2

Economic policy and outlook

- The global banking and credit crisis has precipitated a sharp and deep contraction in the world economy. The onset of recession in much of the developed world has affected developing countries through lower export demand, weaker commodity prices, higher cost of capital, reduced capital flows and falling asset prices. Stimulus measures in major economies should support a global recovery beginning in the second half of 2009, but the outlook is uncertain.
- Sound fiscal and monetary policies, a well-regulated financial system and prudential limits on foreign investment have helped to limit South Africa's exposure to the crisis. Economic growth is expected to weaken in response to the global slowdown, falling to 1.2 per cent in 2009 before recovering gradually to 4 per cent by 2011. Sluggish consumption, weak exports and slowing private-sector investment are expected in 2009.
- Government's countercyclical fiscal policy will support economic activity over the period ahead, accelerating the public-sector investment programme and increasing expenditure on social and economic priorities. Over the medium term, South Africa requires a series of microeconomic reforms to emerge from this crisis stronger and more globally competitive – to grow more rapidly, to create more jobs and to reduce inequality.

Introduction and overview

Macroeconomic conditions will be more difficult over the period ahead

The world economy is in the midst of the most far-reaching decline since the 1930s. Many of the benefits associated with the buoyant global conditions of the recent past will not be revisited for years to come. Macroeconomic conditions have become more difficult as investment flows to emerging markets dry up and the cost of capital on global markets becomes prohibitive.

A rise in the debt burden would severely limit future resources for growth and expanding the social wage

The central goals of economic policy remain accelerating growth and job creation, broadening economic participation and reducing poverty. Progress in these areas will be more difficult over the period ahead. Policy adjustments need to reinforce macroeconomic stability in the context of a deteriorating international environment and provide a temporary cushion to the domestic economy. To raise long-term economic growth above 6 per cent, government needs to prevent a large rise in the debt burden, which would severely limit future resources for growth and the expansion of the social wage. A supportive monetary stance is also required, and lower inflation in the months ahead should contribute to moderating interest rates.

Government will sustain public investment and protect low-income households

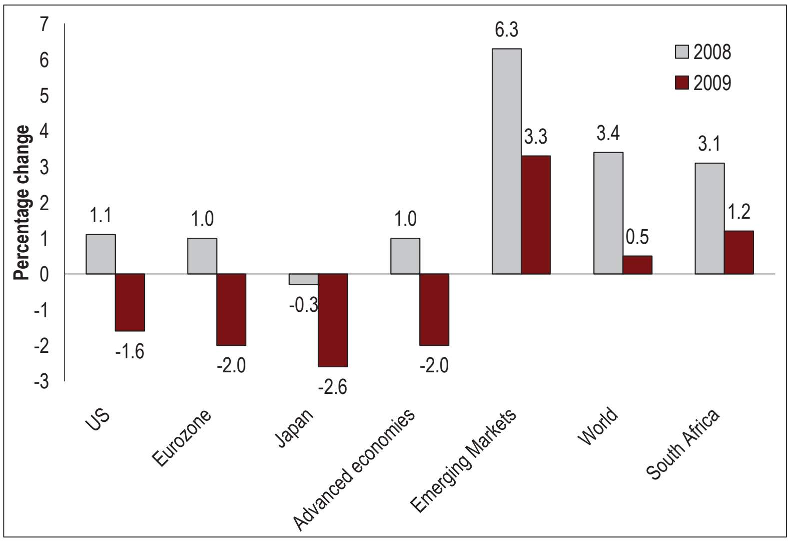
Government's fiscal stimulus seeks to prevent a reversal of improvements in living standards achieved over the past decade. Policy initiatives will support increasing investment in public infrastructure, the protection of low-income households, job creation through public works programmes, and partnerships between the public and private sectors to finance investment.

International and domestic outlook

Developed economies face recession; emerging economies will grow much more slowly

Economic conditions deteriorated rapidly for both developed and emerging economies in the final quarter of 2008. The International Monetary Fund (IMF) expects world growth of only 0.5 per cent in 2009, down from an estimated 3.4 per cent in 2008. Sharp contractions in developed economies and slower rates of growth in emerging markets are expected over the short term.

Figure 2.1 GDP growth, selected countries and regions, 2008-2009



National Treasury forecasts for South Africa; January 2009 IMF World Economic Outlook for others.

The length and depth of the global downturn will depend on the success of efforts to repair the balance sheets of banks in developed countries, to reopen credit channels, to keep markets open to traded goods and services, to implement appropriate fiscal stimulus plans and to restore confidence. Over the longer term, policy makers confront a need to unwind a systemic pattern of global economic imbalances, and to manage the rise in fiscal balances and public debt associated with large-scale bailouts and stimulus packages.

The global crisis and cyclical domestic factors have significantly reduced growth prospects

In combination with cyclical domestic factors, the international crisis has resulted in a significant deterioration in South Africa's growth outlook. GDP growth slowed to an estimated 3.1 per cent in 2008 after averaging 5 per cent in the previous four years. Household consumption has fallen in response to higher interest rates, reduced credit extension, pressure on disposable incomes from rising inflation, and negative wealth effects from declining equity and house prices. The rand fell to a more competitive level in response to capital outflows, but export volumes have been and will continue to be under pressure from reduced demand.

Growth is expected to slow to 1.2 per cent in 2009

GDP growth is projected to slow to 1.2 per cent in 2009. Economic activity is expected to start recovering in the second half of the year in response to declining debt levels, lower interest rates and a more expansionary fiscal policy. Strong growth in public-sector capital spending and investment associated with the 2010 FIFA World Cup will provide an important boost to the economy. Inflation is expected to fall back within the 3 to 6 per cent target band in the first half of the year.

Table 2.1 Macroeconomic projections, 2005 – 2011

Calendar year	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**
		Actual		**Estimate**		**Forecast**	
Percentage change unless otherwise indicated							
Final household consumption	6.9	8.3	6.6	2.5	-0.2	1.9	3.2
Final government consumption	4.8	5.1	4.8	4.5	4.0	4.0	4.0
Gross fixed capital formation	10.2	13.2	16.3	11.5	3.7	5.7	9.0
Gross domestic expenditure	5.7	9.1	6.0	3.4	0.2	4.0	5.0
Exports	8.0	6.0	7.5	2.1	-1.4	3.3	4.9
Imports	10.3	18.9	10.0	3.2	-3.7	6.7	7.7
Real GDP growth	**5.0**	**5.3**	**5.1**	**3.1**	**1.2**	**3.0**	**4.0**
GDP inflation	5.4	7.3	9.0	10.5	5.3	5.0	5.7
GDP at current prices (R billion)	**1 543.9**	**1 745.2**	**1 999.1**	**2 277.0**	**2 426.4**	**2 622.7**	**2 884.6**
Headline CPI inflation	3.3	4.6	7.2	11.6	5.8	5.3	4.7
Current account balance (% of GDP)	-4.0	-6.3	-7.3	-8.1	-6.3	-6.9	-6.9

Table 2.2 Macroeconomic projections, 2007/08 – 2011/12

Fiscal year	**2007/08**	**2008/09**	**2009/10**	**2010/11**	**2011/12**
	Actual	**Estimate**		**Forecast**	
GDP at current prices (R billion)	**2 067.9**	**2 304.1**	**2 474.2**	**2 686.3**	**2 953.0**
Real GDP growth	4.6	2.6	1.4	3.4	4.1
GDP inflation	9.2	8.6	5.9	5.0	5.6
Headline CPI inflation	8.1	10.8	5.4	5.1	4.6

A global financial markets crisis …

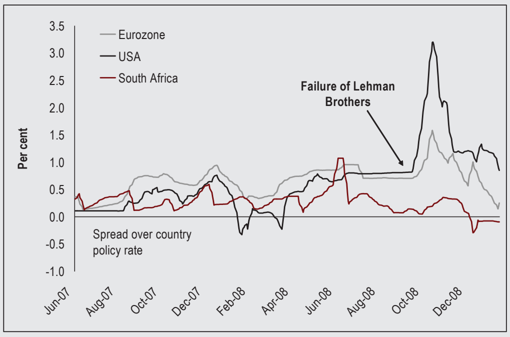
Until the US "subprime" crisis began to unfold in 2007, global asset prices had been supported for a number of years by large capital flows and low interest rates. Increased investor demand for higher-yielding but higher-risk assets encouraged banks to create an array of securitised debt products, backed by assets such as US home mortgages, which were sold to investors around the world.

