2

Economic policy and outlook

- After a period of rapid expansion in the world economy, the global outlook has become more uncertain, characterised by rising costs of credit and slower growth in major economies.
- South Africa's outlook remains favourable as a result of vigorous investment and high commodity prices. Sustained increases in public spending on economic and social infrastructure, and expanding employment, have contributed to improved welfare for millions of South Africans. Over the medium term, accelerated infrastructure development will crowd in private-sector investment and sustain healthy economic growth. A strengthened fiscal position will boost domestic savings and competitiveness. However, rising inflation and a substantial current account deficit are signs of stress in the macroeconomic balance.
- The large current account deficit is an outcome of investment growing more rapidly than domestic saving, and a signal that more needs to be done to improve the efficiency of production, expand exports and accelerate growth. To increase export levels, microeconomic and regulatory reforms are required to reduce economic costs, spur productivity, boost new business creation, and remove bottlenecks in transport and logistics networks. Continued investment and improved outcomes in education and skills development are crucial for growth.

Domestic outlook

GDP growth forecast

In recent years South Africa has benefited directly from macroeconomic stability, robust growth in the world economy and high commodity prices. Low domestic inflation and a marked increase in global liquidity contributed to comparatively low funding costs for rapidly growing investments.

Macroeconomic stability, global growth and high commodity prices have boosted domestic economy

Macroeconomic policy continues to promote growth and competitiveness. The fiscal stance reflects the use of buoyant revenue to invest in physical and human infrastructure, and to increase government savings. These policies support the continued rise in investment as a share of overall growth.

4.9 per cent GDP growth projected for 2007

GDP growth has averaged 4.5 per cent a year since 2003 and about 1.3 million new jobs were created during this period. For 2007, economic growth is expected to be 4.9 per cent. This positive outlook continues over the medium term, with GDP growing by 4.5 per cent in 2008, nearly 5 per cent in 2009, and a projected 5.3 per cent in 2010.

Growth to moderate in 2008 as a result of subprime crisis and slower growth in domestic consumption

The expected moderation in growth in 2008 is largely a result of two factors: slower growth in developed markets as a result of the subprime mortgage crisis in the United States and the associated credit crunch; and slower, more sustainable growth in domestic consumption as the effect of higher interest rates takes hold. Although commodity prices have risen over the past year, record-high oil prices will act as a drag on growth. In addition, higher oil and food prices have put pressure on unit labour costs and domestic inflation.

Inflation remained above the 3-6 per cent target range from April through September of this year. Inflationary pressures have broadened. Cumulative interest rate hikes by the Reserve Bank, totalling 350 basis points since 2006, should in time lead to a moderation of domestic demand and contain inflation expectations. CPIX inflation is expected to average 6.2 per cent in 2007, before declining within the target band over the medium term.

Positive spin-offs from hosting the 2010 FIFA World Cup will boost economic activity

Growth in output should accelerate from 2009 onwards as the global environment improves and the supply capacity of the economy expands. Positive spin-offs from 2010 FIFA World Cup preparations will also boost economic activity over the medium term.

Investment has risen from about 15 per cent of GDP in 2002 to nearly 21 per cent of GDP in the first half of 2007. Investment spending increased by 15.5 per cent in the first half of 2007 compared with the first half of 2006, driven by a 30.7 per cent rise in spending by state-owned enterprises.

Table 2.1 Key labour market indicators, September 2001 – March 2006 (Official definition of unemployment)

Labour market category Thousands	March 2003	March 2006	March 2007
Employed	**11 304**	**12 451**	**12 648**
Unemployed	*5 116*	*4 275*	*4 336*
Total economically active[1]	16 420	16 726	16 984
Not economically active	**12 337**	**13 126**	**13 211**
Total aged 15 - 65 years	28 757	29 852	30 195
Unemployment rate	**31.2**	**25.6**	**25.5**
Labour force participation rate	57.1	56.0	56.2
Labour absorption rate	39.3	41.7	41.9

Source: Labour Force Survey, March 2003, March 2006, March 2007

1. Employed and unemployed.

Investment in fixed capital has grown rapidly, including long-term infrastructure development and capacity expansion in electricity generation, transport and telecommunications. Private-sector investment is also expected to be robust, especially in services, mining, construction and manufacturing.

Expanded employment, rising wages and relatively low interest rates have contributed to rapid growth in household consumption, which has averaged 5.5 per cent a year since 2002. In the first half of 2007, household consumption expanded at a brisk 7.4 per cent, and is expected to slow to a more sustainable rate of 4-5 per cent a year over the forecast period. Real government consumption spending is projected to grow by about 6 per cent a year over the medium term.

Nearly 200 000 new jobs were created in the year to March 2007

The Labour Force Survey for March 2007 shows an increase in total employment to 12.6 million jobs compared with 11.3 million jobs in March 2003. Nearly 200 000 net new jobs were created between March 2006 and March 2007. Employment creation has been consistent with economic expansion over the past three years, but much more needs to be done to improve labour absorption.

Growth pattern has contributed to current account deficit

The specific pattern of growth in recent years has contributed to South Africa’s large current account deficit, which increased from 3 per cent of GDP in 2004 to a projected 6.7 per cent of GDP in 2007. The challenge this presents to economic policy is discussed later in this chapter. Government’s policy stance of building foreign reserves has reduced the vulnerability of the economy to external shocks and moderated the rise in the exchange rate driven by the commodity price boom. Capital inflows, which have for several years more than covered the current account deficit, are expected to remain healthy.

