standards, enforcing accountability frameworks and resolving tradeoffs in the interest of inclusive growth is also essential.

The beginning of a recovery in the real economy

The collapse in global and domestic demand has had a dramatic impact on all sectors except government services and construction. Real GDP, which began contracting in the fourth quarter of 2008, is expected to decline by 1.9 per cent in 2009 before growing again by 1.5 per cent in 2010 and 3.2 per cent by 2012.

In the first six months of 2009, mining output declined by 9 per cent compared with a year ago, while manufacturing production fell by 16.1 per cent. The ratio of industrial and commercial inventories to GDP fell to a record low of 10.8 per cent of GDP in the second quarter of 2009 from 13 per cent a year earlier as production and demand plunged.

Further relaxation of exchange controls: reducing the cost of doing business

South Africa's financial system proved to be highly resilient during the global financial crisis. Given the strength of our regulatory system and the shift towards a risk-management approach in line with other G20 member countries, government is in a position to announce further reforms to lower the cost of doing business in South Africa, while managing risks in a volatile international environment.

Aligning prudential regulations on financial institutions with G20 commitments

The move to a system of prudential regulation of foreign exposure, supported by a strong financial regulatory framework, contributed to moderating the impact of the global financial crisis on South Africa. The regulations governing foreign exposure of institutional investors were last updated in 2008 and will remain part of the country's framework for financial and macroeconomic stability. Government will, however, take into account appropriate international proposals to strengthen our regulatory framework in alignment with G20 agreements.

Removing red tape on business transactions

Proposed reforms to reduce red tape on business transactions are as follows:

- Promoting regional integration by allowing South African companies to invest in Southern African Development Community (SADC) member states through offshore intermediaries. The relaxation excludes investment in member states that are part of the Common Monetary Area.
- Increasing the current R50 million limit for company applications to undertake outward investment to R500 million. Applications below this limit will be processed by authorised dealers, subject to all existing criteria and reporting obligations.
- Removing the 180-day rule requiring companies to convert their foreign exchange into rand. (South African companies are still required to repatriate export proceeds to South Africa).
- Doing away with the R250 000 limit on advance payments for imports.
- Allowing South African companies to open foreign bank accounts for permissible purposes without prior approval, subject to reporting obligations.
- Replacing the current paper-based monitoring system of exports (Form F178) with a more efficient electronic system in due course.

Further relaxation of limits on individuals

The foreign capital allowance for resident individuals, last adjusted in 2006, has been increased from R2 million to R4 million, and the single discretionary allowance from R500 000 to R750 000.

Removing controls on non-residents

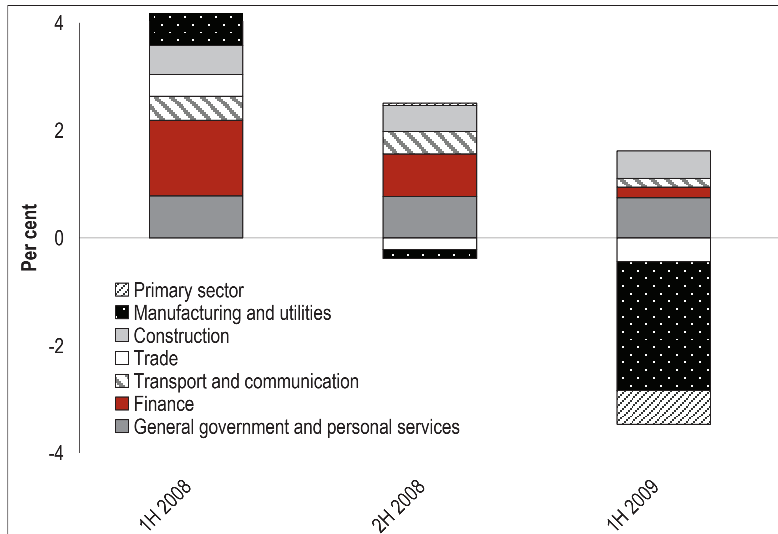
To improve access to domestic credit in the financing of local foreign direct investment (FDI), restrictions on the granting of local financial assistance to affected persons have been further liberalised with the abolition of the 3:1 ratio. This relaxation does not apply to emigrants, the acquisition of residential properties by non-residents, or any other financial transactions – such as portfolio investments, securities lending, hedging or repurchase agreements – by non-residents. In these cases the 1:1 ratio still applies.