When US interest rates started to rise and the housing market began to turn, loan defaults increased sharply. This undermined the value of securitised products and caused a seizure of credit markets as investors scrambled to reduce their very large exposure to bad assets. Banks with large holdings of such assets saw their balance sheets being severely eroded and their solvency under threat.

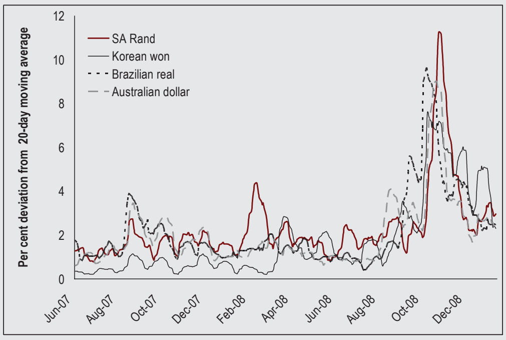
These stresses led to the near collapse of a number of US investment banks, and the demise of Lehman Brothers on 15 September 2008, which contributed to an evaporation of confidence in the global banking system. Since then central banks and governments have intervened on an unprecedented scale, committing more than US$4 trillion to rescue banks and injecting large amounts of liquidity into money markets. Despite signs of stabilisation, market volatility and risk premiums remain high, and developed-country bank balance sheets remain under pressure, severely constraining lending activities.

About US$17 trillion of global equity market capitalisation has been lost since September 2008. The capitalisation of the banking and insurance sector alone has declined by US$5 trillion since January 2007. Volatility remains high in equity and currency markets and commodity prices are down sharply.

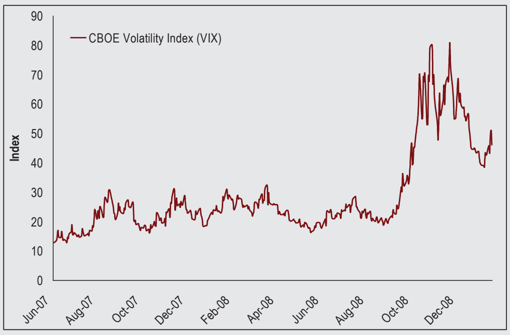
Money market spreads



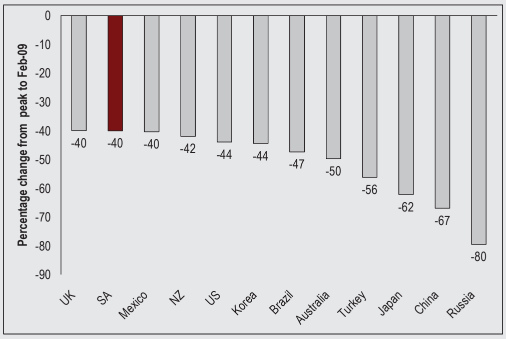
Exchange rate volatility



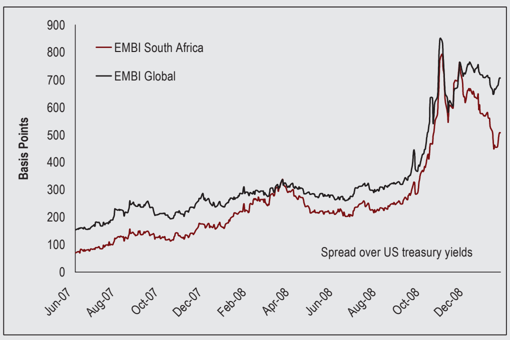
US equity market volatility



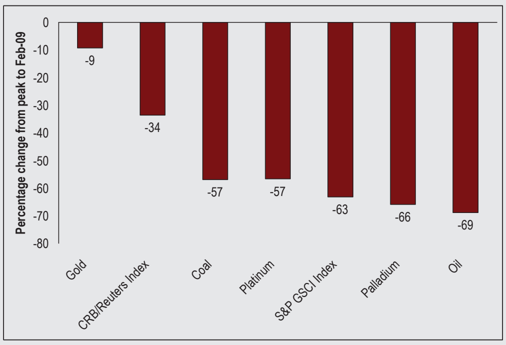
Local currency equity price indices



JPMorgan Emerging Market Bond Index Spread



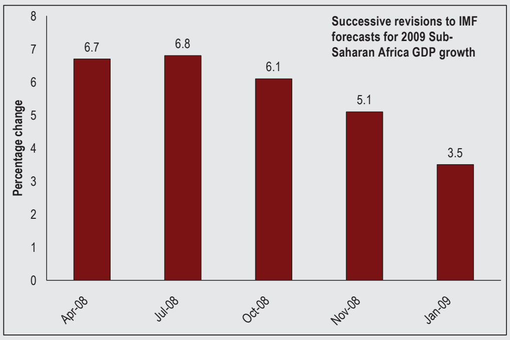
Change in commodity prices (US$)



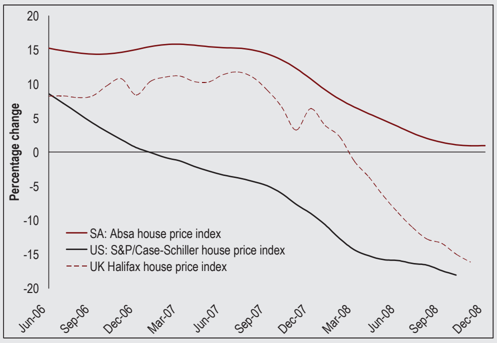
… and a deep downturn in the real economy

Countries at the centre of the crisis – the US, Japan, the UK and members of the European Union – have experienced sharp contractions in growth. Industrial production and exports in both developed and developing countries are in steep decline. Internationally, unemployment is growing rapidly in a range of sectors including financial services, motor vehicles and mining. The US shed 2.6 million jobs in 2008, lifting the unemployment rate to 7.2 per cent from 4.9 per cent at the start of the year. The falloff in export demand has led to large-scale retrenchments in China and other emerging markets.

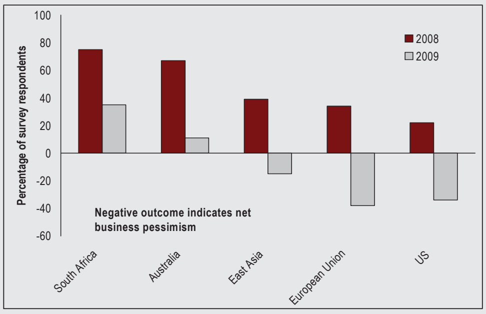
IMF projections: Africa GDP growth in 2009



