2

Economic policy and outlook

Against the background of a marked slowdown in the global economy, South Africa's economic growth slowed to an estimated 2,2 per cent in 2001, and is expected to strengthen moderately in 2002, buoyed by both international recovery and rising domestic demand.

Government policies continue to be focused on sustainable development and creating a strong and stable economic base through tariff liberalisation, prudent fiscal policy, investment in infrastructure, education, land reform, and lower inflation. Deficit reduction and strong revenue performance have created the fiscal room for Government to respond to the present slowdown.

After eight years of strong productivity gains, restructuring of markets, and growth of trade, the South African economy is fundamentally more competitive in international product markets – setting the stage for rising export growth, improved income and employment, and deeper financial integration.

Introduction and overview

Slower world growth in 2001 and 2002 but signs of recovery emerging

The rapid growth that characterised the global economy in the latter part of the 1990s stalled in 2001. The major advanced economies are expected to grow by 1,0 and 0,6 per cent in 2001 and 2002, respectively. Signs of economic recovery, however, became notably stronger in January 2002.

Despite international weakness, South African growth consistently positive

The average rate of growth in real GDP of the South African economy from 1994 to 2000 was 2,7 per cent. Excluding 1998, a year of exceptional international turmoil, the average growth rate was 3,1 per cent. The boom-bust episodes of the 1980s and early 1990s have been superseded by stable, forward-looking policies providing a basis for sustainable economic growth and development.

This chapter examines macroeconomic and sectoral developments of the South African economy in the past year and prospects for the MTEF period.

The domestic economy

Demand and supply show sustained rises

Domestic economic growth in 2001 was sustained by moderate growth in private and government investment, government consumption and household spending – despite slowing foreign demand for South Africa's exports in the latter half of the year. Household spending rose by about 2,7 per cent, although there were signs of rising indebtedness. Increases in real incomes due to real wage growth and tax reductions will contribute to a faster pace of household spending over the next three years.

Prospects for domestic output improving

Domestic output is expected to strengthen, buoyed by a global recovery, rising government spending, a number of major initiatives in a variety of sectors (ceramics, motor vehicles, steel, among others) and better prices for mining and beneficiated resources.

Strong growth in company earnings

In 2000 and the first three quarters of 2001, net operating surpluses grew strongly (19 and 13 per cent) and productivity increased (6 and 4,4 per cent), contributing to subdued domestic inflationary pressures and sustaining lower long-term interest rates. Moderate growth in unit labour costs has contributed to an improved outlook for employment.

Government expenditure contributed positively to growth in 2001, and is expected to accelerate through the MTEF period.

The global slowdown and the depreciation of the rand

South Africa's credit upgrade an endorsement of policies

In November 2001, Moody's provided a strong endorsement of South Africa's macroeconomic policies and improving economic performance by raising the country's foreign debt credit rating. Good economic performance in the first half of last year contributed to the improved assessments.

Global slowdown impacts on the exchange rate

Nevertheless, the global economic slowdown caught up with South Africa in the fourth quarter of 2001. Under the inflation targeting framework, the exchange rate rather than the real economy shouldered the major part of the adjustment, declining by 37 per cent against the US dollar.

Myburgh Commission to look at factors behind the weak rand

Temporary weaknesses and a confluence of special international circumstances have resulted in the market overshooting a fair rate of exchange for the rand. Factors that appear to have contributed to the rand's weakness include wariness of emerging market assets due to the debt default in Argentina and depressed commodity prices globally. The Myburgh Commission will investigate the depreciation of the rand in the second half of 2001, including the role that various transactions or flouting of regulations may have played.

Possible factors behind the depreciation of the rand

Numerous explanations have been advanced for the depreciation of the rand in the fourth quarter of 2001:

- Reduced appetite for emerging market assets in international capital markets
- Heightened speculative position-taking against the rand in comparatively thin currency trading conditions
- Perceived risks associated with developments in other countries, including political stresses in Zimbabwe and Argentina's financial turmoil
- Depressed international commodity prices
- Outflows of portfolio investment by non-residents, together with rising dividend payments abroad
- Investor pessimism internationally about Africa's prospects and economic outlook.

While these and other factors might influence currency markets, they do not call into question the underlying health of South Africa's balance of payments. It is clear that the depreciation of the rand towards the end of the year was overdone and there has been some recovery in exchange rates in early 2002. An investigation into foreign exchange transactions that might have contributed to the depreciation is under way.

Government remains committed to phasing out exchange controls and to the deepening of currency markets. While some volatility may persist, it is expected that a recovery in the value of the rand will continue during 2002 and 2003, partially restoring the real value of the currency lost in 2001.

Adjustment to global slowdown to improve competitiveness

The competitiveness of an economy determines the extent of adjustment needed to a global slowdown, and how this adjustment translates into balance of payments developments. Seemingly adverse movements in exchange rates can help to strengthen the economy by accelerating the adjustment process, and achieving a more export-oriented balance of payments.

Provisional estimates suggest CPIX will be overshot

CPIX inflation (consumer prices, excluding mortgage interest costs) declined to within the target band of 3 to 6 per cent in August, September and October 2001, but the depreciation of the rand since September is expected to raise CPIX inflation above the target range in 2002. Lower inflation over the MTEF period will help to protect the value of real wages, property and other assets.

Current account and balance of payments remain strong

The current account deficit remained small in 2001, as a consequence of the large trade surplus created by healthy exports and more moderate imports. The global turnaround expected later in 2002 is expected to benefit South Africa's more aggressive export stance in the medium term.

Portfolio outflows in the first half of the year were largely balanced somewhat by inflows into equities in the latter half of 2001. The financial account (including unrecorded transactions) registered a cumulative surplus for the first three quarters of 2001.

Renewed global growth to herald resumed capital inflows

Capital flows to emerging markets are expected to increase to 2000 levels as the US and world recovery strengthens over the years ahead. Safer emerging market assets should provide a key component of higher-return portfolios.

The net open forward position (NOFP) of the Reserve Bank has been reduced to about US$3 billion in January 2002 from US$4,8 billion in 2001, and is expected to be phased out by the end of 2002.

Government bond yields declined consistently through 2001, before carrying some of the weight of adjustment late last year, with a period of volatility and higher yields. Stability returned towards the end of January 2002. Real interest rates remain moderate compared with those in other emerging market economies.

Growth forecast

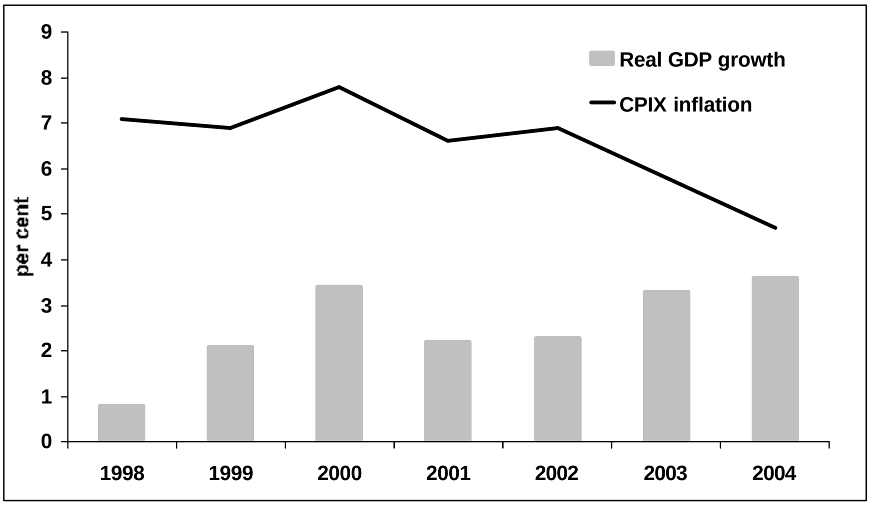
Counter-cyclical fiscal policy, improved competitiveness

Policy adjustments and the exchange rate realignment in 2001 will support improved growth and economic development in the next few years. The policy adjustments include a more expansionary fiscal policy, better targeting of public spending, and a stable monetary policy framework.

Sustained rise in gross domestic product

Gross domestic product is estimated to have grown by 2,2 per cent in 2001. The cyclical strengthening is expected to continue in 2002 with GDP rising by 2,3 per cent and by 3,3 and 3,6 per cent in 2003 and 2004, respectively.

Figure 2.1 Growth in real GDP and CPIX inflation, 1998-2004



Global developments and the balance of payments

Global trends in early 2002

Few regions of the world unaffected by the global economic slump

The past year saw an economic slump in the US affecting the rest of the world through trade and financial links. Exports and industrial production in many East Asian economies have contracted sharply, and South Africa has also been affected.

Co-ordinated fiscal and monetary policy easing

Policy makers in countries facing deflationary pressures have responded to the global downturn with broadly coordinated short-term fiscal and monetary easing. Unlike the policy response required in periods of stagflation – long spells of anti-inflationary policies and institutional reform – current conditions should allow for a relatively quick response to expansionary measures.

The US economy

US economy remains weak, but positive growth for the year

The decline in investment spending in the US economy has affected output in most sectors in that economy and has led to a recession. GDP fell by 1,3 per cent in the third quarter and rose by 0,2 per cent in the fourth quarter of 2001, although for the year as a whole, the US economy grew by about 1,1 per cent.