Table 2.2 Macroeconomic projections

Calendar year	2004	2005	2006	2007	2008	2009	2010
		Actual		Estimate		Forecast	
Percentage change unless otherwise indicated							
Final household consumption	6.7	6.6	7.3	6.6	4.2	4.5	5.3
Final government consumption	6.3	5.2	5.4	6.5	6.1	5.5	5.6
Gross fixed capital formation	8.9	9.6	12.7	15.4	10.4	10.5	11.1
Gross domestic expenditure	7.9	5.9	8.7	5.5	4.8	5.9	6.4
Exports	2.9	8.0	5.5	8.4	4.8	5.3	6.3
Imports	14.5	10.7	18.4	9.8	5.6	8.5	9.1
Real GDP growth	**4.8**	**5.1**	**5.0**	**4.9**	**4.5**	**4.8**	**5.3**
GDP deflator	5.8	4.7	6.9	8.5	6.3	5.0	5.1
GDP at current prices (R billion)	**1 398.2**	**1 539.0**	**1 727.5**	**1 965.0**	**2 182.7**	**2 401.2**	**2 659.2**
CPIX (average for year)	4.3	3.9	4.6	6.2	5.4	4.6	4.5
Current account balance (% of GDP)	-3.2	-4.0	-6.5	-6.7	-6.9	-7.7	-7.8
Fiscal year			**2006/07**	**2007/08**	**2008/09**	**2009/10**	**2010/11**
			Actual	**Estimate**		**Forecast**	
GDP at current prices (R billion)			**1 787.3**	**2 019.1**	**2 230.3**	**2 458.9**	**2 723.8**
Real GDP growth			**5.2**	**4.7**	**4.5**	**4.9**	**5.4**
GDP deflator			7.6	7.9	5.7	5.1	5.1
CPIX (average for year)			4.9	6.5	4.9	4.5	4.5

Risks to the economic outlook

Global and domestic concerns may pose risks to the outlook

The primary risks to the growth forecast fall into two broad categories: firstly, global financial contagion could slow global growth, impacting on commodity prices, capital flows and emerging market prospects, and secondly, the risks associated with South Africa's current account deficit and weak export performance. In this section, we review the international economic environment and provide a synopsis of South Africa's external position.

The global economic environment

International economic growth to remain robust but slows in 2008

Global growth is forecast at 5.2 per cent in 2007 and 4.8 per cent in 2008, down from 5.4 per cent in 2006. Significant features of the international economic environment include the following:

- The credit crunch will expose some countries to heightened financial volatility, especially those economies with significant current account deficits and inflation pressures.
- The US economy has been weakening since early 2006. GDP growth is forecast to moderate to 1.9 per cent in 2007 and 2008, down from 2.9 per cent in 2006. There are risks to this outlook given the severity of the housing market correction. Table 2.3 also suggests slower growth in Europe and Asia in 2008.
- In contrast, a number of emerging market and developing economies continue to grow strongly. The Chinese economy is expanding at a feverish pace, with GDP growth of 11.5 per cent expected in 2007 and 10.0 per cent in 2008. India's economic boom is also strong although expected to moderate slightly over the next two years.

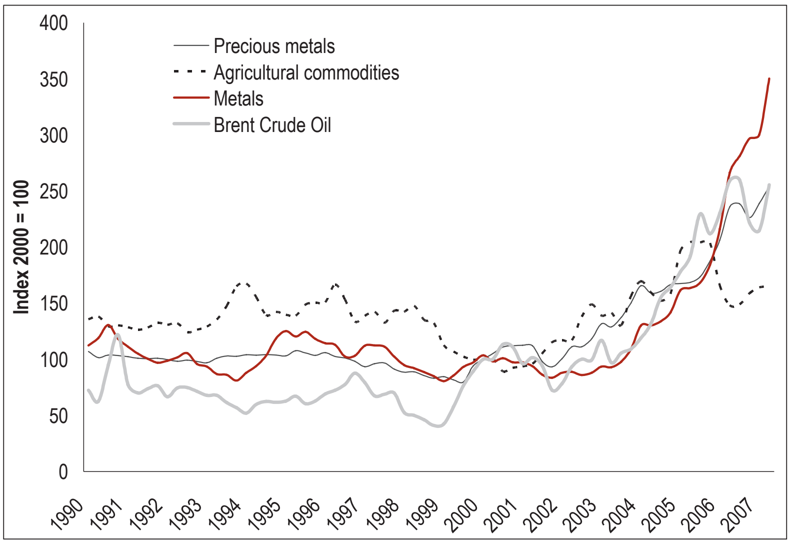
Table 2.3 Trends and projections of global growth and inflation, selected countries, 2006 – 2008

Country/region	2006*	2007	2008	2006*	2007	2008
	Growth projections			CPI projections		
World**	**5.4**	**5.2**	**4.8**	**3.6**	**3.9**	**3.6**
US	2.9	1.9	1.9	3.2	2.7	2.3
Euro zone	2.8	2.5	2.1	2.2	2.0	2.0
UK	2.8	3.1	2.3	2.3	2.4	2.0
Japan	2.2	2.0	1.7	0.3	–	0.5
Emerging markets and developing countries	**8.1**	**8.1**	**7.4**	**5.1**	**5.9**	**5.3**
Developing Asia	**9.8**	**9.8**	**8.8**	**4.0**	**5.3**	**4.4**
China	11.1	11.5	10.0	1.5	4.5	3.9
India	9.7	8.9	8.4	6.1	6.2	4.4
Africa	**5.6**	**5.7**	**6.5**	**6.3**	**6.6**	**6.0**
Sub-Saharan Africa**	**5.7**	**6.1**	**6.8**	**7.3**	**7.6**	**6.7**
South Africa*	5.0	4.9	4.5	4.6	6.2	5.4

