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Economic policy and outlook

■ A gradual recovery

The world economy continues to recover from the severe recession precipitated by the global financial crisis. Fiscal and monetary policies in major developed and developing economies support stronger demand, but the recovery is fragile and marked by persistent global imbalances. The costs of the crisis as reflected in higher unemployment and increased public debt will weigh on growth for many years to come. The world economy is expected to grow at a relatively strong pace of 4.8 per cent in 2010 and 4.2 per cent in 2011.

Global growth of 4.2 per cent is projected for 2011

South Africa's economy gained strength during the first half of the year, and the outlook has improved moderately since the 2010 Budget forecast. Stronger spending by households and income from high commodity prices have been supported by expansionary fiscal and monetary policies and lower inflation. Investment by state-owned enterprises has been sustained. Employment and private investment are expected to rise gradually as growth accelerates. Real GDP growth of 3 per cent is projected for this year, followed by 3.5 per cent in 2011 and 4.4 per cent by 2013. Like other emerging markets, South Africa is experiencing high levels of capital inflows, which provide an important source of funding. Combined with US dollar weakness, however, the surge in capital inflows has led to strengthening of the rand exchange rate.

South Africa's economic recovery continues to gain momentum

While the outlook is improving, the pace of growth has not begun to approach the level required to draw millions of people into employment and to sharply reduce inequality. This is South Africa's development gap: the economy needs much faster, more labour-absorbing growth over an extended period to meet the country's core challenges. To achieve this requires a growth strategy that forges partnerships between government, business and labour to raise competitiveness, expand production and create employment through increased investment and trade.

A new growth strategy is needed to drive massive job creation and meet development challenges

The domestic economic outlook

Domestic growth will pick up moderately in 2011

The economic recovery strengthened in the first half of the year, with real GDP growth expanding at an annualised rate of 3.9 per cent compared with the second half of 2009. Growth was stronger than expected in the first six months of 2010 as a result of temporary factors, including an uptick in consumption related to the soccer World Cup and more stable inventories. The pace of GDP growth is likely to moderate in the second half of the year, before picking up in 2011.

Real GDP growth is projected to rise from 3 per cent in 2010 to 3.5 per cent in 2011, 4.1 per cent in 2012 and 4.4 per cent in 2013. While the level of real GDP returned to pre-crisis levels in the second quarter of this year, it will take some time before the economy reaches full capacity.

Table 2.1 Macroeconomic projections, 2007 – 2013

Calendar year	2007	2008	2009	2010	2011	2012	2013
	Actual			Estimate	Forecast		
<i>Percentage change unless otherwise indicated</i>							
Final household consumption	5.5	2.4	-3.1	2.6	3.4	4.1	4.5
Final government consumption	4.7	4.9	4.7	4.9	4.3	4.2	3.7
Gross fixed capital formation	14.2	11.7	2.3	0.8	5.6	5.0	5.9
Gross domestic expenditure	6.4	3.3	-1.8	4.1	4.2	4.5	4.9
Exports	5.9	2.4	-19.5	4.1	5.7	6.6	7.6
Imports	9.0	1.4	-17.4	8.4	7.8	7.9	8.7
Real GDP growth	5.5	3.7	-1.8	3.0	3.5	4.1	4.4
GDP inflation	8.2	9.2	7.3	6.1	5.3	5.5	5.6
GDP at current prices (R billion)	2 017.1	2 283.8	2 407.7	2 631.4	2 867.1	3 148.0	3 471.9
Headline CPI inflation	6.1	9.9	7.1	4.4	4.7	5.0	5.2
Current account balance (% of GDP)	-7.2	-7.1	-4.0	-4.2	-4.9	-5.3	-5.8

Table 2.2 Macroeconomic projections, 2009/10 – 2013/14

Fiscal year	2009/10	2010/11	2011/12	2012/13	2013/14
	Actual	Estimate	Forecast		
<i>Percentage change unless otherwise indicated</i>					
Real GDP growth	-1.3	3.5	3.6	4.2	4.5
GDP inflation	7.2	5.6	5.5	5.6	5.8
Headline CPI inflation	6.4	4.1	4.8	5.1	5.2
GDP at current prices (R billion)	2 455.6	2 683.9	2 933.5	3 227.9	3 568.7

Policy adjustments support recovery

South Africa's countercyclical response during the recession partly offset the sharp reduction in trade, and will continue to support a recovery in private investment and consumption. The projected fiscal deficit for 2010/11 is 5.3 per cent of GDP, and government expenditure will grow by nearly 5 per cent in 2010 to cover the costs of higher real wages and expanding social services. A slower pace of public expenditure growth is projected over the medium term to ensure that government debt levels remain sustainable and to prevent an undue rise in interest rates.

Monetary policy has also adjusted to weak demand, with interest rates declining further this year in response to lower-than-expected inflation. The Reserve Bank reduced interest rates by 1 percentage point between March and August, bringing the repo rate to 6 per cent, the lowest level since it was introduced in 1998. Subdued headline inflation should allow monetary policy to remain supportive of growth over the medium term.

Interest rates have declined in response to lower-than-expected inflation

The rise in output during 2010 contrasts markedly with continued weakness in the labour market. On the present GDP growth trajectory, private-sector employment will only recover to pre-crisis levels by 2014.

Accelerating growth and creating jobs

To achieve its developmental aims, South Africa needs to promote large-scale job creation, increased investment, greater trade, higher savings and a more competitive economy. This requires addressing constraints to growth, including infrastructure bottlenecks, skills deficiencies, state inefficiency and regulatory burdens that act as a disincentive to small business activity. Partnerships between government, business and labour are needed to:

Partnerships between government, business and labour are needed to create jobs, especially for youth

- Rapidly reduce youth unemployment
- Contain price and wage increases to support competitiveness and higher exports
- Make more effective use of development finance institutions to fund domestic and regional infrastructure development
- Promote sustainable use of energy and natural resources
- Support land reform and bolster agricultural productivity to increase food production and rural development
- Remove constraints to mining and industrial investment, including capacity limitations in energy, transport and telecommunications.

