Annual Economic Report

2010

South African Reserve Bank

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ISSN 0081-2528

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Introduction

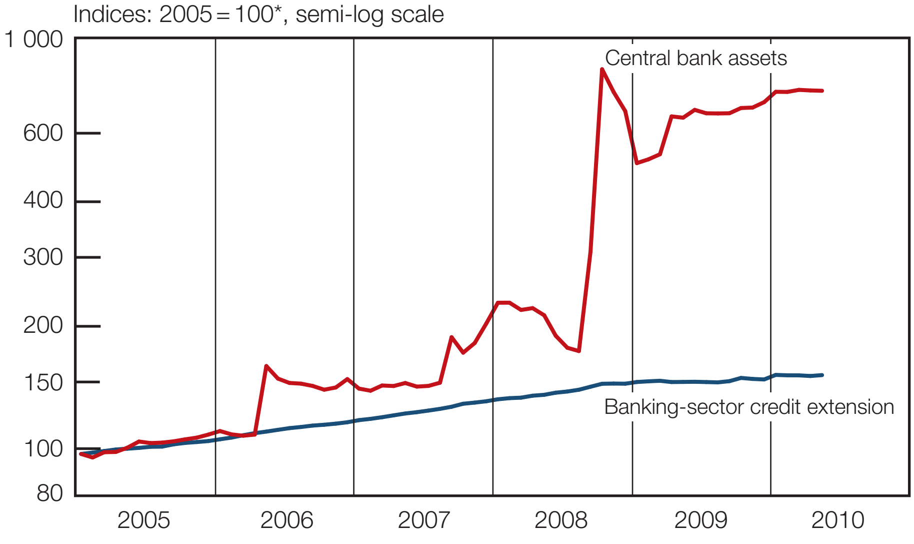
Following the severe recessionary conditions in the year to mid-2009 when the financial crisis disrupted credit extension and paralysed trade and income flows, the past year has been a period of somewhat uncertain and uneven recovery in the global economy. Strongly stimulatory monetary and fiscal policy measures were adopted in most parts of the world in order to restore and nurture economic growth. Large fiscal deficits, however, resulted in a rapid escalation of government debt which triggered severe concerns about fiscal sustainability in a number of countries with high sovereign debt ratios and structural weaknesses. With investors fearing sovereign default, bond yields in Greece and a number of other European countries surged in the first four months of 2010. Calm was only restored in May after the European authorities and the International Monetary Fund (IMF) had announced a large support package to provide overindebted governments with breathing space while restoring fiscal discipline and implementing structural reforms. At the Group of Twenty (G-20) Toronto summit held in June 2010, governments also committed themselves to a programme of reducing large fiscal deficits in a measured way over the medium term. However, some concerns continued to linger regarding the ability of governments to effectively implement austerity measures.

During the past year nominal interest rates remained very low in most of the developed economies, in many cases supplemented by the use of quantitative easing measures to expand liquidity. While central bank balance sheets expanded strongly in this process, private-banking-sector balance sheets were less responsive, as credit extension in these mature economies remained weak.

Throughout the financial crisis, the associated recession and the subsequent recovery, economic growth in emerging-market and developing economies was more robust than in developed economies, with China and India in particular maintaining strong momentum. This provided some traction to help sustain the underlying global economic recovery, which appeared to be losing some momentum as the year progressed due to fragility in a number of economies.

United States, eurozone and United Kingdom: Central bank assets and banking-sector credit extension

Indices: 2005 = 100*, semi-log scale



* Weighted indices

While global consumer price inflation remained low, international commodity prices were bolstered by the economic recovery and strong demand from China. This provided support to economic activity in commodity-exporting countries, among others in Africa. Recent projections put the real growth rate of the African continent for 2010 at more than 5 per cent.

Broadly mirroring developments in global economic activity, the real gross domestic product of South Africa contracted from the final quarter of 2008 to the second quarter of 2009, resuming positive growth thereafter. Activity picked up and registered a brisk rate of growth in the first quarter of 2010, before decelerating somewhat in the second quarter. The resumption of positive growth was spearheaded by the tradeables sectors, particularly manufacturing, which had previously also contracted severely during the global recession. Growth in the services sectors also gained momentum in the first half of 2010.

Among the expenditure components, real government consumption expenditure rose briskly over the past year. Real final consumption expenditure by households contracted throughout the first three quarters of 2009 but recovered thereafter, facilitated by lower interest rates, above-inflation salary increases and improvements in confidence. The recent increases were concentrated in expenditure on durable and semi-durable goods, with purchases of television sets, among other things, bolstered as the 2010 FIFA World Cup™ tournament approached.

Real fixed capital formation by the private sector contracted over the past year, reflecting the large output gap in the economy. By contrast, real capital expenditure by the public sector increased as the expansion of infrastructure continued, partly in final preparation for the football tournament. Real inventories were reduced further during the past year, given the tight business environment.

The severe recessionary conditions in the first half of 2009 were reflected in job losses and a further worsening of unemployment which continued in the subsequent year. A sustained period of high growth will be required before job creation can be expected to take off. Some jobs were, in fact, created in the public sector during the period under review, but this was overshadowed by the employment opportunities lost in the private sector. The high wage settlements in the government sector in 2009 and 2010 to some extent constrained the public sector's ability to appoint more staff and improve service delivery.

Wage settlements more generally moderated very slowly, despite high levels of unemployment. Inflation nevertheless decelerated significantly, with its downward trend reinforced by the appreciation in the exchange value of the rand, the substantial output gap and a marked decline in food price inflation. By late 2009 headline consumer price inflation had declined and hovered around the 6 per cent level – the upper limit of the inflation target range. From February 2010 the targeted inflation rate receded to less than 6 per cent and most recently to less than 4 per cent.

Given its extensive international linkages, the domestic economy continued to be strongly influenced by global economic forces. South African exports rose during the past year, benefiting from increasing trade between South Africa and a number of flourishing trading-partner countries, including China, India and certain economies in the euro area. At the same time, the volume of imported goods regained some momentum as domestic expenditure started to recover. With the terms of trade boosted by favourable international prices of export commodities, the deficit on the current account of the balance of payments remained well contained over the past year.

The very low level of interest rates in the mature economies created incentives for international investors to raise their investment in countries with higher interest rate levels. Along with a reduction in risk aversion towards emerging-market economies, this led to considerable net capital flows to South Africa. Whereas up to the end of 2009 the bulk of the flows went into the share market, non-residents subsequently concentrated more on the acquisition of bonds. The financial inflows exceeded the deficit on the current account, enabling the authorities to accumulate more foreign exchange. Allocations of Special Drawing Rights (SDRs) by the IMF further raised the official reserves. During the past year the exchange value of the rand appreciated further, resulting in lower inflation but also in a loss of competitiveness and calls from exporters and import-competing producers for policy measures to counter the appreciation.

The Monetary Policy Committee (MPC) started lowering the repurchase rate in December 2008. With the outlook for inflation improving, further reductions were effected on five occasions in the course of 2009 and on two occasions in 2010. The latest reduction, from 10 September 2010, was set to provide additional stimulus to the somewhat fragile economy recovery, and brought the cumulative reduction in the policy rate to 6,0 percentage points. Risks to the inflation outlook identified by the MPC included wage increases in excess of productivity increases and administered price inflation. Notwithstanding the easing of monetary policy, weak levels of economic activity and hesitance among lenders and borrowers were reflected in a slight contraction in bank credit extension and virtually no growth in the broad money supply during 2009. As 2010 progressed, a modest pick-up in these aggregates was observed, alongside an improvement in economic conditions.

Over the past year stable conditions were maintained in the banking system and in the money market, where the sizeable purchases of foreign currency by the South African Reserve Bank (the Bank) injected rand liquidity into the market. This was sterilised through a combination of measures, including debentures issued and reverse repurchase agreements entered into by the Bank, government deposits with the Bank and, from August 2010, longer-term foreign-exchange swaps. The Bank's operational procedures for implementing monetary policy were amended from the end of August; for instance, the announcement of the estimated weekly range of the liquidity requirement was discontinued, and the spread between the rates for the standing facilities and the repurchase rate was widened from 50 to 100 basis points.

While house prices edged lower in most of 2009, the economic recovery and low interest rate environment subsequently contributed to renewed increases in dwelling prices, accelerating to double-digit rates by mid-2010. The resultant positive wealth effects were further reinforced by marked increases in share prices from April 2009. Bond prices also fluctuated higher over the past year, reflecting lower inflation and rand strength.

The countercyclical policies that the South African government adopted in the wake of the global crisis resulted in a high public-sector borrowing requirement. While expenditure was increased to improve infrastructure and service delivery, tax revenue simultaneously declined on account of the recessionary conditions. The result was near-record levels of the budget deficit and public-sector borrowing requirement in 2009/10. However, the deficit narrowed in recent months as tax revenue picked up alongside the improvement in economic activity. The smaller fiscal deficit is consistent with government's projections, which provide for a systematic return to well-contained deficits and a sustainable path for the government's loan debt over the medium term.