Source: IMF, World Economic Outlook, October 2007
**National Treasury Forecast*
*** CPI projections exclude Zimbabwe*

- Sub-Saharan Africa continues to perform well. Growth is projected to rise from 5.7 per cent in 2006 to 6.1 per cent in 2007 and 6.8 per cent in 2008, partly due to the completion of new oil production facilities in Angola and Nigeria. Southern African Development Community economies are growing strongly, by an expected 6.9 in 2007 and 7 per cent in 2008.
- The outlook for metals prices remains healthy, supported by strong demand. Platinum rose above US$1 400/oz in October 2007, while gold rose to a 27-year high of US$771/oz, driven by the falling dollar and rallying oil prices. Commodity prices in general are likely to remain volatile.
- Energy and agriculture prices will continue to increase global inflation pressures. After averaging US$67/barrel in the first 9 months of the year, the price of Brent crude oil for immediate delivery rose above US$85/barrel in October.

Figure 2.1 World commodity prices, 1990 – 2007



Continued growth in major emerging markets boosts international economy

The international economic environment holds greater risks for South Africa than it has in some time. Nonetheless, world growth is expected to remain supportive of high commodity prices as a result of continued growth in major emerging market economies and the effects of lower interest rates in some advanced economies. Higher energy and food prices will remain a longer-term source of concern.

Financing the current account deficit

Balance of payments position remains positive

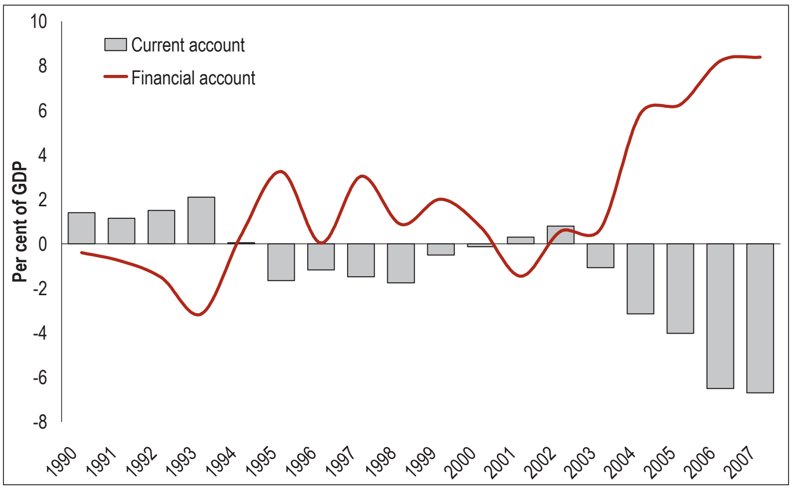
South Africa's balance of payments position remains positive despite the growing mismatch between savings and investment reflected in the deficit on the current account.

From 1994 to 2002 the current account deficit averaged 0.6 per cent of GDP. Since 2001, the economy has required higher levels of imported intermediate goods and capital goods for investment, while real income growth and lower interest rates have raised household consumption. The cumulative result has been a significant deterioration of the trade balance from a surplus in 2003 to a deficit of 2.5 per cent of GDP in 2006.

Current account rose to 6.7 per cent in first half of 2007

These same factors, alongside sharply higher oil prices, pushed the deficit on the current account to 6.7 per cent of GDP during the first half of 2007 from 6.2 per cent in the first half of 2006.

Figure 2.2 Overall balance of payments, 1990 - 2007



Strong demand for South African bonds and equities

Strong domestic growth, high commodity prices and sound macroeconomic fundamentals have stimulated global demand for South African bonds and equities. Non-residents have purchased R226 billion worth of shares on the Johannesburg stock exchange since 2004. As a result, the surplus position on the financial account remained large at 8.4 per cent of GDP in the first half of 2007, compared to 7.6 per cent for the first half of 2006.

Net portfolio inflows of R55.8 billion were recorded in the first half of 2007, compared to R82.2 billion during the same period last year. Non-residents were net purchasers of R33.2 billion worth of shares and R22.6 billion of bonds in the first half of 2007.

Net foreign direct investment amounted to R6.5 billion in the first six months of 2007.

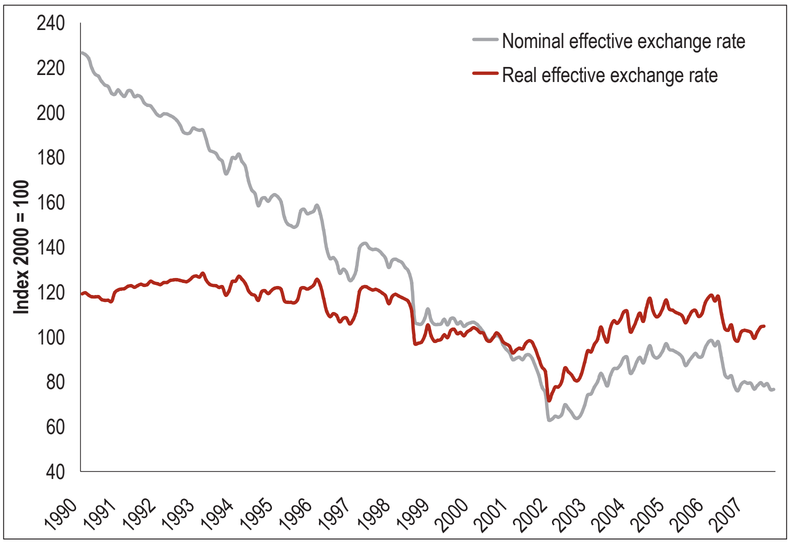
Real effective exchange rate of the rand has been relatively stable during 2007

The sustained flow of capital into South African assets has pushed the nominal exchange rate of the rand to levels consistent with its position prior to the financial contagion of 2001. Although the real effective exchange rate declined by about 10 per cent in 2006, it has rebounded somewhat, remaining relatively stable through the first nine months of 2007.