Factors in the recovery

South Africa has benefited from the global recovery through higher prices of its major export commodities, lower inflation and the falling cost of capital, supported by large inflows to the domestic bond and equities markets. In combination, these developments should stimulate private-sector credit extension and fixed investment over the medium term.

On the downside, the current scale of capital inflows places upward pressure on the real exchange rate, reducing the competitiveness of manufactured exports and encouraging imports. Sustained exchange rate overvaluation will lead to unbalanced growth, widening the current account deficit and increasing the economy's vulnerability to shocks.

Fiscal consolidation and lower interest rates are the macroeconomic prerequisites for a more competitive real exchange rate. The combination of tighter fiscal policy and looser monetary policy will support demand while moderating the build-up of imbalances arising from strong capital inflows. Short-term exchange-rate risks can also be mitigated more directly through stepped-up purchases of foreign exchange reserves and reduced restrictions on capital outflows to encourage an increase in foreign assets.

Fiscal consolidation and lower interest rates will support a more competitive rand exchange rate

Monetary policy needs to remain focused on anchoring inflation expectations

Headline CPI inflation is expected to remain below 6 per cent over the next three years, supported by moderate increases in food prices and a relatively buoyant exchange rate. The strong rand currently offsets the impact of high real wage increases on inflation. While inflation is low, underlying inflationary pressures remain. To prevent a resurgence in inflation that could put further upward pressure on the real exchange rate, monetary policy needs to remain focused on anchoring inflation expectations and supporting financial stability to promote growth and employment.

South Africa is building power stations and roads, extending rail lines and modernising ports

Expanding and maintaining network infrastructure is necessary to support competitiveness. Real investment by public corporations is expected to grow by about 12 per cent in 2010 off an already high base. Average growth of 7 per cent per year is projected over the medium term, led by Eskom (power stations), Transnet (rail, ports and a pipeline) and the South African National Roads Agency Limited (SANRAL, national roads). Municipal underspending on capital and infrastructure maintenance is a challenge that needs to be urgently addressed.

Growth in real gross fixed capital formation is expected to rise from an estimated 0.8 per cent in 2010 to 5.6 per cent in 2011 and 5.9 per cent by 2013. Private investment will recover gradually as higher domestic consumption lifts demand, and as capacity utilisation in manufacturing rises in sectors producing for domestic and regional markets. In the electricity sector, clear direction on the terms of long-term price agreements and regulatory clarity will encourage independent power producers to come on-stream, with positive effects for overall investment.

After a sharp narrowing in 2009, the current account is forecast to widen, reaching 5.8 per cent in 2013

Infrastructure spending combined with a recovery in domestic demand will result in faster growth in imports than exports over the next three years. Strong capital inflows and a recovery in corporate profits will also lead to higher income payments to global bond and equity investors. After narrowing sharply in 2009, the current account deficit is forecast to widen to 4.2 per cent of GDP in 2010 and to rise to 5.8 per cent by 2013.

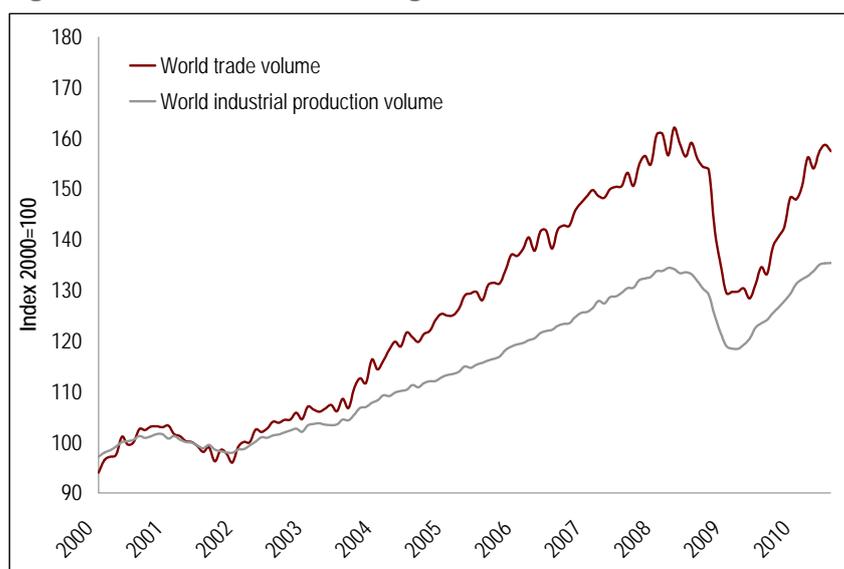
Over the medium term, the strength of South Africa's recovery is greatly dependent on the trajectory of the world economy, though stronger growth can be achieved through appropriate policy measures.

Global recovery: prospects and risks

After contracting by an estimated 0.6 per cent in 2009, global growth has resumed this year, supported by stimulatory fiscal and monetary policies internationally. In the first six months of 2010, world manufacturing and trade rebounded strongly as inventories were rebuilt and investors regained confidence.

China and other emerging economies continue to lead global growth

The IMF forecasts global growth of 4.8 per cent in 2010 and 4.2 per cent in 2011 – a considerable improvement from the nadir of the recession in 2009. Growth continues to be led by emerging and developing economies – such as China, India and Brazil – which are expected to grow by 7.1 per cent in 2010 and 6.4 per cent in 2011.

Figure 2.1 Global manufacturing and trade volumes, 2000 – 2010

Source: Netherlands Bureau for Economic Policy Analysis

While the international outlook is more positive, a sharp slowdown in growth momentum since mid-year highlights the fragility of the recovery. Factors weighing on global growth prospects include the following:

Despite positive signs, global economic recovery remains fragile

- Employment and demand remain depressed in many countries, particularly in the United States, where the impact of stimulus measures is fading.
- Deflation is still a threat in advanced economies due to low levels of capacity utilisation and weak demand. With limited scope for additional fiscal stimulus some governments are taking extraordinary monetary policy measures, such as large-scale purchases of government bonds, to boost liquidity.