The Reserve Bank will provide further details concerning all the above reforms.

Supporting investment and cutting red tape

South Africa continues to welcome foreign direct investment (FDI) and encourages local firms that wish to diversify offshore from a domestic base. Moreover, government recognises the need to modernise the investment framework. In support of these objectives, the National Treasury proposes to improve the current exchange control regulatory framework for approving investments. The key proposals that will form part of the modernised approach will be announced in the 2010 Budget.

Figure 2.1 Sector contributions to real GDP growth, 2008 – 2009



Indicators suggest that the economy turned the corner in the third quarter, although a high degree of volatility remains.

- Mining displayed the first signs of recovery, with production rising strongly in the six months to August. The sector has benefited from a recovery in commodity prices and rising iron ore exports to China.
- Manufacturing production rose at an annualised rate of 3.6 per cent between June and August compared with the previous three months. The improvement has been most noticeable in the motor industry, petrochemicals, and food and beverages.
- Electricity demand has increased since the second quarter of 2009.

Impact on the labour market

Job losses have been concentrated in trade, manufacturing, mining, agriculture and transport

The labour market has been severely affected by the economic crisis, with job losses concentrated in wholesale and retail trade, manufacturing, mining, agriculture and transport. Total employment declined by 3.5 per cent between the fourth quarter of 2008 and the second quarter of 2009, compared with annual growth in employment of 2.4 per cent per year between 2002 and 2008.

The labour market is likely to remain weak over the medium term due to slow recovery in the economy and upward pressure on wages. In addition to job losses, the number of people who are no longer actively seeking employment grew by 409 000 between December 2008 and June 2009. While official unemployment has remained reasonably stable at 23.6 per cent, the broad measure of unemployment has risen to 29.7 per cent from 26.7 per cent in December 2008.

Figure 2.2 Official and broad measures of unemployment, 2008 – 2009

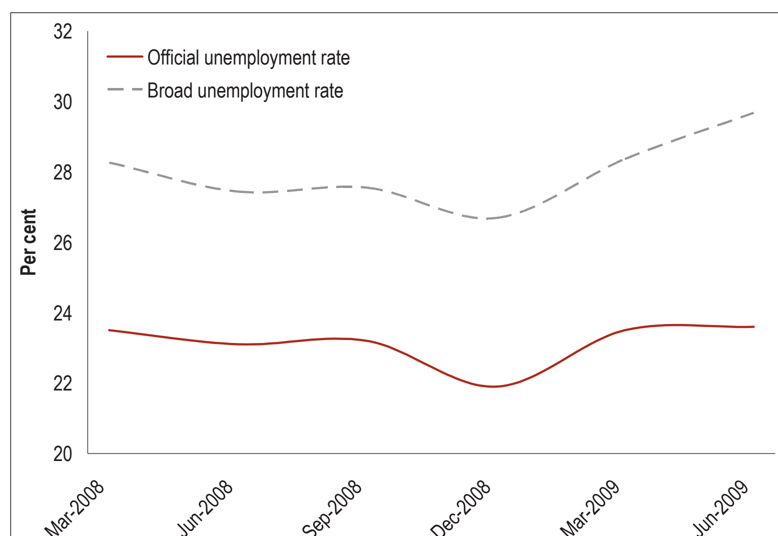


Table 2.4 Formal non-agricultural employment, quarter ended June 2009

	Total employed ('000)	Annual change ('000)	Growth (%, y-o-y)	Change since June 2006 (%)
Mining & quarrying	494	-26	-5.0	7.6
Manufacturing	1 225	-82	-6.3	-8.0
Utilities	59	0	0.0	13.5
Construction	451	-23	-4.9	-1.1
Retail & wholesale trade	1 664	-62	-3.6	0.0
Finance, insurance & real estate	1 827	-80	-4.2	4.7
Transport & communication	357	-7	-1.9	1.4
Community & personal services	2 182	82	3.9	9.0
Total	**8 259**	**-198**	**-2.3**	**2.5**