Vulnerability to external shocks has decreased as government boosts reserves

South Africa's vulnerability to external shocks has declined as government increased its foreign exchange reserves and reduced short-term foreign liabilities. Gross gold and other foreign exchange reserves reached US$30.5 billion at the end of September 2007, US$4.9 billion higher than at the end of 2006. Net reserves, or the international liquidity position, increased from US$23 billion at the end of 2006 to US$28.4 billion at the end of September 2007.

Figure 2.3 Real and nominal effective exchange rate indices, 1990 - 2007

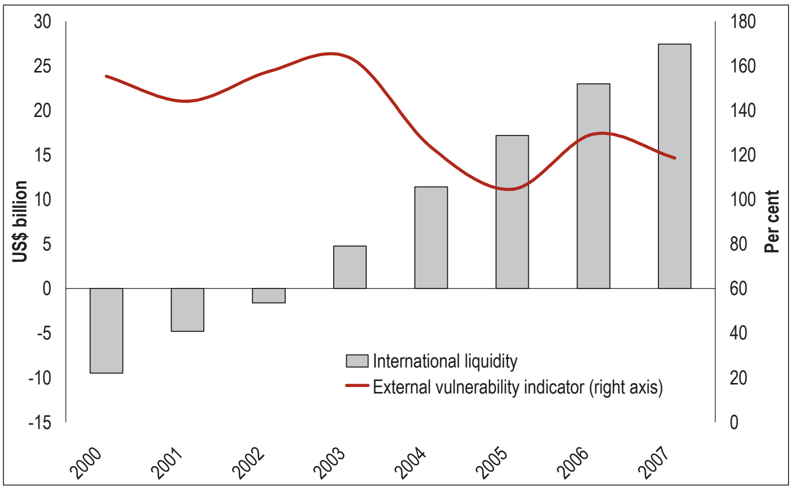


The capital inflows that finance the deficit are driven by greater portfolio investment into emerging markets generally, continued confidence in South Africa's economic outlook and rising interest rate differentials between South Africa and developed markets.

The possibility of sudden and large capital outflows cannot be eliminated

In an environment of greater uncertainty, economies with significant vulnerabilities are at greater risk of financial contagion. So while most emerging markets have benefited from improved macroeconomic fundamentals, this does not eliminate the possibility of sudden and large capital outflows. In South Africa's case, the economy is borrowing to pay for its investment, which highlights the importance of ensuring that investment will generate improved economic growth over the long term.

Figure 2.4 International liquidity position and external vulnerability, 2000 - 2007[1]



[1]External vulnerability is defined as the current account deficit plus short-term, foreign currency denominated debt (including longer-term debt maturing within 12 months), divided by gross reserves.

Greater effort is needed to boost exports and sustain investment levels

The global shift in investment to emerging market and developing economies has helped South Africa to finance domestic capital spending. However, greater effort needs to be made to boost exports to increase the sustainability of the recent domestic investment boom.

Policy challenges

Policy focuses on faster growth, job creation and reducing poverty

South Africa's primary economic policy challenges are to increase the pace of economic growth, expand employment and reduce poverty.

To meet these challenges, production needs to grow more rapidly, and businesses must use available human, physical and financial capital more efficiently. Government's macroeconomic policies aim to maintain a stable economic environment and prevent inflation from undermining competitiveness. Microeconomic interventions need to lower the cost of doing business and improve efficiency, skills, productivity and innovation, so that competitive producers of goods and services will be able to sell in international markets. Getting these policies right will in turn help to ease financing constraints for investment.

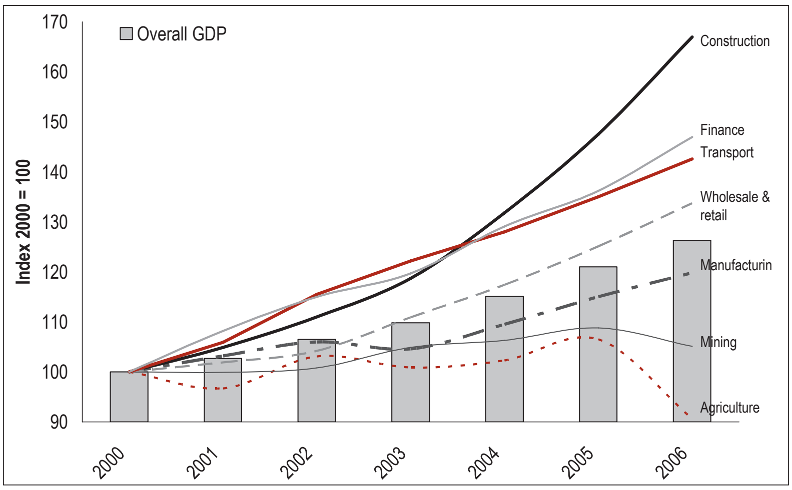
This section reviews key policy issues to be addressed to boost GDP growth above 6 per cent a year and draw more people into economic activity.