Table 2.3 Annual percentage change in GDP and consumer price inflation, selected regions/countries, 2010 – 2012

Region / country	2010	2011	2012	2010	2011	2012
Percentage	GDP projections ¹			CPI projections ¹		
World	4.8	4.2	4.5	3.7	3.1	2.9
US	2.6	2.3	3.0	1.4	1.0	1.4
Euro area	1.7	1.5	1.8	1.6	1.5	1.5
UK	1.7	2.0	2.3	3.1	2.5	1.7
Japan	2.8	1.5	2.0	-1.0	-0.3	0.2
Emerging markets and developing countries	7.1	6.4	6.5	6.3	5.2	4.5
Developing Asia	9.4	8.4	8.4	6.1	4.2	3.2
China	10.5	9.6	9.5	3.5	2.7	2.0
India	9.7	8.4	8.0	13.2	6.7	4.7
Middle East and North Africa	4.1	5.1	4.8	6.8	6.2	6.2
Sub-Saharan Africa	5.0	5.5	5.7	7.5	7.0	6.3
South Africa ²	3.0	3.5	4.1	4.4	4.7	5.0

1. IMF World Economic Outlook, October 2010.

2. National Treasury forecasts.

- Most of the world's largest economies face the challenge of reducing non-performing banking system assets, boosting productivity, and adjusting fiscal policy to reduce public debt.
- Strong growth in China has prompted concerns that asset bubbles could develop. To prevent overheating of the Chinese economy, the authorities are tightening monetary policy.

Price trends for commodities produced in South Africa are expected to remain favourable

Despite the uncertain global outlook, strong growth in emerging markets has kept commodity prices relatively high. Price trends for commodities produced in South Africa are expected to remain favourable over the medium term:

- Gold has benefited from global uncertainty, maintaining its role as a store of value. The gold price has risen by more than 20 per cent since January to record levels above US\$1 300/oz.
- The price of platinum has increased by 14 per cent since January to levels around US\$1 700/oz, and the coal price is up by 14 per cent.
- The price of Brent crude oil has averaged US\$80/barrel this year.

Exchange rates and global economic adjustment

A rebalancing of global demand is necessary to support sustainable growth. Countries with large surpluses, such as China, Japan and Germany, need to reduce savings and increase the contribution of household consumption to growth. Those running large deficits, such as the US, the UK and Australia, need higher savings and less reliance on credit-fuelled consumption.

Attention has recently focused on China's exchange rate. The US has signalled that it will maintain loose monetary and fiscal policies to support demand, causing the dollar to weaken by 16 per cent against the euro since June. China, in contrast, has tightened monetary and credit policies to prevent overheating and has allowed the renminbi to appreciate marginally (2.8 per cent) against the dollar since June. A relative shift in exchange rates would result in higher net exports from the US and lower net exports from China.

As this rebalancing unfolds, sharp movements in the US dollar have caused the exchange rates of many countries to strengthen appreciably, undermining export competitiveness. In response:

- A range of countries, notably Japan, have countered with their own efforts to weaken exchange rates. Emerging markets such as Korea, Singapore, Brazil, Thailand, Mexico, Colombia, South Africa and Turkey have purchased dollars to sterilise large capital inflows.
- Korea, Indonesia, Brazil and Australia have delayed raising interest rates.
- Where strong capital inflows are fuelling asset bubbles and threatening higher inflation, governments are considering prudential measures such as relaxing controls on capital outflows and taxing inflows.

Inappropriate short-term responses to global currency adjustments, such as competitive devaluations or increased trade protectionism, will entail longer-term costs to economic growth. A coordinated international agreement on currency realignment would help to minimise the negative effects of this rebalancing, especially for developing countries.

Capital flows and currency movements

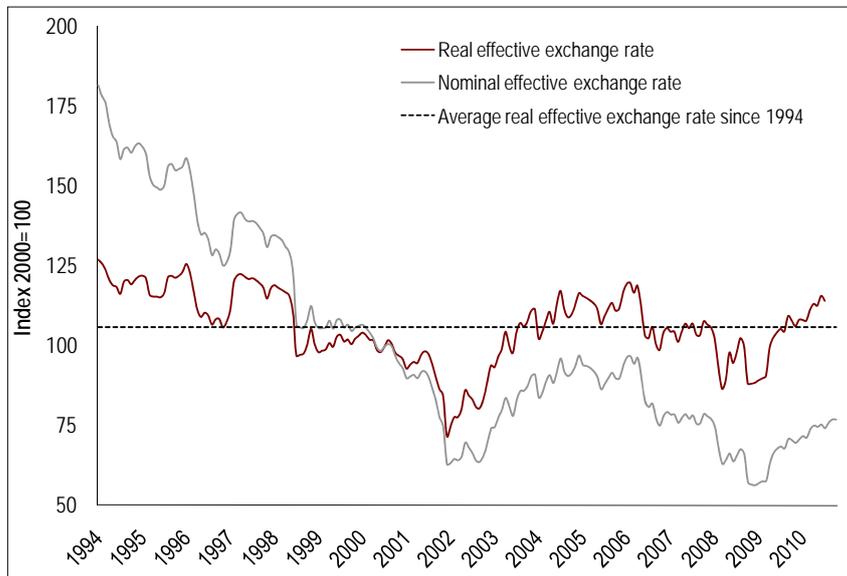
Emerging markets are experiencing massive capital inflows, with both long-term and short-term components

Capital flows to emerging markets have increased steadily over the past decade, supported by favourable growth dynamics, improved credit ratings, greater openness and the development of domestic financial markets. The Institute for International Finance projects that net private capital flows to emerging economies will reach US\$825 billion in 2010, up from US\$581 billion in 2009. JP Morgan estimates that inflows into emerging-market fixed-income investments will rise to a record US\$70-75 billion in 2010. Net capital inflows to South Africa have risen strongly over the past two years, reaching 5.5 per cent of GDP in the first half of 2010 compared with 4.7 per cent in 2009 as a whole.