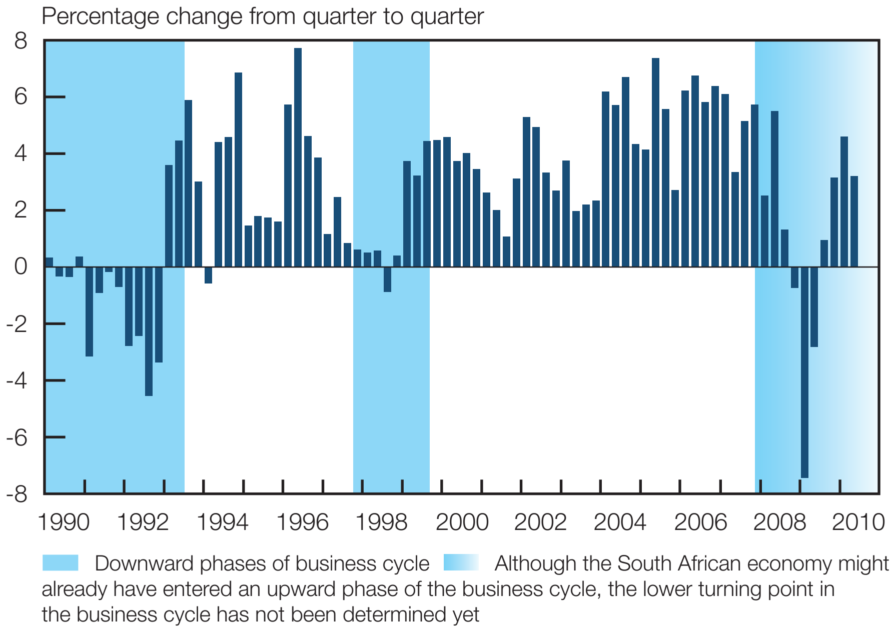
Domestic economic developments

Domestic output[1]

1 The real growth rates referred to in this section are based on seasonally adjusted data.

Real economic activity in South Africa regained momentum during the past year. This followed the tapering off of growth in the course of 2008, culminating in a mild contraction towards the year-end and a sharp decline in the first half of 2009 when the synchronised downswing in global economic activity spilled over into the country. Notwithstanding marginally positive growth in the third quarter of 2009 which gained considerable momentum in the fourth quarter, domestic economic activity still contracted by 1,8 per cent in 2009 as a whole. The impetus of the 2010 FIFA World Cup™ tournament and recovering world economy underpinned activity in the first half of 2010, and growth accelerated perceptibly from an annualised rate of 0,5 per cent in the second half of 2009 to 3,9 per cent in the first half of 2010. The enhanced performance in 2010 was fairly broad-based involving primary, secondary and tertiary production, with manufacturing in particular playing a key role.

Real gross domestic product



Seasonally adjusted annualised rates

The real value added by the *primary sector* declined in both 2008 and 2009, but increased at an annualised rate of 2,5 per cent in the first half of 2010 due to the improved performance of both the agricultural and mining sectors. During the period 2000 to 2010, growth in real output of the mining sector, on average, outpaced growth in the agricultural sector.

Following a decline at an annualised rate of 11,8 per cent in the second half of 2009, real value added by the *agricultural sector* increased at a rate of 2,3 per cent in the first half of 2010. The fluctuations in the growth rates of the agricultural sector emanated primarily from changes in field crop production, including maize. Owing to exceptionally favourable weather conditions and a comparatively large area planted during the 2009/10 production season, a bumper maize crop was harvested, the bulk of which was in the first half of the year.

Real gross domestic product

Percentage change at seasonally adjusted annualised rates

Sectors	2008	2009			2010
	Year	1st half	2nd half	Year	1st half
Primary sector	-1,2	-11,3	-2,5	-6,0	2,5
Agriculture	10,9	-5,6	-11,8	-3,2	2,3
Mining	-5,4	-13,6	1,8	-7,2	2,6
Secondary sector	3,4	-14,8	3,6	-7,2	6,9
Manufacturing	2,7	-20,1	3,2	-10,7	8,4
Electricity, gas and water	1,0	-3,7	2,8	-0,5	2,6
Construction	9,3	9,1	6,1	7,8	2,3
Tertiary sector	4,7	0,1	0,6	1,1	2,9
Commerce	1,1	-2,8	-2,3	-2,9	2,9
Transport and communication	3,9	-0,9	0,8	0,5	2,8
Financial and other services	7,9	-0,5	-1,1	1,3	2,5
Non-agricultural sector	*3,7*	*-4,5*	*1,3*	*-1,5*	*3,8*
Total	**3,7**	**-4,6**	**0,5**	**-1,8**	**3,9**

The real value added by the *mining sector*, which had been in a secular decline since 2005, contracted by 5,4 per cent in 2008 and by a further 7,2 per cent in 2009. The decline in mining production was most severe in the first half of 2009 when real output receded by 13,6 per cent. In subsequent months the mining sector benefited from the recovery in global economic activity and the concomitant demand to replenish inventories. Real output in this sector increased at an annualised rate of 1,8 per cent in the second half of 2009 and gained further momentum in the first half of 2010, accelerating to an annualised rate of 2,6 per cent. The rebuilding of inventory holdings, especially by China and a number of European countries, underpinned a strong demand for commodities during the period. As part of the ongoing efforts to create an enabling environment for the sector, the Minister of Mineral Resources established a Mining Industry Growth, Development and Employment Task Team (MIGDETT) in December 2008 to advise on policy measures to ensure a steady and more sustainable increase in mining production and export earnings.

The improved performance of the mining sector in the first half of 2010 was mainly due to increased activity in the production of platinum group metals (PGMs), diamonds and other mining products. Platinum mines benefited, in particular, from growth in global demand for industrial use and, to a lesser extent, for jewellery. The demand for catalytic converters from vehicle manufacturers in the domestic and export markets supported the demand for platinum, aligned with international standards for cleaner vehicle emissions. At the same time, the production of iron ore, ferrochrome, nickel and copper increased from a low base as global demand picked up somewhat.

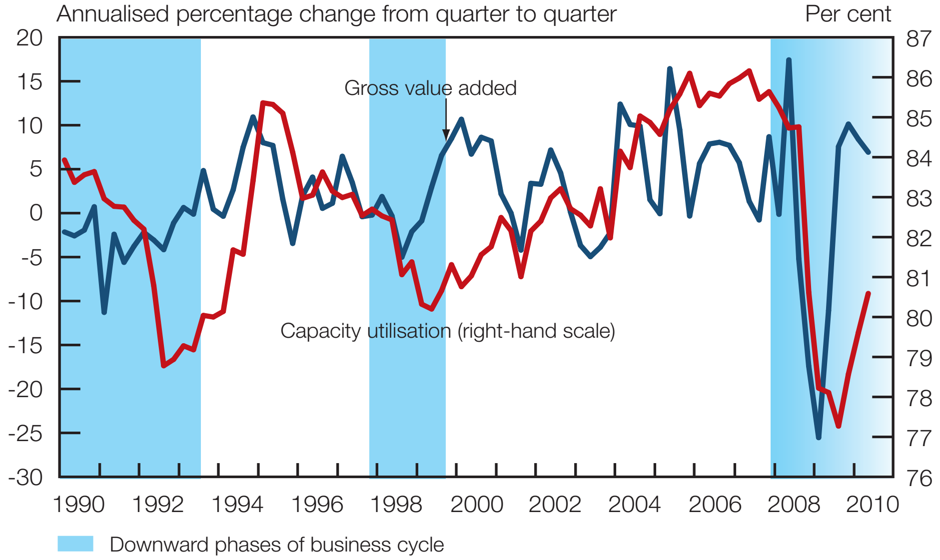
Real output of the gold-mining sector contracted further in the first half of 2010 due to, among other factors, shaft closures and work stoppages related to safety issues and strike action. Steadily rising operational costs of gold mines alongside a marginal increase in the rand price of gold further constrained production activity in this industry.

Owing mainly to a pronounced drop in the real output of the manufacturing sector and a moderate decline in the real production of electricity, gas and water in the first half of 2009, the real value added by the *secondary sector* contracted in 2009 as a whole – the first annual contraction to be recorded by the sector since 2004. However, as real output responded to increased domestic and foreign demand, growth in the real value added by the secondary sector accelerated from the second half of 2009 to the first half of 2010.

The severe contraction in the real value added by the *manufacturing sector* in the year to June 2009 contributed materially to the recession in the domestic economy. Notably, this same sector has played a key role in assisting the economy with emerging from the recession since mid-2009. The sustainability of the recovery in the manufacturing sector will, however, in part depend on the global recovery in general, but more particularly in Europe which imports about one-third of South African manufactured goods.

Manufacturing output, which accounted for 15,1 per cent of gross domestic product in 2009, reached a low point in the first half of 2009. Following an annualised decline of 20,1 per cent in the first half of 2009, the real value added by the manufacturing sector increased by 3,2 per cent and 8,4 per cent in the second half of 2009 and the first half of 2010 respectively. Increased production was particularly pronounced in the subsector for the manufacturing of motor vehicles, parts, accessories, and other transport equipment, due to growing demand from both the domestic and foreign markets. In addition, manufactured exports, including petroleum, chemical products, rubber and plastic products; and basic iron and steel, non-ferrous metal products and machinery also underpinned growth in the first six months of 2010.

Real gross value added and capacity utilisation in manufacturing



Seasonally adjusted

The outcome of the manufacturing sector was also reflected in fluctuations in the utilisation of production capacity, which moved broadly sideways during 2009. Having reached an all-time low of 77,3 per cent in the third quarter of 2009, the utilisation of production capacity increased moderately in the period up to June 2010. The relatively low rate of capacity utilisation probably reflected slow growth in output volumes combined with some additions to production capacity through fixed capital formation prior to mid-2008.

Real value added by the sector supplying *electricity, gas and water* declined by 0,5 per cent in 2009 following an increase of 1 per cent registered in 2008. Following the fairly muted increase in 2008 as a result of the reduction in electricity supply and periodic load shedding, the real output of the electricity subsector decreased moderately in the first half of 2009 due to declines in production activities by a number of electricity-intensive production units in response to the recession-induced pullback in energy demand. Increased domestic demand in the first half of 2010, related to the recovery of manufacturing production and activity in the mining sector, supported growth in the real value added by the electricity sector over the period.

Real output of the *construction* industry rose briskly at a rate of 9,3 per cent in 2008, moderating to 7,8 per cent in 2009 as it was adversely affected by the slowdown in private-sector demand for residential and non-residential buildings. Consistent with the completion of certain infrastructure development projects related to the 2010 FIFA World Cup™ tournament, growth in construction activity eased visibly in the first half of 2010.

A lack of consumer confidence and a decline in aggregate domestic demand were reflected in the real valued added by the *commerce sector*, which contracted throughout 2009. However, in the first half of 2010 retail, wholesale, hotel and restaurant sales were boosted by the 2010 FIFA World Cup™ tournament-induced tourist influx during the period. For the same reason, activity in the *transport, storage and communication sector* increased noticeably from the second half of 2009 to the first half of 2010.