Mixed economic signals with stronger signs of recovery

In the fourth quarter of 2001, the continuing slowdown in the US economy led monetary authorities to announce further cuts in interest rates. This has kept US consumer spending from falling precipitously as saving on mortgage interest costs and lower energy prices have fed back into consumption and new housing. Company earnings have become more volatile and uncertain, however, reflected in greater volatility of the prices of equities on the New York Stock Exchange.

Fiscal policy has also become more expansionary, with the normal counter-cyclical mechanisms working and the original fiscal provisions amounting to about 1 per cent of GDP.

US growth expected to remain modest in 2002

The US recovery is unlikely to be as rapid as previously thought, partly because household consumption did not collapse and therefore no sharp rebound is expected. While growth in 2002 is expected to be positive, it will probably be modest, around 1 per cent for the year.

Developments in Europe

Slower growth in Europe

Although originally thought to be relatively immune from the investment collapse in the US, Europe’s economic performance has been affected, with the German economy in particular decelerating sharply.

Better performance by France, Spain, and the United Kingdom, means that growth the in Euro area for 2001 is expected to be about 1,5 per cent, while growth of about 1,3 per cent is expected in 2002.

Fiscal response by European governments critical to recovery

The European Central Bank (ECB) eased monetary policy in August, September and November by cutting interest rates by a total of 1,25 percentage points.

Monetary policy less effective in Europe

Increasing budget deficits in EU member states also indicate more growth-oriented fiscal positions, as automatic stabilisers in fiscal policy start to work in response to rising unemployment. Fiscal policy is more likely to be expansionary than monetary policy in Europe. Households in Europe are less responsive to changes in interest rates because debt levels are lower than in the US (or the UK), and there is less borrowing for house ownership.

Balance of payments

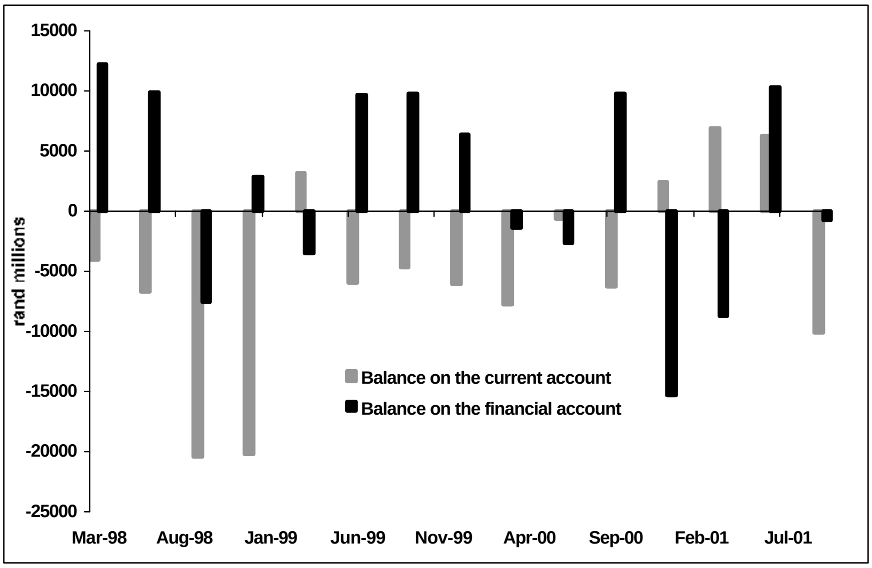
South Africa's external accounts remain stable and strong

Seen from the balance of payments, which reflects the external trade and financial links between South Africa and the rest of the world, the impact of global developments has been relatively mild. The current and financial accounts have remained broadly balanced and moderate relative to GDP.

Heightened importance of trade to the balance of payments

The expected current account deficit was just below 0 per cent of GDP in 2001 (R400 million), and was offset by a net inflow of capital through the financial account of 0,8 per cent of GDP. Indeed, strong exports and moderate imports have increased overall trade as a proportion of GDP, implying an increase in the importance of real economic activity relative to financial flows in the balance of payments.

Figure 2.2 Balance on the financial and current accounts



Financial account

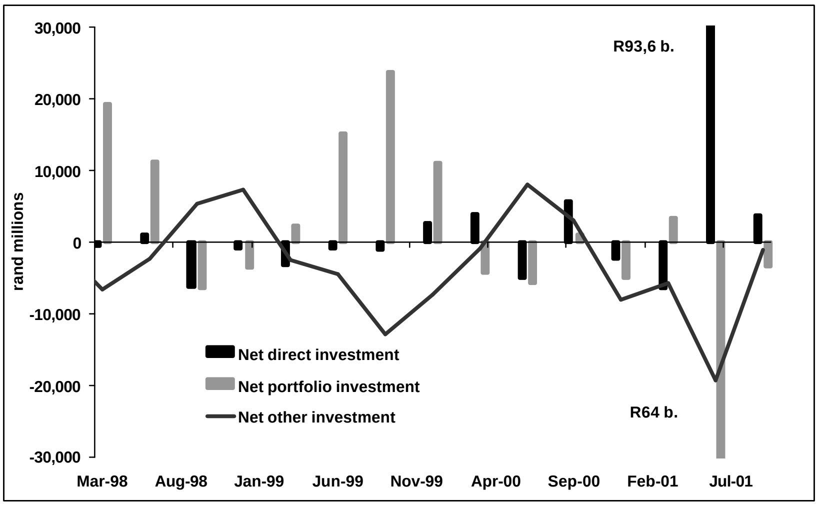
Financial flows more volatile, but balance each other out

The global slowdown, depressed commodity prices and a weakening in the Argentine fiscal and political position are among factors that contributed to volatility in capital flows to emerging economies in 2001. Although affected by the uncertainty in financial markets, South Africa recorded an overall surplus of R7,6 billion on the financial account in the first three quarters of the year, compared with a surplus of R8,5 billion in 2000 as a whole.

Second quarter foreign direct investment flows exceptional

Capital flows in the first half of 2001 were largely dominated by the restructuring of the shareholding in the De Beers mining company, comprising a large foreign direct investment into South Africa, offset by a net portfolio investment outflow. Shareholders received shares in a non-resident company (Anglo American Corporation) in return for the delisting of their De Beers shares.

Figure 2.3 Net balances on the financial account



Consistent positive direct investment flows maintained

Healthy net foreign direct investment flows were sustained in the third quarter of 2001 on the back of continued inward investment by foreign multinationals and the repatriation of offshore investment by South African companies.

In the wake of the global slowdown, portfolio flows have remained modest. Cheaper rand assets and increased competitiveness induced non-residents to continue buying listed shares, although they were net sellers of bonds.

Strong portfolio capital flows should resume with growth in the US and Europe and a decline in the risk-aversion of international investors, around the middle of 2002. As South Africa attracts large capital flows normally, greater stability in the world economy should result in substantial flows into bond and equities markets in 2002, releasing funds for new domestic investment.

External debt and foreign borrowing

South Africa's external debt position healthy

South Africa's total foreign currency debt (public plus private) was about US$ 36,9 billion, 28,8 per cent of GDP and 95,1 per cent of exports at the end of 2000. Both public and private foreign currency debt are low by international standards. Interest payments remain moderate, falling from 8,6 per cent of total export earnings in 1999 to 6,2 per cent in 2000.

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Table 2.1 Earnings and debt ratios

	1996	1997	1998	1999	2000
Total foreign debt to:					
GDP	24.0	26.3	28.0	29.6	28.8
Total export earnings	94.8	103.6	105.0	110.3	95.1
Interest payments to total exports	7.1	8.0	8.4	8.6	6.2
Interest and dividend payments to total export earnings	9.8	10.4	11.2	12.4	12.9
Total private foreign debt to GDP	12.9	13.3	15.7	15.2	15.2
Foreign currency denominated debt of the public sector to GDP	4.6	3.8	3.8	3.1	3.6

Current account

Strong exports and weaker imports contribute to healthy current account in 2001

The current account was in surplus over much of 2001, primarily due to robust export growth. In the third and fourth quarters, however, the current account slipped into a small deficit as global demand for South African exports weakened.

Financial flows, volatility and growth

Since the creation of off-shore financial markets in the 1960s and 1970s (the eurodollar markets) and gradual relaxation of exchange control in advanced economies, capital flows and financial markets have grown alongside development of the global economy. The process accelerated in the 1990s, especially to emerging markets – bringing with it new challenges to financial regulators.

Financial innovation allowed highly liquid flows of capital into and out of economies, resulting in serious financial crises at times across some countries. Global factors played a role in those outflows, but these could also be triggered by local crisis in a particular country.

Governments can mitigate this inherent volatility of capital flows by attracting more foreign direct investment (FDI), improving the regulatory and legal environments, implementing consistent domestic economic policies, and encouraging higher levels of domestic savings.

South Africa has engaged in domestic and international policy development processes (under the IMF, the Financial Stability Forum and the G-20 group of countries, for example) that identify, define and institutionalise macroprudential aspects of the financial system that contribute to greater stability.

The G20 provides a forum for a range of issues relating to the operation of the global financial system. Over the last year, particular emphasis has been placed on the experience of G20 members in integrating into the global economy, and the implications of globalisation for growth, inequality and economic security and the key challenges it poses to public policy. South Africa has used this discussion as a forum for bringing attention both to the gains that may be accrued through greater openness, but also to the negative effects that may arise from difficult structural transformations, and the consequent importance of aligning the timing and extent of these reforms with country priorities and requirements.

