2

Economic policy and outlook

- A period of unprecedented global economic growth has given way to a world economic outlook marked by higher inflation and slower growth in major economies. While South Africa's outlook remains healthy, the economy is not immune from deteriorating international conditions. After four years of robust domestic economic growth, a weaker global environment in combination with domestic constraints will moderate the pace of expansion in 2008 and 2009.
- The South African economy has the resilience to respond to these challenges and continue growing over the period ahead, supported by strong investment in fixed capital and high commodity prices. The fiscal surplus and the inflation targeting framework help to cushion the economy against risks by boosting domestic savings and safeguarding competitiveness.
- Over the next three years, GDP growth is expected to average 4.3 per cent. Policy will focus on reducing imbalances, increasing competitiveness and accelerating growth over the longer term. Partnerships between the private and public sectors and strong investment growth are necessary to expand productive capacity and reduce constraints. Accelerated infrastructure spending and targeted demand management will reduce bottlenecks in electricity and transport. Continued public investment in education and skills is crucial for future growth.
- Further steps are announced to move from exchange controls towards prudential regulation.

Introduction and overview

Expanding employment and public spending increases have contributed to improved public welfare

Over the past four years, the South African economy grew at a robust pace averaging 5 per cent. Expanding employment and sustained increases in public spending on social and economic infrastructure have contributed to improved welfare for millions of South Africans.

During 2007, domestic economic growth remained buoyant, at an estimated 5.0 per cent. GDP growth in 2008 is projected to slow to

4.0 per cent, reaching 4.2 per cent in 2009 and 4.6 per cent in 2010, partly in response to stimulus from the 2010 FIFA World Cup. Growth is expected to remain broad-based, including in agriculture, with a good harvest forecast for 2008. The near-term GDP forecast takes into account slowing global growth, softer growth in household consumption spending due to higher interest rates and the impact of electricity shortages on domestic industry.

High commodity prices and strong fixed investment provide support to economy

The economy continues to benefit from record-high commodity prices and strong fixed investment growth, which will raise productive capacity over time. Sharp increases in commodity prices have benefited the terms of trade, raised national income and boosted tax revenues.

Sustained economic growth has boosted job creation – by about 741 000 jobs between March 2005 and March 2007 – and supported higher fiscal transfers, contributing to rising living standards. Net job creation continued in 2007, though at a slower pace than the previous three years.

Policy initiatives aimed at improving competitiveness and reducing the cost of doing business are needed to sustain growth in the deteriorating international economic environment in the short-term and to ensure that South Africa is well positioned to benefit from a rebound in the global economy when it occurs.

Investment in fixed capital expanded rapidly in 2007

Investment in fixed capital expanded rapidly in 2007 and will remain a key support to GDP growth over the medium term, driven by widespread public sector infrastructure development and its effect on private investment and capacity expansion. Spending on energy-intensive projects may be deferred over the medium term. Growth in fixed capital formation is expected nonetheless to average near 10 per cent per year over the next three years. Improvements in the global economic environment and domestic inflation will have significant positive effects on investment over the medium term.

Capacity constraints in electricity generation will exacerbate the trade deficit over the short term

The current account deficit increased to an estimated 7.2 per cent of GDP in 2007 compared with 6.5 per cent in 2006, reflecting rapid economic growth, high oil prices and sluggish exports. Capacity constraints in the electricity sector will exacerbate the trade deficit over the short term by constraining exports, raising demand for imported fuel to power generators and supporting investment in energy-efficient technologies. These effects will be offset to some extent by continued strong prices for South Africa's main commodity exports and a more competitive currency. The current account deficit is expected to remain large over the medium term, reaching 8 per cent of GDP in 2010.

The balance of payments position remained positive in 2007

The balance of payments position remained positive in 2007. Foreign exchange reserves rose to US$33.6 billion at the end of January 2008. Since the beginning of 2008, reduced investor appetite for risk has resulted in the nominal effective exchange rate of the rand weakening by about 12 per cent. Together with the prudent fiscal stance, the stronger reserves position and floating exchange rate will cushion the economy against shocks by reducing pressure on interest rates. In addition, South Africa's macroeconomic position is considerably better than in previous episodes of financial market contagion.

Food and fuel prices are driving inflation

Rising inflation presents an important policy challenge. Inflation increased to above 6 per cent in April 2007 and has remained above the target range, driven by sharp food and oil price increases, along with capacity constraints and strong demand in sectors such as construction. Domestic demand has begun to moderate in response to cumulative interest rate increases of 4 per cent between June 2006 and December 2007, which should in due course lead to a decline in inflation. CPIX inflation is expected to average 7.1 per cent in 2008 and to decline to 4.9 per cent in 2009.

Table 2.1 Macroeconomic projections, 2004 – 2010

Calendar year	2004	2005	2006	2007	2008	2009	2010
		Actual		Estimate		Forecast	
Percentage change unless otherwise indicated							
Final household consumption	6.7	6.9	8.2	7.0	3.7	3.8	4.2
Final government consumption	6.2	4.8	5.2	5.2	4.6	4.5	4.5
Gross fixed capital formation	8.9	8.9	13.8	15.3	9.6	9.7	9.9
Gross domestic expenditure	7.9	5.7	9.2	6.4	5.0	4.6	4.8
Exports	2.9	8.0	5.6	7.1	3.8	6.0	6.4
Imports	14.5	10.3	18.8	11.0	7.0	6.9	6.3
Real GDP growth	**4.9**	**5.0**	**5.4**	**5.0**	**4.0**	**4.2**	**4.6**
GDP inflation	5.5	5.2	7.2	8.6	7.9	5.5	5.0
GDP at current prices (R billion)	**1 395.4**	**1 541.1**	**1 741.1**	**1 986.1**	**2 229.8**	**2 449.1**	**2 691.2**
CPIX inflation (average for year)	4.3	3.9	4.6	6.5	7.1	4.9	4.7
Current account balance (percentage of GDP)	-3.2	-4.0	-6.5	-7.2	-7.3	-7.8	-8.0

Table 2.2 Macroeconomic projections, 2006/07 – 2010/11

Fiscal year	2006/07	2007/08	2008/09	2009/10	2010/11
R billion	Actual	Estimate		Forecast	
GDP at current prices	**1 807.3**	**2 045.5**	**2 286.9**	**2 506.9**	**2 758.6**
Real GDP growth	5.6	4.7	4.0	4.2	4.7
GDP inflation	8.0	8.1	7.5	5.2	5.1
CPIX inflation	4.9	7.4	6.2	4.8	4.7

Policy challenges for long-term growth

Job creation and improved living standards are dependent on higher growth

A central aim of economic policy is to create an environment conducive to achieving and sustaining economic growth above 6 per cent. More rapid job creation and higher incomes and living standards for all South Africans are dependent on stronger growth. The experience of the past few years has demonstrated the economy's potential. However, this growth was achieved in a relatively favourable global environment characterised by strong demand, ample liquidity and high commodity prices.

In the context of greater global uncertainty, macroeconomic policy is set to address the imbalances associated with inflation and the current account deficit. The projected moderation in GDP growth in 2008 reflects primarily the impact of a slowing global economy. It is also clear, however, that the domestic economy has run up against capacity constraints in a range of areas, including the supply of electricity and skilled labour.

Achieving sustained economic growth and a permanent improvement in exports requires intensified policy attention. South Africa's growth potential will remain constrained unless further reforms are implemented to remove bottlenecks, reduce the cost of doing business, raise the level of skills and productivity, improve competition and raise export levels.