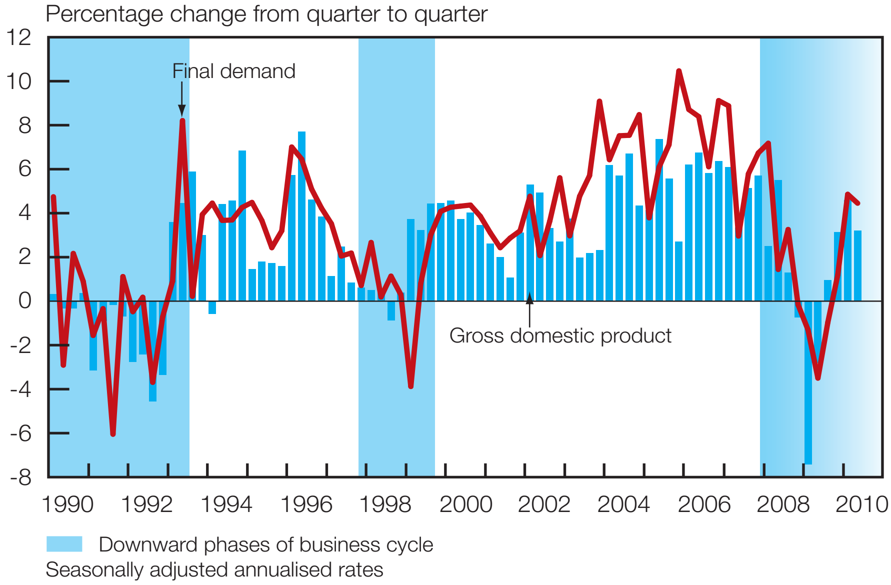
Growth in the real value added by the *finance, insurance, real-estate and business services sector* slowed to 1,3 per cent in 2009 following an increase of 7,9 per cent in 2008. Underpinned by the recovery in the economy, output in the finance sector increased by 2,5 per cent in the first half of 2010. This reversal in growth reflected increased business conditions in the real value added by banks, which was partly countered by lower activity in the securities and derivatives markets during the period.

Real output of the *general government* grew at a rate of 4,2 per cent in both 2008 and 2009 as service delivery was expanded, before losing some momentum in the first half of 2010.

Gross domestic expenditure

Growth in *real gross domestic expenditure*, being cyclically more sensitive, outpaced annual growth in real gross domestic product during the period 2002 to 2007 and provided a strong stimulus in the recent upward phase of the business cycle that lasted from September 1999 to November 2007. In the subsequent downward phase annual

Real gross domestic product and final demand



growth in gross domestic expenditure slowed more severely than real gross domestic product. Both these aggregates contracted at a rate of 1,8 per cent in 2009. In the first half of 2010 the more typical growth pattern resumed and growth in real gross domestic expenditure accelerated to an annualised rate of 7,8 per cent, outpacing growth in real gross domestic product by 3,9 percentage points.

The strong growth in real gross domestic expenditure in the first half of 2010 could mainly be attributed to a marked increase in final consumption expenditure by households and general government. At the same time, the sharp decline in real inventory holdings in the second half of 2009 came to an end as inventories decreased at a more sedate pace, thereby contributing to the growth in real gross domestic expenditure.

Real gross domestic expenditure

Percentage change at seasonally adjusted annualised rates

Components	2008	2009			2010
	Year	1st half	2nd half	Year	1st half
Final consumption expenditure:					
Households	2,4	-4,7	-1,9	-3,1	4,4
General government	4,9	4,4	4,8	4,7	6,0
Gross fixed capital formation	11,7	2,6	-4,1	2,3	0,1
Change in inventories (R billions)*	-7,7	-27,6	-47,6	-37,6	-8,0
Gross domestic expenditure	**3,3**	**-1,9**	**-2,4**	**-1,8**	**7,8**

* At constant 2005 prices

Real final consumption expenditure by households

While the average share of final *consumption expenditure by households* remained at almost 63 per cent of expenditure on gross domestic product during the most recent upward phase of the business cycle from September 1999 to November 2007, it tapered off to about 61 per cent in 2009. Household consumption expenditure – underpinned by noticeable increases in the market value of residential properties and equity holdings – displayed exuberant growth throughout the duration of the upturn in economic activity and it recorded peak growth of 8,3 per cent in 2006. In subsequent years, however, growth in consumption expenditure moderated gradually before contracting at a rate of 3,1 per cent in 2009 as households came to realise the deteriorating prospects of income growth going forward. In addition to the relatively high and unrelenting levels of household debt, asset values came under pressure, which further impaired households' balance sheets and wealth, subsequently rendering the underlying growth in spending unsustainable. The value of household assets, in particular residential properties and equity holdings, started to decline from the first half of 2008, adversely affecting households' propensity to consume. This trend was, however, reversed in the second half of 2009. House prices rose, on average, by about 12 per cent alongside an average increase of almost 38 per cent in the value of equity holdings in the first half of 2010. Recent wage increases, combined with a moderation in inflation, contributed to an improvement in real disposable income of households in the first half of 2010, providing further stimulus to consumption spending.

Real final consumption expenditure by households contracted at annualised rates of 4,7 per cent in the first half of 2009 and 1,9 per cent in the second half. Although spending declined in all expenditure categories in the first half of 2009, particularly large contractions were recorded in real outlays on durable and non-durable goods. In the first half of 2010, growth in real final consumption expenditure bounced back and accelerated to an annualised rate of 4,4 per cent, mainly due to brisk increases in spending on durable and semi-durable goods. Real outlays on services, however, contracted during the period.

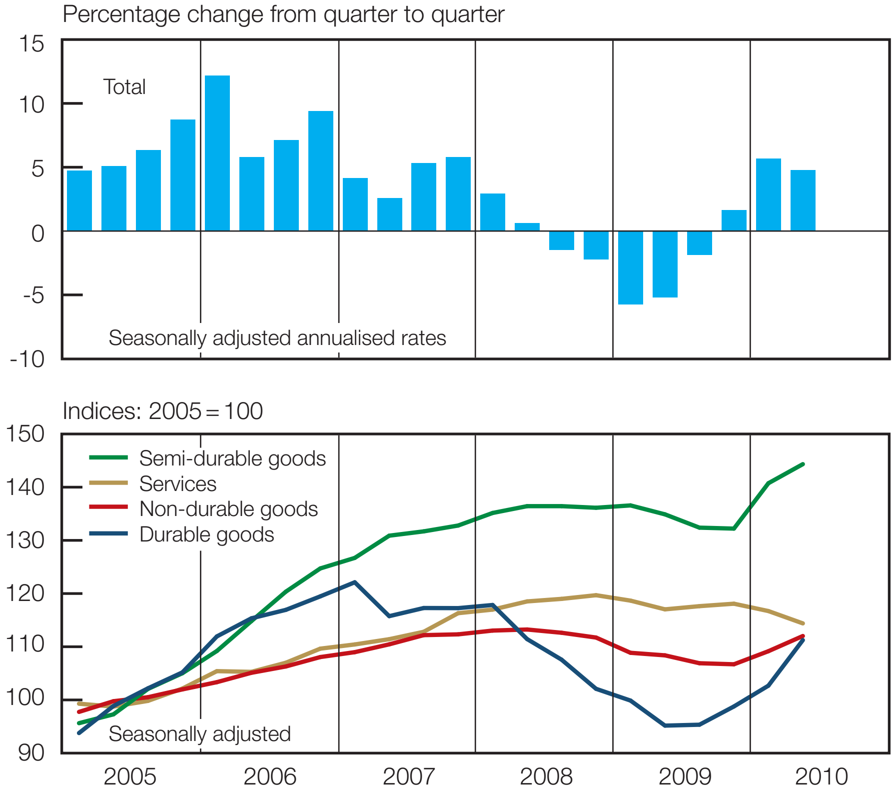
Real final consumption expenditure by households

Percentage change at seasonally adjusted annualised rates

Components	2008	2009			2010
	Year	1st half	2nd half	Year	1st half
Durable goods	-7,1	-13,5	-1,0	-11,3	21,5
Semi-durable goods	4,2	-0,8	-5,0	-1,5	16,1
Non-durable goods	1,5	-6,2	-3,3	-4,4	7,2
Services	5,1	-2,5	0,0	-0,6	-3,9
Total	**2,4**	**-4,7**	**-1,9**	**-3,1**	**4,4**

Real household consumption expenditure on *durable goods* contracted sharply at annualised rates of 13,5 per cent and 1,0 per cent in the first and second halves of 2009 respectively, but increased robustly at a rate of 21,5 per cent in the first half of 2010. Coming from a low base, the growth mainly reflected strong increases in spending on furniture and household appliances, and personal transport equipment. Real outlays on furniture and household appliances, advanced by 24,1 per cent in the first half of 2010