Fostering transformation and business creation

Long-term trends show a structural shift in South African economy

Long-term growth trends show a shift of the structure of the South African economy away from mining and agriculture, and towards services, as indicated in Figure 2.5. Manufacturing has remained stable as a share of the economy for several decades, although its constituent parts have changed considerably.

Figure 2.5 Sectoral trends, 2000 - 2006



Exceptional long-term growth in a given economic sector can result from two factors: a structural shift in demand for outputs, such as with the computer industry; or continuous innovation that improves each generation of product and/or reduces its cost.

In an enterprise economy, companies that are more productive succeed and expand, drawing in capital and labour from those that are less productive and less successful. Policy approaches to corporate insolvency and income loss can support the creation of new businesses, and can ease the release of capital and labour from failing firms into new ventures.

Policy stresses both productivity and a strengthened safety net

Government's approach is to support overall improvements in the productivity of the South African economy while providing a strong safety net for those who are displaced. Work on a new social security dispensation includes a review of the existing safety net, including the efficacy of unemployment insurance. Investment in skills also increases the ability of people to respond to technological change.

Developing human capital a core objective of Jipsa

Developing human capital is a core objective of government spending that underpins both the Joint Initiative on Priority Skills Acquisition and the broader skills framework. Broadening access to the labour market and economic activity for new entrants and mature workers is necessary for growth. An environment of ample skilled labour, low costs of capital, and legal and regulatory systems that facilitate competition will be more supportive of long-term expansion and productivity.

Broadening access and drawing people into formal economic activity is key

Broadening access and drawing people into more formal economic activity is crucial. Construction, financial services, transportation and communications, and wholesale and retail trade have exhibited better long-term growth than other sectors, in part because they are structurally more open to new businesses and have lower fixed costs. Here, government policies that foster transformation and enhance competition are important to economic outcomes. Black economic empowerment policies can help new market entrants and indirectly contribute to higher productivity.

Financial sector shows impressive growth

The Financial Sector Charter has helped to expand the market for financial services to many people previously excluded because of high costs and inappropriate products. For example, some 4 million people have signed up for the low-cost Mzansi accounts. This has contributed to higher industry growth rates. Value added in the finance, insurance, real estate and business services sector grew by 8.2 per cent in 2006 before easing to 6.5 per cent in the first six months of 2007. About 300 000 jobs were created in this sector between September 2001 and March 2006.

Growth in real value added by the construction sector rose to 16.5 per cent in the first half of 2007 compared to the same period in 2006. Activity has been boosted by an expansion of civil works projects and increased construction of non-residential buildings, which has compensated for a slowdown in housing-related investment.

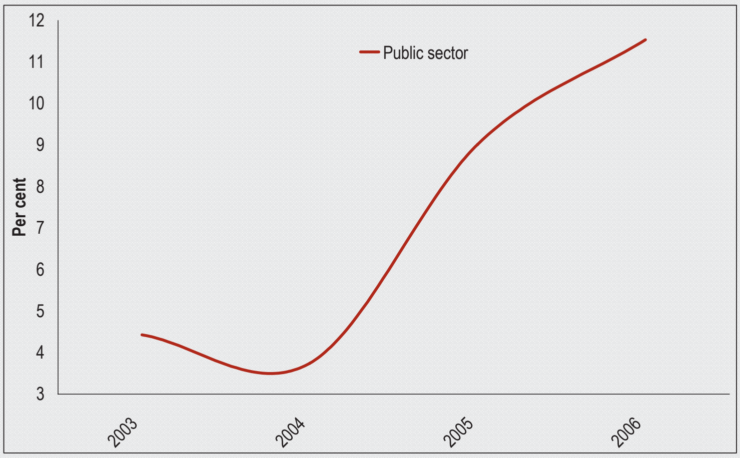
2010 FIFA World Cup infrastructure projects provide strong growth impetus

Construction-related real fixed investment increased at an exceptional rate of 32.3 per cent in the first half of 2007 after growing at an average annual rate of 16.5 per cent since 2002. Infrastructure projects related to the 2010 FIFA World Cup and the upgrading and expansion of power generation and transport infrastructure will continue to drive growth over the medium term. Employment creation in the sector has been robust, with about 320 000 jobs created since 2001.

Building supply capacity in the construction industry

The significant increase in capital investment over the past four years has resulted in increasing supply-side pressures in the construction industry. This is evident from increasing prices and shortages of skills and building materials. The construction boom has forced suppliers to import cement and to contract more workers to meet demand. These constraints are a signal to the sector of the need to increase productive capacity and intensify training to meet demand for skills.