Such considerations have assisted South Africa to minimise systemic risks at the country level, and to strengthen the stability of the financial system with an effective regulatory infrastructure, efficient financial markets and sound financial institutions.

While erratic capital flows pose challenges to policy-makers, this has not had a discernible effect on the underlying stability of the economy. This can be attributed to South Africa's management of its external debt exposure and regulatory prudence over financial institutions. South Africa's institutional, regulatory and policy framework avoids the risks associated with fixed exchange rates and high foreign borrowing by inhibiting the build up of risky exposures. Foreign borrowing by domestic banks, for example, is low.

Underlying improvements in manufacturing exports

Short-term developments, however, mask an underlying trend rise in manufactured exports as a proportion of total exports. Over the last five years, the machinery and transport equipment industry raised its share of total manufactured exports substantially, with automotive exports rising especially strongly.

Agricultural Exports

The dominance of world agricultural exports by industrial countries is not necessarily a reflection of their competitiveness. Agriculture in advanced countries receives massive subsidies and protection from their respective national governments, with estimates of up to US$1 billion per day in protection.

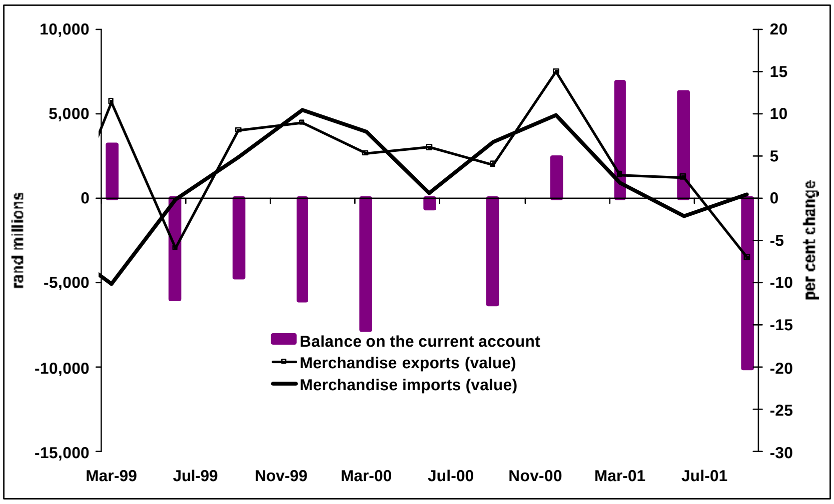
Agricultural exports account for about 10 per cent of total South African exports, and food exports account for about 70 per cent of the total. The largest export items include wine, sugar, grapes and oranges. Among agricultural raw materials, wood, wood pulp and wool are predominant.

The WTO Ministerial declaration in Doha represents a milestone in the multilateral world trading system, and closely mirrors South Africa's own position at these negotiations. The WTO Ministerial declaration committed all member countries to negotiations aimed at making substantial improvements in market access. Negotiations will specifically aim at reducing and ultimately eliminating export subsidies and reducing trade-distorting domestic support for agricultural products. The agreement will encourage development of agricultural export industries, alongside the already completed agreements with the European Union.

Top ten South African exports of agricultural products

	Share of Total		Value R millions	Average Growth Rate
	1996	**2000**	**2000**	**1997-2000**
Wine	5.8%	9.0%	1.466	23.5%
Sugar	8.8%	6.8%	1.111	8.2%
Grapes, fresh	3.5%	6.7%	1.104	30.9%
Oranges	4.8%	6.1%	991	19.2%
Other sugar	3.0%	4.6%	750	22.3%
Tobacco products	1.6%	3.3%	548	33.1%
Apples	3.5%	2.9%	469	7.7%
Maize (corn)	11.7%	2.8%	461	-15.6%
Fish	1.4%	2.7%	450	32.9%
Odoriferous substances	1.0%	2.5%	401	47.2%
Sub Total	45.1%	47.4%	7.751	11.8%
Total	**100.0%**	**100.0%**	**16.369**	

Figure 2.4 Real growth in the value of merchandise imports and exports and the current account balance, 1999–2001 (quarterly data, seasonally adjusted)



Improved exports expected to contribute to better employment

The steady shift away from primary exports to manufactured exports coupled with a depreciating exchange rate should impact positively on total exports in the medium to long term – and lead to greater job creation.

Table 2.2 Industry shares of total manufactured exports

Industry	1996	1997	1998	1999	2000
Semi-manufactures	34,7	29,7	31,7	31,4	33,2
Machinery & Transport	21,3	24,7	25,5	29,2	28,8
Iron and Steel	18,3	20,0	19,5	16,9	17,5
Chemicals	15,4	15,4	13,5	12,7	11,9
Consumer Goods	6,9	6,8	6,7	6,5	5,5
Clothing	1,3	1,4	1,5	1,6	1,7
Textiles	2,0	1,9	1,7	1,7	1,4
Total	**100,0**	**100,0**	**100,0**	**100,0**	**100,0**

SITC Classification Revision 3 includes diamonds in manufacturing as semi-manufactures.

AGOA impact on SA exports growing

The Africa Growth and Opportunity Act (AGOA), which provides preferential access to the US market for African exports, was implemented in January 2001. Between January and October 2001, 8,8 per cent of South African exports to the US entered the US market under AGOA. Total South African exports (in dollars) to the US grew by 8,4 per cent in 2001, despite anti-dumping actions against South African steel exports.

Table 2.3 Changing composition of merchandise exports

Category	1990	1999	2000
Primary Products	58,5	36,7	20,0
Beneficiated Primary Products	26,2	31,8	45,5
Material Intensive Products	6,1	7,9	7,8
Manufactured Products	9,2	23,6	26,7
Total	**100,0**	**100,0**	**100,0**

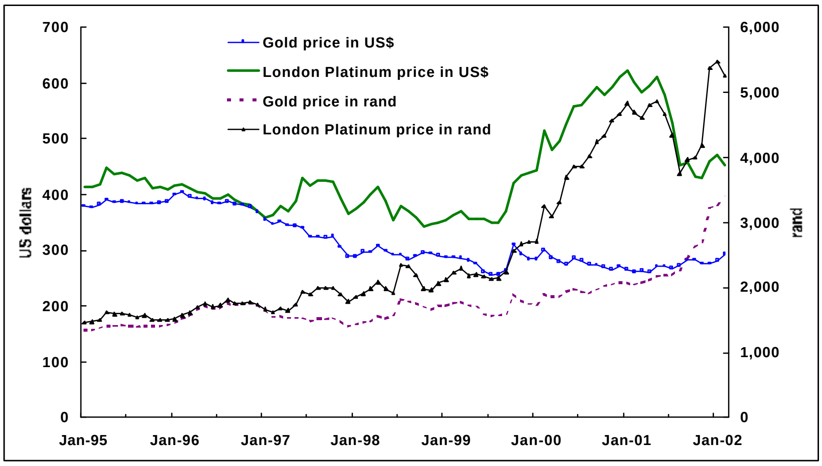
Source: IDC

2000 figures are estimates.

Revenues from gold and platinum exports continue to soar

Despite the longer-term trend toward manufactured exports, exchange rate depreciation has caused revenues from gold and platinum production and exports to soar in the latter half of the year. The value of minerals exports rose by 17,3 per cent in the year to November 2001, while the value of non-mineral exports rose by about 29 per cent.

Figure 2.5 Dollar and rand prices of gold and platinum, 1995-2001



Trade with Africa

Chemicals, machinery and transport equipment dominate SA exports to Africa

Excluding Swaziland, Lesotho and Namibia, African countries take in over 10 per cent of total South African exports and nearly 17 per cent of total manufactured exports. Almost two-thirds of total exports to the rest of the continent comprise manufactured goods, dominated by machinery and transport equipment and chemicals.

Imports

Expenditure-switching affects imports

Higher prices for imported goods resulted in sluggish import demand in the first three quarters of 2001, with import volumes rising by 1,3 per cent compared to the same period of 2000.

From the third quarter, imports weakened further, with substantial declines in imports of textiles, machinery and electrical equipment, and chemicals. It is estimated that merchandise imports fell by

1,2 per cent in 2001. Oil imports accounted for about 13 per cent of total imports in 2000 from 8 per cent in 1995, due to the sustained rise in crude oil prices over the last two years and higher rand prices.

Services and income account

Expanding financial and investment links reflected in the services and income account

The services and income account records payments and receipts to owners of stocks and bonds, and flows related to tourism and other services. Payments and receipts have risen steadily over the past 10 years, in part due to rising foreign equity purchases of SA companies, which rose especially sharply in the second quarter of 2001.

Nevertheless, dividend payments remain a relatively small proportion of overall current account activity, and as in other countries, a relatively stable and moderate proportion of GDP over time.