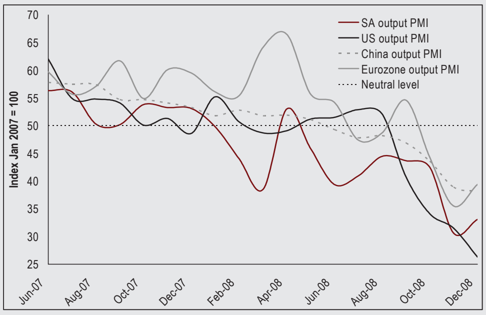
House prices



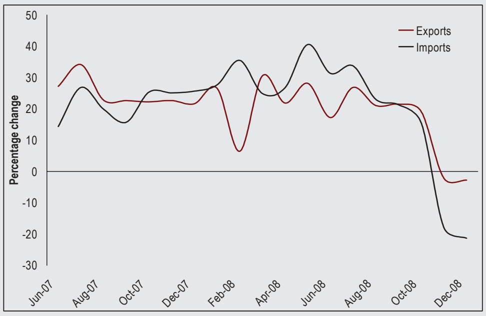
Business confidence



Global purchasing managers' indices

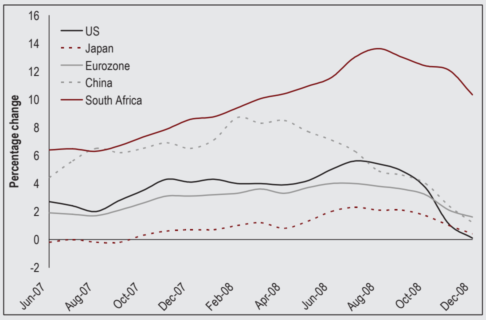


Chinese exports and imports

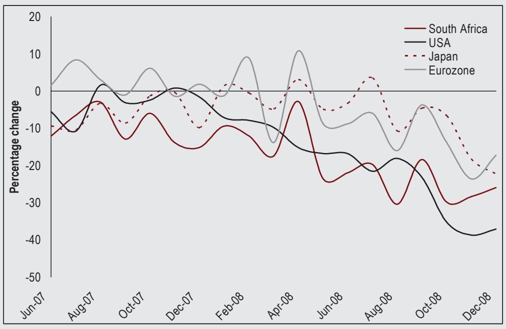


Baltic exchange dry shipping index

CPI inflation



Vehicle sales



The charts in this box are derived from a variety of sources including Bloomberg, the IMF, Grant Thornton and official country sources.

R787 billion infrastructure programme acts as part of broader countercyclical fiscal stimulus

Slowing economic growth has put pressure on government revenues and reduced the fiscal space for increased expenditure. However, government's record of sound fiscal management over the past decade will enable the state to sustain crucial expenditure on social services and investment in the period ahead. Government's R787 billion infrastructure programme serves several purposes in the current environment: it will strengthen the long-term growth potential of the economy and lower the cost of economic activity, it will compensate partially for lower levels of private investment, and it will act as part of the broader countercyclical fiscal stimulus.

Drying up of global liquidity and reduced risk appetite will challenge countries with high external funding needs

Risks to macroeconomic stability have been accentuated by the drying up of global liquidity and rising cost of capital. Country risk premiums have risen and capital flows to emerging markets have receded. Foreign investors sold R67.2 billion worth of bonds and equities in 2008. These changing investment patterns constitute a very serious challenge for countries with high external funding needs: investors are likely to demand higher returns to compensate for perceived risks and deteriorating economic performance.

South Africa's high current account deficit, measuring about 8.1 per cent of GDP in 2008, is expected to fall sharply in 2009 and average 6.7 per cent per year over the medium term. Relative to long-term averages, commodity prices are expected to remain high, supporting the terms of trade and the sustainability of the current account. As a large net oil importer, South Africa will benefit from the lower oil price. Gold's safe-haven status has supported a relatively high bullion price – at 115 per cent above its average level since 1994.

South Africa should continue to attract foreign capital. Strong public investment over the medium term will help to maintain comparatively good economic growth rates in a range of sectors. A healthy financial sector, low external debt levels, and deep and liquid domestic capital markets will help to sustain foreign investor interest in South Africa.

Fiscal measures and microeconomic reforms

Government will recapitalise development finance institutions to support investment and growth

The deterioration in the world economy is a setback to South Africa's economic progress, but government remains committed to reducing unemployment and poverty. In the short term, more expansionary fiscal policy will help to cushion the impact of slower growth on the poor and sustain investment in key network industries such as electricity and transport. Fiscal measures to support investment and poverty relief include:

- Recapitalisation of the development finance institutions. Domestic capital markets will be an important source of funding for public investment, supplemented by a recapitalisation of development finance institutions such as the Development Bank of Southern Africa to support investment and encourage risk-sharing with the private sector.
- Employment support. The second phase of the expanded public works programme focuses on creating longer-term public-sector jobs in areas such as home-based and community care, as well as

project-based employment in infrastructure and environmental protection.

- Support for the unemployed. The Unemployment Insurance Fund is well capitalised (R25.3 billion at end-March 2008) and able to meet a projected increase in claims. Reforms are under consideration to improve and extend unemployment benefits.
- Human capital and skills development. Developing human capital and strengthening the national skills base are core objectives of government spending. New funding will be allocated to further education and training.
- Income support. The number of South Africans receiving social grants expands to a projected 13.6 million in 2009, providing an important safety net for low-income households.

Macroeconomic stability and microeconomic reforms

A stable macroeconomic environment is a prerequisite for more rapid and shared growth

South Africa requires growth-enhancing economic reforms to improve productivity and export competitiveness, and to attract new investment. Such reforms, along with a commitment to improve the quality of public spending, are necessary to ensure a return to higher rates of economic growth once global conditions have improved.

It is essential to maintain macroeconomic policies that promote a stable economic environment and prevent inflation from undermining competitiveness. This is crucial to promote domestic and foreign investment, to finance the current account deficit, and to ensure sufficient fiscal resources to sustain spending on infrastructure and social needs.

New emphasis on higher standards for appropriate market conduct and banking-sector regulation

A well-regulated and adequately capitalised banking system, combined with prudential guidelines for foreign exposure, is also needed to manage financial and macroeconomic risks. Further emphasis will be placed on higher standards for appropriate market conduct alongside prudential regulation in the banking sector.

Productivity and export competitiveness can be improved by reducing the cost of doing business. Trade reform is needed to lower costs to consumers, reduce input costs, support diversification and promote competitiveness. Regulatory reform is needed to facilitate competition, protect consumer rights, support innovation and create greater flexibility in the business environment. In some areas, industrial support measures can promote development of new industries, and more work is needed to design effective policies that can boost employment and exports in competitive global markets. Investment and training in the manufacturing sector are supported by industrial subsidies announced in 2008.

Initiatives to promote more efficient use of energy and water resources

Over the long term environmental considerations will affect the sustainability of growth. Government will promote efficient use of energy and water resources by producers and households, alongside measures to mitigate the effects of climate change. Prices that reflect economic cost and well-structured environmental taxes should provide incentives for efficiency improvements and new investment.

Global developments

Global growth will be anaemic over the short term

Growth in the world economy is expected to slow to 0.5 per cent in 2009 from an estimated 3.4 per cent in 2008. Anaemic economic conditions will prevail through the first half of 2009.

The collapse in export demand and lower commodity prices have sharply reduced the growth outlook for developing countries, from 6.3 per cent in 2008 to 3.3 per cent in 2009. Reduced global liquidity and deleveraging by hedge funds and banks have led to a reversal of capital and investment flows to emerging markets, contributing to widespread exchange rate volatility and slowing economic activity.

Table 2.3 Annual percentage change in GDP and consumer price inflation, selected regions/countries, 2008 – 2010[1]

Region / Country	2008	2009	2010	2008	2009	2010
Percentage	GDP projections			CPI projections		
World	**3.4**	**0.5**	**3.0**	**5.1**	**1.4**	**2.3**
US	1.1	-1.6	1.6	3.8	-2.2	2.4
Euro area	1.0	-2.0	0.2	3.2	0.7	1.3
UK	0.7	-2.8	0.2	3.5	0.6	1.1
Japan	-0.3	-2.6	0.6	1.4	-0.3	-0.2
Emerging markets and developing countries	**6.3**	**3.3**	**5.0**	**8.8**	**4.6**	**3.5**
Emerging Asia	**7.8**	**5.5**	**6.9**	**6.8**	**2.6**	**2.2**
China	9.0	6.7	8.0	5.9	1.0	1.1
India	7.3	5.1	6.5	8.2	6.0	4.5
Africa	**5.2**	**3.4**	**4.9**	**10.8**	**7.1**	**5.9**
Sub-Saharan Africa	**5.4**	**3.5**	**5.0**	**11.3**	**7.5**	**6.4**
South Africa[2]	3.1	1.2	3.0	11.6	5.8	5.3

1. GDP projections: IMF, January 2009. CPI inflation projections: Global Insight, January 2009.
2. National Treasury forecasts.