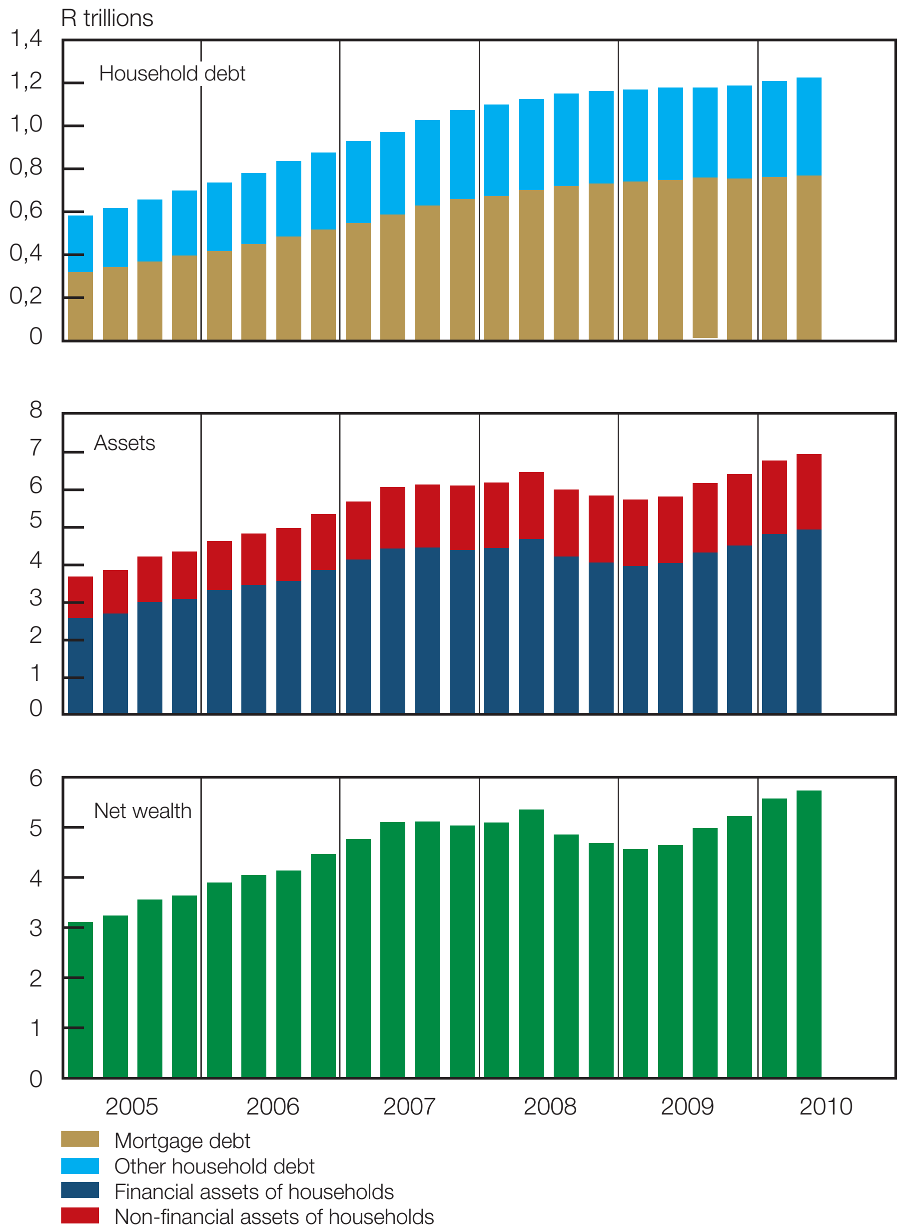
Real final consumption expenditure by households



compared with the preceding six months. Real expenditure on transport equipment surged by 21,7 per cent over the same period, partly enticed by the lower interest rate environment and the proposed introduction of a carbon emission tax to come into effect on 1 September 2010.

Growth in households' real expenditure on *semi-durable goods* also accelerated briskly in the first half of 2010 following negative growth throughout 2009. Strong increases in real outlays were registered in all expenditure categories, except spending on motorcar tyres, parts and accessories. Real outlays on clothing and footwear, and on household textiles, furnishing and glassware increased by 20 per cent and 9,9 per cent respectively in the first half of 2010 as consumers took advantage of the moderation in the prices of clothes. Among other things, outlays on football-related clothing items during the hosting of the 2010 FIFA World Cup™ tournament probably gave further impetus to the high growth in expenditure on clothing and footwear.

Household balance sheet



Seasonally adjusted

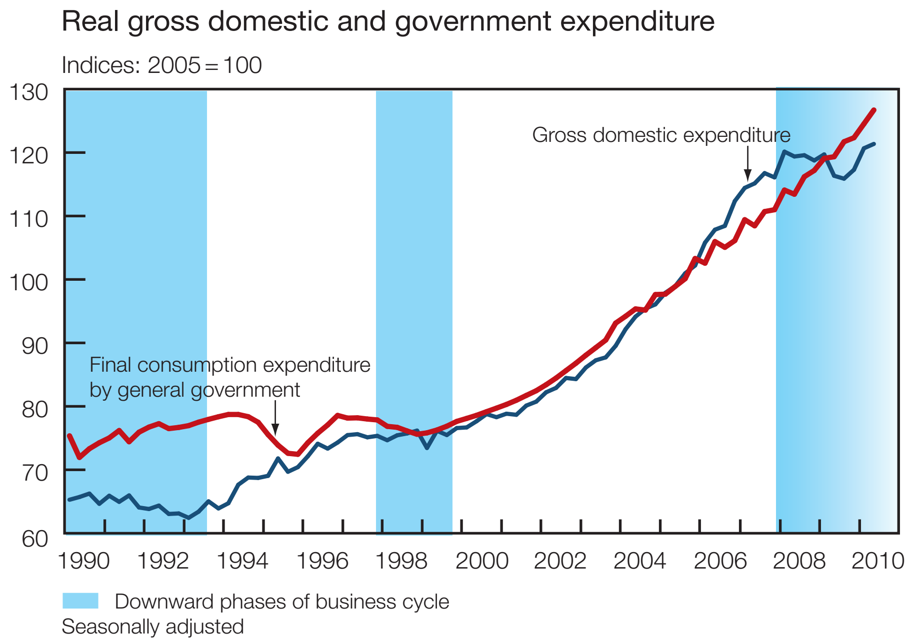
Real final consumption expenditure on goods of a largely non-discretionary nature, namely *non-durable goods*, increased by 7,2 per cent in the first half of 2010 following lower spending in the first and second halves of 2009 – for the year as a whole expenditure on non-durable goods declined by 4,4 per cent. Higher real outlays in the first half of 2010 on food, beverages and tobacco, household consumer goods, medical and pharmaceutical goods, as well as petroleum goods more than neutralised lower spending on household fuel and power, and consumer goods. Despite strong increases in the price of electricity, greater efficiency in the use of energy-consuming appliances has led to a general reduction in spending on household fuel and power since the first half of 2008.

Real final consumption expenditure on services is known to be quite resilient during recessionary phases, but to the contrary it contracted by 3,9 per cent in the first half of 2010 after virtually no growth was recorded in the second half of 2009. Lower spending was registered, among other things, on transport and communication and financial services. An increase in travel-related receipts largely affected by the hosting of the 2010 FIFA World Cup™ tournament in South Africa in the second quarter of 2010 also impacted spending on services, as foreign spending in South Africa exceeded South African consumer spending in the rest of the world during the period.

Real final consumption expenditure by general government

Growth in real consumption expenditure by *general government* moderated from 4,9 per cent in 2008 to 4,7 per cent in 2009. In the first half of 2010, growth in government consumption expenditure, however, accelerated to an annualised rate of 6,0 per cent compared with a rate of increase of 4,8 per cent in the latter half of 2009. The sustained increase in real government consumption expenditure in the first half of 2010 could mainly be attributed to higher real spending on non-wage goods and services, which rose briskly at a rate of 10,9 per cent over the period. In addition, aircraft acquired as part of the government's defence procurement programme also contributed to the increase in government expenditure in the first half of 2010.

At the same time, growth in real compensation of government employees accelerated marginally from an annualised rate of 3,5 per cent in the first half of 2009 to 3,6 per cent in the first half of 2010. Throughout the period, government continued to create jobs,



including those of a more temporary nature under the auspices of its Expanded Public Works Programme (EPWP).

During the 18 months to the end of June 2010, growth in real final consumption expenditure by government outpaced growth in all other expenditure components, thereby lending support to the economic recovery. The ratio of final consumption expenditure by general government to gross domestic product subsequently continued to trend upwards, increasing from 19,1 per cent in 2008 to 21 per cent in 2009 and further to 21,2 per cent in the first half of 2010.

Real gross fixed capital formation

In tandem with the business cycle, the rate of change in real capital expenditure reverted from an annualised rate of decline of about 0,6 per cent in the downward phase of the business cycle from December 1996 to August 1999 to an increase of 9,2 per cent in the upward phase to November 2007. As expected, the rate of increase receded again during the subsequent downturn in economic activity.

Gross fixed capital formation

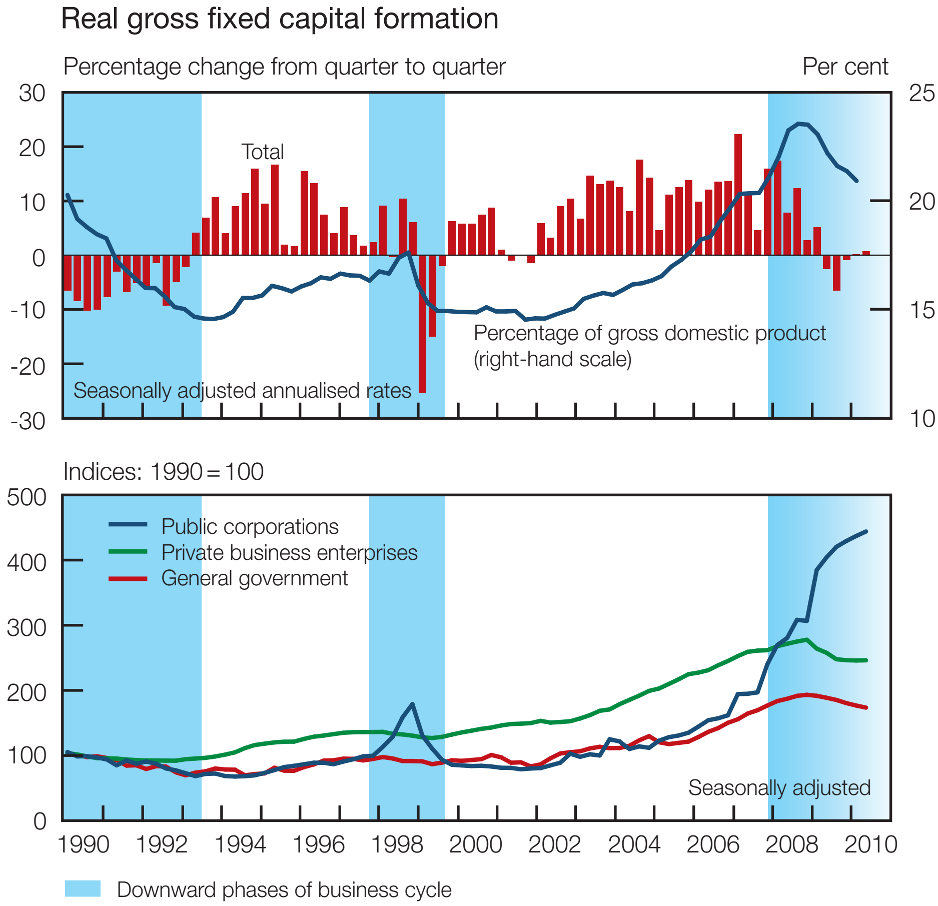
Percentage change at seasonally adjusted annualised rates

