2

Economic policy and outlook

- Economic activity is gradually improving worldwide in the wake of the severe contraction caused by the global financial crisis. The world economy is expected to grow by 3.9 per cent in 2010, supported by expansionary fiscal and monetary policies. A sustained and more robust rise in economic activity over the medium term, however, will require a recovery in consumer demand and private investment, job creation, and careful management of debt and inflation pressures.
- The recession had a far-reaching impact on South Africa, with rising joblessness and falling incomes affecting millions of people. Economic activity has started to revive, but it will take time for stronger confidence to boost consumption, employment and private investment. Real GDP growth is projected to rise to 2.3 per cent in 2010 and 3.2 per cent in 2011. The improved outlook is supported by expansionary fiscal and monetary policies, public-sector investment, lower inflation, high commodity prices and the upturn in global demand.
- Recovering jobs lost in 2009 and reducing high levels of structural unemployment will require much greater focus by government, business and labour. Macro- and microeconomic policies must work in tandem to remove constraints to growth and employment, and enhance export competitiveness.

Introduction and economic outlook

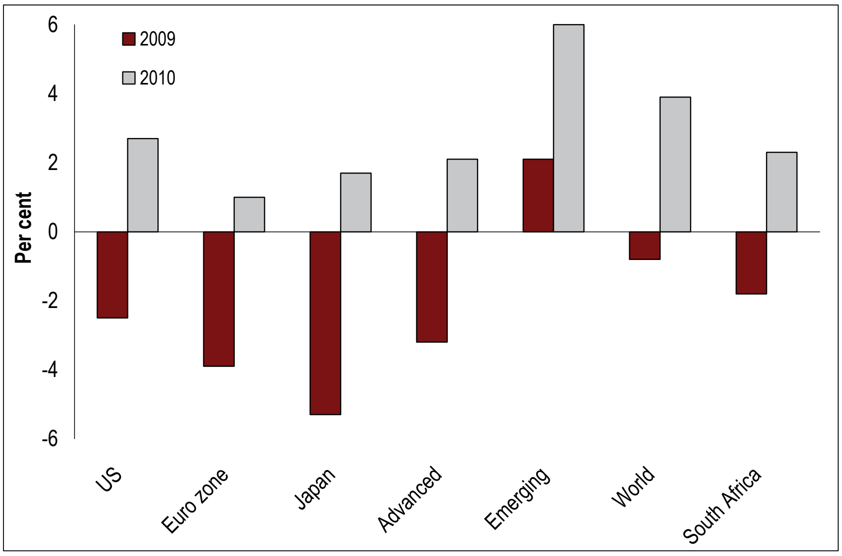
The world economy is recovering from the precipitous decline in demand and output caused by the near-collapse of the global banking system in late 2008. GDP growth is expected to strengthen in the year ahead, but will not reach pre-crisis levels for some time. While expansionary fiscal and monetary policies averted a more severe global recession, the costs of the crisis will be felt for many years to come in the form of higher unemployment and public debt around the world.

The world is emerging from recession, but the costs of the crisis will be with us for years to come

A sustained recovery will require stronger consumption and employment

Since the 2009 *Medium Term Budget Policy Statement*, confidence in the global recovery has strengthened. Many countries, including South Africa, saw growth return in the third quarter of 2009. Economic activity is picking up off a low base as production revives and inventories are rebuilt, but a sustained recovery will require stronger consumption and employment, particularly in developed countries. The main risks to the outlook emanate from premature withdrawal of fiscal and monetary policy stimulus and the management of fiscal pressures in countries with large deficits and high debt burdens – notably in the Eurozone, the US, the UK and Japan.

Figure 2.1 GDP growth, selected countries and regions, 2009 – 2010



National Treasury forecasts for South Africa; January 2010 IMF World Economic Outlook for others.

Moderate pace of domestic recovery demands a greater focus on removing constraints to growth

The recession has taken a heavy toll on South Africa, with about 870 000 jobs lost during 2009. Fiscal and monetary policies have responded in a countercyclical manner – increasing spending and sharply reducing interest rates. The crisis has slowed progress in achieving government's goals of accelerated economic growth and job creation, broader participation in the economy and poverty reduction. The moderate pace of recovery anticipated in the forecast suggests the need for intensified focus on removing constraints to higher growth and employment.

The domestic economy contracted by an estimated 1.8 per cent in 2009 as a result of a decline in consumption spending and weak investment growth. Anaemic internal and external demand resulted in a collapse in manufacturing output to 2004 levels, falling exports, and a sharp decline in commercial and industrial inventories. Economic conditions stabilised in the second half of the year, with some recovery in output, particularly in manufacturing and mining. Trends in consumption and employment, however, remain weak.

South Africa's macroeconomic policies are supportive of a recovery in private demand. The budget deficit increased to 7.3 per cent of GDP and borrowing rose during 2009/10. The Reserve Bank also eased monetary policy, lowering the repurchase (repo) rate by a cumulative five percentage points since December 2008 to 7 per cent.

Fiscal and monetary policies support recovery in demand, and 2.3 per cent growth is expected in 2010

Government expects the economy to recover gradually, driven by positive investment growth, more stable inventories and government consumption. Real GDP growth of 2.3 per cent is projected in 2010, rising to 3.6 per cent by 2012. Spending on stadiums and transport associated with the 2010 FIFA World Cup has already boosted growth. The main event this year will further benefit tourism.

Table 2.1 Macroeconomic projections, 2006 – 2012

Calendar year	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**
		Actual		**Estimate**		**Forecast**	
Percentage change unless otherwise indicated							
Final household consumption	8.3	5.5	2.4	-3.5	0.9	2.6	2.9
Final government consumption	4.9	4.7	4.9	5.7	4.7	4.1	3.6
Gross fixed capital formation	12.1	14.2	11.7	4.0	5.8	7.8	8.7
Gross domestic expenditure	8.6	6.4	3.3	-1.9	3.1	3.5	3.8
Exports	7.5	5.9	2.4	-20.2	3.8	3.9	5.4
Imports	18.3	9.0	1.4	-18.3	6.8	4.9	5.6
Real GDP growth	**5.6**	**5.5**	**3.7**	**-1.8**	**2.3**	**3.2**	**3.6**
GDP inflation	6.5	8.2	9.2	7.4	6.6	7.3	6.5
GDP at current prices (R billion)	**1 767.4**	**2 017.1**	**2 283.8**	**2 407.2**	**2 626.0**	**2 907.7**	**3 210.9**
Headline CPI inflation	3.2	6.1	9.9	7.1	5.8	6.1	5.9
Current account balance (% of GDP)	-5.3	-7.2	-7.1	-4.3	-4.9	-5.3	-5.8

Table 2.2 Macroeconomic projections, 2008/09 – 2012/13

Fiscal year	**2008/09**	**2009/10**	**2010/11**	**2011/12**	**2012/13**
	Actual	**Estimate**		**Forecast**	
Percentage change unless otherwise indicated					
Real GDP growth	2.5	-1.5	2.9	3.4	3.6
GDP inflation	8.8	7.2	7.1	6.3	7.2
Headline CPI inflation	9.9	6.7	5.7	6.2	5.9
GDP at current prices (R billion)	**2 320.1**	**2 449.9**	**2 699.9**	**2 967.6**	**3 295.7**

Household consumption will recover gradually. Credit demand remains weak despite easing lending standards, because debt levels are still high and the labour market is lagging the recovery. Household consumption is projected to grow by 0.9 per cent in 2010, 2.6 per cent in 2011 and 2.9 per cent in 2012.