Price escalation for construction works, 2003 - 2006

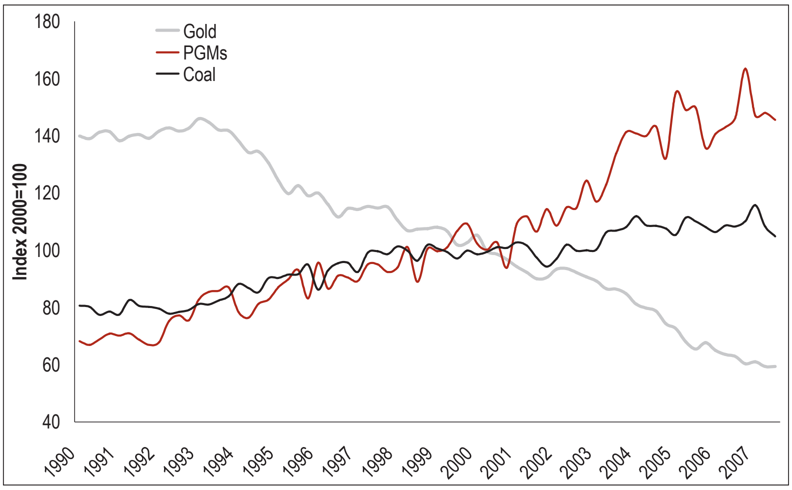


Source: SARB data

The construction industry typically operates within a volatile cycle, which inhibits investment in supply capacity. Given large-scale construction plans, government seeks to manage its fixed investment programme in a way that will sustain growth in the sector. While several infrastructure projects and stadium construction have boosted current activity, major transport and power generation investments are being planned that will extend over the next 10 years and beyond. Greater certainty about capital spending plans helps the industry to invest further in skills and supply capacity.

Mining sector production has been disappointing considering the remarkable rise in commodity prices over the past few years. Mining production increased by only 0.2 per cent in the year to August 2007, weighed down by a 6 per cent decline in gold output. Production of platinum group metals and coal increased by 1.6 and 1.8 per cent respectively.

Figure 2.6 Mining production by commodity, 1990 - 2007



Fixed investment in mining is starting to pick up

After contracting sharply in 2004 and 2005, fixed investment in mining has started to respond to high commodity prices. In the first half of 2007, mining recorded an impressive 33 per cent increase in real investment, compared with 14.8 per cent for 2006 and a decline of 13.2 per cent in 2005. Signs of a recovery are evident in the employment numbers, with a 7.4 per cent increase in the number of mining jobs in June 2007 compared to the same period in 2006.

Effects of climate change on agriculture need to be factored into policy

The agriculture sector remains vulnerable to changes in global demand and shifts in the climate. Over the past two years drought took a toll on domestic agricultural production. The agriculture, forestry and fisheries sector contracted by 1.2 per cent in the first half of 2007 compared to the same period in 2006. Farmers are also grappling with rising costs for fertiliser, tractors and fuel. Over the longer term, climate change could result in reduced rainfall over parts of the country. Projected long-term shifts in weather patterns need to be factored into policy development, and support mechanisms such as crop loss insurance for new and distressed farmers may require consideration.

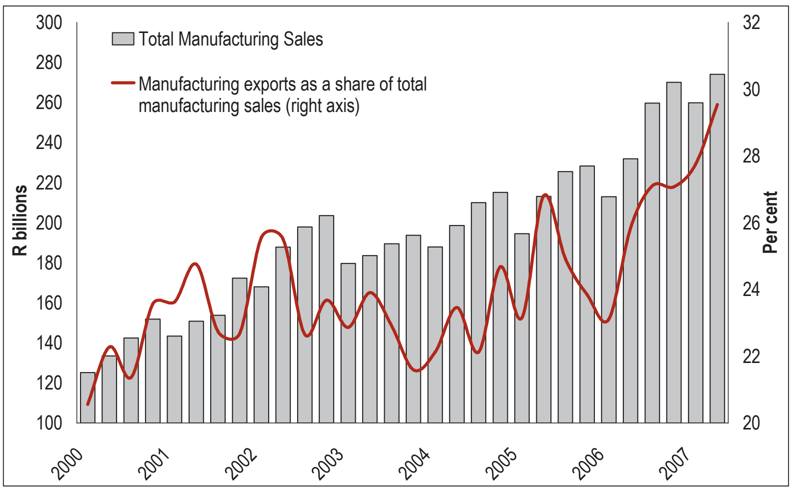
Accessing and growing global demand

Relatively few South African companies have penetrated international markets

Reintegration with the world economy in the 1990s had the major structural effect of helping South African exporters to take advantage of greater openness to access and to exploit global markets. Yet this shift was limited to certain sectors and (mostly large) producers. Many companies have not taken advantage of export opportunities or have struggled to gain a foothold in international markets.

To boost economic growth beyond 6 per cent in coming years, it is crucial for South African companies to take advantage of market access and systematically expand global market share in manufacturing, agriculture, mining and services.

Figure 2.7 Manufacturing sales and exports, 2000-2007



Policy adjustments must support developing export capacity of economy

The case for policy adjustments to develop exports is clear. South Africa's export performance is strong in base metals, minerals, automobiles and some chemicals, but inconsistent and weak in other manufactured exports.

Manufacturing gross value added has increased at an average rate of 4.9 per cent a year since 2004, and 3.9 per cent since 2000. Output grew by 5.1 per cent in the year to August 2007, driven by sustained levels of domestic expenditure and higher exports. The real value of manufactured exports increased by 18.2 per cent in the first half of the year, dominated by basic iron and steel and non-ferrous metals, which account for half of total manufacturing exports. Exports of some niche market products such as pumps and valves, gas purifying systems, and motor vehicle engines have also done well.

Research by Presidency, National Treasury stresses need for diversified manufacturing base

Economic research undertaken on behalf of the Presidency and the National Treasury has stressed the long-term importance of developing a diversified, export-oriented manufacturing base. This requires competitive input costs, markets that are open to foreign competition to create innovation incentives, and addressing market failures where they occur.