Figure 2.6 The openness of the South African economy,1990–2001

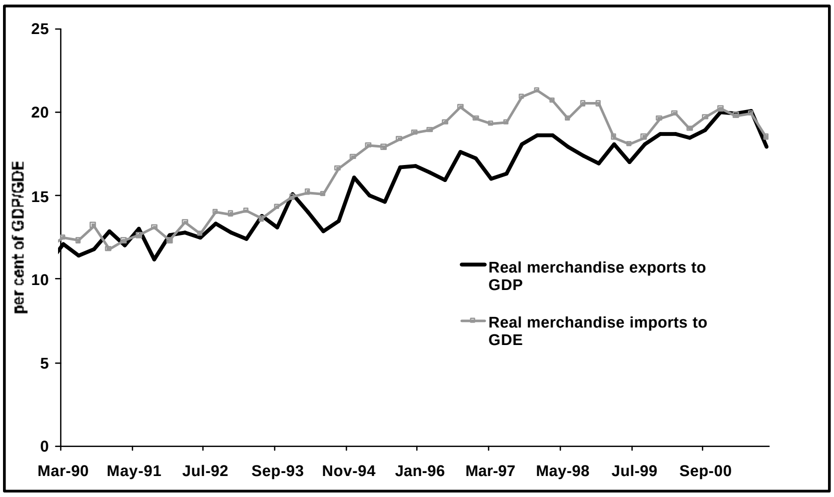


Figure 2.7 Net factor payments as a percentage of GDP in SA, Canada and Australia,

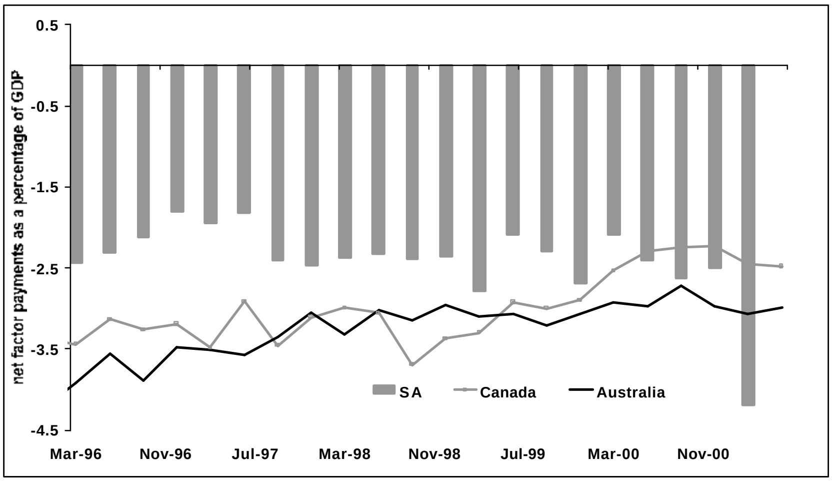
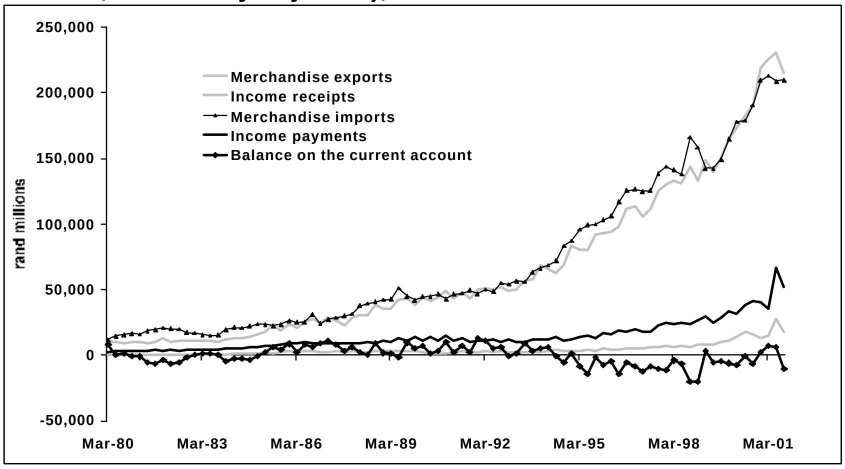


Figure 2.8 Major components of the current account (rand millions, seasonally adjusted), 1980 - 2001



Following the sharp rise in the second quarter, payments and receipts due to foreign direct investment and non-direct investment moderated significantly in the third quarter of 2001.

Income flows moderate in the second half of 2001

Overall, factor payments as a proportion of export earnings remain modest.

High returns to exports priced in dollars and lower rand-denominated production costs suggest that South African assets remain well priced – which should encourage higher inward FDI and portfolio flows.

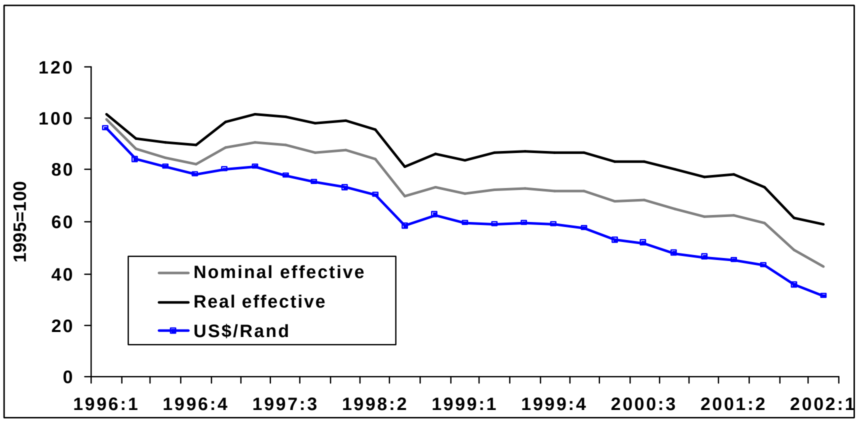
Exchange rate developments

Uncertainty about global growth prospects led to significant weakness in the value of many emerging market currencies in 2001.

The rand depreciated by 37,4 and 34,2 per cent in nominal terms against the US dollar and Euro, respectively, in 2001. The real trade weighted effective exchange rate declined by 6,5 per cent from December 2000 to August 2001.

Adjustment to slower world growth shouldered by the exchange rate

Figure 2.9 Exchange rate indices (index 1995 = 100)



Internal and external price stability and capital flows

Both internal and external price stability is difficult to achieve in an environment of high international capital mobility. The current crisis in Argentina, and those in East Asian economies in 1998, provide examples of what can happen when exchange rates (external prices) are inflexible.

While fixed exchange rates can provide some stability to internal prices, the nominal exchange rate can become overvalued, leading to unsustainably low economic growth rates and the temptation to use fiscal policy to increase growth.

In Argentina, that combination of policies proved to be disastrous as firms and the government borrowed in US dollars while economic growth was not rapid enough to enable the debt to be serviced. Employment losses and firm closures make it more difficult over time to service debt and maintain the exchange rate.

South Africa has taken an alternative route to external and internal price stability. Fiscal policy and inflation targeting have focused primarily on internal price stability and releasing resources for growth. As the potential and actual rate of growth of the economy strengthens, this will add greater stability to external prices. In the meantime, the floating exchange rate means that external prices can help the economy to adjust to international financial and economic shocks, without interfering unduly with growth and employment.

In the 1990s, political news and global contagion effects appear to have become more important factors affecting the currency than domestic economic developments or balance of payments issues. As the table shows, in comparison with earlier episodes, the recent depreciation appears unrelated to economic or financial imbalances.

Comparative rand depreciation episodes and macro conditions

	1985	1998	2001
Fiscal deficit/GDP	-2,7	-2,6	-1,6
Current acc/GDP	4,0	-1,7	-0,0
Inflation (CPI)	16,3	6.9	5.1
Financial account[1]	-6,4	9,2	7,6[3]
Import cover[2]	8,2	11,5	16,7
GDP growth	-1,2	0,8	2,2
Nominal depreciation of the effective exchange rate	-39,8	-18,6	-34,4

1 Including unrecorded transactions
2 Average for the period
3 First three quarters of 2001

Foreign reserves

Gross and net reserve positions remain stable

Gross official reserves remained stable in 2001, falling marginally from US$7,51 billion in January to US$7,47 billion in December. Net reserves declined from US$4,92 billion to US$3,49 billion over the same period.

Gross reserves in rand (reserves held by the Reserve Bank and those held by the private sector) have risen strongly since 1994, and stabilised in 2001. Part of the steady increase in gross reserves has been a consequence of the rise in the rand value of foreign currency bank deposits and reserves.

Decline in the net open forward position (NOFP)

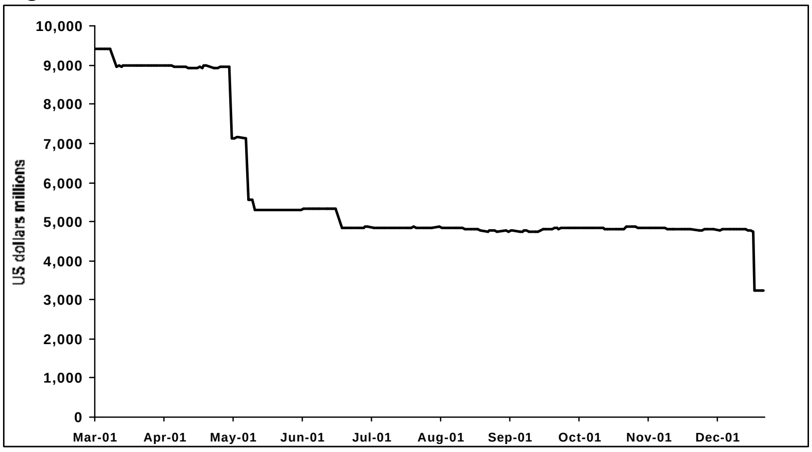
Continued good progress in reducing the NOFP

Progress in reducing the NOFP was rapid in 1999 and slowed in 2000 due to smaller capital inflows.