Continuing public-sector investment in economic infrastructure provides crucial support to the recovery and is essential to reduce bottlenecks and draw in private-sector investment. Real fixed investment by public enterprises is projected to continue growing at a rapid pace.

Public-sector infrastructure programme provides a very strong medium-term boost to fixed investment

Exports will benefit from stronger global demand and high commodity prices, largely as a result of growth in China and India, but the appreciation of the exchange rate, driven by a resumption of capital flows to emerging markets, has reduced competitiveness somewhat. The availability of foreign capital, however, has helped to contain financing costs for infrastructure investment, and the stronger exchange rate has reduced the cost of imported capital goods.

CPI is projected to average about 6 per cent over the next three years

Headline consumer price inflation (CPI) fell below 6 per cent for the first time in 31 months in October 2009, ending the year at 6.3 per cent. Inflationary pressures eased as a result of the stronger rand and lower prices for food and petrol. CPI inflation is projected to average 5.8 per cent in 2010 and about 6 per cent over the medium term.

The current account deficit narrowed to an estimated 4.3 per cent of GDP in 2009 in response to weak demand for imports and lower net income payments to the rest of the world. However, the deficit is expected to increase to 4.9 per cent in 2010 and 5.8 per cent by 2012.

Policies for growth

'The loss of jobs is now the biggest cost that societies are paying for serious policy and design flaws in the global economy.' –
Minister of Economic Development Ebrahim Patel

The painful impact of the recession on the lives of many South Africans has increased the urgency of forging a new growth path – one that combines faster economic expansion with large-scale job creation to reduce high levels of poverty and inequality.

Government will maintain prudent macroeconomic policies that promote a favourable environment for investment and job creation through low and stable inflation and interest rates, a competitive real exchange rate and measures to support financial stability. Responsible management of fiscal policy will prevent an unsustainable rise in debt that would limit the ability of the economy to grow at a faster rate in the future. Social and economic spending priorities will remain in focus to support poverty reduction and investment.

Government, business and labour must work in partnership to address our economic challenges

To address constraints to growth, microeconomic reforms are required to increase private investment and support competitiveness by lowering costs, raising productivity, and taking advantage of changing patterns of global demand to raise exports. To be successful, these policy adjustments must be underpinned by partnerships between business, labour and government.

Microeconomic policies cover a range of issues that affect the quantity, quality, and cost of inputs into production such as labour, capital, land and technology. Economic growth is more rapid and welfare increases more quickly if the quality of these inputs improves over time – and if they are used more efficiently. The quality of public infrastructure and public services, such as education and health, are decisive in achieving better growth outcomes, as are government policies that support the mobility of labour, promote competition and ensure effective regulation of markets.

Constraints to higher growth in South Africa have been identified in various studies – notably the work of the International Growth and Advisory Panel (2006-2008) and the Organisation for Economic Cooperation and Development's *Economic Assessment of South Africa* (2008). Recommendations to improve growth potential have focused on the need to pursue countercyclical fiscal and monetary policies, while doing more to ensure that goods markets are competitive, labour markets function well, the economy is open to trade and investment, and infrastructure is modernised and expanded.

In 2008 and 2009, the Grant Thornton *International Business Report*, which surveys business executives around the world, rated the availability of skilled workers in South Africa as the most important impediment to growth, followed by burdensome regulations and red tape. Similarly, the World Bank's *Doing Business* reports and the World Economic Forum's *Global Competitiveness* reports highlight areas that adversely affect small businesses such as the regulatory burden.

Lack of skills has been identified as a crucial impediment to growth

Independent assessments on competition and regulation in network industries, commissioned by the National Treasury in 2007, identified a number of inefficiencies in key sectors such as electricity, telecommunications and freight transport that impose additional costs on the economy.

To reduce South Africa's high unemployment rate, we need both higher growth and greater labour absorption, particularly for lower skilled workers. This requires greater focus on raising investment, creating incentives for job creation, raising productivity and expanding exports. While the state plays an important role in addressing inequality and infrastructure backlogs, a climate conducive to dynamic private-sector investment, entrepreneurship and growth must be supported.

South Africa needs higher growth and greater labour absorption, particularly for lower-skilled workers

Key initiatives to support higher growth that have been suggested in the studies mentioned above include:

- Steps to reduce youth unemployment, including a targeted wage subsidy accompanied by greater flexibility in hiring young people and better training.
- Supporting labour-intensive industries through industrial policy interventions, skills development, infrastructure investment, public employment programmes and a rural development strategy.
- Helping industries to better manage scarce resources and reduce greenhouse gas emissions through appropriate pricing of energy to enable investment in sustainable technologies.
- Investment in and improved maintenance of energy, transport, water and communications infrastructure, supported by appropriate and sustainable tariff structures.
- Raising productivity and competitiveness by reducing regulatory hurdles and red tape (especially for small firms), reviewing the scope of collective bargaining, enforcing competition laws, lowering logistics and communications costs, providing incentives for foreign direct investment and reducing barriers to trade.
- Increasing access for private investment and participation in critical input markets, such as energy, telecommunications and transport.
- Further steps to raise savings and investment through responsible fiscal management, tax incentives, monetary policy that pursues low and stable real interest rates, programmes to support financial literacy and expanded access to banking services.

- Keeping inflation low, striving for a stable and competitive exchange rate, and buffering the economy against global volatility with adequate stocks of foreign exchange reserves and low foreign debt levels.

Global developments

The global economy is in recovery, driven by expansionary fiscal and monetary policies, a revival in industrial production and the rebuilding of inventories. The International Monetary Fund (IMF) expects the world economy to grow by 3.9 per cent in 2010, after contracting by an estimated 0.8 per cent in 2009. Emerging and developing countries are expected to expand at a more robust pace of 6.0 per cent in 2010, thanks to strong recoveries in China, India and Brazil.

In Europe, the costs of fiscal indiscipline loom large

Over the medium term, policy makers face the challenge of managing large fiscal deficits and high public debt associated with corporate bailouts and stimulus packages. The risks posed by unsustainable fiscal management are starkly illustrated by the experiences of Portugal, Ireland, Greece and Spain, which face mounting debt and interest costs, accompanied by calls for wide-ranging austerity measures. The fiscal deficit of Greece reached 12.7 per cent of GDP in 2009, and government debt rose to 113.4 per cent of GDP.