Source: Statistics South Africa

A gradual recovery in consumption

Gross domestic expenditure declined in the first half of 2009 due to declining household consumption, a sharp contraction in private investment and significant inventory shrinkage. However, government spending and accelerating growth in public investment have contributed positively to growth.

Table 2.5 Contribution to gross domestic expenditure growth

	2006	2007	2008	2009*
Household consumption expenditure	5.3	4.2	1.5	-1.7
Government consumption expenditure	1.0	0.9	0.9	0.8
Gross fixed capital formation	2.3	2.9	2.0	1.3
Change in inventories	0.6	-1.0	-0.8	-2.8
Residual item	-0.1	-0.9	-0.4	–
Gross domestic expenditure	**9.1**	**6.0**	**3.1**	**-2.4**

** First two quarters of the year*

Source: South African Reserve Bank

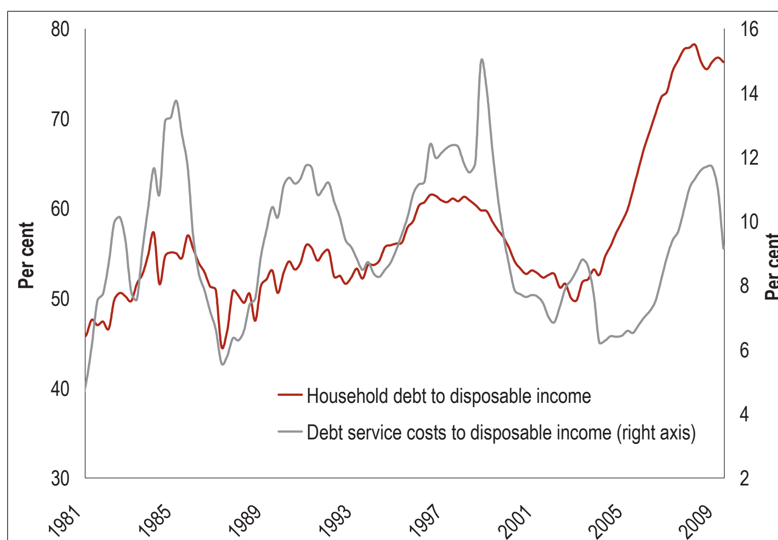
Fiscal and monetary policies have been eased substantially to support demand. However, the full benefit of lower interest rates for consumption and investment will only be seen in time. Banks remain cautious about extending credit and households have been reluctant to take on new debt. Indicators of domestic demand remain weak, with a gradual recovery projected over the medium-term.

Lower interest rates and falling inflation are expected over the period ahead

Household consumption expenditure contracted in the first half of 2009. A sharp rise in inflation in 2008 reduced disposable incomes and spending, and the effects were compounded by tighter credit conditions, job losses and lower house prices accompanying the recession. Although households will benefit from lower interest rates and falling inflation in the period ahead, consumer sentiment will remain muted until greater certainty returns to the labour market and household debt is reduced.

Nevertheless, a gradual improvement in asset prices will help to rebuild household wealth. The ABSA house price index has improved markedly in recent months: prices were only 0.3 per cent lower than a year ago in September after contracting by 3.5 per cent in April 2009.