In 2001, significant further progress was made, with the NOFP falling to US$4,8 billion from US$9,5 billion in January. The National Treasury has since drawn down a US$1,5 billion syndicated loan, and used it to help reduce the NOFP further to its current level of about US$3 billion at the end of February 2002.

The NOFP is expected to be phased out over the coming year, providing room for deepening financial relations in a comprehensive prudential regulatory framework.

Figure 2.10 The NOFP,2001, in billions of US dollars



Real output and expenditure trends

Broad-based development expected in coming years

Investment and output in manufacturing, construction, trade, and services are expected to strengthen in the next few years as lower production costs raise profitability in export-oriented sectors of the economy and those producing non-traded goods.

Major initiatives in chemicals, mining and beneficiated products and tourism support sustained growth across the economy. Rising gold prices indicate continued strengthening of the industry and associated upstream and downstream activities.

The global slowdown has reduced prices for many intermediate and final goods produced abroad, which will benefit some sectors as they offset some of the rise in imported prices caused by the depreciation.

The structure and output of the economy

The structure of the economy continues to evolve toward a larger tertiary sector and smaller, but more productive primary sector. The latter has declined as a proportion of total GDP, from 12,4 per cent in 1991 to about 10,1 per cent in 2001.

The secondary sector has retained its weight in the economy, largely due to good growth in production of manufactured goods for both domestic consumption and export.

The primary sector

Mining production set to recover

Total mining production increased by about 0,2 per cent in the first three quarters of 2001 despite a sharp decline (7,2 per cent) in gold production. Mining production excluding gold, however, grew by about 2,5 per cent for the year, largely due to continued strong output of platinum (6,2 per cent).

New investment in resource-based production facilities

A stronger gold price (about US$ 300 per ounce in February 2002) and the surging revenues of resource-based industries should reinforce investment. The value of Industrial Development Corporation financing of new mining and beneficiation projects increased by well over 100 per cent from 2000 to 2001. Output of platinum, ferro-chrome, aluminium and other products is expected to rise over the next three years.

Declining output and better income from agriculture

Strong growth in agriculture in 2000 was followed last year by a decline in output of an estimated 2,8 per cent. In the year to June 2001, gross farm income rose by 17,6 per cent, largely due to increased income from field crops. Continued high prices should result in a significant decline in farm debt.

Higher prices and widening export opportunities in 2001 and into 2002 should induce sustained increases in output over coming years. Large increases in agricultural exports in the past year derive from better prices and greater output of higher value-added agricultural products, such as cut flowers and fruit.

Lower protection by advanced economies would boost SA growth

Lower protection of agriculture by developed countries is one of South Africa's primary goals in the next WTO trade round. Agriculture remains an important part of the South African economic landscape, with extensive developmental linkages capable of increasing employment and reducing income inequality.

The secondary sector

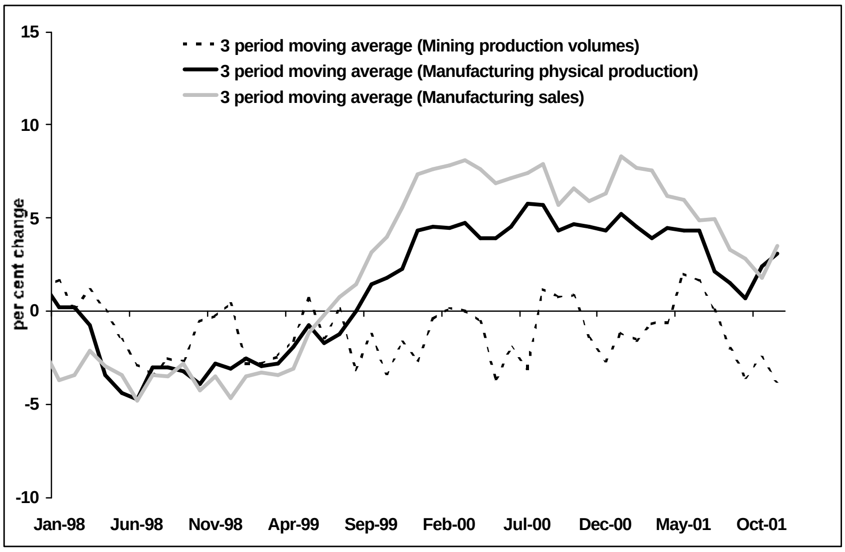
Solid growth in manufacturing and construction

Manufacturing and construction have been reasonably strong in 2001, buoyed by improved competitiveness and lower interest rates – the latter boosting the sales and construction of homes and buildings. Construction grew by about 5 per cent. Manufacturing output increased by 3,4 per cent in the first three quarters of 2001, while electricity, gas and water production fell by 1,2 per cent.

Large-scale projects, municipal development support energy and water expansion

Large-scale and intensive projects, such as the planned production of nitrogen trifluoride and ceramics, are expected to boost electricity generation and distribution. The water and gas sub-sectors will benefit from continued development of more efficient water systems and services at the municipal level, new gas reserve discoveries, and gas pipeline development.

Figure 2.11 Manufacturing and construction output, 1998-2001 (real, monthly data)



The tertiary sector

Wholesale and retail trade, and financial services grew by an average rate of 3,5 per cent in the first three quarters of 2001. Over the same period, the transport, storage and communications sector grew by an average of 3,7 per cent.

Service sector growth remains healthy

Growth in services sector output reflects increases in consumption of services by households and firms as incomes rise and new markets are created, and rising services exports.

A number of initiatives in environmental and tourism policy are expected to boost tourism into South Africa and the region, including the Transfrontier Conservation Area programme, World Heritage Sites, and the Lubombo spatial development initiative, Coastcare and the Wetlands Conservation programme. A sustained rise in investment in tourism infrastructure and community-based tourism ventures is expected to extend the gains from tourism development to low-income communities.

Innovative programmes support tourism development

Domestic expenditure

Gross domestic expenditure rose sharply (8,4 per cent) in the third quarter of 2001 after having declined somewhat in the second quarter. For the year as a whole, gross domestic expenditure grew by an estimated 1,4 per cent, with all categories of expenditure (inventories, government and households) contributing to the rise.

Sustained rise in all demand categories

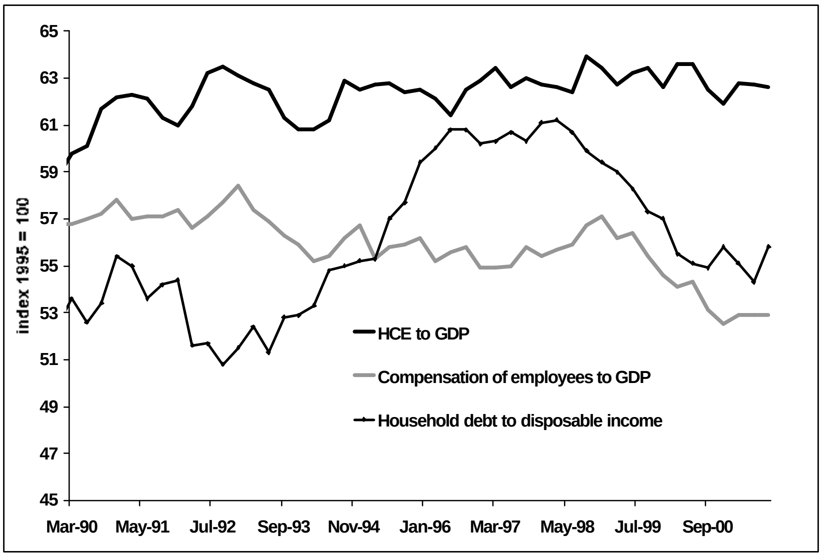
Real household spending and government consumption expenditure rose by an estimated 2,7 and 1,4 per cent, respectively, in 2001, and are expected to increase on average by 2,5 per cent per year over the MTEF period. It is estimated that gross fixed capital formation increased by more than 3 per cent in 2001.

Government spending rising

Household consumption

The rise in household spending in 2001 (2,7 per cent) was financed by a combination of increased disposable income and higher borrowing. Higher real income growth is expected to boost household consumption growth to about 3 per cent a year.

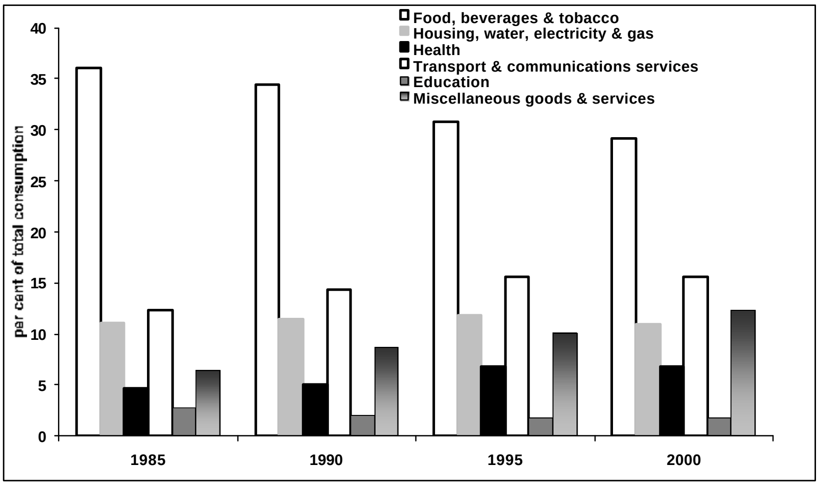
Figure 2.12 Ratios of household consumption and its determinants, 1994-2001



Less food consumption, more transport, communications and health

Households' consumption patterns are not subject to short-term changes. Over 15 years, food consumption has declined from about 36 per cent of the total consumption basket to about 29 per cent. Expenditure on transport and communications and health services has increased, while consumption of education has decreased. Consumption of housing initially rose in the late 1980s and early 1990s, but has since declined.