Risks to the global outlook

The trajectory of global economic recovery is uncertain. The IMF revised its forecast for world growth in 2010 from 3 per cent in January 2009 to 1.9 per cent in April, before reaching the current projection of 3.9 per cent. While the National Treasury's current forecast incorporates a greater degree of confidence that the basis for a sustained recovery has been established, several risks must be considered. These include:

- Withdrawal of stimulus measures and implementation of "exit" strategies that reduce support for growth, even as employment remains weak.
- High fiscal deficits that have resulted in unsustainable levels of public debt in many countries. Greece, Ireland, Spain and Portugal are facing the reality of sharp spending cuts and higher interest rates due to ballooning debt levels and collapsing investor confidence.
- Policies supporting growth in China that may become unsustainable as extraordinary fiscal and monetary measures continue to inflate asset prices. Too much tightening, however, could prevent wages and the real exchange rate from rising, dampening consumer demand and prolonging global macroeconomic imbalances.
- Expansionary monetary policies in developed countries that have boosted global liquidity, leading to renewed financial market exuberance and a surge in capital inflows to emerging markets. The ensuing rise in exchange rates and asset prices may weaken growth in some countries, including South Africa.
- Unprecedented support provided to bail out large banks during the crisis. There is concern that banks are returning to business as usual, and using state support to generate windfall profits. Left unchecked, this behaviour may sow the seeds of a future crisis.

Trends in major economies and regions

- Supported by strong stimulus measures, the US has emerged from recession. After contracting by an estimated 2.5 per cent in 2009, the US economy is projected to grow by 2.7 per cent in 2010.
- Growth prospects are weaker in Europe. The Eurozone contracted by 3.9 per cent in 2009 and is forecast to grow by just 1 per cent in 2010.

- China is projected to grow by 10 per cent in 2010, and to account for 41 per cent of global growth over the next five years. India's economy is expected to expand by 7.7 per cent in 2010.
- Stronger global demand combined with improving commodity prices will support growth of 4.3 per cent in sub-Saharan Africa in 2010, following modest growth of 1.6 per cent in 2009.

Table 2.3 Annual percentage change in GDP and consumer price inflation, selected regions/countries, 2009 – 2011

Region / Country	2009	2010	2011	2009	2010	2011
Percentage	GDP projections[1]			CPI projections[2]		
World	**-0.8**	**3.9**	**4.3**	**2.5**	**2.9**	**2.8**
US	-2.5	2.7	2.4	-0.3	2.2	1.9
Euro area	-3.9	1.0	1.6	0.3	1.2	1.5
UK	-4.8	1.3	2.7	2.1	2.4	1.7
Japan	-5.3	1.7	2.2	-1.3	-1.0	-0.3
Emerging markets and developing countries	**2.1**	**6.0**	**6.3**	**5.2**	**6.2**	**4.6**
Developing Asia	**6.5**	**8.4**	**8.4**	**3.0**	**3.4**	**3.1**
China	8.7	10.0	9.7	-0.7	2.8	3.2
India	5.6	7.7	7.8	10.4	7.1	5.9
Africa	**1.9**	**4.3**	**5.3**	**9.0**	**6.5**	**5.8**
Sub-Saharan Africa	**1.6**	**4.3**	**5.5**	**10.5**	**7.3**	**6.6**
South Africa[3]	-1.8	2.3	3.2	7.1	5.8	6.1

1. GDP projections: IMF World Economic Outlook, January 2010.
2. Country data: Consensus economics, January 2010; aggregate data: IMF World Economic Outlook, October 2009 and January 2010.
3. National Treasury forecasts.

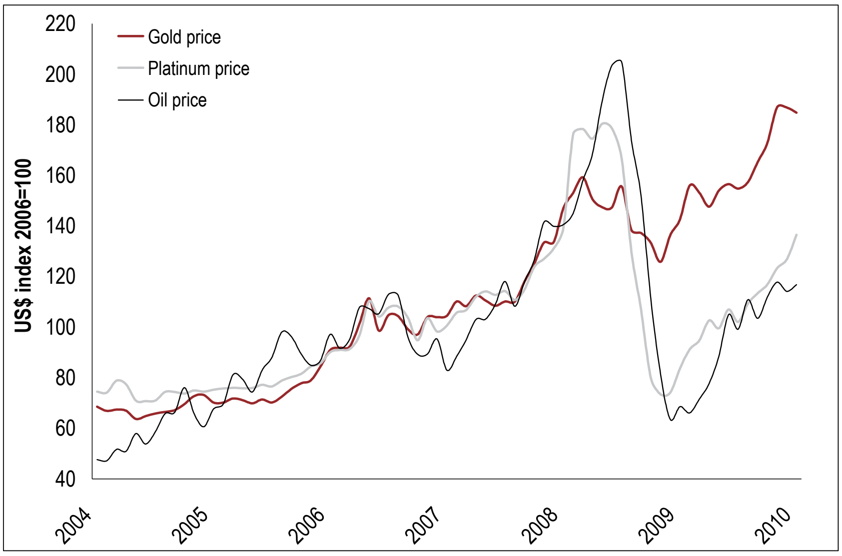
Commodity price trends

After falling sharply at the height of the global financial crisis, commodity prices have benefited from improving global demand, US dollar weakness and strong investor demand for alternative assets. These factors are likely to support high prices for the foreseeable future. However, increases in production costs since 2007 will dampen the impact on production, profits and associated government revenue.

Global demand and US dollar weakness will support high commodity prices

- The gold price reached a new record of US$1 214/oz in December 2009, and remained above US$1 050/oz in early February 2010.
- The platinum price jumped 84 per cent between December 2008 and January 2010, reaching US$1 557/oz.
- The oil price remains volatile. From a level of US$41/barrel in December 2008, the price of Brent crude oil has increased by 76 per cent to about US$72/barrel in early February 2010.

Figure 2.2 Trends in gold, platinum and oil prices, 2004 – 2010



Balance of payments

The current account deficit narrowed to an estimated 4.3 per cent of GDP in 2009

The current account deficit narrowed to an estimated 4.3 per cent of GDP in 2009 from 7.1 per cent in 2008. This deficit was more than adequately financed by foreign capital inflows, as investors sought to place cash into higher-yielding emerging markets. Net purchases of bonds and equities by non-residents amounted to R102 billion in 2009. The stronger balance of payments was reflected in a recovery of the rand exchange rate after its sharp weakening at the height of the financial crisis in October 2008 – an experience common to other emerging markets and commodity producers.

Current account

Declining imports during the first three quarters of 2009 saw the trade deficit fall sharply

Declining import volumes in the first nine months of 2009 resulted in a trade deficit of 0.3 per cent of GDP, sharply lower than the 1.6 per cent deficit for 2008. The value of imports of mineral products (mainly oil) fell by 36.2 per cent, while exports of iron ore showed a marked increase of 46.7 per cent. Weak domestic consumption and investment also reduced imports of machinery and equipment. Lower dividend payments to non-resident investors reduced net income payments to the rest of the world.

Net service, income and transfer payments fell to 4.1 per cent of GDP in the first nine months of 2009 from 5.6 per cent in 2008. Dividend payments to non-resident investors as a share of GDP fell to levels last seen in 2006, but are likely to rise again over the medium term given the expected revival in company profits and higher foreign ownership of domestic bonds and equities. Transfer payments to other members of the Southern African Customs Union (SACU) also declined due to lower revenues from import tariffs.

The current account deficit is expected to rise to 4.9 per cent of GDP in 2010 and 5.8 per cent by 2012, as domestic demand strengthens and foreign dividend payments increase.