The investment pattern over the past decade suggests that a structural change is under way in global savings allocations. This shift may result in a long-term rise in levels of fixed and portfolio investments held in well-managed developing countries, providing an important source of funding for private-sector growth and infrastructure development.

A structural change in global savings allocations appears to be underway

Figure 2.2 Trade-weighted rand indices, 1994 – 2010



Source: South African Reserve Bank. Data for 2010 is up to July for the real effective exchange rate and October for the nominal effective exchange rate

At the same time, low interest rates in advanced economies are supporting a short-term investment wave motivated by the prospect of quick gains. These include “carry trades” in which investors borrow money at low interest rates and invest in assets that pay higher interest rates. Such short-term investments are inherently volatile. The policy challenge is how to benefit from these capital inflows while minimising the attendant risks.

The policy challenge is how to benefit from capital flows while minimising the attendant risks

The rand has appreciated by 7.5 per cent against the US dollar since December 2009, and by 6.1 per cent against a trade-weighted basket of currencies (see Figure 2.2). Because South Africa has higher inflation than its major trading partners, the real effective rand exchange rate, which reflects losses or gains in competitiveness, is now about 12 per cent above its average level for the past decade.

Fiscal and monetary policy have adjusted to take account of these circumstances. As a small open economy with low domestic savings and relatively high financing needs, South Africa cannot fully offset the impact of massive global capital flows, barring a much sharper tightening of fiscal policy that diverts resources towards substantially larger reserve purchases. Complementary policies to support sustainable gains in productivity and international competitiveness are also necessary.

South Africa cannot fully offset the impact of massive global capital flows

■ Towards faster, more labour-absorbing growth

South Africa’s present economic growth trajectory cannot meet the country’s employment needs. Faster growth is required over an extended period of time to significantly increase labour absorption, reduce high

unemployment and achieve a more equitable distribution of income. Modelling work by the National Treasury shows that if South Africa were to sustain 7 per cent growth for 10 years, national income would double and the economy would generate about 5.5 million jobs, leading to a dramatic reduction in poverty and inequality.

To achieve 7 per cent growth, South Africa requires higher productivity and investment

For South Africa to grow at 7 per cent per year, jobs, investment and productivity all need to grow more quickly. Prudent and sustainable macroeconomic and fiscal policies that keep inflation low, reduce real interest rates, moderate government debt levels, support financial stability and maintain a competitive real exchange rate, must form the foundation of a higher growth path. Such policies promote investment and job creation, and help to reduce the severity of boom/bust economic cycles.

G-20 process highlights the need for prudent macroeconomic and fiscal management

The Group of Twenty (G-20) mutual assessment process underscores the need for prudent economic management. This process has identified “growth-friendly” fiscal consolidation for countries with high or rapidly rising deficits and debt levels as a precondition for a balanced and sustainable international recovery. While governments are mindful of the risks of reducing spending too quickly, which could jeopardise growth, there is a general commitment to halve fiscal deficits by 2013.

The desire to raise growth potential among G-20 members has focused attention on microeconomic reforms and complementary measures needed to support higher productivity. These include better-quality education, stepped-up skills development, increased retirement savings, reforms to product and labour markets to promote efficiency and boost employment, greater competition, increased openness to international trade and infrastructure investment.

OECD recommendations for structural reform in South Africa

The Organisation for Economic Cooperation and Development (OECD) has participated in the G-20's mutual assessment process by providing country-specific recommendations on structural reforms needed to increase global growth. The OECD benchmarks countries against each other and conducts annual surveys to assess progress. The OECD's 2011 *Going for Growth* publication recommends the following for South Africa:

- Improve the **quality of education** by improving teacher training; addressing teacher underperformance effectively; improving provision of textbooks and teaching materials; and upgrading school infrastructure.
- Enhance **competition in network industries** by removing legal barriers to entry; ending state-owned enterprises' exemptions from competition laws; moving towards separating generation, transmission and distribution of electricity; and strengthening the independence of the telecommunications regulator.
- Reform the **wage bargaining system** to increase labour absorption.
- Strengthen policies to **tackle youth unemployment** through age-differentiation of minimum wages in sectors where these are set by the state; implementing a wage subsidy; and intensifying placement assistance for young workers.
- Reduce **barriers to entrepreneurship** such as the burden of licenses and permits, and the complexity of rules and procedures; introducing a systematic regulatory impact assessment for significant new regulations; and reviewing existing legislation to reduce administrative burdens for small businesses.

Competitiveness: a prerequisite for growth

More competitive economies have higher productivity, attract more foreign direct investment (FDI) and can grow their export industries. Competition is an essential driver of innovation and productivity growth. FDI enables technology transfer, brings in skills and encourages local

companies to become more efficient. FDI is generally higher in countries with a stable and predictable policy environment, which includes legal protection and effective enforcement of investor rights.

South Africa's competitiveness has declined over the past few years relative to our emerging-market peers. The *Global Competitiveness Report* for 2010/11 ranks South Africa 54th out of 139 countries, down from 45th in 2009/10. South Africa still ranks highly in several areas – the soundness of banks, the availability of financial services, the strength of auditing and reporting standards, and the legal system. But these positive rankings are offset by poor performance in other areas, including basic education and health (129th), labour-market efficiency (97th), technological readiness (76th), higher education and skills (75th) and infrastructure (63rd).

While South Africa ranks highly in areas such as soundness of banks, overall competitiveness is declining

Competition, along with low costs of capital and other production inputs, is important for inventing new goods or services and for breaking into new markets. For South Africa to produce goods that are competitive internationally, the costs of production need to be in line with (or even lower than) those prevailing in other countries. Currently, South Africa's prices of transport and communication are higher than those of our major competitors. Containing inflation, and aligning wage costs and productivity, are also important factors in increasing competitiveness.