Figure 2.13 Detailed household consumption categories as a percentage of total consumption, 1985-2000



Employment and remuneration

Employment trends

The Survey of Employment and Earning shows a slower rate of job loss in the older, formal sector of the economy, suggesting that a turning point in employment trends may have been reached.

Fewer job losses in 2001

Nonetheless, unemployment and labour absorption among South Africa's youth remains a serious concern. A report by Statistics South Africa using 1996 Census data shows disturbingly low employment levels for youth, linked to low participation rates.

Youth employment is a priority

Productivity and earnings

Although the rate of growth has been somewhat slower since 2000, real consumption wages continue to contribute to higher disposable real income (about 2,5 per cent) of employees and their families. Real wages per worker have increased by 22,5 per cent since 1994, and have made it possible for sustained increases in real disposable income of households.

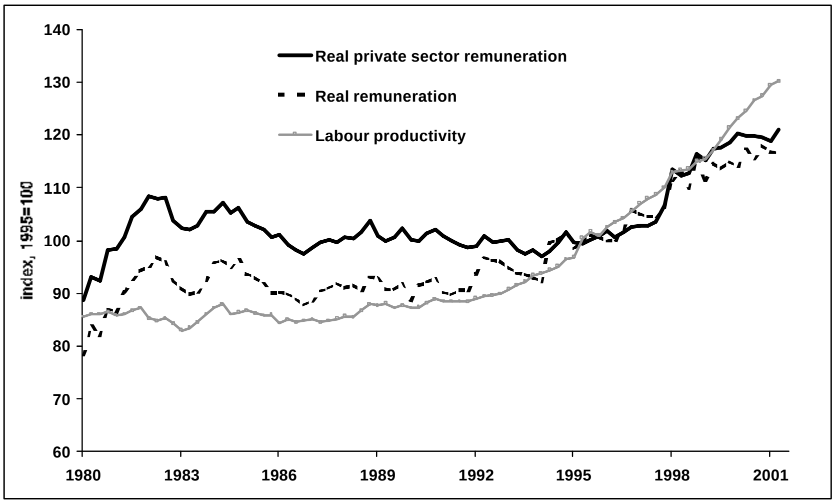
Household's real income continues to rise strongly

Productivity growth remained strong in 2000 and the first quarter of 2001, resulting in a slower rate of increase in unit labour costs, lower domestic price inflation and healthy corporate earnings.

Continued productivity gains equals lower labour costs to companies

Over the past two years, productivity has risen faster than real product wages (or the cost of employment to firms), setting the stage for employment increases in the medium term.

Figure 2.14 Real remuneration and productivity, 1980-2001



Finance, saving and investment

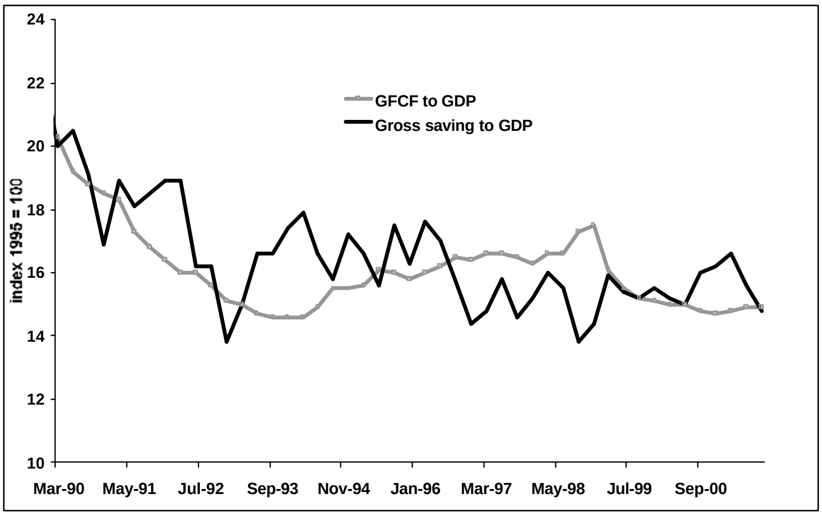
Saving

Although gross domestic saving declined quite sharply over the course of 2001, gross saving has been quite stable since 1996. A drop in household saving and higher net dissaving (expenditure over income) by government contributed to the overall decline in saving.

Gross domestic saving remains historically good, despite recent decline

Household debt rose to about 56 per cent of disposable income in the second half of 2001, but remained well below its peak of 61,2 per cent of disposable income reached in the first quarter of 1998.

Figure 2.15 Investment and saving, 1990-2001 (quarterly data)



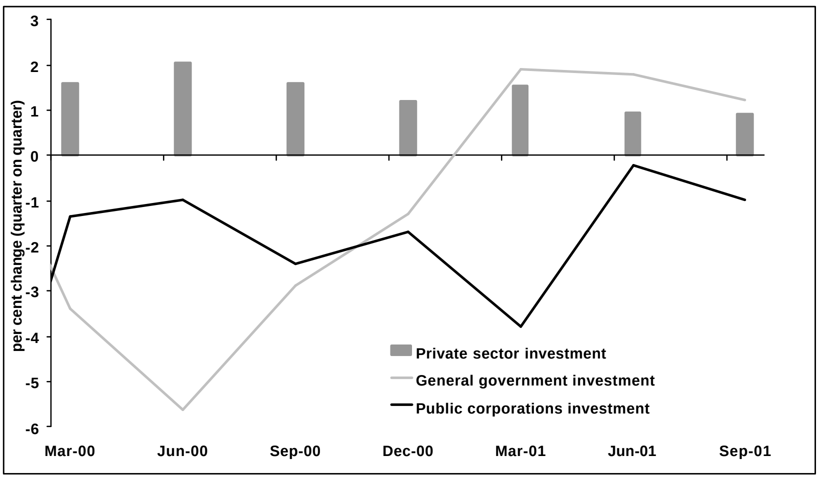
Investment trends

Investment spending spread broadly across sectors

Horizontal and vertical links extending through the economy allow major increases in export production to feed through into non-tradable and import-competing sectors. Partly as a consequence of such supply side connections, investment performance improved in almost all sectors and by most institutions in 2001.

Gross domestic fixed investment as a percentage of GDP was stable at about 15 per cent in 2001. Private businesses and general Government contributed positively to the 3 per cent rise in investment in 2001. By contrast real gross domestic fixed investment by public corporations declined throughout 2001.

Figure 2.16 Real investment by type of institution, 2000-2001 (quarter on quarter change)



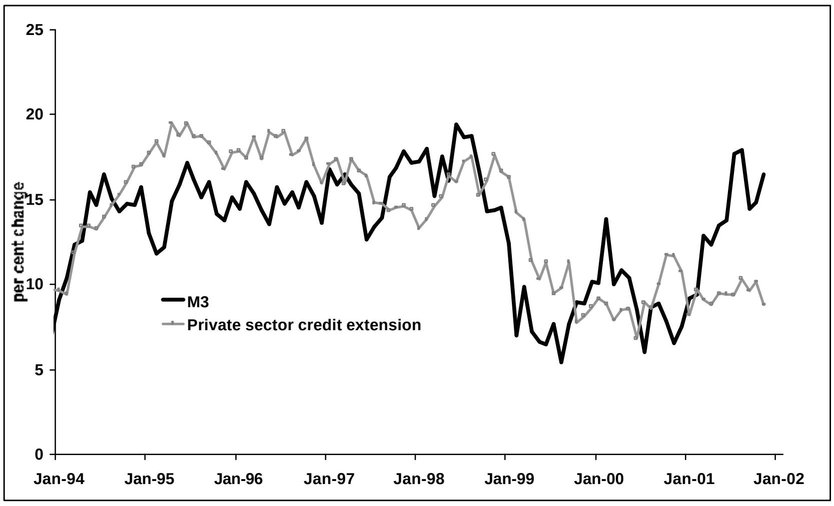
Prices and money market developments

Money supply

Money supply growth in 2001 affected by increase in value of foreign currency assets

After declining for much of the previous year, money supply growth accelerated in the first half of 2001, slowed mid-year, and then rose again from October to December. A considerable portion of the latter rise in M3 occurred due to an increase in the rand value of the foreign assets of the Reserve Bank and of the foreign currency deposits of firms.

Figure 2.17 M3 and credit to the private sector, 1994-2001 (monthly, percentage change over 12 months)



Moderate credit extension to the private sector

Credit extended to the private sector remained more moderate through the year, rising by about 9,3 per cent for the year as a whole (compared with 14,1 per cent for M3). Mortgage advances and other loans and advances provided the major part of the rise in overall credit.

Interest rates

Small rise in interest rates following sustained decline

The Reserve Bank cut the repurchase rate by 250 basis points from 12 to 9,5 per cent over the course of 2001, resulting in a decline in banks' prime lending rates from 14,5 to 13,0 per cent.[1] On 15 January 2002, the repurchase rate was raised from 9,5 to 10,5 per cent, leading to one percentage point increases in prime lending rates.