Table 2.4 Summary of South Africa's balance of payments, 2005 – 2009

Percentage of GDP	2005	2006	2007	2008	2009[1]
Total current account	**-3.5**	**-5.3**	**-7.2**	**-7.1**	**-4.4**
Trade balance	-0.1	-1.7	-2.0	-1.6	-0.3
Net services, income and transfer payments	-3.3	-3.7	-5.2	-5.6	-4.1
Net service payments	-0.3	-0.8	-0.9	-1.5	-0.9
Net income payments	-2.0	-2.0	-3.4	-3.2	-2.3
Net dividend payments	*-1.6*	*-1.6*	*-3.1*	*-2.6*	*-1.6*
Net transfer payments (mainly SACU)	-1.0	-0.9	-0.8	-0.8	-0.9
Current account excluding current transfers	-2.5	-4.4	-6.3	-6.3	-3.5
Financial account balance	**5.6**	**7.0**	**9.5**	**8.2**	**5.2**
Net portfolio investment	1.9	7.3	3.6	-5.9	3.4
Net foreign direct investment	2.3	-2.5	1.0	4.4	2.2
Net other investment	0.6	1.2	3.0	5.7	-1.1
Unrecorded transactions	0.8	0.9	1.9	4.0	0.7
Change in net reserves due to BoP transactions	**2.2**	**1.7**	**2.4**	**1.1**	**0.8**

1. Includes data for the first three quarters of 2009, seasonally adjusted and annualised.
Source: South African Reserve Bank

South Africa's terms of trade, which capture the ratio of export prices to import prices, improved considerably during the first half of 2009 as prices of precious metals rose more strongly than oil prices. A recovery in oil prices partially reversed these gains in the third quarter.

Volumes of exports and imports tumbled by 23 per cent and 20.5 per cent respectively in the first three quarters of 2009 compared with the same period in the previous year, with strong demand from the East supporting exports of coal and iron ore.

Table 2.5 Composition of trade, 2000 – 2009

	Share of total trade (%)		Trade balance			
	2009		R billion			
	Exports	Imports	2000	2005	2008	2009
Precious metals and stones	24.8	0.9	38.2	75.5	143.6	124.7
Base metals	14.8	4.3	23.8	44.5	80.9	54.1
Agricultural produce, food and beverages	9.2	6.7	7.7	10.8	7.6	11.7
Pulp and paper products	2.0	1.8	2.9	1.0	1.8	0.8
Transport equipment	8.6	8.9	0.2	-12.6	-2.2	-3.0
Miscellaneous manufacturing	0.8	1.6	0.2	-1.7	-4.8	-4.2
Mineral products (oil, coal, ore, etc)	20.1	21.8	-0.5	-5.5	-51.1	-12.8
Textiles, clothing, footwear and accessories	1.0	4.1	-3.6	-10.0	-16.5	-17.1
Other[1]	2.6	5.2	17.2	-11.4	-25.1	-21.2
Motor vehicle components	0.0	5.5	-15.0	-30.6	-48.1	-30.0
Chemical products, plastics and rubber	7.4	13.1	-12.3	-17.1	-36.9	-32.1
Machinery and appliances	8.6	26.1	-38.8	-62.4	-120.9	-96.5
Total	**100.0**	**100.0**	**20.0**	**-19.3**	**-71.6**	**-25.8**

1. Other includes optical and photographical equipment, stone plaster, wood, hides, leather and skin etc. and articles thereof, works of art and unclassified products.
Source: South African Reserve Bank

A framework for strong, sustainable and balanced growth

The Group of Twenty (G-20) has emerged as the most important forum in which to seek collaborative solutions to the global economic crisis. As part of these efforts, leaders have agreed to implement a Framework for Strong, Sustainable and Balanced Growth. Governments will work together to ensure that their fiscal, monetary, exchange rate, trade and structural policies are consistent with the stated objectives of the framework.

G-20 finance ministers were mandated to initiate a cooperative process of mutual assessment among member countries to assess the implications of policies for the pattern and sustainability of global growth. The exercise involves an analysis of each country's macroeconomic policies and projections, microeconomic reforms and financial sector regulations.

Improving financial regulation in the wake of the global crisis

As a member of the G-20, the Financial Stability Board (FSB) and the Basel Committee on Banking Supervision, South Africa has been an active participant in dialogue on improving international financial regulation. While South Africa's regulatory framework proved robust during the crisis, we will not be complacent, and the supervision of financial services will be enhanced.

The following steps are being considered.

- The regulators' roundtable, which began to improve regulatory coordination when it was formed in 2008, will focus on financial stability, enforcement, market conduct and legislative alignment during 2010. Government is considering a proposal to formalise the roundtable into a council of regulators.
- The governance and accountability of the financial regulatory agencies will be improved.
- In March 2010, the IMF will review South Africa's adherence to global regulatory standards in banking, insurance and securities and the balance between regulators' independence and accountability. This forms part of the country's G-20 and FSB commitments.
- The Basel Committee on Banking Supervision has proposed changes to the Basel II framework. These include measures to raise the quality and quantity of capital, steps to reduce the pro-cyclicality of current rules, a new risk framework, and liquidity and leverage ratios. Implementation of the relevant proposals is planned for 2011/12, following an impact assessment.
- The World Bank will review South Africa's crisis contingency framework in the first half of 2010.
- The scope of regulation covering previously unregulated activities, such as hedge funds and private equity firms, will be reviewed. The National Treasury and Financial Services Board will release a discussion document on the appropriate response. Changes to regulations covering over-the-counter derivative products have been incorporated into proposed amendments to the Security Services Act.
- Credit rating agencies, which play an important role in global investment, are currently unregulated. A draft Credit Ratings Services Bill will soon be released for public comment.

Financial account

A strong rebound in portfolio flows and FDI drove foreign capital inflows

In the first three quarters of 2009 foreign capital flows were mainly driven by a strong rebound in portfolio flows and foreign direct investment (FDI). Net purchases by non-residents of South African equity and debt instruments amounted to R102 billion in 2009 after an outflow of R69.5 billion in 2008. Net FDI inflows totalled R40 billion in the first three quarters of the year, in large part due to investments in telecommunications.

Exchange rate and international reserves

The rand appreciated by 24 per cent against a trade-weighted basket of currencies in 2009, reversing the decline precipitated by the financial crisis in 2008. The strengthening in the rand, alongside currencies such as the Brazilian real and Chilean peso, was driven by renewed weakness in the dollar, stronger commodity prices and a surge in capital flows to emerging markets. The average level of the real exchange rate is still about 8 per cent weaker in 2009 than during its previous peak in 2006.