South Africa has a range of industrial policy measures in place, including generous tax incentives and import tariffs to support sector growth in automobile and components manufacturing, textiles and clothing, and general manufacturing. The benefits of these subsidies to the rest of the economy can be enhanced by refining the conditions attached to state-support to ensure that companies work to increase their productivity and eventually prosper without protection.

Industrial policy measures include generous tax incentives and import tariffs to support specific sectors

Realigning pricing structures to reflect negative externalities such as carbon emissions, or scarcity of resources such as water, can help new industries to emerge. Such realignment will promote investment and employment in "green" businesses that make South Africa's use of natural resources more sustainable.

Deepening regional integration can support innovation and new product development. Expanding infrastructure and transport networks to reduce the cost of trade in goods and services would bolster manufacturing exports while increasing South Africa's role as a market for products from the Southern African region.

South Africa can also make more effective use of development finance institutions to finance domestic and regional infrastructure development. Institutions such as the Development Bank of Southern Africa and the Industrial Development Corporation can play a greater role in financing public infrastructure, enterprise development and investments in the built environment.

Development finance institutions to provide greater support for domestic and regional infrastructure

In some respects, South Africa's weak global competitiveness ranking reflects the country's legacy of social inequality. To bolster competitiveness and improve the living standards of all South Africans, government must reduce backlogs and bottlenecks that impede growth by prioritising spending on social and economic services, including education,

health and infrastructure investment. With limited fiscal resources, the quality of spending must also improve.

Support for job creation and skills development

Public-sector initiatives complement private-sector job creation, which accounts for most employment

While social grants provide an important safety net for about a quarter of the population, South Africa's long-term prosperity depends on more people being drawn into work. The private sector accounts for 75 per cent of all economic activity and a slightly higher share of employment, and will remain the primary driver for job creation. The public sector plays a complementary role in this process. Alongside a range of initiatives to increase training and skills development, specific government interventions to raise employment include the following:

- The expanded public works programme supports job creation by increasing the labour intensity of public-sector projects and services. The current phase of this programme aims to create 4.5 million short-term jobs lasting 100 days on average over the 2010-2014 period. A new performance-based incentive grant encourages municipalities and provinces to carry out their work using more labour. The cost-effective community works programme provides useful services such as home-based care, food gardens, environmental services and maintenance of community assets.
- A youth jobs initiative is proposed to provide work experience, on-the-job and vocational training in the public sector. This forms part of a broader strategy to address high levels of youth unemployment, including consideration of a hiring subsidy to help first-time job seekers to gain experience in the formal labour market.

The nexus between education, skills and jobs

Several recent surveys highlight the shortage of skilled workers as a binding constraint for South Africa. The World Economic Forum's *Global Competitiveness Report 2010/11* cites "an inadequately educated workforce" as the second most problematic factor for doing business. The *2010 Grant Thornton International Business Report* found that 34 per cent of all businesses see the availability of skilled workers as the major constraint to business expansion.

There is a clear link between education, skills and employment. Labour market statistics show that among workers with four years of university training or more, unemployment is near zero. In contrast, joblessness among those with some secondary education is more than 30 per cent. During the recent recession, the burden of job losses fell disproportionately on those with lower levels of education.

Increasing the depth and quality of South Africa's skills reservoir will raise the productive potential of the workforce and reduce inequality by increasing job opportunities.

■ The recovery in the real economy

The economy has continued to grow in the second half of the year, but at a slower pace than in the first half. While business and consumer confidence have nudged higher, output volatility in mining and manufacturing has increased due to fluctuations in global demand, and domestic factors such as increased strike activity, rand volatility and regulatory uncertainty. The latter is also inhibiting growth in private investment.

Measures to reduce regulatory uncertainty in mining

The Minister of Mineral Resources has announced the following measures to reduce regulatory uncertainty in the mining industry and root out corruption in the awarding of mining licenses:

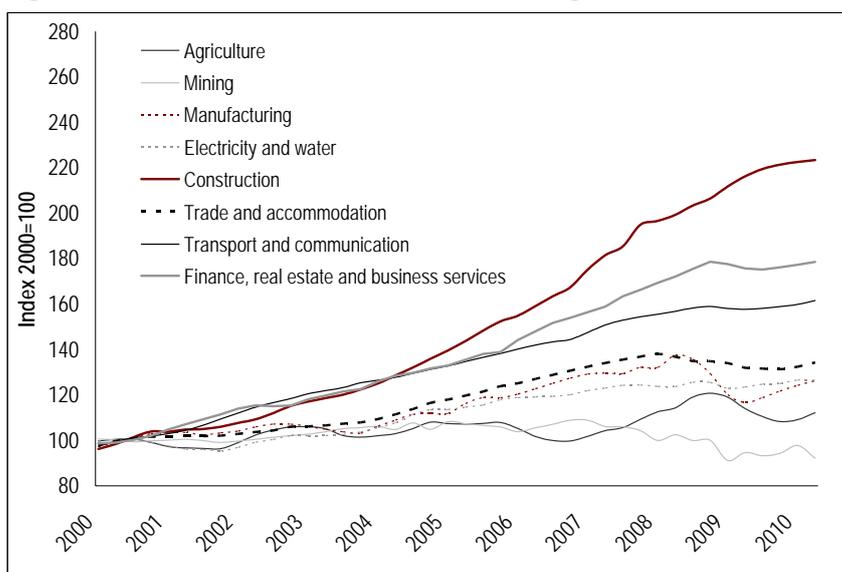
- With effect from 1 September 2010, the Department of Mineral Resources will place information on the status of exploration and mining licenses on its website.
- The department has imposed a moratorium on accepting prospecting applications to allow for a comprehensive audit of licenses granted since the promulgation of the current act.
- The department will develop a new license process tracking system during the course of 2010/11.
- Prospecting rights, previously issued at regional offices, will only be issued from head office.