Figure 2.3 Household debt and debt service costs, 1981 – 2009



Increase in investment by public enterprises helped to offset decline in private-sector investment

Gross fixed investment grew in the first half of 2009, but at a much slower pace of 6.3 per cent compared with growth of 12.6 per cent in the same period in 2008. Private-sector investment fell by 2.5 per cent in the first half of the year, but this decline was partially offset by a sharp increase in investment by public enterprises. The largest declines were in manufacturing, finance and real estate.

Table 2.6 Contribution to overall investment growth

	2005	2006	2007	2008	2009*
General government	0.1	2.4	2.9	1.5	0.4
Public corporation	1.2	1.7	4.1	4.1	7.6
Private enterprises	8.9	9.2	9.3	4.7	-1.7
Total	**10.2**	**13.2**	**16.3**	**10.2**	**6.3**

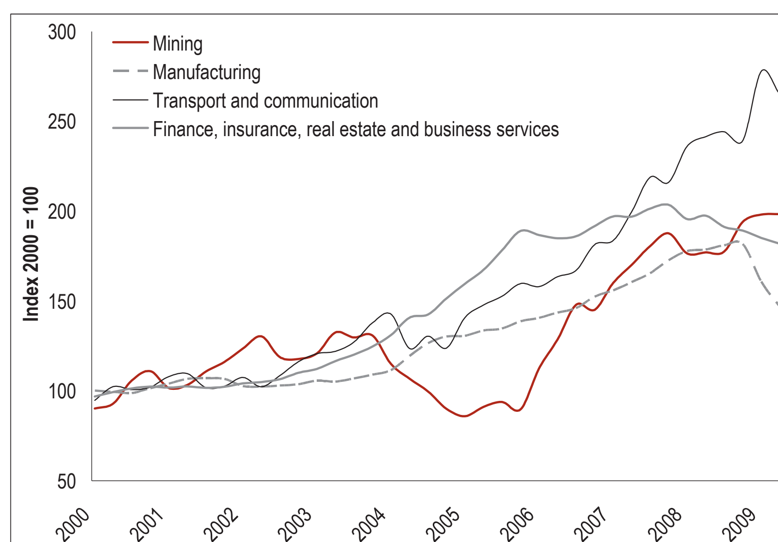
** First half of the year*

Source: South African Reserve Bank

Ratio of gross savings to GDP is rising as a result of weak domestic demand

Weak domestic demand resulted in the ratio of gross savings to GDP rising to 16.5 per cent by the end of June 2009 from 15.2 per cent 12 months earlier, largely due to corporate savings.

Figure 2.4 Real gross domestic fixed investment by sector, 2000 – 2009



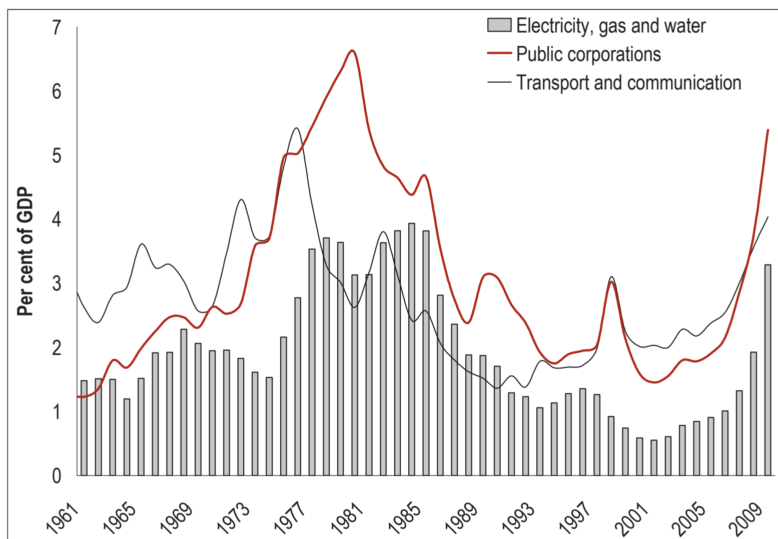
The importance of sustaining public investment

Investment in key infrastructure is part of government's strategy for long-term growth

Public-sector investment, focused on key infrastructure, is a cornerstone of government's strategy to support higher sustainable economic growth in the future. Such expenditure will also help to sustain growth in overall investment and GDP over the medium term.