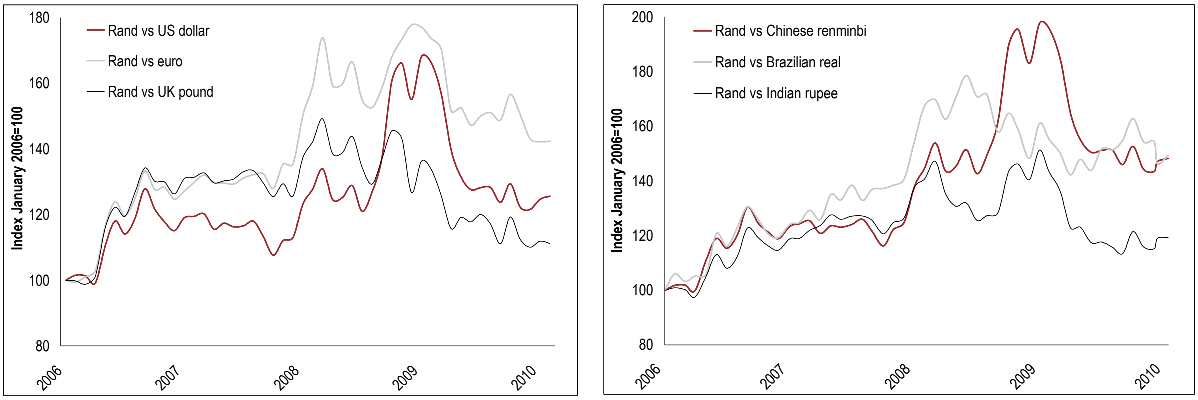
South Africa needs to minimise the costs – and maximise the benefits – of its open capital account

Capital flows can have a significant impact on the exchange rate in the short term. Over the long term, the level of the rand is affected primarily by differences in growth and inflation rates. South Africa needs to minimise the costs associated with a relatively open capital account – including currency appreciation and excess volatility – while maximising its benefits, which include lower-cost capital funding and cheaper imported goods. This requires a combination of countercyclical fiscal and monetary policies, along with reserve accumulation and appropriate prudential regulation.

Foreign currency reserves grew to $US39.5 billion in January 2010

Gross gold and other foreign currency reserves increased from US$34.1 billion at the end of 2008 to US$39.5 billion at the end of January 2010. Of this increase, US$2.4 billion consisted of an allocation of the IMF's Special Drawing Rights (SDRs)[1] to member countries in September 2009. The international liquidity position improved from US$33.5 billion in December 2008 to US$38.6 billion at the end of January 2010.

Figure 2.3 The rand versus developed and emerging market currencies, 2006 – 2010



Relative to the level in January 2006: rising line = depreciation; falling line = appreciation.

Real output trends

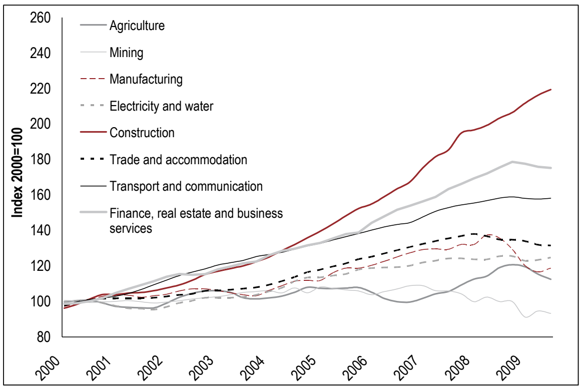
After shrinking for three quarters, the economy began to grow again in the third quarter of 2009

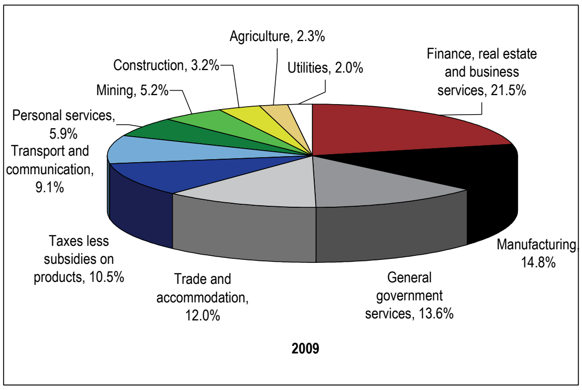
South Africa's economy emerged from recession in the third quarter of 2009, with real GDP rising at a seasonally adjusted annualised rate of 0.9 per cent after contracting in the previous three quarters. Overall, the real economy is projected to have shrunk by 1.8 per cent between 2008 and 2009.

Although a high degree of volatility remains, a range of indicators is pointing to an improvement in economic conditions. The leading indicator of economic activity, which fell to its lowest level in March 2009, rose strongly between August and November. The recovery is expected to gain momentum through the first half of 2010, resulting in GDP growth of 2.3 per cent in 2010, 3.2 per cent in 2011 and 3.6 per cent in 2012.

[1] SDRs are international reserve assets representing the right of the holder to acquire foreign exchange or other reserve assets from other IMF member countries when external liquidity is needed.

Figure 2.4 Growth in real value added by sector and the composition of GDP, 2000 – 2009





The figures for 2009 are for the first three quarters of the year.

Agriculture

Outlook for maize is slightly more positive, but the price is down sharply due to a global surplus

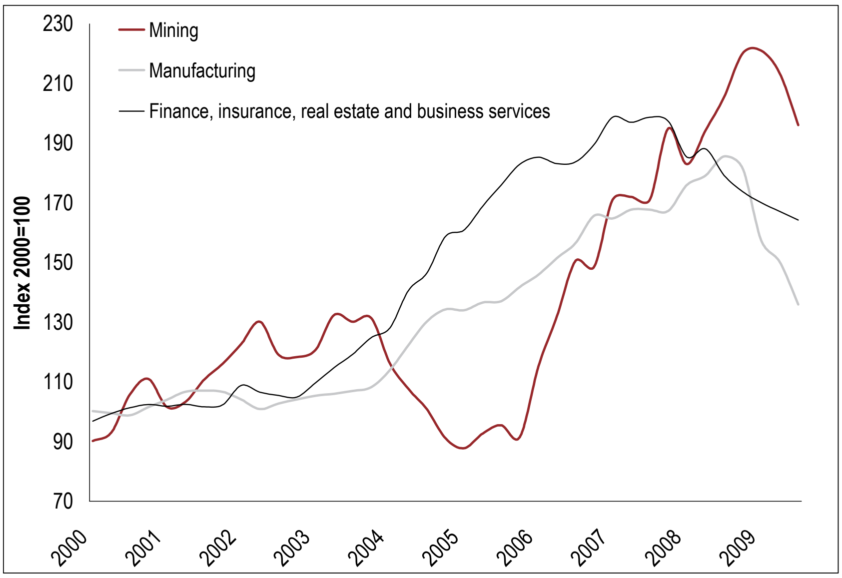
The agriculture, fisheries and forestry sector grew by 0.4 per cent in the first nine months of 2009 after expanding by 11 per cent in the same period in 2008. Farmers planted fewer crops during the year in response to lower prices of agricultural commodities relative to the price boom in 2008. The outlook for the year ahead is slightly more positive and the area planted for maize is expected to increase in 2009/10 compared to the previous year. The maize price, however, declined to its lowest level in more than three years in the first two months of 2010 due to surplus global production. This may depress production levels in the 2010/11 season.

Mining

Mining production was affected by a sharp drop in demand early in 2009, but has since picked up

Value added in the mining sector declined by 7.7 per cent in the first nine months of 2009 compared to the same period in 2008. Production was affected by a sharp drop in demand at the start of 2009, but recovered gradually thereafter as global conditions improved and commodity prices resumed their upward trend.

Figure 2.5 Gross domestic fixed investment for mining, manufacturing and finance sectors, 2000 – 2009



The figures for 2009 are for the first three quarters of the year.