International inflation is down sharply, largely on the oil price, and will continue to respond to weak demand

The inflation outlook has also changed markedly. Global inflation rose to 6 per cent in July 2008, fuelled by record-high commodity prices, tight labour markets and high capacity utilisation rates, but these factors have reversed with the onset of recession in advanced economies and a sharp decline in commodity prices – particularly oil. In the short term the declining inflation trend will be reinforced by weak economic conditions.

Trends in major economies and regions

- The United States has been in recession since the fourth quarter of 2007 and the economy is forecast to contract by 1.6 per cent in 2009. The Federal Reserve has cut interest rates to almost zero.
- Growth in the Eurozone slowed to 1 per cent in 2008 and is forecast to contract by 2 per cent in 2009. The UK economy is expected to shrink by 2.8 per cent in 2009.
- Export-oriented emerging economies are suffering from the decline in global demand. China's GDP growth fell to 6.8 per cent in the

final quarter of 2008 and is forecast to be 6.7 per cent in 2009, its lowest level since 1990.

- Sub-Saharan Africa is feeling the effects of the commodity price plunge and investor risk aversion. Projected growth for the region slows to 3.5 per cent in 2009 from 5.4 per cent in 2008.

Commodity price trends

- Commodity prices collapsed in the second half of 2008 after rising to record high levels early in the year. Between June 2008 and January 2009 the Bloomberg Global Commodity Index dropped by 41 per cent as demand fell and speculative positions were unwound.
- Oil prices plunged 69 per cent from a peak of US$145 a barrel in July 2008 to about US$45 per barrel at the start of February 2009. World oil consumption started to fall in the third quarter of 2008 in response to weaker global demand.
- The platinum price has fallen by about 57 per cent, from a record high of US$2 254/oz in March 2008 to US$976/oz at the beginning of February 2009, following the decline in world car sales. The gold price fell 9 per cent from US$1 003/oz in the first quarter of 2008 to about US$911/oz at the start of February 2009.

Balance of payments

The current account deficit is expected to average 6.7 per cent of GDP

The gap between savings and investment in South Africa widened further in 2008, pushing the current account deficit to an estimated 8.1 per cent of GDP from 7.3 per cent in 2007. Slower economic growth and higher savings will narrow the deficit in 2009, but imports associated with public and private infrastructure investment are expected to keep the average current account deficit at about 6.7 per cent of GDP over the medium term.

Capital inflows covered the current account deficit in the first nine months of 2008, with foreign direct investment (FDI) and other inflows rising relative to portfolio flows. Outflows from the equity markets in the fourth quarter highlight the ongoing risks presented by the global crisis to the balance of payments.

Table 2.4 Summary of South Africa's balance of payments, 2004 – 2008

Percentage of GDP	2004	2005	2006	2007	2008[1]
Total current account	**-3.2**	**-4.0**	**-6.3**	**-7.3**	**-8.1**
Trade balance	-0.1	-0.4	-2.3	-2.0	-2.1
Net services, income and transfer payments	-3.1	-3.6	-4.0	-5.3	-6.0
Net service payments	-0.3	-0.4	-0.9	-1.1	-1.6
Net income payments	-2.0	-2.0	-2.0	-3.2	-3.3
Net dividend payments	*-1.3*	*-1.6*	*-1.6*	*-2.9*	*-2.7*
Net transfer payments (mainly SACU)	-0.8	-1.2	-1.1	-1.0	-1.1
Current account excluding SACU transfers	-2.4	-2.8	-5.2	-6.3	-7.0
Financial account balance	**5.9**	**6.2**	**8.0**	**9.7**	**9.2**
Net portfolio investment	2.9	1.9	7.4	4.2	-0.7
Net foreign direct investment	-0.3	2.4	-2.6	1.0	3.2
Net other investment	0.6	0.6	1.3	3.0	4.5
Unrecorded transactions	2.6	1.3	1.9	1.5	2.2
Change in net reserves due to BoP transactions	**2.7**	**2.2**	**1.7**	**2.4**	**1.2**

1. Includes data for the first three quarters of the year, seasonally adjusted and annualised.

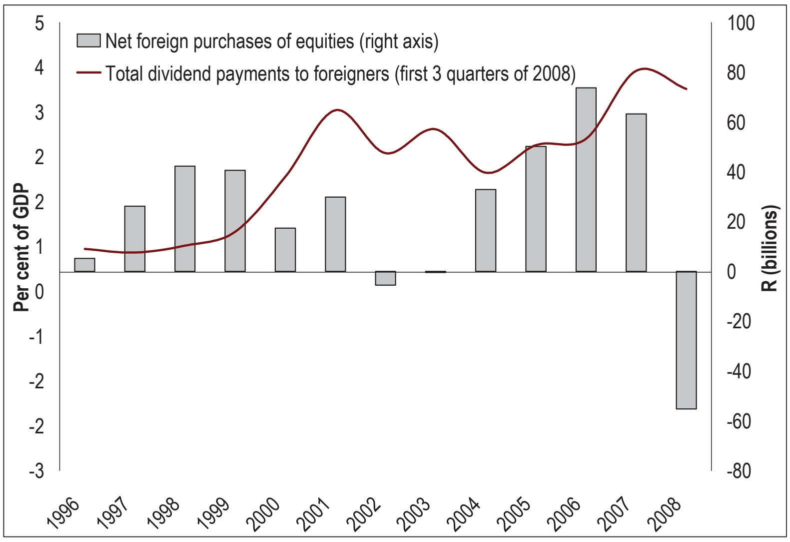
Source: Reserve Bank

Current account

The trade deficit has been a strong contributing factor to the current account deficit

A strong contributing factor to the current account deficit has been the deterioration in the trade balance, which moved from an almost balanced position in 2004 to a deficit of more than 2 per cent of GDP in less than two years. Transfer payments to other South African Customs Union members have steadied at about 1 per cent of GDP after rising sharply between 2003 and 2005. Growing service and income payments to international investors, in part due to higher dividend and interest payments arising from strong capital inflows, have also been a source of pressure on the current account. The trade and services and income payments deficits are expected to decline in 2009 and 2010 as growth slows and import prices moderate.

Figure 2.2 Portfolio investment and foreign dividend payments, 1996-2008



South Africa's terms of trade – the ratio of export to import prices – improved during the first part of 2008 as commodity prices rose to record high levels, but these gains were partially erased in the second half of the year. On average the terms of trade were 1.5 per cent higher in the nine months to September 2008 compared with the same period in 2007. Export and import values in 2008 were driven sharply higher by a weaker rand and high inflation, increasing by 35 and 30 per cent in 2008 compared with 2007, respectively.

Terms of trade improved in early 2008, but deteriorated as commodity prices fell

Export volumes were volatile due to disruptions to electricity supply in early 2008, and increased by only 3.5 per cent in the first nine months of the year compared with the same period in 2007. The outlook for exports has subsequently been clouded by the collapse in global demand. Table 2.5 shows that South Africa's export profile remains heavily tilted towards minerals and metals.

Growth in import volumes slowed to 4.4 per cent in the first nine months of 2008 after expanding at an average annual rate of 13.5 per cent between 2004 and 2007. The value of mineral product imports such as crude oil and refined petroleum products increased 57.2 per cent in 2008 due to high oil prices in the first half of the year, higher oil demand in the economy and the weaker exchange rate. Lower consumer demand and the softer real exchange rate should dampen import demand in 2009, but infrastructure investment will continue to draw in capital goods.