Securing reliable electricity requires new plants, demand-side management and market pricing

In conjunction with investment in new power projects and demand-side management, reliable electricity supplies can be secured through a revised regulatory approach that better reflects the cost of production now and in the future, and creates space for independent producers. In the long run, South Africa must pay more for electricity. The impact of energy-saving on production processes will create benefits in the form of a more energy-efficient and competitive economy.

For South Africa to grow beyond 6 per cent over the longer term, policy must continue to focus on the following areas:

- **Macroeconomic stability.** Macroeconomic policies aim to maintain a stable economic environment and to prevent inflation from undermining competitiveness. This is crucial to promote domestic and foreign investment, to finance the current account deficit, and to ensure sufficient fiscal resources to sustain spending on infrastructure and social needs.
- **Capacity expansion.** Strong growth in public and private sector investment is needed to ensure that the economy can sustain higher rates of growth without overheating. The upgrading and expansion of network industries such as transport and electricity must continue without delay.
- **Productivity and competitiveness.** The cost of doing business needs to be reduced for South Africa to be competitive in global markets. Further trade reform is necessary to lower costs to consumers, reduce input costs, support diversification, and promote innovation and competitiveness.
- **Human capital and skills development.** Developing human capital and strengthening the national skills base are core objectives of government spending. Broadening access to the labour market and economic activity for new entrants and mature workers is necessary for growth.
- **Red tape and regulatory reform.** In some areas, such as electricity, it may be necessary to increase prices to promote efficient use of scarce resources. Legal and regulatory systems that facilitate both competition and consumer protection will be more supportive of long-term expansion and productivity in most sectors, especially telecommunications.

- **Industrial support measures**. Government has taken some important steps forward in designing a framework to guide sound and affordable industrial policy interventions. Higher levels of productivity, innovation and reduced unit costs must be favoured, with the aim of encouraging businesses to boost employment and exports in highly competitive global markets.

Global developments

Effects of weaker US growth are expected to spill over into Europe and Japan

Market turbulence and the sharp economic slowdown in the US are expected to have a negative impact on international growth. Financial market contagion has increased considerably since the start of the year and equity markets around the world have already registered sharp declines. Global growth is forecast to slow from 4.9 per cent in 2007 to 4.1 per cent in 2008, as the effects of weaker US growth spill over into Europe and Japan. Emerging markets may also be negatively affected, although continued strong growth is expected in China and India in particular.

Commodity prices are expected to remain near their current high levels. The unwinding of global imbalances, efforts to ease liquidity in credit markets, and revised approaches to credit provision in the US housing market are important steps towards a global recovery in the medium term.

The US subprime mortgage crisis and the global credit crunch

In recent years, global asset prices have been supported by large-scale international capital flows and low interest rates. Increased investor demand for higher-yielding but risky assets encouraged banks to create an array of securitised debt products, some of which included US subprime mortgages – residential loans with a lower expected probability of full repayment. Securitised assets were sold internationally, creating a link for potential global contagion.

The default rate on US subprime mortgages rose sharply in 2007 in response to successive interest rate increases. The risks associated with this market were compounded by a range of other negative factors, including fraudulent mortgage lending practices and errors by credit rating agencies. Stock markets across the globe tumbled in July and August of 2007 when investors started to withdraw capital in an attempt to limit their subprime exposure. When commercial banks became reluctant to lend to other banks for fear of exposure to the crisis, a global credit crisis ensued. Some banks, such as Northern Rock in the UK, found it increasingly difficult to finance their day-to-day operations, requiring emergency liquidity provision by central banks.

Due to the complex and interlinked nature of the securitised debt market, the full extent of the credit crisis is yet to be revealed. Banks and financial institutions around the world have already written off US$120 billion of losses, and the Group of Seven finance ministers fear that losses could soon reach US$400 billion.

The scale of these losses has had a major impact on banks' balance sheets and on the availability and cost of credit to households and companies. Central banks have injected large amounts of liquidity into money markets and several large US banks have been recapitalised by sovereign wealth funds.

The decline in the US housing market and tightening credit conditions have reduced growth prospects in the US and other major economies. It is unclear whether steep interest rate cuts and the announcement of a fiscal stimulus package worth about US$161 billion will put a floor under the housing market and ease the credit crunch.

Trends in major economies and regions

- The US economy weakened significantly in the second half of 2007. GDP growth is forecast to fall to 1.5 per cent in 2008 from an estimated 2.2 per cent in 2007. In the face of a growing risk of recession and market turbulence, the Federal Reserve has reduced interest rates from 5.25 per cent in August 2007 to 3 per cent at the end of January 2008.
- Growth in the Eurozone is forecast to decline to 1.8 per cent in 2008 from 2.6 per cent in 2007, as a result of rising food and oil prices, the effects of the strengthening euro and weakening demand on corporate profitability. Similar pressures will weigh on Japan's GDP growth in 2008.
- China's economic growth is expected to soften from an estimated 10.0 per cent in 2007 to 9.5 per cent in 2008. High growth has been driven by robust exports and high levels of investment, but a US slowdown could dampen exports.
- Similarly, GDP growth in India is expected to moderate from 8.4 per cent in 2007 to 7.8 per cent in 2008.
- Sub-Saharan Africa continues to perform well, with growth projected to remain robust at 6.1 per cent in 2008 from 6.8 per cent in 2007, owing in large part to oil and commodities producers benefiting from high prices. Total gross private capital inflows to the region amounted to US$45 billion in 2006 compared with about US$9 billion in 2000.

Table 2.3 Annual percentage change in GDP and consumer price inflation, selected regions/countries, 2006 – 2008

Region / Country	2006	2007	2008	2006	2007	2008
Percentage		GDP projections			CPI projections[1]	
World[2]	**5.4**	**4.9**	**4.1**	**3.8**	**3.5**	**3.5**
US[2, 3]	2.9	2.2	1.5	3.2	2.9	2.8
Euro area[3]	2.9	2.6	1.8	2.2	2.1	2.4
UK[3]	2.9	3.1	1.8	2.3	2.3	2.3
Japan[3]	2.4	1.9	1.5	0.2	–	0.4
Emerging markets and developing countries[2]	**7.9**	**7.5**	**7.1**	**5.3**	**5.4**	**4.9**
Developing Asia[2]	**9.4**	**8.8**	**8.4**	**4.0**	**3.9**	**3.4**
China[2]	10.7	10.0	9.5	1.5	2.2	2.3
India[2]	9.2	8.4	7.8	6.1	6.2	4.3
Africa[2]	**5.5**	**6.2**	**5.8**	**9.5**	**10.7**	**10.4**
Sub-Saharan Africa	**5.7**	**6.8**	**6.1**	**11.5**	**12.7**	**12.2**
South Africa[4]	5.4	5.0	4.0	4.6	6.5	7.1

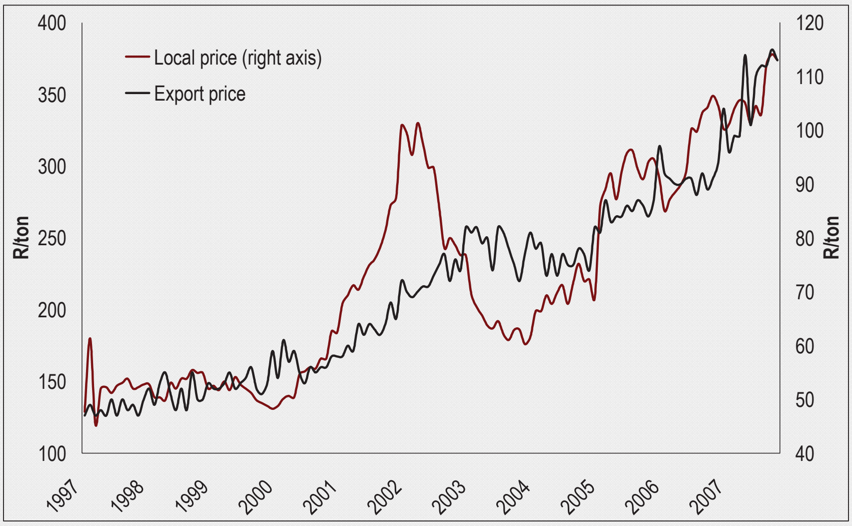
1. The targeted rate of inflation, CPIX, used for South Africa.
2. IMF, World Economic Outlook, October 2007 and January 2008 update for US and World GDP.
3. Consensus Forecast, January 2008.
4. National Treasury, January 2008.