In the whole of 2009, production of platinum group metals declined by 1.3 per cent compared with the previous year, while gold production contracted by 7.6 per cent despite the record-high gold price. South Africa has fallen to third place in the global ranking of gold producers, behind China and Australia, reflecting rising costs associated with mining at greater depths and the declining grade of remaining deposits.

A more positive global outlook, combined with high commodity prices and strong demand from China, should provide impetus for the expansion of mining in the years ahead.

Manufacturing

Production fell sharply in 2009, but the Purchasing Managers' Index points to modest recovery

Value added in manufacturing fell by 12.2 per cent in the first nine months of 2009 compared with the same period in 2008. Monthly output started to rise in May 2009. The improving trend is reflected in the Purchasing Managers' Index (PMI), which rose from a low of 36.1 in April 2009 to 53.6 in January 2010.

The rebuilding of inventories in the automotive sector, and in basic iron and steel, boosted production and exports in the third quarter of 2009. However, production remains under pressure in domestically oriented sectors, such as clothing and textiles and furniture, given weak consumer demand. The improved outlook should support manufacturing growth in the months ahead, but the profitability of producers is likely to be affected by the stronger rand, higher unit labour costs and increases in electricity tariffs.

Table 2.6 Growth in manufacturing output by sector in 2009

	Weights[1]	Average % change (y-o-y)	December % change (y-o-y)	Average annual growth (2004 – 2008)
Petrochemicals	22.1%	-8.9	5.6	4.6
Basic iron and steel	22.9%	-18.6	9.9	1.3
Food and beverages	15.4%	1.7	4.0	4.6
Wood and paper	10.2%	-15.0	-15.1	3.2
Motor vehicles and parts	10.9%	-24.4	34.6	4.7
Furniture and other	5.2%	-20.0	-7.8	5.4
Textiles and clothing	4.9%	-14.6	-13.0	1.2
Glass and non-metallic mineral products	4.8%	-12.3	-0.1	4.9
Electrical machinery	2.5%	-3.0	-4.9	3.4
Radio and television	1.1%	-6.6	-7.0	3.0
Total	**100.0%**	**-12.5**	**3.2**	**3.4**

1. Weights are based on the large sample manufacturing survey of 2005.
Source: Statistics South Africa

Electricity and water

New power plants are expected to come online beginning in 2012

Value added in the electricity, gas and water sector declined by 0.5 per cent in the first nine months of 2009. The sector will grow as Eskom builds now power plants. The Medupi coal-fired power station will produce 4 764 MW of electricity, with the first unit expected online in 2012; the Kusile coal-fired power station will produce 4 800 MW, with the first unit being commissioned in 2014; and the Ingula hydroelectric station will produce 1 368 MW, with the first unit commissioned in 2013.

Government has set a target of 30 per cent of electricity to be supplied by the private sector.

Construction

Public-sector infrastructure programme continues to support robust performance in construction sector

Growth in the construction sector remained robust in the first nine months of 2009, with value added growing by 8.4 per cent compared with the same period in 2008. Growth was supported by public spending on infrastructure development, particularly power plants, ports, railways, freeways and passenger rail, and completion of the 2010 FIFA World Cup stadiums.

Public investment has cushioned the impact of falling residential demand and lower private investment on the sector. Residential investment should start to recover if house prices continue to rise and the economic recovery strengthens.

Financial services

Growth in the finance, insurance, real estate and business services sector slowed to 2.3 per cent in the first nine months of 2009 from 8 per cent in the same period in 2008.

Banking sector came under pressure in 2009, but lending standards have begun to ease

During 2009, the banking sector faced higher non-performing loans and difficult capital-raising conditions. Impaired advances as a percentage of gross loans and advances rose from 3.6 per cent in November 2008 to 5.9 per cent in November 2009. Bank lending standards have begun to ease after a period of slowing credit extension, house prices started to rise in May 2009 and there are signs that impaired advances are close to a peak.

Table 2.7 Bank credit extension to households and companies, 2008 and 2009

	% of total advances	% growth over 12 months	
Percentage	**December 2009**	**December 2008**	**December 2009**
To household sector	55.3	15.5	2.1
To corporate sector	44.7	12.3	-4.7
By type of advance:			
Mortgage advances	53.7	13.3	2.9
Instalment sale credit and leasing finance	12.8	7.5	-6.0
Overdraft	6.8	3.9	-7.2
Credit card advances	3.0	3.8	-2.8
General advances	23.7	17.9	-5.0
Total loans and advances	**100.0**	**14.0**	**-1.1**

Transport and communication

Investments ahead of the 2010 FIFA World Cup have lent support to the sector

Value added in the transport, storage and communications sector contracted by 0.7 per cent in the first nine months of 2009 compared with 2008. Over the past few years, government and state-owned enterprises have made significant investments in public transport, road and rail projects to improve the capacity and efficiency of South Africa's transport system and to prepare for the FIFA World Cup.

In telecommunications, the slowdown in economic activity has resulted in a fall in average revenue per user for cellphone companies, as well as a decline in growth of new subscribers. Efforts are under way to expand the country's broadband capacity and, it is hoped, to lower costs. The SEACOM submarine fibre optic cable came online in July 2009. Additional capacity will be added through the East African Submarine Cable System and the West African Cable System by mid-2010 and mid-2011 respectively.

Exchange control reform: strengthening financial stability and prudential regulation

The 2009 *Medium Term Budget Policy Statement* reinforced government's intention to lower the cost of doing business in South Africa, while managing risks in a volatile international environment.

In the wake of the global financial crisis, the broad strategy remains prudential management of foreign exposure risk, along with improved management of capital flows, and maintaining macroeconomic and financial stability. In keeping with this stance, South Africa will implement relevant financial regulatory reforms in line with G-20 recommendations. These include better management of the foreign risk exposure of banks and institutional investors.

Government announces the following steps:

Prudential foreign exposure limits

Government has finalised reporting measures for prudential foreign exposure limits on banks. These measures will liberalise exchange controls for these institutions. As of 1 March 2010, South African banks will be able to acquire direct and indirect foreign exposure of up to 25 per cent of their total liabilities (excluding equity), covering all foreign exposure but excluding FDI. The initial limit of 40 per cent has been adjusted downwards in light of recent international developments.

Research is under way to complete the move from rules-based to principles-based regulation of foreign exposure for institutional investors, and to finalise the definition of "foreign asset" that captures the underlying risks. The National Treasury will consult on these matters during 2010. For now, the existing inward listing policy and definition of foreign asset for companies – which is based on place of incorporation and/or primary listing – remain in place.

Reforming exchange control legislation

The National Treasury will release a framework document on reforming exchange control legislation. Preparatory work in this area will also inform a modernised approach to policy on inward and outward investment. The National Treasury will initiate public consultation on these reforms.

Gateway into Africa

Appropriately mandated private equity funds meeting certain criteria will be able to obtain upfront approval from the Reserve Bank for investments in Africa for up to one year.

Technical amendments to Regulation 28

Regulation 28 of the Pension Funds Act (1956) limits the amount and extent to which private pension funds may invest in certain asset categories. Technical amendments that cover a range of matters, including incentives to invest in Africa, will be released for public comment.