Import demand is likely to decline, offset by capital goods requirements

Table 2.5 South Africa's imports, exports and trade balances, 2008

	Share of total trade		Trade balance		
R billion	Exports	Imports	2000	2004	2008
Precious metals and stones	23.1%	1.3%	38.2	74.5	143.5
Base metals	17.3%	4.9%	23.8	44.2	78.7
Agricultural produce, food and beverages	7.2%	5.4%	7.7	7.9	8.4
Pulp and paper products	1.8%	1.5%	2.9	1.3	1.2
Transport and equipment	10.3%	9.7%	0.2	-15.8	-2.6
Miscellaneous manufacturing	0.8%	1.4%	0.2	0.2	-4.8
Textiles, clothing, footware and accessories	0.9%	3.1%	-3.6	-7.9	-16.5
Chemical products, plastics and rubber	8.7%	12.2%	-12.3	-16.5	-31.6
Mineral products	18.3%	23.7%	-0.5	-12.1	-51.6
Other[1]	2.0%	11.3%	2.2	-35.3	-68.6
Machinery and appliances	9.8%	25.5%	-38.8	-55.7	-120.7
Total	**100.0%**	**100.0%**	**20.0**	**-15.2**	**-64.5**

1. Includes optical and photographical equipment, wood, hides, leather and skin, works of art and unclassified.
Source: South African Revenue Service, unaudited figures for 2008.

Financial account

Over the past five years the financing of the current account deficit has been heavily dependent on portfolio inflows to the equity and bond markets. Though still adequate to finance the current account deficit, the composition of inflows changed significantly in 2008. Net portfolio outflows were recorded in the third quarter and outflows accelerated in October and November at the height of global deleveraging. International investors were net sellers of R54.4 billion in equities and R12.8 billion in bonds in 2008. Portfolio outflows were

Composition of the financial account is changing in line with capital flows offset by inward FDI, increased use of loan financing, repatriation of foreign assets by the banking sector and unrecorded transactions.

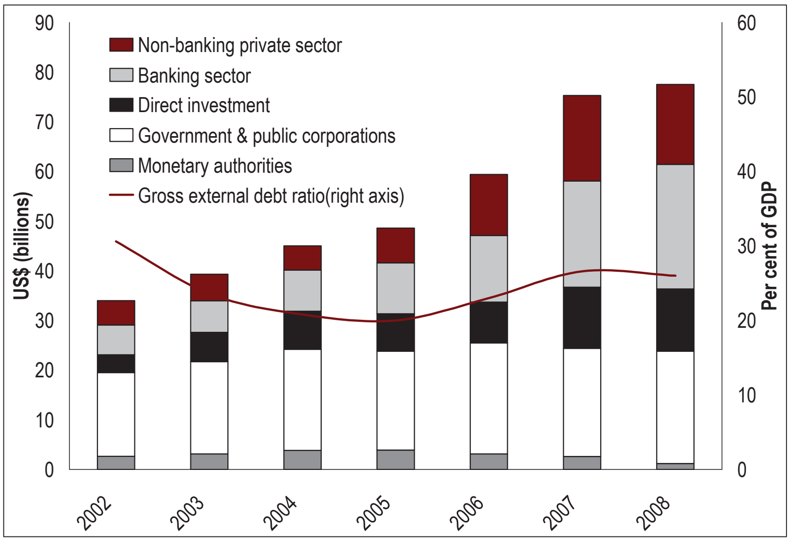
Inward FDI totalled R69.4 billion during the first nine months of 2008, with net FDI of R53.7 billion. The sectors that attracted foreign inflows were financial services, motor vehicles and beverages.

South Africa will remain a favoured destination as a corporate gateway to Africa

Although South Africa will remain a favoured destination for companies looking to expand their presence in Africa, the global economic slowdown will reduce cross-border corporate activity over the near term. The value of global cross-border mergers and acquisitions fell by 27 per cent in 2008 to US$1.2 trillion.

Although South Africa's overall level of foreign debt remains low, the private sector has made increased use of foreign loans to finance investment over the past three years. Gross foreign debt increased to about 26 per cent of GDP in September 2008 from 20 per cent in 2005. This includes rand-denominated debt instruments issued by the public and private sectors that are purchased by non-residents.

Figure 2.3 South Africa's gross external debt, 2002 - 2008



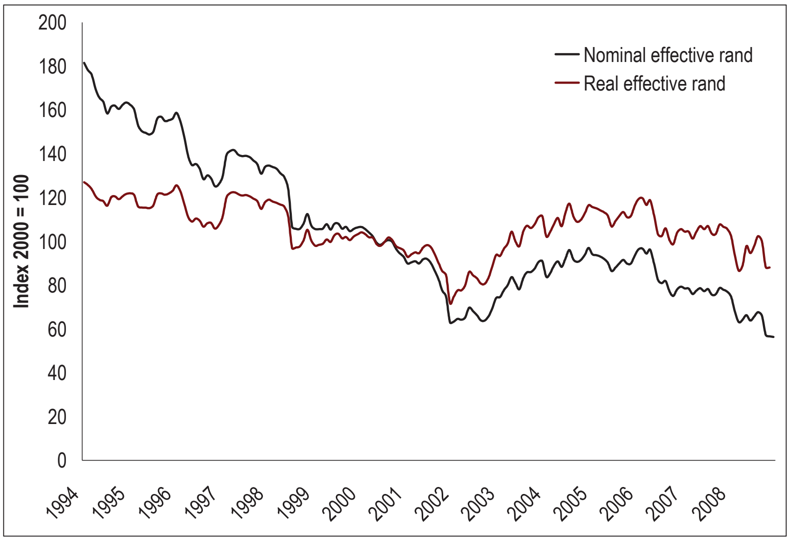
Calculations based on year-end debt stock, except 2008 which is up to September.

Exchange rate and international reserves

Exchange rate volatility increased in 2008

Exchange rates became highly volatile during 2008 as a consequence of risk aversion and dramatic movements in commodity prices.

Figure 2.4 Nominal and real effective rand indices, 1994-2008



The nominal effective rand exchange rate declined by 26.8 per cent in 2008, affected by investor flight to the dollar and reduced global liquidity. The floating exchange rate helped to cushion the impact of the commodity and capital flow shocks on the real economy, but the competitiveness gain from the weaker exchange rate was reduced by rising inflation. The real effective exchange rate declined by 17.4 per cent in the 12 months to November 2008.

Competitiveness gain from weaker rand was reduced by rising inflation in 2008

Gross gold and foreign exchange reserves increased modestly to US$34.1 billion at the end of 2008 from US$33 billion a year earlier. The value of reserves is subject to fluctuations in the gold price and exchange rates. South Africa's international liquidity position reached US$33.5 billion in December 2008, up from US$31.3 billion at the end of 2007.

South Africa's net reserves reached US$33.5 billion in 2008

Real output trends

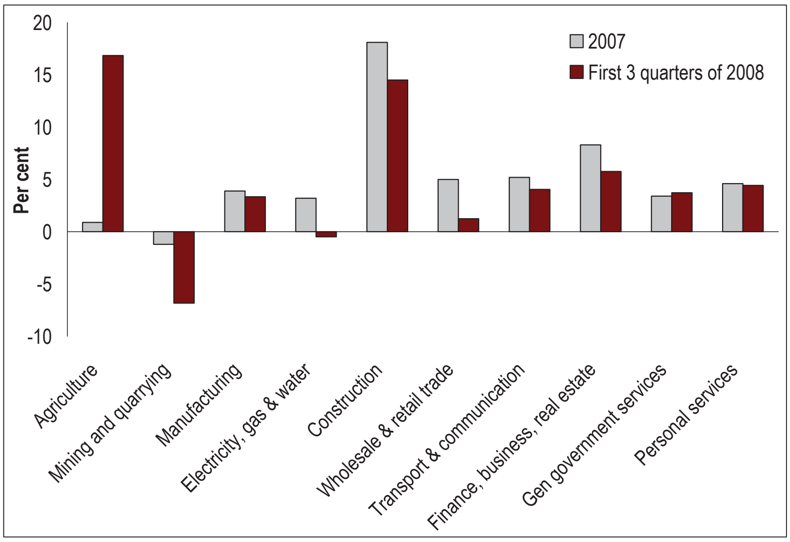
Over the past five years the pattern of GDP growth has been marked by strong performances in sectors with exposure to domestic demand, such as wholesale and retail trade, banking and financial services, real estate, transport and construction. Manufacturing growth slightly underperformed overall domestic growth over that period, while agriculture and mining displayed a greater degree of volatility.