Lower short-term interest rates in 2001 were accompanied by a continuous decline in long-term bond yields until November, when further sales of government bonds by residents and non-residents put pressure on prices and yields. Yields on the R153 fell from 12,6 per cent in January 2001 to about 10,2 per cent in November, before rising to 11,7 per cent in December, and then retreating to 11,6 per cent in January 2002.

[1] The repurchase rate declined by 250 basis points in 2001, but only 150 basis points of the decline was for policy reasons. The other 100 basis points was a technical change made to the relationship between the repurchase rate and the prevailing money market interest rates charged on overnight borrowing.

Domestic borrowing was muted and capital market yields declined in 2001

The public sector borrowing requirement (PSBR) fell from 4,8 per cent of GDP in 1997 to an expected 1,1 per cent of GDP in 2001, contributing to lower government bond yields across the full maturity spectrum. As illustrated in figure 2.18, yields fell between February and October 2001, before increasing in the wake of the depreciation of the rand towards the end of the year.

Figure 2.18 Comparison of yield curves, April 2001, October 2001 and February 2002

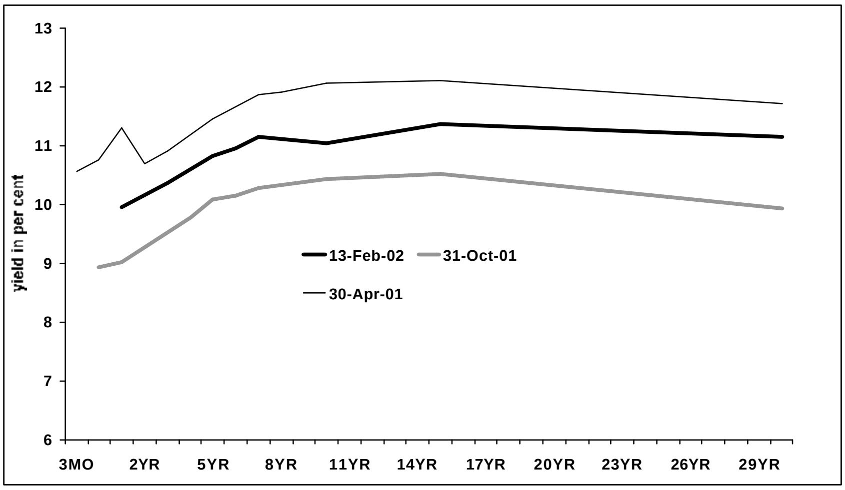
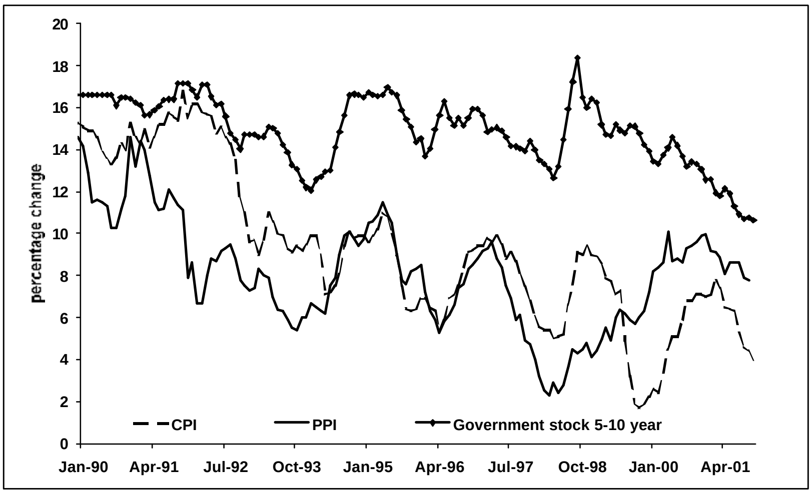


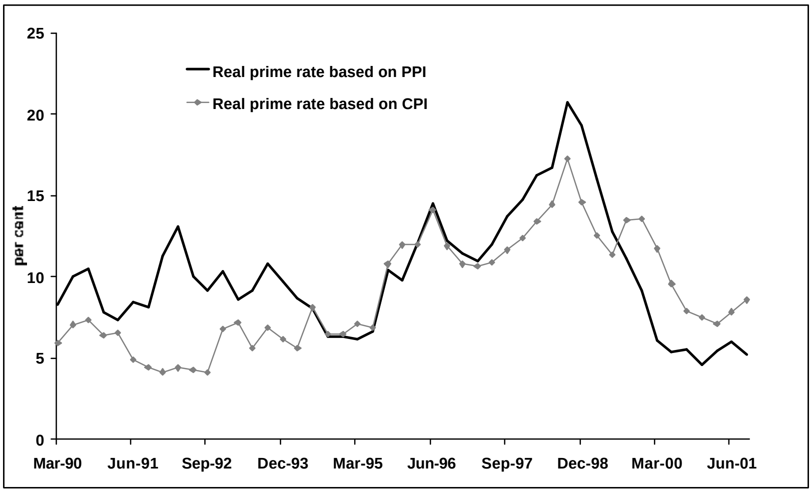
Figure 2.19 Yields on government debt, 1995-2001



Borrowing costs to companies and consumers

In terms of real borrowing costs to companies (the prime rate adjusted for producer price inflation), real interest rates have declined from an average of about 12 per cent from 1996 to 1999 to about 6 per cent by the end of 2001. Lower real prime interest rates have accordingly contributed to a moderate reduction in the weighted average cost of capital.

Figure 2.20 Real interest rates and investment, 1989-2001



Inflation

The major determinants of changes in the producer price level are oil prices, the prices of imported goods, domestic producers' prices, and unit labour costs. In a less volatile environment, the largest effects on consumer prices come from unit labour costs and producer prices.

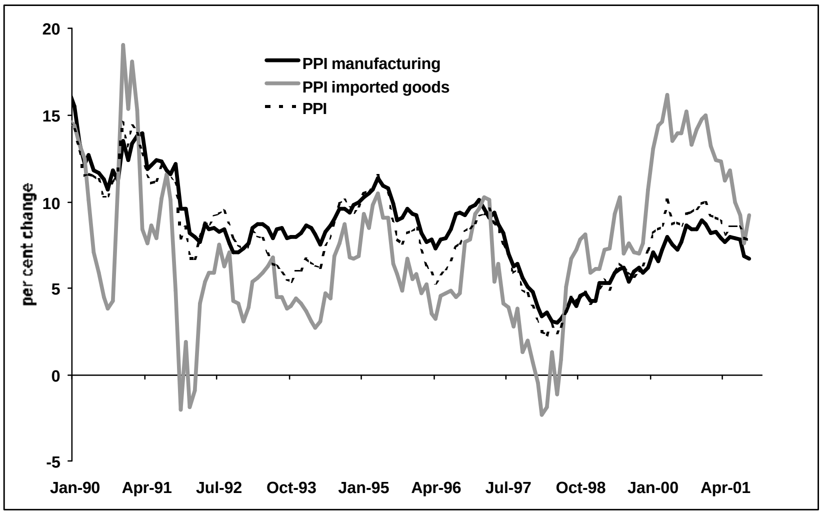
External factors driving inflation

In 2001, changes in oil prices and the exchange rate resulted in marked swings in imported goods prices. The US dollar price of oil started the year at US$ 22,97 and finished the year at US$ 19,30. The nominal effective exchange rate of the rand depreciated by about 32 per cent against the US dollar over the year.

Domestic pressures subdued

Increases in unit labour costs and most domestic producer prices (excluding food) have remained quite moderate in 2001, averaging 3,4 per cent (January to June) and 8,4 per cent (January to November), respectively.

Figure 2.21 Producer prices (monthly data, year on year change), 1990-2001



Maize and meat prices affected by the exchange rate

Consumer price inflation as measured by CPIX (the targeted measure) peaked in 2000, and declined to a low of 5,8 per cent in September before rising by 6,3 per cent in the year to November, and to 6,5 per cent in December, as maize and meat prices rose sharply.

The price of maize rose particularly quickly in the year to December, and can be largely explained by producers pricing their output to the US dollar prices of these goods as the currency depreciated. Meat products use maize as an input, and prices have consequently also risen sharply.

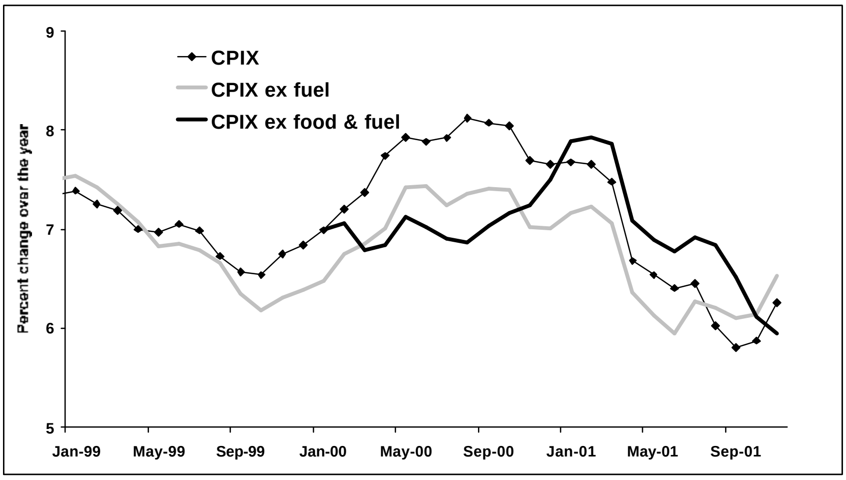
Excluding maize and meat, consumer prices remain low

Subtracting the total food component from CPIX shows that underlying inflation remains weak and does not appear to be driven by demand-side pressures.