Components	2008	2009			2010
	Year	1st half	2nd half	Year	1st half
Private business enterprises	5,6	-10,9	-10,3	-7,0	-0,8
Public corporations	41,0	64,6	16,0	40,7	7,5
General government	13,4	-2,3	-7,5	-1,2	-8,3
Total	**11,7**	**2,6**	**-4,1**	**2,3**	**0,1**

Having expanded each year from 2002, *real gross fixed capital formation* surged by an impressive 14,2 per cent in 2007 and 11,7 per cent in 2008, before contracting for the first time in 29 quarters in the second quarter of 2009. Subsequent to an increase at an annualised rate of 2,6 per cent in the first half of 2009 and a decline of 4,1 per cent in the second half, the level of real fixed investment spending moved broadly sideways in the first half of 2010. The ratio of fixed capital formation to gross domestic product subsequently declined to an average of 21,1 per cent in the first half of 2010 – lower than the rate of 22,6 per cent registered for 2009 as a whole.

Over the past 18 months there was a substantial divergence in the behaviour of the various types of capital investment. On account of preparations for the 2010 FIFA World Cup™ tournament, the Public Works Programme and the drive to expand electricity generation capacity, infrastructure-related spending by public corporations surged, while private-sector-based capital investment contracted and investment activity by the general government slowed abruptly over the period.

Accounting for about 60 per cent of total fixed investment activities, real gross fixed capital formation by *private-sector* enterprises contracted throughout 2009 and in the first half of 2010, reflecting subdued domestic demand conditions and low levels of business confidence. Business confidence remained fragile and receded somewhat in the second quarter of 2010, mainly on concerns over a potential spill-over from Europe's debt crisis and strike action by transport workers that affected business logistics in the first half of 2010.



Private-sector investment activity receded in all major sectors of the South African economy, but the decline was more pronounced in the mining and manufacturing sectors where the relative strength of the external value of the rand partly constrained firms' ability to compete successfully in export markets. Steep declines were also observed in capital formation in the trade sector and in private residential development in the aftermath of the global financial crisis. Downward pressure on income and employment, the high indebtedness of households and restrictive credit requirements imposed on households by the National Credit Act probably underpinned the contraction in capital spending on private residences. Moreover, the lagged impact of monetary policy tightening in 2008, low capacity utilisation and the global financial crisis kept investment appetite subdued throughout the period under review.

Robust growth in capital formation by *public corporations* has resulted in double-digit growth rates being registered since 2005. However, owing to the completion of various infrastructure-related projects associated with the 2010 FIFA World Cup™ tournament, the momentum began to taper off from the second quarter of 2009, culminating in a slowing of the annualised growth rate to 7,5 per cent in the first half of 2010. The strength of fixed capital formation by public corporations nevertheless had a significant countercyclical impact and was brought about by major projects including

– capital spending by the country's electricity utility, Eskom, to increase capacity;
– construction activities by Transnet to upgrade port facilities and railway lines, and to expand a petroleum pipeline;
– the building, upgrading and improvement of airports by the Airports Company of South Africa; and
– the Gauteng Freeway Improvement Project by the South African National Road Agency Limited (SANRAL).

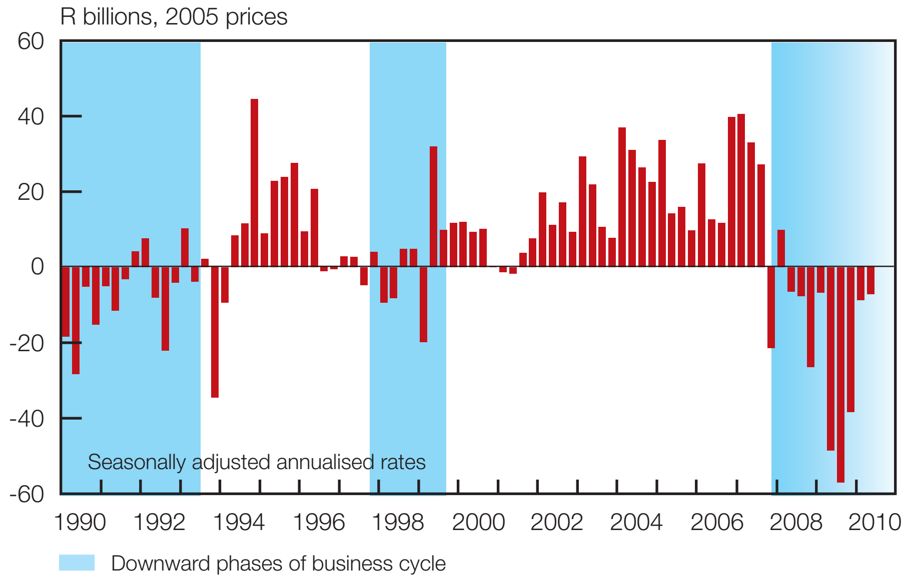
Real gross fixed capital formation by *general government* contracted slightly in 2009 and declined at an annualised rate of 8,3 per cent in the first half of 2010, largely due to the completion of infrastructural projects related to the hosting of the 2010 FIFA World Cup™ tournament. National and provincial governments did not fully spend their allocated capital budgets in 2009.

Change in inventories

In the aftermath of the global financial crisis, slowing and subsequent contracting global and domestic demand resulted in a protracted decline in *inventories* from the second quarter of 2008. For 2008 as a whole, the level of real inventories declined by R7,7 billion,[2] reinforced by the relatively high interest rates in South Africa at the time. This was the first annual decline to be recorded since 1998. The level of real inventories subsequently declined by R37,6 billion in 2009 and by a further R8 billion in the first half of 2010.

2 Measured at constant 2005 prices.

Change in real inventories



The decline in inventory holdings in 2008 mainly reflected a reduction in manufacturing output, a decline in oil imports and a slowdown in the volume of other non-oil imports. In 2009 the depletion of inventories was most pronounced in the subsector for the manufacturing of motor vehicles, as manufacturers scaled down production on account of the weaker demand for new vehicles. Consistent with the recovery in production and expenditure, the pace of depletion slowed markedly in the first half of 2010 and inventories were, in fact, accumulated in the mining sector. Coal stocks in particular were deliberately replenished in anticipation of an improvement in demand for seasonal heating purposes and to ensure a reliable supply of power during the 2010 FIFA World Cup™ tournament.

The substantial decline in inventory levels in 2009 subtracted 1,6 percentage points from growth in aggregate real gross domestic expenditure, while the much smaller decline in the first half of 2010 caused inventory investment to make a positive contribution of 4,4 percentage points over the period.

As inventory deaccumulation continued, the ratio of industrial and commercial inventories to non-agricultural gross domestic product receded from 17,3 per cent attained in 2008 to 14,2 per cent in 2009 and 12,4 per cent in the first half of 2010.

Factor income

Aggregate nominal factor income increased at a compound annual rate of 12 per cent during the upward phase of the business cycle from the third quarter of 1999 to the fourth quarter of 2007. However, from the first half of 2008 to the first half of 2010, the compound rate of growth slowed to 9,7 per cent. Year-on-year growth in aggregate nominal factor income decelerated to only 5,8 per cent in 2009, the year of negative real economic growth, following an increase of 14,9 per cent in 2008. In the first half of 2010 growth accelerated to an annualised rate of 9,0 per cent, supported by stronger growth in the gross operating surpluses of business enterprises.

The compound annual growth in aggregate nominal *gross operating surpluses* during the most recent upward phase of the business cycle amounted to 13,6 per cent per year. In the subsequent period up to the first half of 2010 the compound annual growth moderated to 10,4 per cent; in 2009 year-on-year growth of only 3,1 per cent was recorded. This slowdown in 2009 was fairly widespread among all the sectors of the economy, although year-on-year growth ranged between a positive 28,8 per cent in the construction sector and a negative 12,7 per cent in the manufacturing sector. In the first half of 2010 annualised growth in aggregate gross operating surpluses accelerated to 9,2 per cent as the general business environment improved due to the global recovery, accommodative monetary policy stance and expansionary fiscal policy that induced higher growth in production and expenditure.

The compound annual growth in *compensation of employees* was 10,5 per cent in the upward phase of the business cycle from the third quarter of 1999 to the final quarter of 2007. The year-on-year growth in compensation of employees slowed from 13,6 per cent in 2008 to 8,5 per cent in 2009. This slowdown was recorded in all the industries and reflected job shedding, a reduction in working hours and smaller bonuses paid to workers, given weak sales volumes. In the first half of 2010 annualised growth accelerated to 8,9 per cent as a result of wage increases in excess of inflation and to compensate workers who worked longer hours, or were appointed temporarily to render services required during the 2010 FIFA World Cup™ tournament. The ratio of compensation of employees to factor income was 49,7 per cent in the first half of 2010, moderately lower that the most recent peak of 51,4 per cent recorded in the second half of 2009, but higher than the ratio of 49,4 per cent recorded in 2008. The resilience of compensation of employees, regardless of job losses, was partly due to wage increases in excess of inflation and business enterprises' willingness to retain scarce skilled employees in anticipation of the likely reversal of adverse business conditions.