South African producers were affected by a series of economic shocks in the first nine months of 2008, including electricity shortages, rising input costs, higher interest rates and slowing demand. This led to a marked slowdown in consumer-oriented sectors and weak mining and manufacturing output. Construction performed strongly, supported by ongoing infrastructure investment.

Construction performed strongly, supported by infrastructure investment

Challenges intensified in the fourth quarter as global confidence collapsed and external demand declined. Real GDP growth is expected to average 3.1 per cent in 2008 as a whole and slow to 1.2 per cent in 2009.

Figure 2.5 Growth in real value added by sector, 2007-2008



Agriculture

Agriculture, supported by high crop yields, was the best performer in 2008

Agriculture, fisheries and forestry was the best-performing domestic economic sector in the first nine months of 2008, with growth of 14.6 per cent compared with 2.3 per cent in the same period in 2007. Favourable weather supported higher-than-expected crop yields. During the first half of 2008, the prices of maize, sunflower seeds and wheat rose to record highs.

The maize crop for the 2007/08 season was 78 per cent higher than the previous year and the 2008 wheat crop is expected to be 9.2 per cent higher. However, the area planted for major summer crops is slightly lower than last year mainly due to a 7.3 per cent fall in maize plantings for the 2008/09 season.

Mining

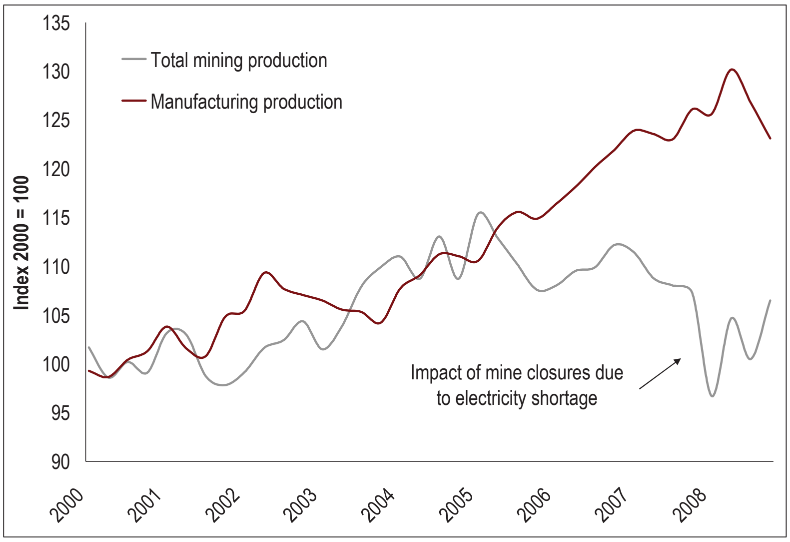
Electricity failures contributed to a poor mining performance in 2008

The mining sector had another poor year in 2008, with output contracting for the third year in succession. Output fell by 6.9 per cent in the first 11 months of 2008, with lower production of diamonds, copper, nickel, gold and platinum group metals. Last year gold production was about 21 per cent below that of 2006, lowering South Africa to third place in global production after China and the US.

The sector was set back by electricity supply failures and shutdowns related to mine safety, followed by retreating commodity prices and weakening international demand. The shortage of electricity had a severe effect, with mining operations shut down for two weeks in January 2008, after which supply was limited to about 95 per cent of required capacity.

Electricity supply constraints, along with the weaker global outlook, are likely to have a negative impact on new mining investment. Most mining houses have said that capital projects are under review or on hold.

Figure 2.6 Production indices for total mining and manufacturing, 2000-2008



The fourth quarter of 2008 is the average index level for October and November.

Manufacturing

After growing at an average rate of about 4 per cent a year between 2003 and 2007, growth in manufacturing output fell below 3 per cent in 2008. Output slid sharply on the electricity crisis in the first quarter of 2008, followed by the rapid deterioration in global and household demand, which contributed to production falling 4.4 per cent in November from a year earlier.

Manufacturing output growth fell below 3 per cent in 2008

Export earnings for manufactured goods increased in 2008, reflecting price effects from the weaker exchange rate. Chemicals and motor vehicles recorded solid volume growth. All export sectors are at risk from declining global growth and output has already fallen sharply in sectors most sensitive to international demand. Production of basic iron and steel products plunged more than 40 per cent between November 2007 and November 2008, while parts and accessories for vehicles and fully assembled vehicles declined by 31.5 per cent and 22.6 per cent respectively.

All export sectors are at risk from reduced world demand

Electricity and water

Electricity production fell by 1.2 per cent in the first 11 months of 2008 compared with 2007. Consumption was down by 1.5 per cent due to power cuts and energy-efficiency initiatives. Though Eskom's reserve margin is still low, the electricity system is much more stable than a year ago due to lower demand, larger coal stockpiles and improved system maintenance.

Larger coal stockpiles and better maintenance have improved stability of electricity system

Over the past year, higher coal and diesel prices have significantly raised the cost of electricity generation. The National Energy Regulator approved price increases of 27.5 per cent for 2008 and indicated that prices are likely to increase by between 20 and 25 per cent a year over the next three years. Over the medium term, it is expected that investment in new power projects and demand-side management measures will result in more reliable electricity supply. Price increases should in due course align the price of power to the cost of supply, encouraging more efficient electricity use.

Improved maintenance, new dams and adjusted tariffs will support better water supply management

South Africa faces similar challenges with regard to water supply as demand growth outstrips supply. Better maintenance of infrastructure, new dam construction and cost-reflective tariffs will ensure that the supply challenges are managed in future.

Construction

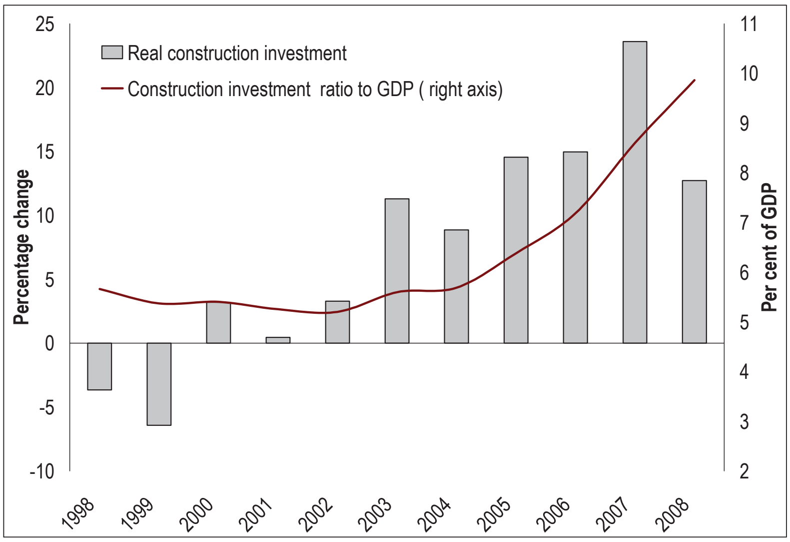
After agriculture, construction was the best-performing sector in the first nine months of 2008, with gross value added expanding by 14.5 per cent, following exceptional growth of 17.2 per cent over the same period in 2007. The resilience of construction, despite a sharp slowdown in residential activity, is supported by continuing growth in infrastructure investment, particularly in transport, water, electricity and stadiums for the 2010 FIFA World Cup.

Residential building activity has declined in response to the housing market correction. The volume of residential building plans passed by large municipalities fell by 24.3 per cent in the first 11 months of 2008, and residential activity is likely to remain subdued until the cost of borrowing falls and the housing market stabilises.

International slowdown in construction is likely to result in greater skills availability in South Africa

Though the private sector is likely to curtail investment spending in 2009, the public-sector investment programme remains on track and is expected to support civil construction activity over the medium term. The international slowdown in building and construction activity should increase the availability of skilled personnel for local projects, while slower demand should also increase competition among contractors and lower building cost inflation.

Figure 2.7 Investment in construction works and buildings, 1998-2008



Data for 2008 is for the first three quarters of the year.