Administered prices weakening

Although administered prices continue to increase more rapidly than CPIX, the trend in the rate of growth is easing. Transport costs, education, public transport services, and communication costs all remain moderate.

Figure 2.22 Consumer prices (monthly percentage changes)



CPIX inflation in 2002 and 2003

In the February 2000 budget, Government established an inflation targeting framework to help guide monetary policy and private sector price setting in order to continue the process of lowering inflation. The target was set at 3 to 6 per cent of consumer price inflation minus mortgage interest costs (CPIX). Changes to the inflation targeting framework were announced in the MTBPS in October. These included the explicit articulation of a procedure to allow for adjustment to a shock rendering the target unattainable.

The sharp depreciation of South Africa's nominal exchange rate in 2001 has affected the outlook for prices, particularly the prices of maize and food products such as meat that use maize as an input. After declining during most of last year, year-on-year CPIX inflation increased from 5,8 per cent in September to 6,5 per cent in December 2001.

Subtracting food prices from the CPIX reveals a decelerating rate of inflation in the rest of the economy. CPIX minus food and fuel rose by 5,4 per cent in the year to December – well within the Reserve Bank's inflation target of 3 to 6 per cent for 2002 and 2003.

Nonetheless, it is likely that CPIX will exceed the 2002 target, rising by an expected average rate of 6,9 per cent before declining to within the target range in 2003 and beyond.

Factors likely to contribute to dampening inflation pressures this year include the moderation in wage and salary trends, competitive price-setting in industry, the subdued level of oil prices and the interest rate rise in January. Food price inflation is expected to subside later in the year.

Global and domestic outlook

Improving economic indicators in 2002

The global economy began weakening around the middle of 2001, with poor economic news, deteriorating output projections and declining asset prices continuing through the second half of the year. Aggressive fiscal and monetary stimuli were applied by monetary authorities and governments in North America, Europe and Asia, and by January 2002 the deterioration of many economic indicators had slowed.

Developments in the US

While the timing of a US economic recovery still remains uncertain, economic conditions appear to have marginally improved over the past several months. Employment in the US continued to decline in December, but at a considerably slower pace than in October 2001.

Consumption spending in the US holding up

The Fed's infusion of liquidity after 11 September has been massive and the consequent rise in the narrow measure of money (M1) was unprecedented. This is not only underpinning the stock market, but also household consumption. Net-wealth-to-income ratios of US households remain very high. Despite the inability of the US Congress to agree to a further fiscal stimulus package, fiscal policy remains supportive of growth.

Developments in the euro area

Monetary policy in the euro area was loosened in the latter half of 2001, and rising budget deficits in EU member states also indicate more growth-oriented fiscal positions.

Modest growth expected in the EU in 2002

A number of indicators, including the Manufacturing Purchasing Managers survey, suggest underlying improvement in prospects. The euro is expected to remain relatively weak in the short-term as the dollar will be underpinned by expectations of the US outperforming the euro-region in the short term. Over the medium term, the euro should regain some of its lost ground against the dollar, as sentiment and growth performance in the euro area improves. Growth in 2002 is expected to be 1,3 per cent.

Developments in Japan

Japan's economy remains stagnant

A further delay in Japan's economic recovery is expected due to the weak outlook for the world economy. Business confidence in Japan experienced its largest decline in more than three years.

Fitch, Standard & Poor's and Moody's have downgraded the country's credit rating, citing Japan's high budget deficit (over 8 per cent of GDP), and ballooning public debt (over 140 per cent of GDP) as the main reasons.

Commodity prices

Short-term weakness and medium-run improvements

Commodity prices came under renewed pressure after September 2001. Although the short-term outlook remains poor, commodity prices are expected to recover over the medium term in line with the rebound in global economic activity.

The price of oil dropped to around US$18 per barrel in November, as the demand for oil declined with decelerating world growth. Over the medium term, however, economic growth and hence demand for oil products could put some upward pressure on oil prices as will OPEC's recently announced production cuts. Nonetheless, it is expected that crude oil will continue to trade in a range of about US$22-25 in the next few years.

Positive jump in the gold price

Although the price of gold rose by about US$20/oz since the US attacks, a major increase in the US dollar price of gold is not expected over the medium term. Prices for platinum group metals are expected to remain relatively high.

Domestic economic outlook

Sound policies contribute to a stable outlook for the South African economy, which is well-placed to take advantage of global economic recovery in 2002 and beyond.

Economic growth of 2,3 per cent in 2002 and 3,3 per cent in 2003

Nonetheless, domestic growth slowed during the third quarter of 2001 as the international economy weakened. GDP growth of 2,3 per cent is projected for 2002, and is expected to strengthen into the next three years as domestic confidence improves, exports rise, gross fixed capital formation accelerates, and government capital expenditure increases. GDP growth rates of 3,3 and 3,6 per cent are projected for 2003 and 2004, respectively.

Stronger household spending

Final consumption by households is expected to accelerate from 2,7 in 2001 to about 3 per cent over the forecast period due to stronger consumer confidence, lower interest rates, real wage increases and employment creation.

Investment spending to be buoyed by a number of factors

Rising business confidence has sustained a healthy rate of growth in investment. This is expected to strengthen over the MTEF period, due to lower tax rates, declining labour costs, increased competitiveness and a more stable exchange rate.

Public corporations' fixed capital formation is also expected to pick up from current levels as the privatisation process injects new capital to raise efficiency. Growth in gross fixed capital formation is expected to average 5,7 per cent per year over the period 2002 – 2004.

Improved Government spending to continue

Growth in final consumption by government is expected to average 2,5 per cent over the forecast period.

Exports to strengthen on back of rising world demand and improved competitiveness

Export performance is expected to benefit from the real depreciation in the value of the rand, which should cushion the effects of lower world demand. The anticipated recovery in the global economy from the second half of 2002 onwards and a further liberalised world trade environment, are likely to provide additional impetus for strong export growth.

Despite higher domestic spending in 2001, merchandise import volumes declined as import prices rose sharply. Imports are expected to accelerate as domestic economic activity gains momentum, although expenditure switching effects of the depreciation will keep import growth moderate.

Current account to remain healthy

Although the deficit on the current account is expected to increase from the marginal deficit of 0 per cent of GDP in 2001, it is not expected to rise above 1 per cent of GDP over the forecast period.

A more stable exchange rate is predicted over the forecast period, as emerging market pressures decline due to improved global economic performance.

Inflation to peak in 2002 before moderating in 2003 and 2004

CPIX inflation for the 2002 calendar year is forecast at 6,9 per cent, declining to 5,8 per cent in 2003. Over the medium run, inflation is expected to remain on its long-term downward trend and to decline to 4,5 to 5 per cent by 2004.

Macroeconomic performance since 1998 and projections for the next three years are set out in table 2.4. Growth and inflation for the fiscal years 2000/01 to 2004/05 are summarised in table 2.5.

Table 2.4 Macroeconomic projections (calendar years): 1998 to 2004

Calendar year:	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**
Real growth in demand:							
Final household consumption	1,4%	1,4%	3,3%	2,7%	2,5%	2,8%	3,1%
Final government consumption	-1,9%	-0,7%	0,5%	1,4%	2,3%	2,6%	2,7%
Gross fixed capital formation	5,0%	-7,8%	0,3%	3,2%	4,5%	5,5%	7,1%
Gross domestic expenditure	0,5%	0,0%	3,0%	1,4%	2,2%	3,0%	3,4%
Exports	2,2%	1,3%	8,2%	2,1%	2,6%	6,6%	6,7%
Imports	1,2%	-7,4%	7,4%	-1,2%	2,4%	6,1%	6,3%
Real GDP growth	**0,8%**	**2,1%**	**3,4%**	**2,2%**	**2,3%**	**3,3%**	**3,6%**
GDP deflator	7,0%	6,3%	7,0%	6,9%	6,6%	5,7%	4,6%
Gross domestic product at current prices (Rbillion)	**739,5**	**802,8**	**887,8**	**969,1**	**1 057,0**	**1153,9**	**1250,5**
CPI inflation:							
CPIX (Metropolitan and urban areas)	7,1%	6,9%	7,7%	6,6%	6,9%	5,8%	4,7%
Balance of payments:							
Current account balance (% of GDP)	-1,7%	-0,4%	-0,3%	0,0%	-0,5%	-0,5%	-0,7%

Table 2.5 Macroeconomic projections (fiscal years): 2001/02 to 2004/05

Fiscal year:	2000/01	2001/02		2002/03		2003/04		2004/05
	Outcome	2001 Budget	Revised	2001 Budget	Revised	2001 Budget	Revised	
Gross domestic product (R bill)	**910,5**	**987,2**	**990,0**	**1 069,3**	**1 082,8**	**1 154,9**	**1 178,9**	**1 277,5**
Real GDP growth	3,4	3,7	1,9	3,5	2,7	3,3	3,3	3,6
GDP deflator	7,2	6,0	6,6	4,7	6,5	4,6	5,4	4,6
CPI inflation:								
CPIX	7,8	6,2	6,5	5,2	6,7	4,6	5,5	4,6