Coal prices and coal exports

Strong global demand pulled up international coal prices in 2007 by 87 per cent. Coal is used to generate about 90 per cent of South Africa's electricity, and sustained higher prices will push up the price of electricity. In 2007, the energy sector used about 110 million tons of coal, which was 5 per cent more than in 2006.

South Africa exports about 28 per cent of coal production. Domestic coal production increased by only 0.8 per cent in 2007 and the volume of exports increased by only 1.6 per cent in the year to August 2007. In nominal terms, coal exports increased by about 25 per cent last year, which was roughly in line with the average increase in the coal price in rand terms.

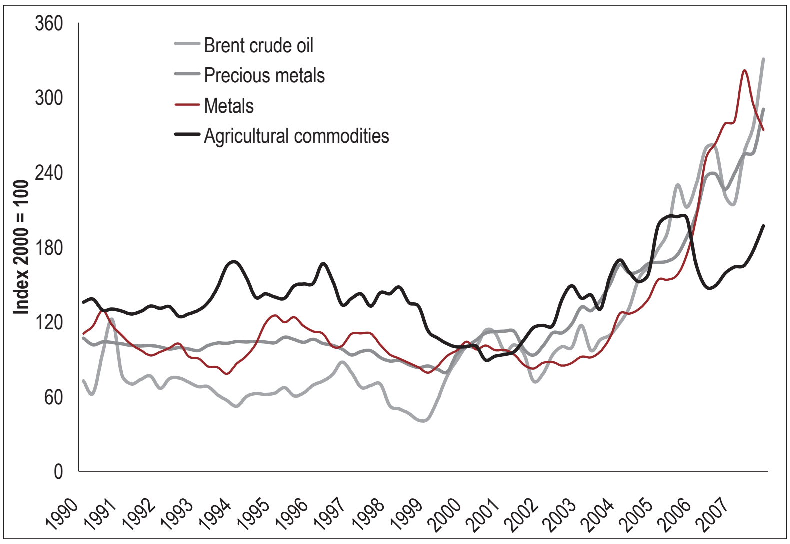
Prices for local and export coal, 1997 - 2007



Commodity trends

- The prices of all major commodities are expected to remain near their 2007 highs as a result of strong growth in developing countries. Precious metals prices rose by 28 per cent in 2007 after being up 20 per cent in 2006. Over the same period, the IFS Energy Index increased by 45 per cent.
- Oil prices have risen by 385 per cent since November 2001 and are expected to remain at elevated levels. The price of Brent crude oil rose to more than US$100 per barrel towards the end of 2007.
- Precious metals prices also broke through record levels in December 2007 and continue to rise, driven by dollar weakness, a "flight to safety" by investors and supply disruptions. The gold price increased by 29 per cent in 2007 after rising by 23 per cent in 2006. Platinum surpassed US$2 000/oz in February 2008.
- Export coal prices rose by 87 per cent in 2007, from US$50.69 to US$95 per metric ton. The price increases were driven by strong demand from China and India, along with infrastructure constraints.

Figure 2.1 World commodity prices, 1990 - 2007



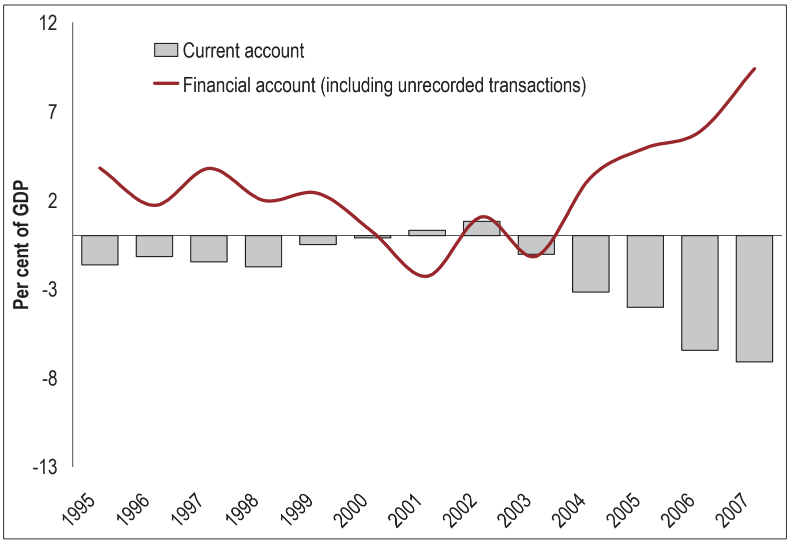
Balance of payments

Balance of payments positive in 2007 but outflows in early 2008

South Africa's balance of payments position remained positive last year, despite the significant mismatch between savings and investment. In the first six weeks of 2008, however, international financial contagion has contributed to some unwinding of non-resident positions in rand-denominated assets.

South Africa's floating exchange rate will help to cushion the impact of volatile capital flows on the real economy over the short and medium term. Over the longer term, the structural improvements to economic management in emerging markets – particularly those characterised by solid growth prospects such as South Africa – will support continued investment.

Figure 2.2 Overall balance of payments, 1995 - 2007



Unrecorded transactions is an item in the balance of payments that reconciles the change in official reserves with the balance of the current, capital transfer and financial accounts.

Current account

High current account deficit is cause for concern

Robust economic growth, strong investment, high oil prices, and higher net service and income payments pushed the deficit on the current account to 7.1 per cent of GDP during the first three quarters of 2007 from 6.5 per cent in 2006 as a whole.

Between January and September 2007 the trade deficit widened to 2.3 per cent of GDP, up from 2 per cent over the corresponding period in 2006. Likewise, the deficit on the net income, services and current transfer account increased from 4 per cent to 4.8 per cent of GDP, partly as a result of higher dividend payments by South African companies to non-resident investors. South African Customs Union (SACU) payments were also large in the first nine months of 2007, amounting to 1.1 per cent of GDP.