Financial services

The finance, insurance, real estate and business services sector grew by 5.8 per cent in the first nine months of 2008 compared to 6.4 per cent in the same period in 2007.

Domestic banking sector remains relatively insulated from the global crisis

The domestic banking sector has been relatively insulated from the global financial crisis due to adequate levels of capitalisation and low exposure to risky offshore assets. However, the cooling housing market, increased cost of borrowing and pressure on household disposable income have dampened sector profitability. More stringent criteria are being applied to new loan approvals in the wake of the global credit crunch. Non-performing loans as a percentage of gross loans and advances rose from 2 per cent in January 2008 to 2.9 per cent in August, but remain at manageable levels.

Transport and communication

Value added by the transport and communication sector grew by 4.1 per cent in the first three quarters of 2008 compared with 5.7 per cent in the same period in 2007.

Investments in airports, rail and roads contribute to strong growth in transport sector

Investment in the transport sector increased strongly in the first nine months of 2008, driven in part by state-owned enterprises' infrastructure expansion programmes, such as the upgrading of airport terminals ahead of the 2010 FIFA World Cup and a major national roads maintenance programme. Investment in transport-related infrastructure projects will total R50.9 billion over the next three years. Transnet will invest R80.3 billion over the next five years to build a multi-product pipeline from Durban to Gauteng, expand the ports of Durban and Cape Town, and extend the coal and iron ore rail lines. Such investments are necessary to expand export capacity.

Undersea cable project will boost internet bandwidth in 21 African countries

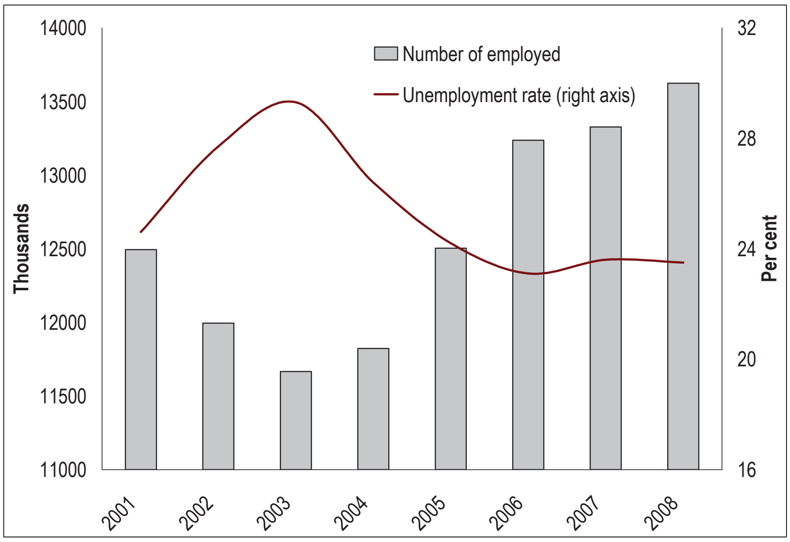
The communication sector has also benefited from significant capacity expansion. To improve coverage and bandwidth by 2010, Telkom expects to spend R11.3 billion in 2008/09. Neotel, the second fixed-line operator, plans to invest R11 billion on its network over the next decade. The Eastern Africa Submarine Cable System, which will increase the bandwidth available to 21 African countries, including South Africa, is expected to be completed in the second half of 2010. Telkom, Neotel and MTN are partly funding the cable.

Employment and remuneration

The economy created nearly 2 million jobs over the past five years

The South African economy created nearly 2 million jobs over the past five years, lowering the unemployment rate from about 30 per cent to 23.2 per cent. Employment continued to rise in the first nine months of 2008, though at a slower pace. Non-agricultural formal employment grew by an estimated 1.8 per cent (149 000 jobs) between September 2007 and September 2008 after growth of 2.7 per cent in the previous year.

Figure 2.8 Labour market trends, 2001 – 2008



Includes historical revisions of Statistics South Africa's March Labour Force Survey.

Employment gains were largely concentrated in service-oriented sectors such as community and personal services, and financial intermediation. Mining employment was buoyed by rising commodity prices in the year to September 2008.

Slowdown is leading to retrenchments in mining and retail trade

These increases in employment are at risk, however, as slower consumer spending and lower commodity prices have led to retrenchments in the retail trade sector and in mining. The sharp contraction in residential building activity has reduced employment in construction. Manufacturing employment has also declined.

Table 2.6 Employment in the formal non-agricultural sectors, September 2008

Thousands	Total employed	Annual change	Change from Sep 2007	Percentage of total
Mining and quarrying	528	23	4.6%	6.2%
Manufacturing	1 288	-30	-2.3%	15.2%
Utilities	59	4	7.3%	0.7%
Construction	470	-5	-1.1%	5.5%
Retail and wholesale trade	1 723	-18	-1.0%	20.3%
Finance, insurance, real estate	1 927	76	4.1%	22.7%
Transport & communication	365	7	2.0%	4.3%
Community & personal	2 132	92	4.5%	25.1%
Total	**8 492**	**149**	**1.8%**	**100.0%**

Source: Statistics South Africa

Nominal wage settlements were up strongly in 2008

Nominal wage settlements averaged 9.8 per cent in 2008, up from 7.3 per cent in 2007, in response to rising inflation and pressures on disposable income from high food and petrol prices. Growth in real wages and unit labour costs, however, has been moderate, and this will tend to support employment as economic growth weakens.

Domestic expenditure

Real growth in gross domestic expenditure slowed to an estimated 3.4 per cent in 2008 after growing at an average annual rate of 7.2 per cent between 2004 and 2007. This mainly reflects much slower growth in household consumption, which was partly offset by continued growth in investment expenditure and government consumption.

Gross domestic expenditure growth slowed to about 3.4 per cent in 2008

Table 2.7 Weighted contribution to domestic final demand, 2000 – 2008

Per cent	2000	2005	2006	2007	2008[1]
Household consumption expenditure	2.7	4.3	5.3	4.2	2.0
Government consumption expenditure	0.5	0.9	0.9	0.9	0.8
Gross fixed capital formation	0.7	1.8	2.3	2.9	2.4
Domestic final demand	**3.9**	**7.0**	**8.5**	**8.0**	**5.2**

1. Includes data for the first three quarters of the year.

Source: Reserve Bank

Household debt and consumption expenditure

After several years during which household debt rose strongly, growth in consumption spending has slowed sharply, to an estimated 2.5 per cent in 2008. The deceleration in household spending growth has been more prominent in consumer durable goods than services.

Households have been affected by rapidly rising inflation, higher interest rates and receding wealth effects from falling property and equity prices. Reduced spending has improved household savings and lowered debt. The ratio of household debt to disposable income fell from 78.5 per cent to 75.3 per cent in the third quarter of 2008 and is likely to have fallen further in the fourth quarter. Real consumption is expected to decline by 0.2 per cent in 2009 before resuming growth of 1.9 per cent in 2010 and 3.2 per cent in 2011. Households will benefit from lower petrol prices, falling inflation and reduced interest rates in the period ahead.

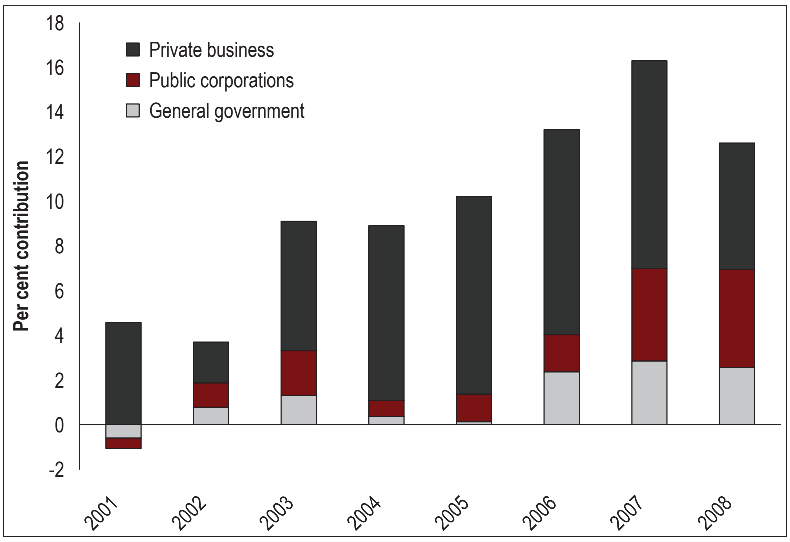
Households will benefit from cheaper petrol, lower inflation and reduced interest rates in 2009

Gross fixed capital formation

Sustained increases in public-sector investment over the past several years and higher commodity prices contributed to the strong rise in fixed investment to 24 per cent of GDP in the third quarter of 2008, its highest level since 1985. Fixed investment growth for 2008 is projected at 11.5 per cent for the year as a whole.