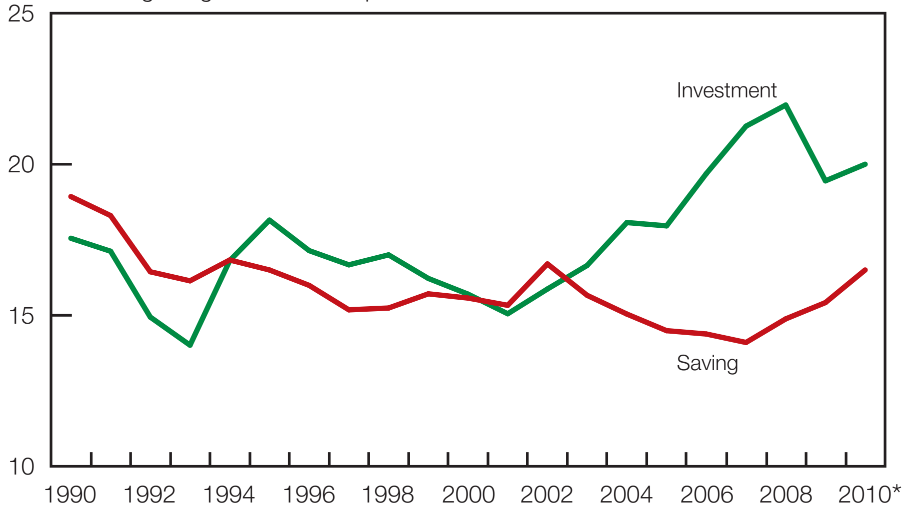
Domestic saving

The *national savings rate* as measured by the ratio of gross domestic saving to gross domestic product deteriorated from a high of 17,5 per cent in the final quarter of 2002 to a low of 12,9 per cent in the third quarter of 2007 as consumption expenditure increased briskly. In the current downward phase, a strong slowdown in household consumption expenditure and a sharp decline in dividend payments boosted the national savings ratio. The savings ratio of South Africa recovered continually from 14,2 per cent in the first half of 2008 to 16,5 per cent in the first half of 2010. The improvement of the national saving rate lowered South Africa's shortfall of savings to finance capital formation. The percentage of gross capital formation financed by foreign capital simultaneously decreased from 35,2 per cent in the first half of 2008 to 17,7 per cent in the first half of 2010.

The improvement of the national savings rate during 2008 and 2009 and in the first half of 2010 was primarily due to an increase in the savings ratio of *corporate business enterprises*. The savings ratio of corporate business enterprises increased from 10,4 per cent in the first half of 2008 to 16,1 per cent in the first half of 2010. The curtailment of dividend payments and cost containment, together with growth in domestic demand, contributed to the improvement of the savings rate.

Saving and investment ratios

Percentage of gross domestic product



* First half

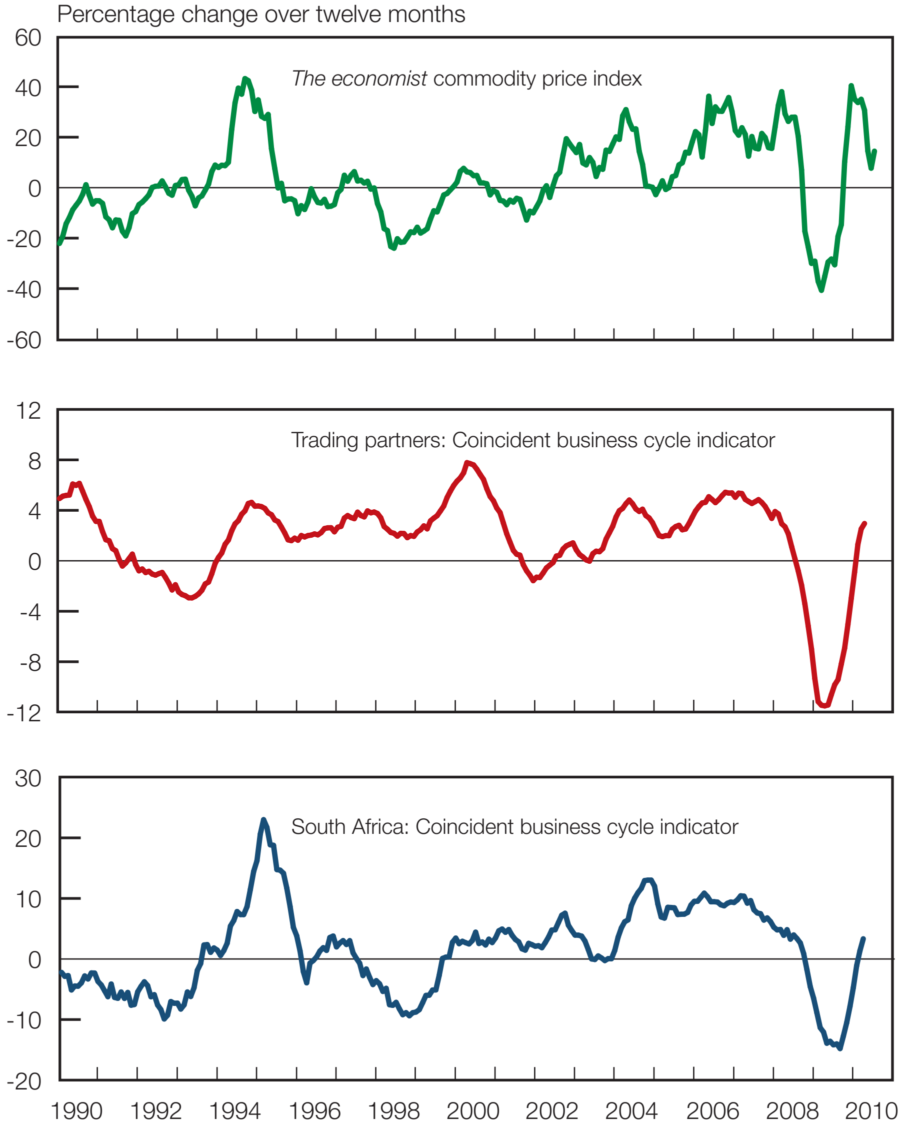
The savings ratio of *general government* declined from 2,9 per cent in the first half of 2008 to a rate of dissaving of 1,2 per cent in the first half of 2010. The contra-cyclical expansionary fiscal policy adopted by general government increased government's recurrent expenditure, while the recessionary conditions adversely affected income.

The savings ratio of households improved from 1,0 per cent in the first half of 2008 to 1,7 per cent in the second half of 2009, mainly reflecting a decline in household expenditure over the period. Stricter lending criteria and uncertainties brought about by the financial crisis contributed to a more cautious approach to spending. In the first half of 2010 the savings ratio receded slightly to 1,6 per cent due to increased consumption expenditure associated with the easier monetary and fiscal policies, and an improvement in households' wealth as asset prices continued to rise in the first six months of 2010.

Business cycle developments

Following an extended period of around eight years, the upward phase of the South African business cycle reached an upper turning point in November 2007, registering the longest uninterrupted expansion in aggregate economic activity since World War II. The ensuing downward phase in the business cycle coincided with the global financial crisis that reached its apex during the second half of 2008 and the opening months of 2009, and gave rise to the most severe synchronised recession in the world economy since the 1930s. South Africa, with its strong reliance on commodity exports, was adversely affected by the ensuing marked decline in world commodity prices as indicated in the accompanying graph, contributing to the severity of the downward phase of the business cycle during 2009.

Commodity price index and coincident business cycle indicators

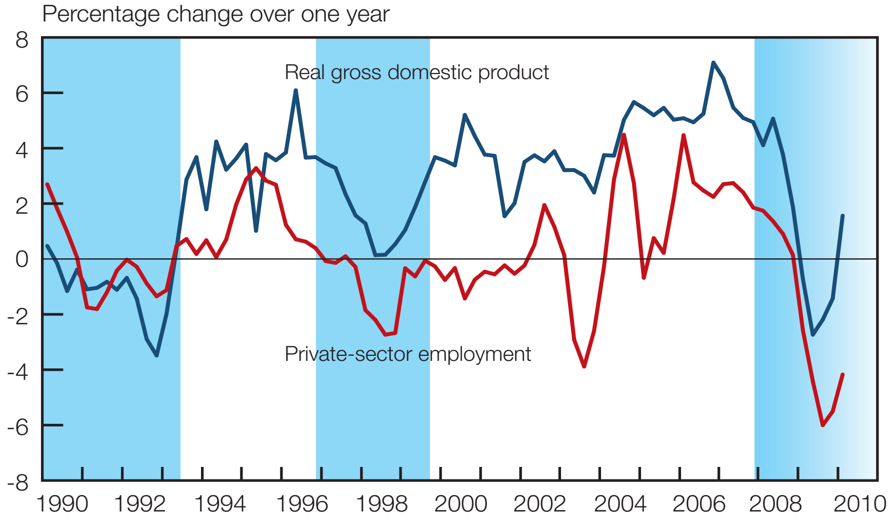


Subsequently, the leading business cycle indicator started to increase notably after reaching a lower turning point in March 2009, while the coincident business cycle indicator has been on an upward trend since September 2009, confirming that the domestic economy has entered the early stage of a recovery phase in the business cycle. However, the formal dating of a turning point in the business cycle still awaits the accumulation of more comprehensive information on the performance of the South African economy.

Employment

Consistent with the meaningful growth registered in the South African economy, an upward phase in the employment cycle commenced in the first quarter of 2005, lasting for almost four years and adding a total of 771 000 formal job opportunities over this period. However, from a peak in the third quarter of 2008, the level of formal non-agricultural employment started to contract, shedding a total of 385 700 employment opportunities up to the first quarter of 2010. As indicated in the graph on page 18, changes in the level of private-sector employment generally move in tandem with phases of economic expansion. This relationship has been acutely evident during the most recent downturn in economic activity, characterised by a marked decline in the level of employment especially in 2009.