Industrial policy is part of this discussion. The basic economic idea of industrial support measures is to increase productivity, and hence the volume of production and use of inputs. Getting the balance of objectives right in industrial support programmes, and amending them when needed to increase efficiency and address flaws, is an important focus of current policy reviews.

The Motor Industry Development Programme, to take one example of South African industrial policy, has been successful in promoting exports, stabilising employment and increasing investment in related component industries. However, it has also been costly.

Government is working to develop sound and affordable industrial policy interventions

Government has taken some important steps forward in deciding what level of analysis is required to devise sound and affordable industrial policy interventions. Those incentives that result in higher levels of productivity, innovation and reduced unit costs will be favoured, with the aim of encouraging businesses to boost exports in highly competitive global markets.

Some net economic gains could be achieved through further tariff reduction and simplification that promotes innovation in production and market strategy. In some sectors, such as textiles and clothing, tariffs remain high enough to maintain producer profitability even with competition. The tariffs maintain profitability of domestic firms and boost profitability of foreign exporters at the expense of South African consumers – but there has been little new investment, while wages have stagnated and employment levels have not increased.

Depreciation allowances used to encourage investment

Investment depreciation allowances are one lever that government uses to encourage investment. Mining, manufacturing and small businesses are targeted. Depreciation allowances have contributed to higher real investment in manufacturing, which has increased at an annual average of 11.4 per cent since 2004, and 8.7 per cent in the first six months of 2007.

Table 2.4 Annual percentage change in exports and imports, 2003 – 2006

Products exported	2003	2004	2005	2006
Base metals	2.5%	30.6%	2.3%	19.6%
Chemical products	-20.3%	13.3%	21.8%	5.9%
Food products	-9.5%	-7.4%	15.7%	9.6%
Machinery	-12.6%	8.0%	11.4%	35.5%
Mineral products	-21.1%	1.3%	38.1%	22.1%
Other	-45.6%	-5.2%	9.2%	2.8%
Precious and semi-precious stones	21.9%	7.4%	2.8%	33.0%
Textiles	-15.0%	-20.2%	-9.7%	-0.3%
Transport (including motor vehicles)	-8.9%	-0.7%	28.5%	17.4%
Total	**-12.7%**	**6.9%**	**12.0%**	**20.9%**
Products imported				
Base metals	-6.1%	19.7%	13.8%	54.8%
Chemical products	-14.7%	6.7%	13.6%	20.3%
Equipment	-13.8%	10.9%	15.6%	27.0%
Machinery	-7.5%	12.8%	15.1%	32.5%
Mineral products (including oil)	-9.0%	41.9%	13.6%	67.7%
Other	-6.2%	11.4%	15.8%	21.2%
Textiles	-7.0%	23.6%	11.1%	28.1%
Transport (including motor vehicles)	17.2%	34.5%	13.8%	17.8%
Total	**-6.0%**	**18.6%**	**14.6%**	**32.5%**

Source: South African Revenue Service, January 2007

Greater competition has supported investment and productivity in network industries

More competition has been supportive of investment and productivity in network industries. In the transport sector, for example, the relative ease of transporting freight by road instead of rail has highlighted the need for renewal of rail freight services, efficiency gains and lower costs to rail freight users.

The transport sector has been a major driver of growth due to the expansion and upgrade of the main airports, the expansion of the Richards Bay Coal Terminal, 2010 FIFA World Cup site preparations and construction related to the Gautrain. Real investment by the transport sector accelerated to 24.6 per cent in the first half of 2007 compared with 19.4 per cent during 2006.

Trade reform and productivity

International trade is a key determinant of economic growth and employment. The simplification and reduction of tariffs has stalled in recent years, following a period of rapid reform in tariff and trade policy in the 1990s. Significant tariff peaks still exist and effective rates of protection have increased in some sectors despite considerable tariff reductions. This is because duties on intermediate goods and final products are higher than the duties on raw materials, which leads to tariff escalation. High rates of protection reduce the profitability of exports relative to domestic sales. In South Africa high protection rates are found in textiles, leather, footwear, clothing, motor vehicles, parts and accessories and in food processing.

Trade reform increases productivity by encouraging businesses to become more efficient. Higher productivity growth improves the competitiveness of import-competing firms and exporters. Investment in trade-related infrastructure such as transport and telecommunications and in effective skills development programmes helps to make the boost in economic growth more inclusive. To take better advantage of strong economic growth in the rest of the world and with the continuing impasse in the World Trade Organisation's Doha round, a more unilateral approach to capturing the economic gains of lower tariffs may be appropriate.

Less restricted operating environment is needed in telecommunications sector

It is also recognised that a less restricted operating environment in the telecommunications sector would have strong positive economic effects and raise growth beyond the 5.4 per cent achieved in this sector in the first half of 2007.