In the first half of 2009, real fixed investment by state-owned entities increased by 50 per cent compared with the previous year, driven by an 83 per cent rise in spending on electricity, gas and water. Significant investment is also taking place in transport infrastructure, including air, rail, ports and buses. Fixed investment by public corporations rose to 5.4 per cent of GDP in the first half of 2009, a level not seen since the significant capacity expansion of the late 1970s.

Figure 2.5 Investment by public corporations, 1961 – 2009



Data for 2009 is for the first two quarters

Between 2009 and 2012, capital expenditure by Eskom, Transnet and the South African National Roads Agency will total about R441 billion. Higher levels of investment will generally be financed by increased borrowing by state-owned enterprises. In the case of Eskom, the state will provide guarantees where necessary, and tariff increases will be required to align the price of electricity with the cost of generation. Expanded capacity in electricity, rail, ports and roads will help to increase private investment and the potential growth rate of the economy as a whole.

Tariff increases are necessary to align prices with the cost of electricity generation

Development finance institutions are also playing a greater role in supporting companies through the downturn and providing infrastructure finance. The Development Bank of Southern Africa will be supported to leverage its borrowing up to R140 billion. The Industrial Development Corporation intends to invest more than R70 billion in the economy over the next five years, of which R6.1 billion is set aside to assist distressed companies.

Banking sector and credit extension to support recovery

A sustainable economic recovery will require stepped-up credit extension to businesses and households. Although South Africa's financial sector was spared the enormous losses incurred by banks in advanced economies, banking operations have been affected by the downturn and lower house prices. Over the past 12 months, lending growth has slowed sharply across all categories of credit. Growth in private-sector credit extension slowed to only 2.3 per cent in August 2009, with credit extension to the corporate sector 2.4 per cent lower than a year ago. Non-performing loans have more than doubled over the past year from 2.8 per cent of total advances in July 2008 to 5.8 per cent in August 2009.

Stepped-up credit extension is needed to support businesses and households in the recovery

Banks will benefit from the gradual improvement in economic activity. The current stabilisation in the housing market and improved sentiment in financial markets will also reduce pressure on balance sheets. Conditions for raising capital have already improved and banks

have taken advantage of this to strengthen their balance sheets. Monetary policy has eased to lower the cost of capital.

Reduced pressure on the current account

The current account has narrowed to a deficit of 5.1 per cent of GDP

Declining domestic expenditure and rising savings have helped alleviate pressure on the current account, which narrowed to a deficit of 5.1 per cent of GDP during the first half of 2009 from 8.1 per cent in the same period in 2008. The trade deficit shrank in the first half of 2009 as imports contracted more sharply than exports, due to weak demand and the rising terms of trade.