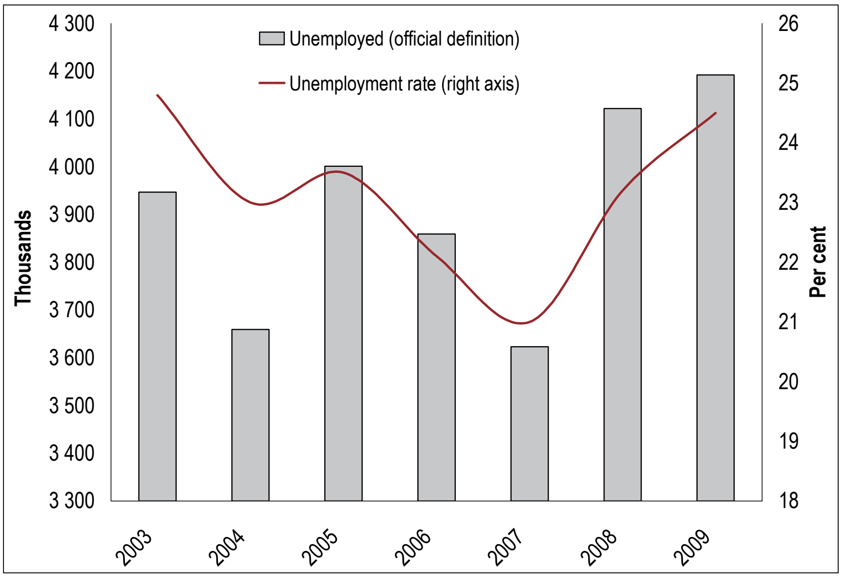
Further details concerning the above measures will be provided by the National Treasury or the Reserve Bank.

Employment and remuneration

South Africa's broad measure of unemployment now stands at 31 per cent

The recession resulted in a sharp fall in employment, with recorded job losses of 870 000 between December 2008 and December 2009. During this period the unemployment rate increased by 2.4 percentage points to 24.3 per cent. Taking into consideration the high number of people who stopped looking for work during that period, the broad unemployment rate increased sharply from 26.7 per cent to 31.1 per cent.

Figure 2.6 Official unemployment in South Africa, 2003 – 2009



'Stemming the rising tide of retrenchments is critical for us all. What will also be critical will be high-quality and courageous leadership from government, business and labour.' – *Minister of Labour Membathisi Mdladlana*

Total employment contracted by 6.3 per cent in December 2009 compared with the previous year. The pattern of annual job losses has broadly tracked sectoral growth trends, with the largest declines in agriculture, mining, manufacturing and trade. Construction also experienced job losses. The only sectors with positive employment gains in the 12 months to December were finance, insurance and business services and utilities.

Nominal wage settlements declined from 9.8 per cent in 2008 to an average of 9.3 per cent in 2009, resulting in real wage growth of about 2 per cent. However, pressure on wage settlements had subsided somewhat as inflation has trended lower. South Africa's international competitiveness is of decisive importance in shaping the country's long-term growth path. Productivity growth was less than 1 per cent in the first half of 2009, which caused unit labour costs to rise by an average of 9.6 per cent.

Table 2.8 Total employment per sector, December 2009

	Total employed (thousands)	% of total	Annual change (thousands)	Annual % change
Agriculture	615	4.7%	-149	-19.5%
Community and personal services	2 628	20.3%	-33	-1.2%
Construction	1 085	8.4%	-106	-8.9%
Finance, insurance and real estate	1 759	13.6%	123	7.5%
Manufacturing	1 742	13.4%	-202	-10.4%
Mining and quarrying	296	2.3%	-25	-7.8%
Private households	1 135	8.7%	-163	-12.6%
Retail and wholesale trade	2 873	22.1%	-291	-9.2%
Transport and communication	739	5.7%	-35	-4.5%
Utilities	98	0.8%	12	14.0%
Total	**12 974**	**100.0%**	**-870**	**-6.3%**

Source: Statistics South Africa

Monetary policy and inflation targeting

Monetary policy plays a crucial role in supporting sustainable growth and employment, and in protecting real incomes. Countries set policy, whether explicitly or implicitly, to target a low and stable rate of inflation to reduce the long-term cost of borrowing and provide confidence about the future. This in turn stimulates investment, employment and competitiveness – particularly among exporters and import-competing industries. Low inflation is especially important to protect the living standards of workers and the poor.

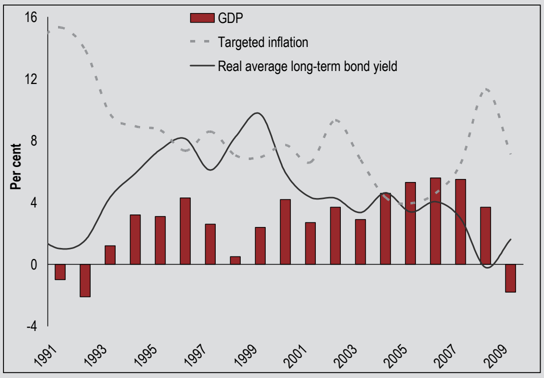
The global financial crisis has illustrated the need for central banks to monitor a broad range of indicators, including inflationary pressures and the development of economic imbalances that could exacerbate volatility in output and employment.

Section 224 (1) of the Constitution states "The primary objective of the South African Reserve Bank is to protect the value of the currency in the interest of balanced and sustainable economic growth."

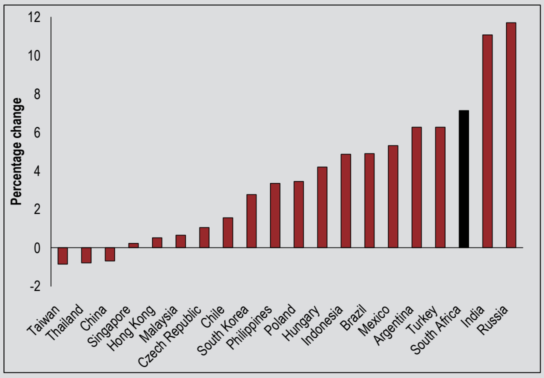
In exercising this mandate, the Reserve Bank will continue to pursue a target for CPI inflation of 3 to 6 per cent in a consistent, transparent and flexible manner. The existing framework allows for a temporary deviation of inflation from the target in event of shocks over which monetary policy has no control. The time frame for adjusting inflation back to within the target range should avoid unnecessary instability in output and interest rates, and should consider factors that affect the attainment of balanced and sustainable growth. These factors include the business cycle (and whether growth is above or below the economy's potential), credit extension and asset prices, labour market developments, and the stability and competitiveness of the exchange rate.

The graphs below show the relationship between growth and inflation in South Africa, and compare South Africa's inflation rate with those of other developing countries.

GDP growth, inflation and interest rates



Comparative country inflation rates



Domestic expenditure

As household consumption and private investment pick up, growth in domestic expenditure will recover

Gross domestic expenditure contracted by an estimated 1.9 per cent between 2008 and 2009. This reflected a sharp contraction in household consumption, slowing growth in gross fixed investment and a significant drawdown on real inventories. Estimated real growth in government consumption of 5.7 per cent in 2009 helped to cushion demand through the recession. Growth in domestic expenditure is expected to rise over the medium term to 3.1 per cent in 2010 and 3.8 per cent by 2012 as household consumption recovers and private investment picks up.