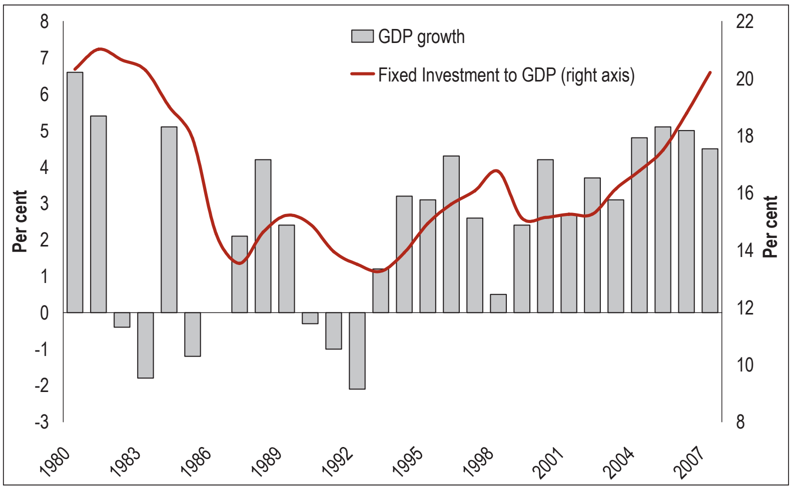
Sustaining growth with lower inflation

Energy and food price spike have driven inflation

In South Africa, as with any small and open economy, rapid increases in investment spending put pressure on domestic capacity, raise imports and push up prices. Over the past year, a spike in energy and food prices has added to inflationary pressures. The policy challenge is to maintain robust investment and economic growth while keeping inflation from rising, undermining competitiveness of the economy and pushing up the cost of capital.

Investment has played a major role in strong economic growth, rising from about 15 per cent of GDP in 2002 to nearly 21 per cent in the first half of 2007. The ratio of fixed investment to GDP of 25 per cent by 2014 should be achieved ahead of schedule, helping to reduce capacity constraints and supporting sustained higher growth.

Figure 2.8 Gross fixed capital formation and GDP growth, 1980 – 2007



Household consumption should moderate in response to rate hikes and National Credit Act

Household consumption expenditure continued to expand at the brisk pace of 7.4 per cent in the first half of 2007. Rising interest rates and the effects of the National Credit Act will help to slow excess growth in spending. Spending on interest-sensitive durable goods has already slowed. Over time, the ratio of household debt to disposable income, which had reached a high level of 76.6 per cent in June this year, will return to more sustainable levels.

Overall growth in the broad measure of money supply (M3) and private-sector credit is expected to remain strong given robust demand from the corporate sector to finance investment and the general rise in income across the economy.

CPIX inflation above the target band

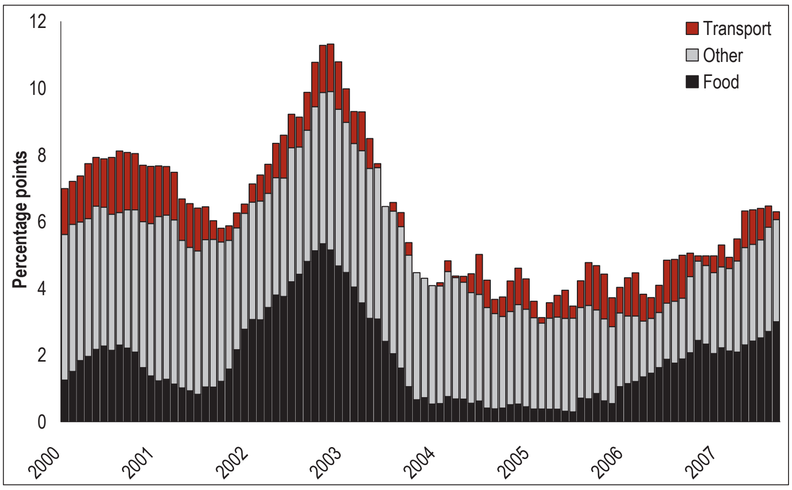
After remaining between 3 and 6 per cent for 43 months, CPIX inflation breached the upper end of the target band in April 2007 and remained above target through September. External shocks to food and oil prices have been the primary drivers of inflation over the past year, but inflation pressures have broadened recently due to the weaker rand, buoyant demand and capacity limits in domestic industry.

Inflation expectations on the rise

Sharp upward adjustments in homeowners' costs in July – assessment rates, refuse removal, water and electricity – have added to pressure on service price inflation, which rose by 5.8 per cent year on year in September. Inflation expectations and wage settlements have also moved higher after a period of relative stability.

There is significant wage pressure in the economy following a series of strikes in the first nine months of the year. Average wage settlements are expected to be in the range of 7 to 8 per cent in 2007 from 6.5 per cent in 2006. Real wage settlements have averaged about 2 per cent since 2003 and will remain close to that level this year.

Figure 2.9 Contributions to CPIX inflation, 2000-2007



Upward pressure on wage settlements poses a risk to the inflation outlook if productivity growth does not keep pace. Productivity grew by 2.4 per cent in the first quarter of this year, which was roughly the same pace as in 2006, but lower than the rate of 4 per cent achieved in 2005. Unit labour costs increased by 3 per cent and 5 per cent respectively in 2005 and 2006.

Greater investment in skills and education required

Low and stable inflation promotes economic growth and helps to keep the economy internationally competitive. Rising inflation over the past year highlights the need for more balanced growth, which can be achieved as household consumption moderates, and as capacity constraints ease as a result of sustained investment. Greater investment in education and skills development is also necessary to reduce wage pressures in key sectors where skilled labour is in short supply and for employment generally.

Conclusion

South Africans are on average considerably better off today than they were in 1999 as a result of more rapid increases in real income, lower borrowing costs and more widely available public services. These achievements have been supported by growing public sector investment in infrastructure, a stable financial environment and significantly improved terms of trade in an expanding world economy.

South Africa needs to expand both exports and production

Future growth needs to reflect a much stronger expansion in South African exports and production. Improved export growth alongside the accumulation of foreign reserves will help to reduce the economy's exposure to international financial risks.

A more explicit focus on export capacity also supports government's efforts to broaden participation, reduce poverty, and make more meaningful the idea of shared growth through more rapid job creation and small enterprise development.