In the third quarter of 2008 fixed investment reached its highest level since 1985

Figure 2.9 Weighted contributions to total fixed investment growth, 2001-2008



Data for 2008 is for the first three quarters of the year.

Weight of public sector is becoming more pronounced in fixed investment

The impetus for growth is shifting from the private sector to general government and public corporations, which expanded real spending by 17.1 per cent and 33.7 per cent respectively in the first three quarters of 2008. The share of private spending in total investment fell from a peak of 74.8 per cent in the fourth quarter of 2005 to 66.6 per cent in the third quarter of 2008, while the share of public corporations rose from 11.2 per cent to 16.8 per cent during that time. General government accounts for 16.7 per cent of total investment.

The sharp rise in spending by public corporations is most striking in the electricity sector, where investment grew by 44.7 per cent in the first nine months of 2008. Transport and communications was the second-strongest performer, growing 20.3 per cent in the first three quarters of 2008 compared with 2007. Spending in these areas is having the greatest impact on investment in construction works, non-residential buildings and machinery and other equipment, which saw growth of 28.9 per cent, 15.4 per cent and 15.1 per cent respectively in the first nine months of 2008.

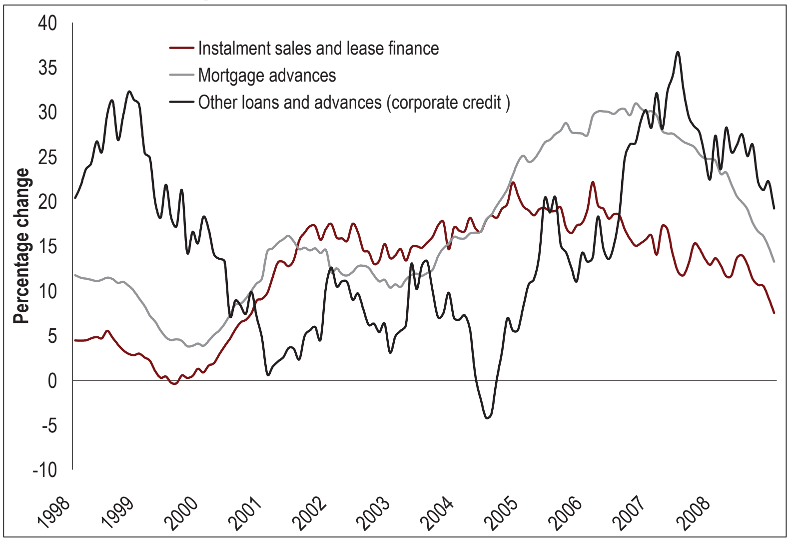
Money supply and credit extension

Slower credit extension has reduced growth in broad money supply

Slower credit growth dampened the pace of expansion in broad money supply (M3) to 14.5 per cent in December 2008, down from 23.6 per cent a year earlier.

Rapid growth in credit extension supported booming household consumption over the past five years. Credit growth moderated to 14 per cent in December 2008 from 23 per cent at the start of the year. Stagnant house prices and the National Credit Act have slowed growth in mortgage advances, which make up almost half of total credit extension, to 13.2 per cent in December 2008 from a peak of 30.9 per cent in October 2006. Credit extension to the corporate sector has also softened.

Figure 2.10 Growth in private-sector credit extension components, 1998-2008

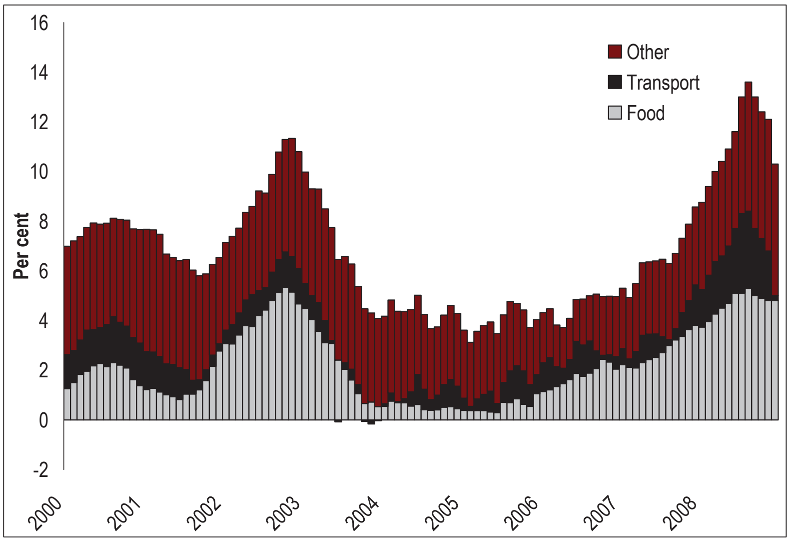


Inflation and interest rates

Lower inflation will make room for interest rate cuts, supporting credit extension

Over the past two years inflation has been fuelled by rapid increases in food and oil prices, domestic capacity constraints, a weaker rand exchange rate and adjustments to electricity tariffs. CPIX inflation averaged 11.3 per cent in 2008. Lower oil and food prices, and weak domestic demand, are expected to bring inflation back within the 3 to 6 per cent target band during the first half of 2009. This will help to make room for monetary easing in the coming months, supporting credit extension to businesses and households.

Figure 2.11 Contributions to CPIX inflation, 2000-2008



Reweighted and rebased CPI replaces CPIX as target measure of inflation

From January 2009, headline CPI for all urban areas will replace CPIX as the new target measure of inflation. The reweighting and rebasing of the index is expected to result in a technical drop in the rate of CPI inflation for January, which will be released on 25 February.

Long-term inflation outlook is improving and monetary policy is adjusting

Long-term inflation expectations have improved. CPI inflation expectations for 2009 (surveyed in December 2008) decreased by 0.1 percentage point to 8.6 per cent and expectations for 2010 declined by 0.2 percentage points to 7.5 per cent. In response to the improved inflation outlook, the Reserve Bank cut interest rates in December 2008 and February 2009 by a cumulative total of 1.5 percentage points.

Conclusion

Policy supports a gradual recovery, but much depends on global environment

The effects of the global downturn will be felt for some time to come. Though economic activity is expected to contract most severely in developed countries, the ripple effects of weak demand, low confidence and reduced liquidity are being felt in every corner of the globe. Policy measures to restore market liquidity and to support domestic demand will help to lay the foundations for a gradual recovery. However, the outlook remains highly uncertain and the risks favour a more prolonged slump if developed-country efforts to stabilise the balance sheets of loss-making banks and financial institutions fail.

South Africa's financial system has weathered the storm well so far, but the global contraction will constrain economic growth over the medium term.

South Africa must emerge from the crisis more productive and competitive

More expansionary fiscal and monetary policies will support a gradual recovery in domestic demand and help to sustain investments in public infrastructure that are essential for long-term growth. But with sights still set on the attainment of a higher sustainable rate of growth needed to reduce high levels of unemployment and poverty, South Africa must emerge from this crisis more productive and more globally competitive. This will require rapid progress on a range of microeconomic reforms to improve education and skills, lower the cost of doing business, ensure more efficient use of scarce resources, and improve the quality of government spending.