Table 2.4 Summary of South Africa's current account, 2000 – 2007

Percentage of GDP[1]	2000	2004	2005	2006	2007*
Exports (excl. gold)	21.1	20.2	21.1	22.9	24.8
Gold exports	3.0	2.1	1.8	2.0	1.9
Exports (incl. gold)	24.1	22.3	22.9	25.0	26.8
Imports	20.5	22.3	23.3	27.4	29.0
Trade balance	**3.5**	**-0.1**	**-0.4**	**-2.4**	**-2.3**
Net service receipts	-0.6	-0.3	-0.4	-0.9	-1.1
Net income receipts	-2.4	-2.0	-2.0	-2.1	-2.6
Current account balance excl. SACU payments	**0.6**	**-2.4**	**-2.9**	**-5.4**	**-6.0**
SACU payments[2]	-0.7	-0.8	-1.2	-1.1	-1.1
Current account balance incl. SACU payments	**-0.1**	**-3.2**	**-4.0**	**-6.5**	**-7.1**

1. *Columns may not add up due to rounding.*
2. *Includes other current transfers, which are minimal.*

* *Average seasonally adjusted annualised level for first nine months.*

South Africa's terms of trade – the ratio of export to import prices – continue to benefit from high commodity prices and increased by 2.9 per cent in the first three quarters of 2007 compared with the same period in 2006. Exports have improved somewhat over the past year, but not enough to offset rising imports. Robust growth in fixed investment spending has boosted demand for capital goods imports, while domestic capacity constraints have necessitated higher imports of raw materials such as cement and steel.

Efficient energy use and continued high metals prices would reduce pressure on current account

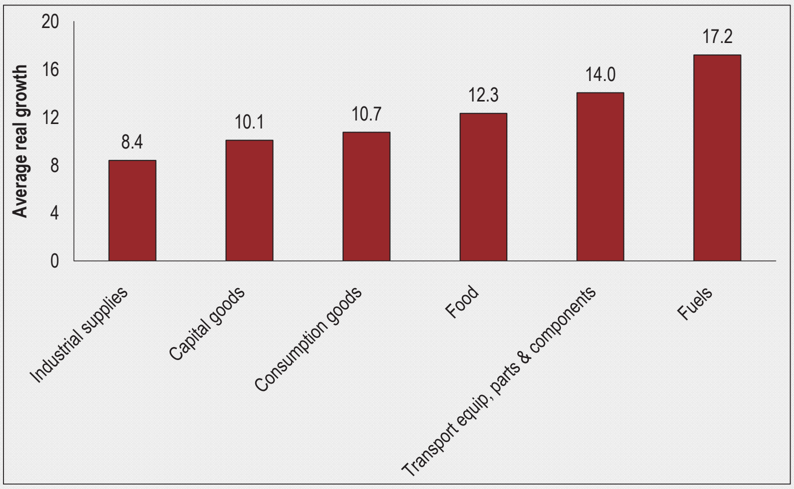
Export production, particularly of commodities, has been negatively affected by electricity shortages and will take time to recover. At the same time, import demand is likely to rise due to more investment in energy-saving technologies, and growth in imports of refined hydrocarbons to fuel Eskom's gas turbines and electricity generators for domestic and commercial use. More efficient use of energy and continued high prices for platinum and gold would help to alleviate pressure on the current account.

Over time, pressures on the current account will also be moderated by slower growth in consumption spending, increased exports supported by a more competitive real exchange rate, sustained high commodity prices and capacity expansion by local manufacturers.

Import trends and drivers

Real import volumes grew by 9.6 per cent per year between 2000 and 2007. Most categories of imports grew strongly in response to domestic demand, with the largest increases in fuel, transport equipment and food. The chart below shows import trends by end-use category.

Annual average real growth in imports by end-use category, 2000-2007



Fuel imports made up 18 per cent of total imports in 2007 up from 12.8 per cent in 2000. The sharp rise in fuel imports reflects rising local demand for refined petroleum due to the increased number of vehicles on the country's roads, strong growth in industrial production and Eskom's use of open cycle gas turbines as peaking power stations. Transport equipment imports reflect strong domestic demand, investment by state-owned enterprises in new aircraft and rolling stock, and purchases of components for vehicles manufactured for export.

Financial account

Capital inflows remained positive in 2007 despite turbulence in global financial markets. Strong domestic growth, high commodity prices and a sound macroeconomic environment underpinned global demand for South African bonds and equities. The surplus position on the financial account remained large at 9.5 per cent of GDP in the first three quarters of 2007, compared with 8.1 per cent in 2006.

Net portfolio inflows of R85 billion in 2007 and net FDI of R12 billion

Non-resident purchases of bonds and equities continued to make up the bulk of financing of the current account deficit in the first nine months of 2007. Net portfolio inflows amounted to R85 billion in that period, while net foreign direct investment (FDI) totalled R11.9 billion. Non-residents were net purchasers of R62.3 billion worth of shares on the Johannesburg Stock Exchange and R7 billion of bonds in 2007. In January 2008, foreigners were net sellers of R11.3 billion worth of bonds and R7.9 billion in equities following capital outflows from emerging markets and concerns over the impact of electricity shortages on economic growth.

A vote of confidence from the world's largest bank, which is investing in South Africa

Direct investment inflows were boosted by several private equity transactions last year, but South African firms also expanded their presence abroad. Outward FDI amounted to R13.6 billion in the first nine months of 2007, while inward FDI totalled R25.5 billion. Large inward investments in 2007 and early 2008, such as the Industrial and Commercial Bank of China's purchase of a 20 per cent share in Standard Bank, reflect optimism about longer-term growth prospects.

From exchange controls to prudential regulation

Recent turbulence in global financial markets triggered by the collapse of the US subprime mortgage market and the ensuing credit crisis has underscored the importance of a sound framework for ensuring financial stability, including prudent limits on financial institutions' exposure to various risks.

South Africa's robust system of financial regulation has helped to insulate local institutions from the worst effects of the current turmoil. The regulatory framework includes limits on the extent to which banks and institutional investors are exposed to foreign risks. These are commonly applied internationally and will remain part of South Africa's overall framework for financial and macroeconomic stability.

Limits on foreign diversification by institutional investors

Exchange control limits on foreign investment by institutional investors – insurers, pension funds, collective investment schemes and investment managers – have been gradually liberalised since 1996. Foreign diversification of investment portfolios, consistent with prudential limits, has largely been achieved. This allows the authorities to replace exchange controls on institutional investors with a system of prudential regulation. This shift will entail the removal of the pre-application process for foreign investment and its replacement with a system of quarterly reporting and monitoring of foreign exposures by the Reserve Bank. The reporting system will be supported by a pre-notification requirement for substantial changes in foreign exposure to enhance surveillance.

Further work will be conducted during 2008 on final prudential foreign exposure limits. In the interim, the foreign exposure limit for pension funds and the underwritten policies of long-term insurers is increased from 15 per cent to 20 per cent of total retail assets, while the foreign exposure limit on collective investment schemes, investment managers and the investment-linked business of long-term insurers is increased to 30 per cent of total retail assets. There will continue to be an additional allowance for portfolio investment in Africa, equal to 5 per cent of total retail assets, for all institutional investors.

Prudent limits on foreign diversification by banks

In 2005, measures were announced to enable South African banks to undertake foreign transactions and investment, supported from their domestic balance sheets, within prudent foreign exposure limits. During 2008, the Reserve Bank and the National Treasury will finalise measures to simplify the regulation of banks' foreign exposure, within a macro-prudential limit equal to 40 per cent of a bank's liabilities.

Foreign diversification by companies

To further enable South African companies, trusts, partnerships and banks to manage their foreign exposure, they will be permitted to participate without restriction in the rand futures market on the JSE Securities Exchange. Enabling companies to diversify and hedge their currency exposure supports macroeconomic stability, reduces exchange rate volatility and deepens domestic financial markets. This dispensation is also extended to investment in inward-listed (foreign) instruments on the JSE and Bond Exchange of South Africa.