A task team has identified areas in the legislation that require clarification, including the order of processing applications; the interpretation of regulations on transfer of rights; regulations covering associated minerals; and regulations to prevent the fragmentation of rights. The department will table proposals to Cabinet.

Trends in the real economy include the following:

- In the first six months of 2010, manufacturing value added grew by 5.8 per cent compared with the previous year, driven by increased production of motor vehicles, petrochemicals, and basic iron and steel.
- Growth momentum in manufacturing has slowed in the second half of the year. The purchasing managers' index fell from a peak of 60.4 in February – a level consistent with an expansion of production – to an average level below 50 between June and September.
- Value added in mining increased by only 2.2 per cent during the first half of 2010, despite favourable commodity prices. Output growth jumped from 0.7 per cent in June to 10.3 per cent in August.
- The construction sector continued to grow during the first six months of 2010, but growth during this period was 4.2 per cent compared with 7.8 per cent in 2009.
- Real retail sales were 4.6 per cent higher in August compared with a year earlier, but the pace has slowed since the end of the World Cup.

Figure 2.3 Sector contributions to real GDP growth, 2000 – 2010



Source: Statistics South Africa. Data for 2010 is for the first two quarters of the year

Labour market response to the recovery

While employment levels are stabilising, the labour market remains weak

The labour market was affected severely by the recession and remains weak, despite the pickup in economic activity and signs that employment levels are stabilising after a period of steep job losses.

Total employment declined by more than a million jobs (8 per cent) between the fourth quarter of 2008 and the second quarter of 2010, with losses concentrated in the trade, manufacturing and construction sectors. The unemployment rate has increased by 3.4 percentage points to 25.3 per cent. The rate of labour force participation has fallen sharply because many people have stopped looking for work.

Average wage settlements of 8.3 per cent in the nine months to September 2010 were higher than average CPI inflation of 4.7 per cent between January and August. Average settlements in the public sector, particularly in state-owned enterprises and municipalities, were higher than private-sector settlements. High wage settlements may have reduced the incentive of companies to rehire workers laid off during the recession and to create new jobs. In the past, employment growth has been associated with strong GDP growth and moderate growth in real earnings (see Figure 2.4).

Table 2.4 Total employment per sector, June 2010

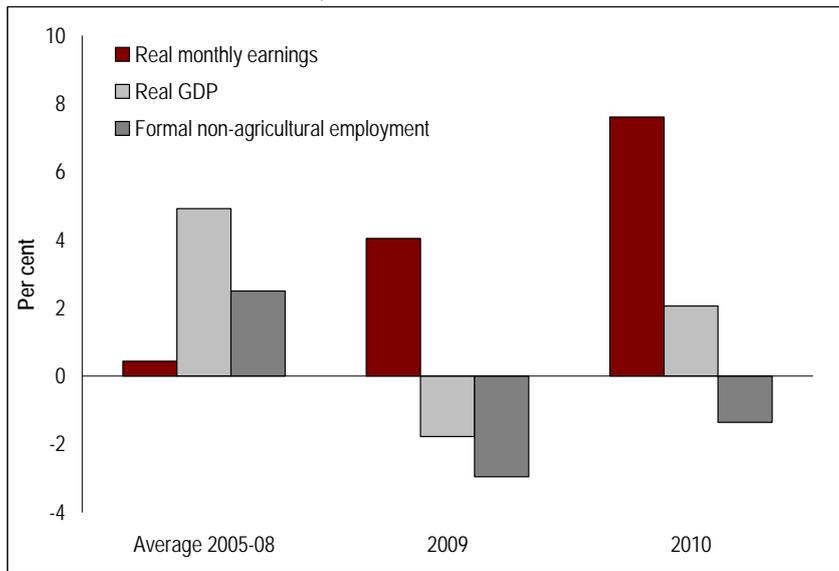
	Total employed (thousands)	% of total	Change since December 2008 (thousands)	% change since December 2008
Agriculture	618	4.9	-146	19.0
Community and personal services	2 659	20.9	-2	-0.1
Construction	1 006	7.9	-185	-15.5
Finance, insurance and real estate	1 670	13.1	34	2.1
Manufacturing	1 656	13.0	-288	-14.8
Mining and quarrying	305	2.4	-16	-5.0
Private households	1 155	9.1	-143	-11.0
Retail and wholesale trade	2 839	22.3	-325	-10.3
Transport and communication	734	5.8	-40	-5.2
Utilities	93	0.7	7	8.1
Total	12 735	100.0	-1 104	-8.0

Source: Statistics South Africa

Cooperation is needed to protect workers' rights and to ensure wage-setting flexibility

Cooperation between business, labour and government, including through bargaining councils, is needed to ensure that workers' rights are adequately protected and that the wage-setting process does not undermine employment and new job creation.

Figure 2.4 Growth in formal-sector employment, real earnings, and real GDP, 2005 – 2010



Source: Statistics South Africa. Data for 2010 is for the first two quarters of the year

How government can help small business create jobs

A successful job creation strategy needs to address constraints that make it more difficult to open or expand small businesses. About 20 per cent of employees in South Africa work for microenterprises (fewer than 5 workers) and another 40 per cent are employed in small firms (fewer than 50 workers). The latter account for almost 80 per cent of hiring by companies.

Small and micro businesses face an onerous regulatory burden and limited access to finance. Among businesses with turnover of less than R1 million, the cost of regulatory compliance is about 8 per cent of total turnover, compared with less than 1 per cent for large businesses (over R25 million). Starting a business takes on average 22 days and involves complicated procedures with multiple government departments to obtain trading licences. Rules friendly to small business are needed across all regulations (tax, company registration, labour, zoning, etc) to minimise compliance burdens and costs.

Government communication on issues affecting small business should be in plain language, clear, direct and concise, and made more accessible through advertising campaigns, libraries, post offices and the internet. New laws should be subjected to regulatory impact assessments to review their effect on small businesses.