Table 2.7 Summary of South Africa's balance of payments, 2004 – 2009

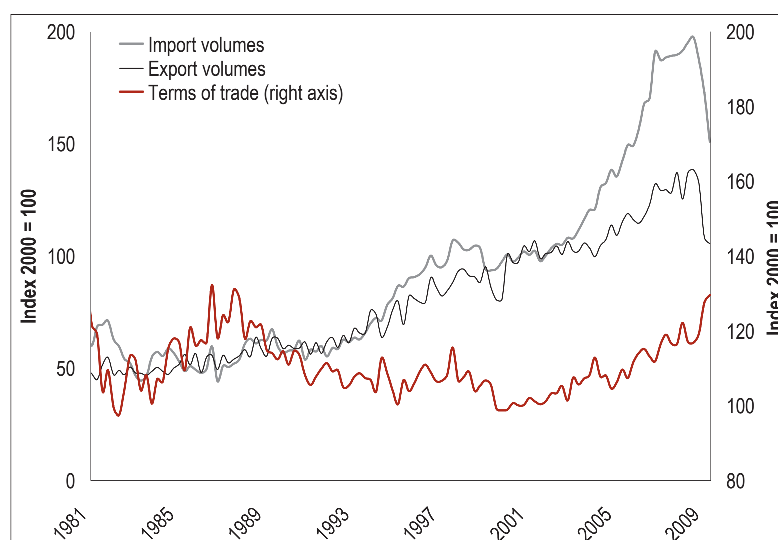
Percentage of GDP	2004	2005	2006	2007	2008	2009*
Trade balance	-0.1	-0.4	-2.3	-2.0	-1.6	-0.6
Net service receipts	-0.3	-0.4	-0.9	-1.1	-1.5	-1.0
Net income receipts	-2.0	-2.0	-2.0	-3.2	-3.2	-2.4
Net dividend receipts	*-1.3*	*-1.6*	*-1.6*	*-2.9*	*-2.5*	*-1.7*
SACU and other current transfers	-0.8	-1.2	-1.1	-1.0	-1.1	-1.2
Net services, income & transfer receipts	-3.1	-3.6	-4.0	-5.3	-5.8	-4.5
Total current account	**-3.2**	**-4.0**	**-6.3**	**-7.3**	**-7.4**	**-5.1**
Current account excl. SACU and other current transfers	-2.4	-2.9	-5.2	-6.3	-6.4	-3.9
Financial account balance	5.9	6.2	8.0	9.7	8.5	5.4
Unrecorded transactions	2.7	1.3	1.9	2.0	4.0	0.7
Change in net reserves due to BoP transactions	**2.7**	**2.2**	**1.7**	**2.4**	**1.1**	**0.8**

** First half of 2009*

Source: South African Reserve Bank

The two largest import categories – capital goods and industrial supplies – have fallen significantly in response to declining manufacturing production and exports. Imports of fuel and lubricant oils have also dropped off.

Figure 2.6 Volumes of exports and imports and the terms of trade, 1981 – 2009



The improvement in the current account is likely to be temporary since demand for imports will rise as domestic demand recovers and inventories are rebuilt. As the economy recovers, income payments to the rest of the world will also rise gradually as foreign holdings of South African assets increase and profit growth strengthens. The current account deficit is expected to rise to 5.7 per cent of GDP in 2010 from an estimated 4.9 per cent in 2009.

The current account deficit is projected to increase to 5.7 per cent in 2010

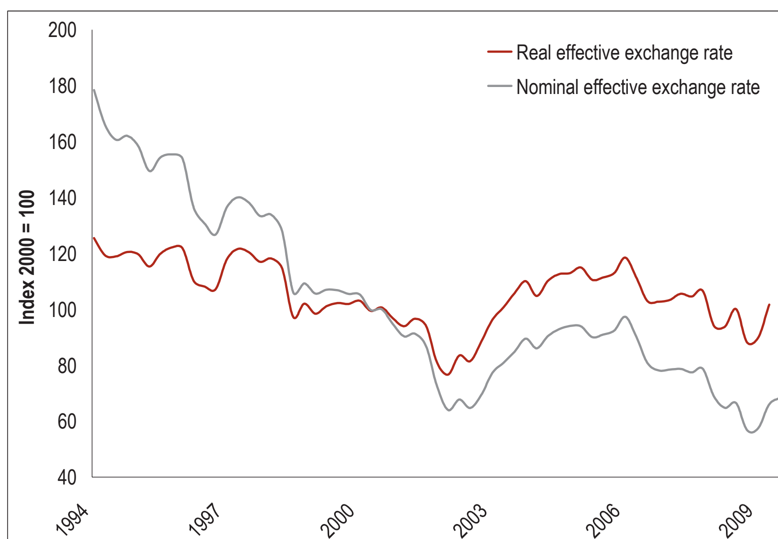
South Africa's overall balance of payments recorded a surplus of R8.9 billion in the first half of 2009. The smaller current account deficit reduced the external funding requirement, but capital inflows also increased strongly as investors purchased more emerging-market assets.