Private-sector employment and real gross domestic product



Downward phases of business cycle — Although the South African economy might already have entered an upward phase of the business cycle, the lower turning point in the business cycle has not been determined yet

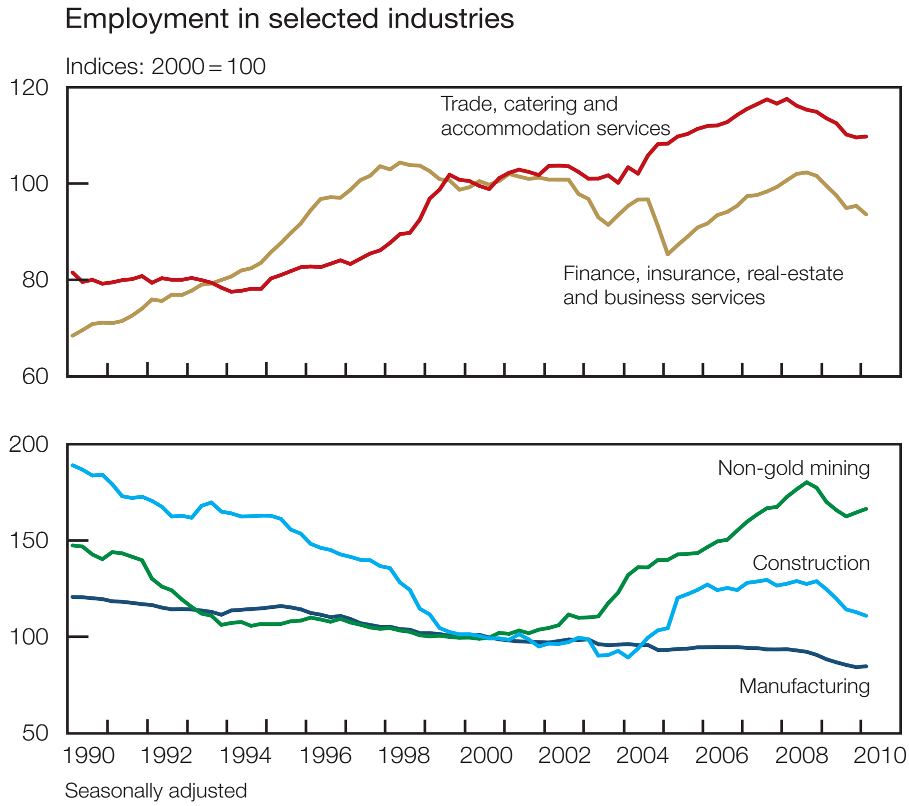
Seasonally adjusted annualised rates

An analysis of the upward phase in the employment cycle that lasted up to the third quarter of 2008 indicated that the upturn was initially rooted in steady increases in consumption expenditure supported by an uptake of credit and positive wealth effects through rising asset prices. However, as the upward phase in the employment cycle matured, consumption-led employment increases were augmented by investment-led employment creation in the construction and mining sectors. The expansion in mining activity was encouraged by a surge in international commodity prices and occasional bouts of depreciation in the exchange value of the rand. Employment creation took place mainly in the non-gold mining sector, which accounted for just more than 67 per cent of total mining-sector employment in 2008.

The surge in residential and non-residential building activity coincided with rising property values, an increase in the number of consumers taking part in property purchases and brisk increases in consumer expenditure in general. Civil construction activity contributed meaningfully to economic growth, as investment in infrastructure projects gained momentum, partly related to the 2010 FIFA World Cup™ tournament and partly to longer-term infrastructure objectives. In response to the higher consumption expenditure the trade, catering and accommodation; finance, insurance, real estate and business services; as well as the transport, storage and communications sectors increased employment numbers. However, the manufacturing sector continued to contend with the challenge of remaining competitive in a globalised environment, resulting in lacklustre employment growth during this period.

Following this fairly prolonged period of employment gains up to the third quarter of 2008, employment levels in the formal non-agricultural sector of the economy decreased unabatedly for six consecutive quarters up to the first quarter of 2010, albeit at a more moderate pace in the last two quarters.

According to the *Quarterly Employment Statistics survey* conducted by Statistics South Africa (Stats SA), approximately 8,1 million people were employed in the formal non-agricultural sectors of the economy in the quarter ended March 2010. This reflects an annual decrease of 2,9 per cent or about 244 400 shed job opportunities since March 2009. Previously, a further 141 000 jobs were lost in the six months to March 2009. The decrease in employment in the finance, insurance, real-estate and business services sectors accounted for almost half of the number of jobs lost over the year to March 2010.



Sizeable further job losses were recorded in manufacturing, construction, and trade, catering and accommodation services, collectively shedding around 158 600 job opportunities.

Acting in a countercyclical manner, public-sector employment, contributing roughly 23 per cent of total employment in the formal non-agricultural sector, increased by 1,4 per cent in the year to March 2010, as opposed to a decrease of 4,2 per cent in the private sector. Over the year to the first quarter of 2010, all private subsectors recorded employment losses except for the community, social and personal services sector.

Change in enterprise-surveyed formal non-agricultural employment in the four quarters to March 2010

Sector	Over four quarters	
	Number*	Percentage change
Mining	-9 000	-1,8
Gold mining	-1 800	-1,1
Non-gold mining	-7 200	-2,1
Manufacturing	-51 600	-4,2
Electricity supply	-3 200	-5,4
Construction	-50 500	-11,0
Trade, catering and accommodation	-56 400	-3,3
Transport, storage and communication	-1 100	-0,4
Financial intermediation and insurance	-111 400	-6,0
Community, social and personal services	12 900	3,2
Total private sector	**-270 400**	**-4,2**
National, provincial and local government	38 800	2,4
Public-sector enterprises	-12 800	-5,1
Total public sector	**26 000**	**1,4**
Grand total*	**-244 400**	**-2,9**

* Components may not add up to totals due to rounding

Employment losses started to occur at a much earlier stage in the manufacturing sector as total employment declined by as much as 131 000 jobs over the two-year period to the fourth quarter of 2009. However, a steady recovery in export and domestic demand resulted in a moderate increase in manufacturing production from the second quarter of 2009. Higher production levels eventually led to a marginal pick-up in the number of people employed in the manufacturing sector in the first quarter of 2010 when 6 000 jobs were created.

The mining sector has continually shed jobs during the past year, albeit at a slower pace in the first quarter of 2010. A decrease in mining output, resulting primarily from subdued international demand, contributed to the high employment dismissal rate in the sector despite the higher commodity prices experienced in the gold and platinum markets.

The construction sector has lost an estimated 66 000 job opportunities since the start of 2009. The completion of a number of civil construction activities related to the FIFA World Cup™ tournament and a slowdown in infrastructure expenditure by government are likely to curb growth in the civil engineering construction sector in the coming months. Furthermore, moderate increases in residential building plans passed during the middle months of 2010 indicated little signs of an immediate recovery in the building sector. Notwithstanding the pressing demand for electricity and the large-scale expansion drive by the electricity-supply sector, job losses occurred at a rate of 2 per cent in this sector in 2009.

Employment in the trade, catering and accommodation services sector reached a peak in the first quarter of 2008 with roughly 1,7 million people employed. Subsequently, 116 000 job opportunities were lost in the period to the end of the first quarter of 2010, due to the earlier contraction in consumer spending and the economic recession that were mirrored by a marked decrease in the First National Bank/Bureau for Economic Research (FNB/BER) Consumer Confidence Index during 2008. Consumer confidence recovered in recent months, due in part to the hosting of the FIFA World Cup™ tournament, lower interest rates, the moderation in inflation, a recovery in global economic activity, and was reflected in rising consumption expenditure. Nevertheless, consumer spending was restrained as many households continued to work down their high levels of indebtedness alongside caution on the side of the banking sector in extending credit.

Even though South African financial institutions were not directly affected by the global financial crisis, the resulting economic recession nevertheless had a bearing on the financial sector through, among other factors, a depressed residential property market, a rise in impaired advances and a lack of demand for credit. The finance, insurance, real-estate and business services sector – the largest job-creating sector in the South African economy, which collectively provides jobs for roughly 22 per cent of the formal non-agricultural sector – shed an estimated 111 000 jobs during the year to the end of the first quarter of 2010.

In order to improve service delivery, the staff complement of the public sector was expanded by around 300 000 in the five years to the end of 2008; roughly a third of these job opportunities were created during the calendar year 2008 as government simultaneously attempted to mitigate the negative employment consequences of the recession. During 2009 the public sector gained a further 17 000 jobs, while the private sector shed about 363 000 jobs. Most new jobs created by the public sector during 2009 were at local and provincial government levels. The share of employment in the public sector in total formal non-agricultural employment rose from 20,5 per cent in 2004 to 22,4 per cent in the first quarter of 2010. The quarter-to-quarter pace of increase in public-sector employment numbers slowed in the course of 2009 and even turned marginally negative in the fourth quarter, before increasing again in the first quarter of 2010.

According to the latest Stats SA *Quarterly Labour Force Survey*, total employment in the domestic economy peaked at 13,8 million in the fourth quarter of 2008, thereafter decreasing to 12,7 million in the second quarter of 2010. As a consequence, the official unemployment rate rose from 21,9 per cent in the fourth quarter of 2008 to 25,3 per cent in the second quarter of 2010. Furthermore, the number of discouraged work-seekers rose from 1,2 million in the first quarter of 2009 to 1,8 million in the second quarter of 2010.

According to the *Global Employment Trends* 2010 report of the International Labour Organization (ILO), the global unemployment rate, which had decreased for four consecutive years, increased in both 2008 and 2009. The number of unemployed persons in 2008 amounted to 212 million, reflecting an increase of almost 34 million compared with the previous year. According to the ILO, the global unemployment rate in 2009 stood at 6,6 per cent, but would have been considerably higher had it not been for the concerted policy actions taken by governments to counter the impact of the economic crisis and to minimise the negative impact on labour markets. The estimated South African labour participation rate, defined as the economically active population as a share of the working-age population, was 54,3 per cent in the second quarter of 2010, substantially below the average global labour participation rate of 65 per cent.