Source: Stats SA, Quarterly Labour Force Survey (2Q 2010); OECD Economic Assessment of South Africa, 2008.

Consumption resumes as households repair balance sheets

Gross domestic expenditure accelerated in the first half of 2010 due to a recovery in household consumption and growth in government consumption. Fixed investment spending by the private sector also stabilised somewhat after falling in 2009 and the rate of inventory drawdown slowed considerably as production growth strengthened.

Fixed investment spending by the private sector has begun to stabilise

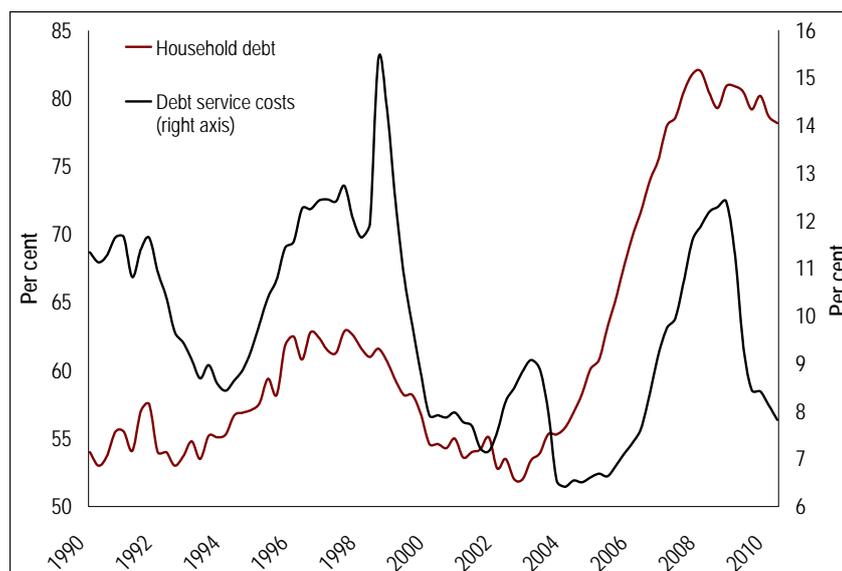
Stimulatory fiscal and monetary policies have combined to support the recovery in demand. Lower-than-expected inflation has allowed the Reserve Bank to reduce the repo rate by one percentage point since March to 6 per cent. The full benefit of lower borrowing costs on consumption and investment will only be seen in time, but banks have already started to increase lending to households. Over the medium term, high household debt levels will moderate credit demand and spending growth.

Table 2.5 Contribution to gross domestic expenditure growth, 2007 – 2010

Percentage	2007	2008	2009	2010 ¹
Household consumption expenditure	3.5	1.5	-1.9	0.7
Government consumption expenditure	0.9	0.9	0.9	1.0
Gross fixed capital formation	2.4	2.1	0.5	-0.4
Change in inventories	-0.2	-1.5	-1.6	1.1
Residual item	-0.2	0.3	0.4	0.1
Gross domestic expenditure	6.4	3.3	-1.8	2.5

1. First half of 2010 compared to the same period in 2009.

Source: South African Reserve Bank

Figure 2.5 Ratios of household debt and debt-service costs to disposable income, 1990 – 2010

Source: South African Reserve Bank. Data for 2010 is for the first two quarters of the year

Sustaining and financing public investment

Public-sector infrastructure investments will continue to raise the economy's growth potential

Public-sector investment remains the cornerstone of government's strategy to support higher sustainable economic growth, because it reduces bottlenecks in the economy and draws in private-sector investment. Higher levels of public and private investment are necessary over the medium term to raise the economy's growth potential and create employment.

During 2009, overall growth in gross fixed investment was sustained by a strong expansion in spending by public corporations, particularly for capacity expansion in the electricity sector. Private-sector investment contracted by 7 per cent during the year, with the largest declines in manufacturing, finance and real estate as companies cut back purchases of new machinery and equipment, and residential building contracted further.

Table 2.6 Contribution to overall investment growth, 2006 – 2010

Percentage	2006	2007	2008	2009	2010 ¹
General government	2.4	2.9	2.1	-0.2	-1.2
Public corporation	2.2	4.0	5.7	7.2	2.7
Private enterprises	7.6	7.2	3.9	-4.6	-3.5
Total	12.1	14.2	11.7	2.3	-2.0

1. First half of 2010 compared to the same period in 2009.

Source: South African Reserve Bank

To remove bottlenecks and reduce the cost of doing business, the core investment plans of state-owned enterprises remain focused on capacity expansion in electricity, rail, ports and roads with the bulk of spending carried out by Eskom, Transnet and SANRAL.

Capital infrastructure investments will expand electricity, rail, ports and roads capacity

Investment in water sector infrastructure is crucial to address an estimated refurbishment backlog of R10 billion. A review of water pricing is underway to realign prices where necessary. Tariff caps and exemptions in the current pricing strategy impede the efficient allocation of water. Cost-reflective tariffs are necessary to moderate demand, ensure the long-term sustainability of water-related infrastructure and preserve the natural environment. Continuous investment and stronger regulation should reverse current trends and prevent what would otherwise become a crisis in the future.

In the energy sector, the integrated resource plan will provide clarity on committed generation projects and the future direction of power generation technology, such as nuclear and renewable energy. The planned increase in generation capacity from the Medupi and Kusile coal-fired stations will be supplemented by independent power producers.

Integrated energy resource plan is expected to provide clarity on the direction of power generation

Recovery in banking sector lending

While the banking sector has weathered the crisis reasonably well, banks have faced high levels of non-performing loans and reduced margins as a result of falling interest rates. This should improve as economic growth strengthens and bank revenues are boosted by falling impairments. Impaired advances as a percentage of gross loans and advances have stabilised at just below 6 per cent over the past 12 months, more than double pre-crisis levels.