Streamlining administration

In line with broader efforts to cut red-tape for small and medium-sized businesses, the current application process for exchange control approval before undertaking foreign direct investment will be removed for company transactions totalling less than R50 million per year.

The current transaction reporting system will remain in place to enable proper surveillance and supervision by the Reserve Bank. To streamline administrative controls on individuals, a single R500 000 per year discretionary allowance for purposes of travel, gifts, donations and maintenance is introduced. This discretionary allowance is in addition to the existing R2 million individual investment allowance.

Institutional structure for financial surveillance

The reforms outlined above have significant implications for the functions and responsibilities of the Reserve Bank's Exchange Control Department. The shift from exchange controls to prudential regulation changes the focus of activities from pre-approval of applications to monitoring of cross-border flows. Financial surveillance is expected to remain an important pillar of the financial stability framework. As a result, the Exchange Control Department will be renamed the Financial Surveillance Department of the Reserve Bank.

The Reserve Bank will provide further details of these reforms.

Table 2.5 Financial account of the balance of payments, 2004 – 2007

R billion	2004	2005	2006	2007*
Net portfolio investment	40.6	29.9	129.2	85.0
Net FDI	-3.6	36.4	-49.1	11.9
Net other investments	8.7	9.8	21.9	23.0
Unrecorded transactions	36.0	20.2	39.9	18.9
Total financial flows	**81.8**	**96.3**	**141.9**	**138.7**

Source: SARB

**First nine months of 2007*

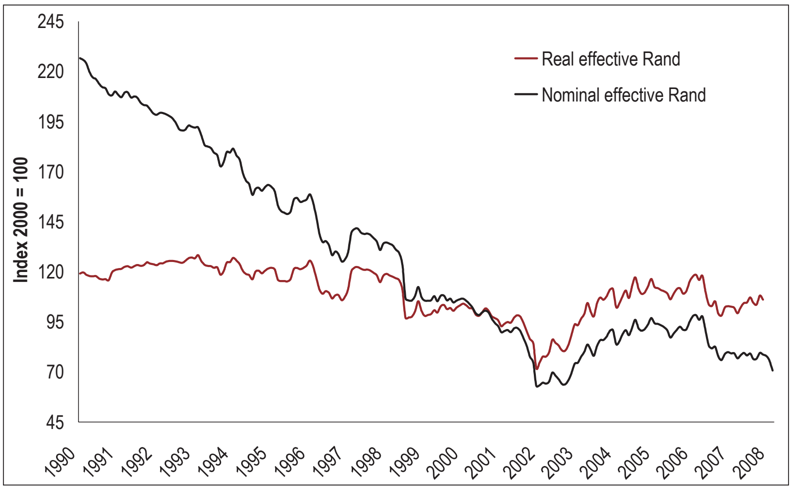
Exchange rate and international reserves

The rand is trading at a more competitive level

During 2007, the rand traded in a more stable range and at a more competitive level than in 2006. The average nominal effective exchange rate of the rand was about 9.7 per cent lower in 2007 than in 2006. However, the competitiveness of the real exchange rate was partially eroded by rising inflation, resulting in a decline of about 3.5 per cent in 2007. Since the end of 2005 the real effective exchange rate of the rand has depreciated by about 8 per cent.

A number of countervailing forces acted on the rand in 2007. While rising precious metal prices, interest rate differentials, and the weakening dollar provided support to the currency, financial market turmoil and concern about the long-term financing of the current account deficit had a dampening effect. This became more pronounced in the first two months of 2008 in response to a generalised increase in investors' perceptions of risk across all emerging markets.

Figure 2.3 Exchange rate of the rand, 1990 - 2008



Reserve Bank continues to build foreign exchange reserves

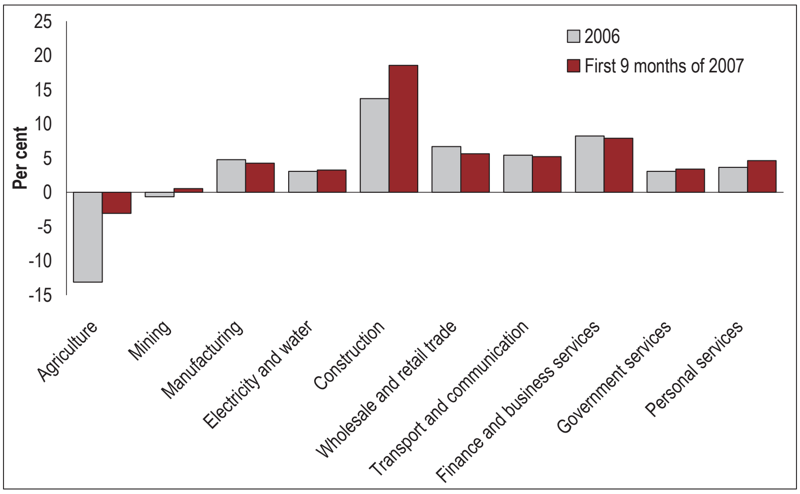
The Reserve Bank continued to strengthen South Africa's reserve position in 2007, further improving external liquidity. Gross gold and other foreign exchange reserves reached US$33.6 billion at the end of January 2008, US$8 billion higher than a year earlier. Net reserves, or the international liquidity position, increased from US$23 billion at the end of 2006 to US$32.1 billion at the end of January 2008.

Real output trends

The South African economy grew by 5.3 per cent in the first three quarters of 2007 compared with the same period in 2006. Construction, financial services, transport and communication, and wholesale and retail trade continued to grow at rates above 5 per cent, although some sectors are showing signs of slowing due to rising interest rates, more moderate household spending and capacity constraints.

Construction, financial services, transport and communication set the growth pace in 2007

Figure 2.4 Sectoral growth, 2006 and 2007



Agriculture

The agriculture, forestry and fishing sector contracted by 3.1 per cent in the first nine months of 2007 compared with the same period in 2006. Production volumes were lower because of low rainfall in the first quarter, followed by fires in the second quarter. In combination with global developments, these factors drove agricultural commodity prices to record high levels. Grain prices are expected to remain high in 2008.

Grain prices are likely to remain high in 2008, but a good domestic harvest is expected

Good rainfall during the 2007/08 season, coupled with a 9.2 per cent increase in the area of maize planted, should support a good domestic harvest by the second quarter of 2008. The exclusion of maize from government's biofuels strategy will also act to lower domestic maize prices. However, high crude oil prices will continue to put upward pressure on the costs of agricultural production.

Mining

The mining sector grew at a sluggish pace in the first three quarters of 2007, with gross value added rising by only 0.5 per cent compared with the same period in 2006. Although producers have benefited from record high commodity prices, output volumes have been slow to respond to new investment and gold production has continued to decline. Mining production fell by 0.2 per cent in 2007, weighed down

While growth was sluggish during 2007, mining investment has increased sharply by a 6.5 per cent reduction in gold output. Output of platinum group metals increased by 1.1 per cent and coal increased by 0.8 per cent.

Mining investment has increased sharply – by 42.8 per cent in 2006 as a whole and 19.2 per cent in the first nine months of 2007. This should bode well for improved productivity, output and exports over time, once power failures – which partially shut down mining operations in January and February of 2008 – are overcome.

A need for higher electricity prices

At just over 22 cents per kilowatt hour, the average price of electricity in South Africa is well below comparable prices internationally, contributing to the existing mismatch between supply and demand. Current price levels give incorrect signals for energy-intensity to both households and industry, and are insufficient to generate appropriate returns on new investment in power generation.