Household debt and consumption expenditure

Household consumption expenditure was very weak in 2009, with an estimated contraction of 3.5 per cent in the real value of spending compared with the previous year. Discretionary spending, especially on durable goods such as cars, was worst affected. The deterioration in the labour market, combined with pressure on asset prices and stubbornly high inflation, had a negative effect on real disposable incomes.

Despite a contraction in credit extension to households, the ratio of household debt to disposable income remained relatively high at 79 per cent in the third quarter of 2009. Household consumption is expected to recover gradually, supported by a stabilisation in the labour market and a slow revival in credit appetite. Growth of 0.9 per cent is projected for 2010, rising to 2.9 per cent by 2012.

Gross fixed capital formation

Growth in spending by public corporations offset a contraction in private investment

The ratio of gross fixed capital formation to GDP rose to 23.1 per cent in the first nine months of 2009 from 22.5 per cent in 2008. During that period, real investment spending expanded by 4.6 per cent compared with the previous year, with a 42.1 per cent expansion in spending by public corporations offsetting a 5.1 per cent contraction in private investment.

Between January and September 2009, private investment was cut back most sharply in the manufacturing sector, leading to a decline in spending on machinery and equipment. Investment in financial intermediation, insurance, real estate and other business services also declined, mostly due to lower investment in residential buildings.

Table 2.9 Average real growth in fixed investment by sector, 1960 – 2009

Percentage change	Mining	Manufac–turing	Electricity	Transport and communi–cation	Finance and real estate	Commu–nity and social services	Total
1960 – 1969	-0.6	10.4	9.2	4.3	9.8	10.3	**7.6**
1970 – 1979	10.5	6.3	10.0	4.8	-1.3	0.2	**3.5**
1980 – 1989	2.1	-4.0	-4.3	-5.6	2.9	0.7	**-1.5**
1990 – 1999	-2.1	2.2	-4.3	10.2	1.1	1.7	**1.7**
2000 – 2009[1]	8.6	4.4	24.1	13.4	5.9	8.8	**9.1**

1. First three quarters of 2009.

Capacity expansion in electricity has been a key driver of investment growth over past three years

Capacity expansion in the electricity sector has been by far the strongest driver of investment growth over the past three years. The pace of spending accelerated further in the first nine months of 2009, with growth of 74.3 per cent compared with 2008. Investment in transport, storage and communication also continued to expand at a healthy pace of 14.9 per cent in the first three quarters of 2009 compared with 2008.

The construction sector has been the main beneficiary of greater spending by public corporations, with total spending on construction investment rising to 31.6 per cent of total investment in the first nine months of 2009, from only 15.5 per cent in 2005.

Growth in fixed capital formation is expected to reach 5.8 per cent in 2010 and 8.7 per cent by 2012, supported by strong growth in public investment and a marginal resumption of growth in private investment.

Money supply and credit extension

Growth of broad money supply slowed sharply in 2009

The economic downturn and rapidly slowing credit growth reduced growth in the broad money supply to just 1.6 per cent in December 2009 from 14.8 per cent at the end of 2008.

Having supported strong household consumption growth since 2004, the total value of credit extended to the private sector slowed sharply during the course of 2009, ending the year 0.8 per cent lower compared with the previous year.

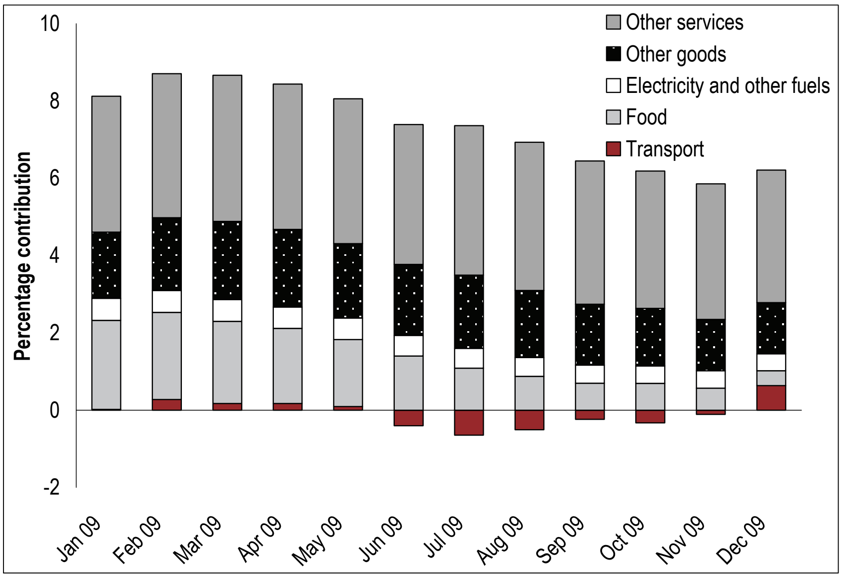
Credit extension to households increased by just 2.1 per cent in December 2009 compared with the previous year, while the value of corporate credit declined by 4.7 per cent. The contraction in credit extension was moderated by continued expansion in mortgage advances, which responded to improved conditions in the housing market in the second half of 2009.

Inflation and interest rates

More moderate prices for petrol and food contributed to lower inflation in 2009

CPI inflation declined from a peak of 13.6 per cent in August 2008 to 6.3 per cent in December 2009 as petrol prices fell and food prices moderated. Weak domestic demand combined with the recovery in the rand also dampened price pressures. While goods price inflation slowed to 5.5 per cent in December 2009, inflation for services remained relatively high at 7.2 per cent, led by insurance and rent. Excluding food, non-alcoholic beverages and petrol, the core measure of CPI fell to 6.7 per cent in December from 7.8 per cent at the start of the year.

Figure 2.7 Contributions to CPI inflation, 2009



Sharp increases in electricity tariffs have pushed inflation up by about 1.3 percentage points over the past two years. Large tariff increases are likely over the medium term, keeping CPI inflation close to the upper end of the inflation target range over the forecast period.

Inflation expectations have moderated, but remain high, with headline inflation expected to average 7.5 per cent in 2010

Although inflation expectations have moderated, data published by the Bureau for Economic Research shows that average inflation expectations remained elevated in the final quarter of 2009, with headline inflation expected to average 8.1 per cent in 2009, 7.5 per cent in 2010 and 7.7 per cent in 2011.

The Reserve Bank reduced the repo rate by 5 percentage points between December 2008 and August 2009. Adjusting interest rates for inflation, the real repo rate averaged about 1 per cent in 2009, compared with 3.5 per cent between 2003 and 2007.

Conclusion

Returning to growth of 5 per cent and higher requires a concerted effort to broaden economic participation

As South African production, consumption and investment recover and strengthen in the period ahead, fiscal and monetary policies will be managed responsibly to provide a sustainable platform for future growth.

Returning to annual growth rates of 5 per cent and higher will require much greater efforts to broaden economic participation to young people, rural communities and marginalised groups.

A range of microeconomic reforms is needed to complement the macroeconomic policies that are presently supporting the economy through the global recession. The quality of public inputs must be improved, public infrastructure needs to be extended, and more jobs must be created, particularly for young people, to ensure a better future for all.