The South African banking sector remains well capitalised. The sector's "tier one" capital adequacy ratio, which measures the highest-quality assets held in reserve to protect depositors and promote the stability of the financial system, stood at 11.2 per cent in July 2010, well in excess of the Basel III accord's 7 per cent requirement. Total capital adequacy stands at 14.3 per cent.

Banking sector remains well capitalised, and banks have begun to ease lending standards

Financial sector reform

The global crisis exposed serious weaknesses in financial regulatory systems internationally. South Africa is participating actively in multilateral reform initiatives.

While South Africa's financial system remained sound and stable during the global contagion, there is scope to strengthen domestic financial sector regulation. Government proposes to implement the Basel III accord, which will tighten some banking regulations. In addition, government is committed to modernising exchange controls to reflect a prudential approach, updating regulation 28 in terms of Pension Funds Act, expanding the scope of regulation (to include, for example, credit ratings agencies), reviewing the approach to investment funds regulation and strengthening capital markets regulation.

These measures, together with others aimed at improving market conduct and encouraging access to financial services, are addressed in a discussion document entitled *Strengthening the Financial Sector to Better Serve South Africa*. This document, to be released shortly after the *Medium Term Budget Policy Statement* is tabled in Parliament, sets out a range of National Treasury initiatives.

Credit extension to households has picked up, but credit extension to companies remains weak

Credit extension to households has picked up as banks have begun to ease lending standards, but credit extension to companies remains weak. Growth in private-sector credit extension rose to 3 per cent in August 2010, but bank lending to companies was still 1 per cent lower than a year ago. Corporate cash balances have been rising and private investment rates are low, which may explain weak demand for credit.

Temporary decline in the current account deficit

The current account deficit narrowed from 7.2 per cent of GDP in 2007 to 4.0 per cent in 2009. The deficit remained relatively small at 3.6 per cent of GDP in the first six months of 2010 due to a continued improvement in the trade balance.

Table 2.7 Summary of South Africa's current account, 2005 – 2010

Percentage of GDP	2005	2006	2007	2008	2009	2010 ¹
Trade balance	-0.1	-1.7	-2.0	-1.6	0.1	0.0
Net services, income and transfer receipts	-3.3	-3.7	-5.2	-5.5	-4.1	-3.6
<i>Net service receipts</i>	-0.3	-0.8	-0.9	-1.5	-1.0	-1.0
<i>Net income receipts</i>	-2.0	-2.0	-3.4	-3.2	-2.2	-1.9
<i>Net dividend receipts</i>	-1.6	-1.6	-3.1	-2.5	-1.6	-1.5
Net transfer payments (mainly to SACU)	-1.0	-0.9	-0.8	-0.8	-0.9	-0.7
Total current account	-3.5	-5.3	-7.2	-7.1	-4.0	-3.6
Current account excl. current transfers	-2.5	-4.4	-6.3	-6.3	-3.1	-2.9

1. Data for 2010 is for the first half of the year, seasonally adjusted and annualised.

Source: South African Reserve Bank

As domestic and international demand have recovered, export and import volumes have risen, but they remain well below pre-crisis levels. The improvement in the current account is expected to be temporary and the deficit is expected to rise from an estimated 4.2 per cent of GDP in 2010 to 4.9 per cent in 2011 and 5.8 per cent in 2013, driven by rising import demand.

Net capital inflows exceed the country's external funding requirement

Net capital inflows currently exceed the country's external funding requirement. Portfolio investments have made up the bulk of overall inflows, with strong demand for rand-denominated bonds driven by

attractive yield differentials, falling inflation and interest rates. In the nine months to September, non-residents were net buyers of R77.6 billion worth of bonds and R21.7 billion worth of equities. Although net FDI was relatively small in the first six months of the year, several large cross-border mergers involving local companies such as Dimension Data and Massmart have been announced since July, fuelling positive sentiment towards the rand.

Income payments to the rest of the world will also rise as profit growth strengthens and increased international holdings of domestic bonds result in larger offshore interest payments. Payments to international investors will be offset over time by rising income from global assets as investments by South African companies and households become more internationally diversified. Strong capital inflows will ensure that the deficit remains adequately financed over the medium term.

Strong capital inflows will ensure that the deficit remains adequately financed over medium term

Table 2.8 Summary of South Africa's financial account, 2005 – 2010

R billions	2005	2006	2007	2008	2009	2010 ¹
Net portfolio investment flows	30.1	129.5	73.5	-134.9	92.5	64.0
Net foreign direct investment flows	36.4	-44.6	19.2	100.3	34.8	2.1
Net other investment flows	9.8	21.9	60.8	130.7	-21.6	-4.8
Unrecorded transactions	12.3	16.6	38.7	91.4	7.7	9.0
Financial account balance	88.6	123.4	192.2	187.5	113.4	70.4
<i>As a percentage of GDP</i>	<i>5.6%</i>	<i>7.0%</i>	<i>9.5%</i>	<i>8.2%</i>	<i>4.7%</i>	<i>5.5%</i>
Change in net reserves due to balance of payments transactions	34.3	29.8	47.8	26.1	17.0	30.2
<i>As a percentage of GDP</i>	<i>2.2%</i>	<i>1.7%</i>	<i>2.4%</i>	<i>1.1%</i>	<i>0.7%</i>	<i>2.4%</i>

1. Data for 2010 is for the first two quarters of the year, not annualised.

Source: South African Reserve Bank

Conclusion

As the economy continues its gradual recovery, supported by countercyclical fiscal and monetary policies, it is important to remain focused on South Africa's larger economic challenge of reducing poverty through achieving more rapid growth and creating more jobs, particularly for low-skilled and young workers. Higher growth is needed to improve the living standards of all South Africans. To achieve this goal, our policies need to create a favourable environment for investment and productivity growth by removing bottlenecks to trade, reducing red tape, lowering the costs of doing business, delivering quality public services, increasing competition, removing barriers to entry, supporting innovation, expanding exports and encouraging youth employment.

Higher levels of economic growth are needed to raise the living standards of all South Africans

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