The price of electricity is currently based on the average cost of supply plus a profit margin. The average cost of supplying South Africa's electricity requirements in 2007 was about 15 c/kWh.[1] The short-run marginal cost of supply, based on the most expensive resource used, was estimated at 21 c/kWh in 2007, increasing to 43 c/kWh in 2011, and the long-run marginal cost is estimated to be about 30 c/kWh. The higher marginal cost is due to higher fuel prices, power stations operating at higher load factors and increased use of gas turbines.

The current price of electricity is based on an average cost of production. The marginal cost – that is, the cost of creating one additional unit – is a more relevant measure for price determination. Basing prices on the marginal cost suggests that prices should increase by more than 6 c/kWh to correctly reflect the cost of supplying additional electricity, or by 15 c/Kwh to reflect the future cost of supplying additional electricity. The higher price based on marginal cost will ensure that suppliers are remunerated at correct levels, which will encourage investment by power utilities and foster more efficient energy usage by households and businesses.

Current electricity prices also do not account for the environmental damage caused by coal-fired electricity generation. South Africa's emissions of air pollutants and carbon dioxide are high and growing – 0.978 tons of CO_2 per MWh of electricity produced compared to 0.703 tons in the US, 0.392 tons in Japan and 0.586 tons in the UK. About 96 per cent of South Africa's electricity is generated by coal-fired power stations.

[1] *The prices mentioned in this box are based on National Treasury estimates.*

Manufacturing

Resilient manufacturing sector boosts output in the face of global and domestic pressures

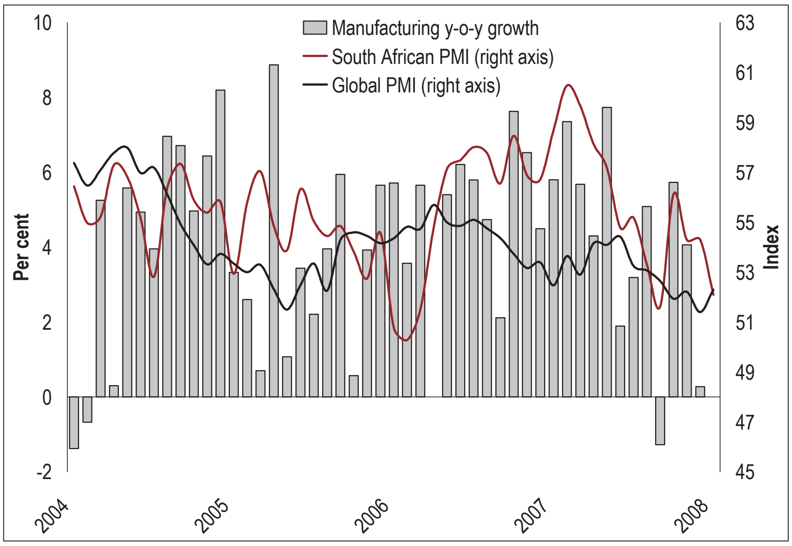
During 2007, manufacturing exhibited resilience in the face of slower growth in consumer demand, increased import competition, industrial action and disruptions in the wood and paper subsector due to forest fires. In the latter part of the year, producers have also had to adjust to weakening global demand, although this has been partially offset by improvements in competitiveness.

Despite these challenges, output grew by 4.1 per cent in 2007 compared with 4.9 per cent in 2006. With the exception of the motor industry, the main manufacturing subsectors all registered positive growth in 2007 and output increased by more than 4.5 per cent in the petrochemicals, furniture, radio and television, iron, steel and machinery, as well as the building materials subsectors, which combined account for about 56 per cent of total manufacturing.

Gross fixed capital formation in manufacturing increased at an average 12.8 per cent in the first three quarters of 2007 compared with the same period in 2006 driven by additions to new production capacity. Mindful of constraints to electricity supply, many firms are investing in alternative power sources to sustain continuous production processes. Investments in energy-efficient production processes will increase the manufacturing sector's long-term cost-competitiveness, in light of rising global energy prices.

Robust growth in gross fixed capital formation to bolster production capacity

Figure 2.5 South Africa manufacturing PMI versus JPMorgan global PMI, 2004 - 2008



PMI refers to the Purchasing Managers' Index

Construction

Construction has been the fastest-growing sector in South Africa since 2003. In the first nine months of 2007, real value added in construction increased by 18.6 per cent compared with the same period in 2006. Non-residential building and construction works were the main drivers of growth due to increased demand for office and retail space, and the maintenance and upgrading of infrastructure.

Construction remains the fastest-growing sector

Rising interest rates and slower growth in house prices have eased the rapid pace of residential development. Growth in residential building plans passed by larger municipalities fell by an average of 11.2 per cent between July and November 2007 compared with the same period in 2006, while growth in cement sales also slowed in the second half of 2007. Gross fixed capital formation in construction works grew by 31.8 per cent in the first three quarters of 2007.

Transport and communication

Value added by the transport and communication sector increased by 5.3 per cent during the first nine months of 2007 compared with the same period in 2006. Robust investment and sustained demand for logistics, storage and distribution services have underpinned the

Sustained demand for logistics, storage and distribution underpins transport growth sector's consistent performance, with annual growth ranging between 4 and 6 per cent since 2003.

Transnet spent about R11.7 billion on its capital expenditure programme in 2007. In telecommunications, the number of cellphone subscribers continues to increase rapidly, as does the demand for broadband and wireless services.

Financial services

Financial sector benefits from corporate spending on infrastructure, mergers and acquisitions

Growth in value added by the finance, insurance, real-estate and business services sector remained strong at 7.9 per cent in the first nine months of 2007 compared with the first nine months of 2006, driven by buoyant corporate activity related to infrastructure spending and mergers and acquisitions.

Transformation is progressing with the implementation of the Financial Sector Charter. More than 4.2 million South Africans have opened entry-level bank accounts since 2005, and financing for black economic empowerment transactions reached R55 billion in 2006.

Successful implementation of Basel II protects financial system from global shocks

The banking sector has successfully adapted to the new capital adequacy standards required in the Basel II agreement and the necessary regulations have been effective since 1 January 2008. South Africa is one of the first countries to fully implement Basel II. The new approach to risk will strengthen the financial sector, and ultimately the economy, from international and domestic shocks.

Employment and remuneration

Employment growth continued in the first three quarters of 2007

Employment continued to rise in the first nine months of 2007, though at a slower pace than in the previous three years. The Quarterly Employment Survey for September 2007 indicated that 194 000 jobs were created in the non-agricultural formal sector between September 2006 and September 2007, an increase of 2.4 per cent, with the largest employment gains in the financial intermediation and wholesale and retail sector.