Net purchases of rand-denominated bonds and equities by non-residents amounted to R116 billion in the nine months to September 2009, which is more than the inflows recorded in the same period in 2007. Net inflows of foreign direct investment were also large, at R36.3 billion in the first half of the year.

Strong capital inflows, rising commodity prices, returning risk appetite and a weaker dollar have strengthened the rand to levels last seen before the intensification of the global crisis in September 2008. However, the longer-term trend in the rand is still lower. After a depreciation of more than 40 per cent against the US dollar between January and October 2008, the rand has recovered to pre-crisis levels. In nominal terms, the trade-weighted rand was 27 per cent weaker in September 2009 compared with its peak in February 2006, while the real exchange rate was about 12 per cent weaker over the same period.

Despite the rand's strength in the third quarter of 2009, the long-term trend is lower

Figure 2.7 Nominal and real effective rand indices, 1994 – 2009



Despite strong capital inflows, the squeeze on fiscal resources has limited the Reserve Bank's ability to accumulate more foreign exchange reserves. Gross foreign exchange reserves rose to US$39.1 billion in September 2009 from US$33.7 billion in January, largely due to proceeds from the National Treasury's foreign bond

Gross foreign exchange reserves reached US$39.1 billion in September 2009

issue and the allocation of IMF special drawing rights worth US$2.1 billion. The combination of higher foreign exchange reserves and a smaller current account deficit reduced South Africa's external vulnerability in the second quarter, with reserves adequately covering external obligations.

Conclusion

South Africa's recovery is closely linked to the fortunes of the world economy

The recession has resulted in rising unemployment and business failures, increasing hardship for millions of South Africans. Government has responded to this crisis by sustaining core social expenditure and increasing public infrastructure investment to support higher growth in the future. Interest rates have also declined sharply since the end of 2008 to support growth. South Africa's recovery is closely linked to the fortunes of the world economy, which is expected to improve gradually in the period ahead. Although there are still significant risks to the outlook, the worst of the crisis appears to have passed.

Commodity producers will continue to benefit from strong and sustained expansion in Asia. While many lower-income countries will struggle to manage the aftermath of the global contraction, proximity to better-performing economies, greater regional integration, and improvements to macroeconomic frameworks will tend to support their growth and development. Competitive, well-managed and fiscally sound emerging-market economies are poised to reap the benefits of renewed capital investment flows. Such economies will experience steady increases in per capita incomes.

Over the medium-term, South Africa requires a greater focus on increasing labour absorption in the economy. Reforms to improve competitiveness and to stimulate higher levels of investment, and to foster increased activity by the private sector, are essential to support sustainable employment creation.

Strengthening global financial regulation

The global financial crisis has highlighted the need for a coordinated effort to improve regulation of the financial services industry. To achieve this, the G20 established the Financial Stability Board.

The Financial Stability Board is a high-level forum drawing together policy-makers from important financial centres. It advises on best practice in meeting regulatory standards, and promotes coordination among member countries. South Africa joined the forum 2009. The board has made headway in improving regulation in the following areas:

- Developing a systemic risk ("macro-prudential") approach to financial regulation.
- Raising the quality and level of capital held by banks to improve resilience.
- Reforming the Basel II capital framework to ensure that capital buffers are not procyclical.
- Expanding regulation to reduce risks posed by hedge funds and over-the-counter derivatives.
- Ensuring that banks follow appropriate guidelines for compensating senior executives.
- Strengthening adherence to international standards through a transparent peer review process.
- Improving global accounting standards.

During 2010 work will be undertaken to align South African financial sector policy and regulations with the recommendations of the G20 process.