Table 2.6 Formal non-agricultural employment, September 2007

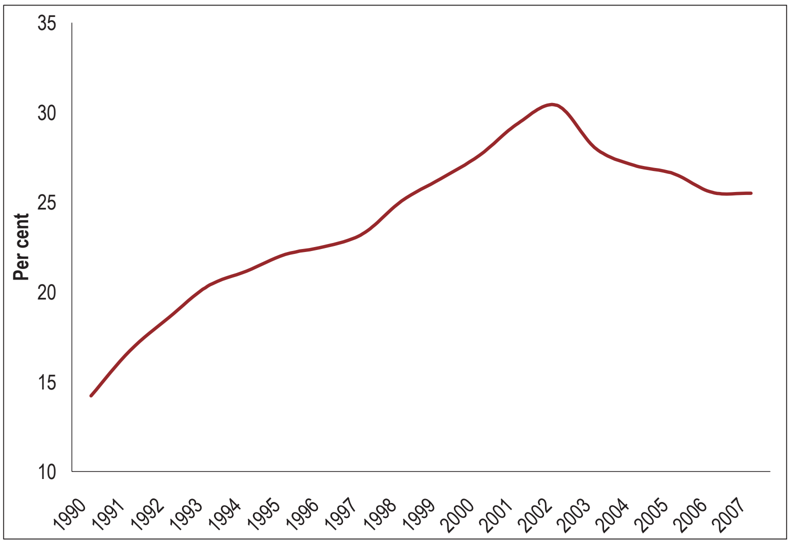
Sector	Share (per cent)	Total Employed ('000)	Annual Change ('000)	Growth (per cent)
Mining and quarrying	6.0	501	38	8.2
Manufacturing	15.9	1 319	-15	-1.1
Electricity supply	0.7	55	4	7.8
Construction	5.7	475	16	3.5
Trade	20.8	1 732	59	3.5
Transport and communication	4.3	358	-2	-0.6
Finance	22.0	1 834	61	3.4
Community and personal services	24.6	2 044	34	1.7
Total	**100.0**	**8 318**	**195**	**2.4**

Source: Statistics South Africa, Quarterly Employment Statistics, September 2007

The unemployment rate has declined from a peak of 31.2 per cent in March 2003 to 25.5 per cent in March 2007. The pick-up in the pace of employment creation is consistent with the upward trend in economic growth over the past four years, but rates of labour market participation remain relatively low. South Africa's current labour force participation rate of 56.2 per cent is lower than rates in African countries such Cameroon (64.3 per cent) and Ethiopia (65.3 per cent), and considerably lower than developed nations such as the US (75.4 per cent) and UK (76.2 per cent). [1]

South Africa needs to boost its rate of labour market participation from a low level of 56 per cent

Figure 2.6 Unemployment rate, 1990 - 2007



Wage pressure remains strong following a series of strikes in 2007, but inflation during the year resulted in further moderation in real wage growth. Average wage settlements were 7.3 per cent in 2007, up from 6.5 per cent in 2006.

Wage pressure remains strong

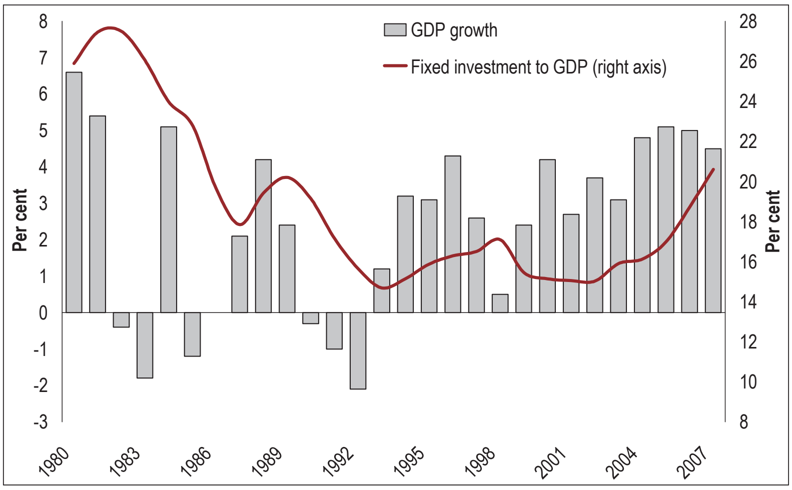
Domestic expenditure

Growth in real domestic expenditure on consumption and investment remained strong at 8.6 per cent in the first nine months of 2007. Slower growth in household consumption was offset by an acceleration in investment spending between January and September. That rebalancing of expenditure in favour of investment is expected to continue over the medium term and will be supportive of stronger future economic growth.

Slower growth in household consumption offset by greater investment spending

[1] Figures are for 2004 for all countries except Cameroon (2001). Source: "Why has unemployment risen in the new South Africa?" Banerjee, Galiani, Levinsohn and Woolard, CID Working paper, October 2006.

Figure 2.7 Gross fixed capital formation and GDP growth, 1980 – 2007



Gross fixed capital formation

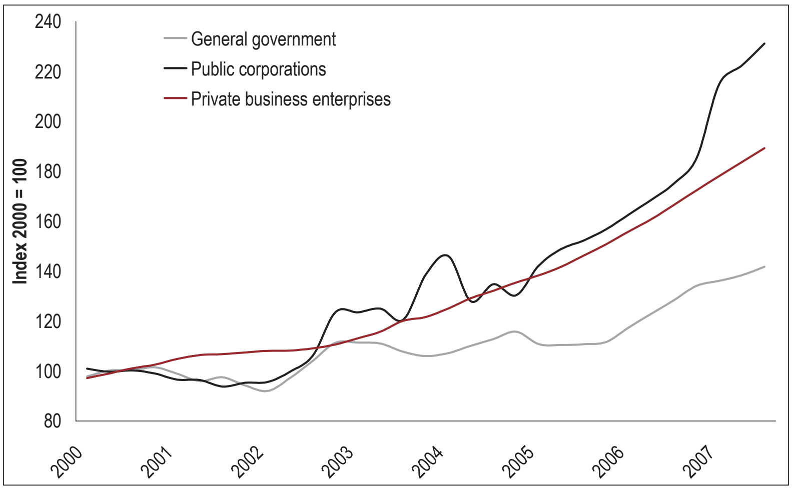
Growth in real fixed capital investment continues to rise

Investment remains robust across most sectors of the economy and asset types, reflecting a rebuilding of the capital stock and progress in the creation of new capacity. Growth in real fixed investment rose to 15.7 per cent in the first nine months of 2007 from 13.8 per cent in 2006 as a whole. The ratio of fixed investment to GDP increased to 21.2 per cent in the third quarter, its highest level since 1985.

Investment spending by public corporations grew 31 per cent in first nine months of 2007

Public corporations were important drivers of investment in the first nine months of 2007, with growth in excess of 31 per cent. Public investment in infrastructure continues to crowd in private sector investment, which remains the main source of gross fixed capital formation. The private-sector investment ratio rose to 15 per cent in the first nine months of 2007 from 13.7 per cent in 2006.

Figure 2.8 Gross fixed capital formation by sector, 2000 - 2007



Investment growth exceeded 10 per cent for all asset types[2] in the first nine months of 2007. Investment in construction works expanded by 31.5 per cent, while real investment in transport equipment increased by 23.7 per cent due to Transnet expenditure on freight rail and ports. Gross investment in electricity, gas and water grew by 34.7 per cent in the first nine months of 2007, up from 13.3 per cent in 2006, reflecting Eskom's continued investment in power generation and transmission.

Strong investment in construction, freight rail and ports, electricity, gas and water

Household consumption expenditure

Household consumption expenditure increased by 7.6 per cent in the first nine months of 2007 compared with the same period in 2006, but quarterly growth momentum slowed considerably to an annualised rate of 4.5 per cent in the third quarter. The slowdown continued in the fourth quarter, with real growth in retail sales contracting by 0.5 per cent in December 2007 from 11.5 per cent growth a year earlier.

Spending on durable goods has been affected by rising interest rates and the implementation of the National Credit Act (NCA), although the ratio of household debt to disposable income continued to rise in the third quarter of 2007 to 77 per cent from 75.1 per cent in the first quarter. Real growth in durable goods expenditure, including motor vehicles and furniture, slowed to 3.1 per cent in the third quarter from about 15 per cent a year earlier. Spending on semi-durables, non-durables and services recorded growth of 14.3 per cent, 5.8 per cent and 5.2 per cent respectively in the third quarter.

Rising interest rates begin to have an effect on consumption spending

Consumption growth will continue to slow to more sustainable levels in 2008 as the full impact of higher interest rates is absorbed. Reduced appetite for credit will assist in lowering the household debt ratio to more sustainable levels.

Money supply and credit extension

Strong growth in money supply reflects continued economic buoyancy, robust credit extension and capital inflows, with some recent moderation. Growth in the broad measure of money supply (M3) peaked at 25.8 per cent in August 2007 before slowing slightly thereafter. The rate of increase in private-sector credit extension eased to 21.5 per cent in December 2007.

Growth in M3 reflects continued economic buoyancy and robust credit extension

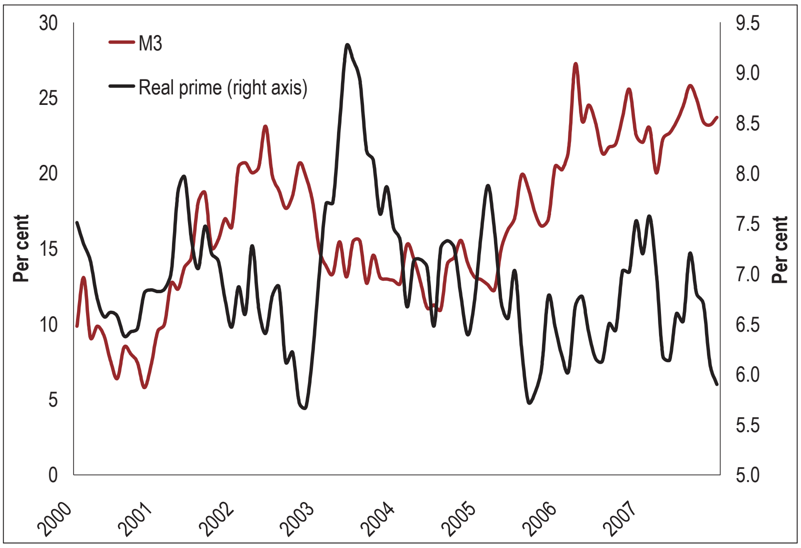
Inflation and interest rates

CPIX inflation has been above the target range of 3-6 per cent since April 2007 and reached 8.6 per cent in December. The sharp jump in food prices was the main driver of consumer inflation in 2007, but increased petrol prices due to high crude oil prices were also a factor. Food price inflation increased sharply in 2007 from 8.3 per cent in January to 13.9 per cent in December.

Food and fuel price increases drive consumer inflation

[2]Residential and non-residential buildings, construction works, transport equipment, machinery and other equipment.

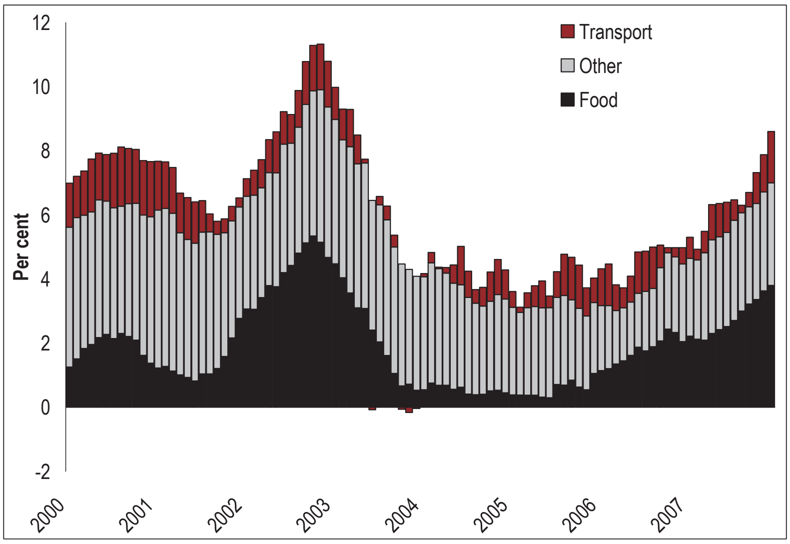
Figure 2.9 Money supply growth and real prime rate, 2000-2007



Rising inflation for services indicates that inflation pressures broadened in the second half of 2007, although CPIX inflation excluding food and petrol prices remained within the inflation target range at 4.9 per cent in the final quarter of last year.

PPI inflation rose sharply in the first half of 2007, to a peak of 11.3 per cent in May, before ending the year at 10.3 per cent. Producers experienced pressure from the weaker rand, rising food prices and high crude oil prices. Inflation expectations have risen over the past year, but the December 2007 survey of inflation expectations showed CPIX inflation falling below 6 per cent in 2009.

Figure 2.10 Contributions to CPIX inflation, 2000 - 2007



Rising food inflation a global trend

Rising food prices have been the largest contributor to recent increases in domestic consumer price inflation. But as the table below demonstrates, rising food prices are a global phenomenon, especially in fast-growing developing economies.

CPI food inflation for selected countries, 2004 – 2007

Year	US	SA	India	Indonesia	China	Mexico
2004	3.7	2.3	2.3	5.8	6.4	7.3
2005	1.9	2.2	4.0	10.3	-6.5	5.5
2006	1.8	7.2	6.8	14.8	-0.6	3.6
2007	4.3	10.3	7.1	11.0	9.9	6.5

Source: OECD main economic indicators

Continuing pressure on international food prices stems from poor harvests of key crops in major exporting economies, higher commodity and energy prices, and growing demand for grains for biofuel production. Meanwhile, income growth in Asia has led to increased demand for meat, triggering increases in feed grain prices.

Conclusion

South Africa's economy will grow more moderately over the period ahead, following a period of robust expansion since 2003. Highlights of the economic outlook include the following:

- GDP growth of 4 per cent in 2008, rising to a projected 4.6 per cent by 2010
- CPIX inflation rising to 7.1 per cent in 2008 before declining to 4.9 per cent in 2009
- Continued robust growth in gross fixed capital formation, projected to rise from 21 per cent of GDP in 2007 to 24 per cent in 2010
- Strong growth in public sector infrastructure investment to extend well into the next decade, as major energy and transport projects gain momentum
- A projected deficit of 7-8 per cent of GDP in the current account of the balance of payments, highlighting the need for continued capital inflows
- Underlying resilience of the economy supported by the strong fiscal position and steady growth in net foreign reserves, which reached US$32 billion at the end of January 2008.

Economic and fiscal policies remain firmly focused on accelerating growth in the longer term and broadening participation. Policy priorities, elaborated further in the spending and revenue proposals outlined in the 2008 *Budget Review*, include:

- Promoting employment creation, further education and skills development
- Investment in infrastructure and productive capacity, and improved maintenance of infrastructure network assets

- Interventions focused on broad-based empowerment and reducing poverty
- Industrial development and raising net exports
- Improving public service delivery.

Given the nature of short- to long-term challenges in the economy – from resolving electricity shortages to surpassing 6 per cent economic growth – greater coordination and partnership is required between the public and private sectors. Prudent fiscal policy is crucial to maintain macroeconomic stability and to ensure that the benefits of growth enhance the living standards of all South Africans. The details of the 2008 fiscal framework are presented in Chapter 3.