The unprecedented pace of employment decline during the economic recession prompted several policy actions aimed at curbing the impact and extent of job losses observed in the economy. In his maiden State of the Nation Address, the President of the Republic of South Africa announced the creation of 500 000 jobs through the Expanded Public Works Programme by the end of 2009. The *Budget Review 2009* announced a public-sector investment initiative worth R787 billion over the subsequent three fiscal years, aimed at improving the efficiency of public service delivery and creating an enabling environment for sustained economic growth. This initiative has the potential to counter dwindling private-sector fixed investment and support employment creation in the construction sector in particular. In addition, the Department of Labour announced an increase in the payout value for laid-off Unemployment Insurance Fund (UIF) contributors, and an extension in the UIF payout period from eight months to a year. Early in 2010, a loan facility of R2 billion was launched between the Industrial Development Corporation and the UIF, aimed at creating and sustaining jobs.

In an effort by government to address youth unemployment in particular, initiatives were proposed to improve information services to help young people access job and training opportunities. These reforms will be supported through a subsidy to employers that will lower the cost of employing young people without work experience. Also under consideration is a cash reimbursement to employers for a two-year period, operating through the South African Revenue Service's payroll tax system, and subject to minimum labour standards, with a view to raising the employment of young school leavers by a further 500 000 by 2013.

Labour cost and productivity

Notwithstanding widespread job losses in the domestic economy during the 18 months to June 2010, increases in *nominal remuneration per worker* in the formal non-agricultural sector accelerated briskly to an annual rate of 12,8 per cent in 2008, before decelerating to 11,3 per cent in 2009. Nominal remuneration per worker increased at double-digit rates in both the private and public sectors in 2009, with the increase in the public sector being more pronounced. Despite a meaningful deceleration in consumer price inflation during 2009 and into the first half of 2010, the rate of increase in nominal remuneration per worker remained elevated, enhancing the real salary and wage levels of those that were gainfully employed.

Average remuneration per worker in the enterprise-surveyed formal non-agricultural sector

Per cent

	Year-on-year change		
	2008	2009	1st qr 2010
Mining	26,7	14,5	11,5
Gold mining	11,4	14,5	14,8
Non-gold mining	32,6	14,8	10,4
Manufacturing	11,5	11,8	16,1
Electricity supply	10,6	22,0	16,1
Construction	18,2	15,8	26,4
Trade, catering and accommodation	13,6	8,5	10,5
Transport, storage and communication	7,1	12,7	12,4
Financial intermediation and insurance	8,5	9,4	12,5
Community, social and personal services	10,7	15,8	24,6
Total private sector	**12,4**	**11,3**	**14,1**
Total public sector	**12,9**	**11,3**	**16,4**
Grand total	**12,8**	**11,3**	**15,1**

According to the *Wage Settlement Survey* compiled by Andrew Levy Employment Publications (a private-sector labour consultancy), the average wage settlement rate in collective bargaining agreements moderated to 9,3 per cent in 2009 and further to 8,2 per cent in the first half of 2010. The number of worker-days lost due to industrial action almost doubled to 1,25 million in the first half of 2010, compared with the same period in 2009, which does not augur well for productivity gains during this period.

Consistent with the trend in industrial action and a decline in production levels, *labour productivity growth* in the formal non-agricultural sector of the economy decelerated to 1,9 per cent in 2008 and further to 1,6 per cent in 2009. Labour productivity growth picked up to a year-on-year rate of 5 per cent in the first quarter of 2010, as output improved while the number of people employed contracted further. Labour

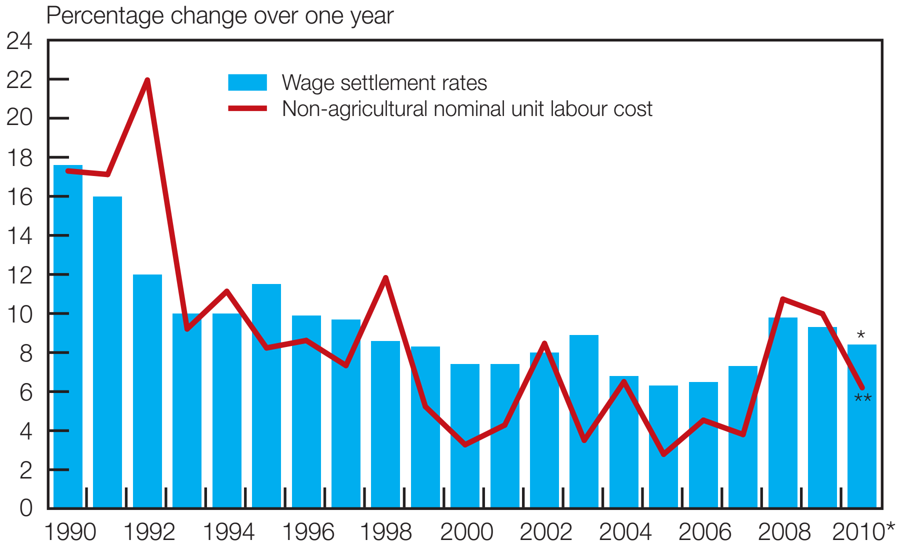
Formal non-agricultural employment and labour productivity

Percentage change over one year

productivity in the manufacturing sector decreased markedly by 6,2 per cent in 2009 as a whole in the wake of the economic recession. Measured over four quarters it reverted to an increase in the fourth quarter of 2009. This rate of increase accelerated to 9,4 per cent in the year to the first quarter of 2010 as manufacturing output increased alongside a decrease in the number of people employed, when measured over a four-quarter period.

The rate of increase in *nominal unit labour cost* in the formal non-agricultural sector of the economy moderated slightly to 10 per cent in 2009. Owing to a marginally lower rate of increase in nominal remuneration per worker and an improvement in labour productivity, the year-on-year rate of increase in nominal unit labour cost moderated further to 9,6 per cent in the first quarter of 2010. Although moderating somewhat, growth in nominal unit labour cost remained well above the upper limit of the inflation target range, thus contributing to domestically generated inflationary pressures. When measured over four quarters, the rate of increase in nominal unit labour cost in the manufacturing sector eased to 6,1 per cent in the first quarter of 2010, compared with an increase of 19 per cent in 2009 as a whole.

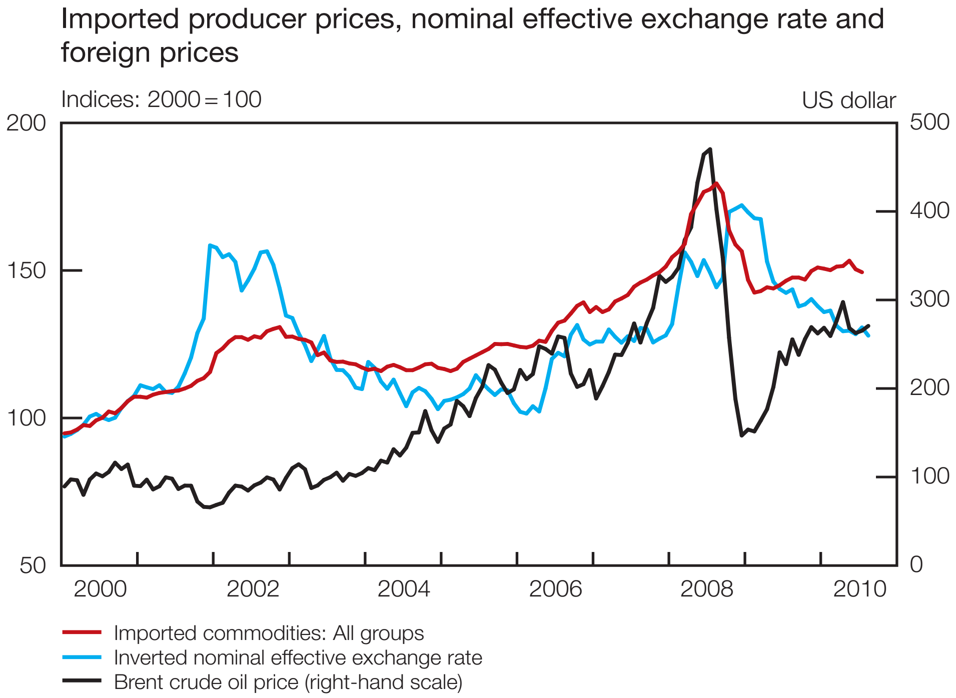
Nominal unit labour cost and wage settlement rates



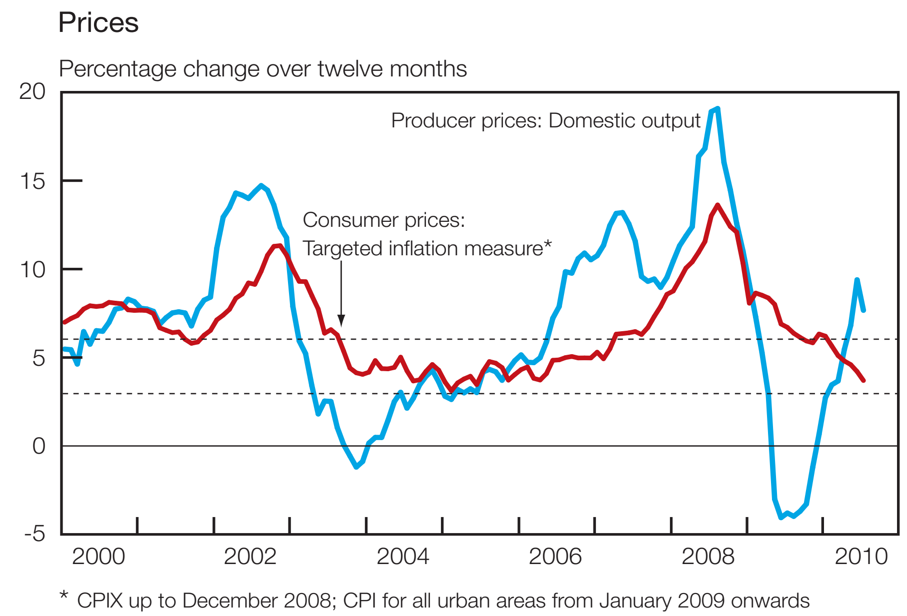
* First half
** Estimate based on national accounts aggregates

Prices

Price developments in the domestic economy during the past year and a half were, to a large extent, influenced by the international financial crisis. International commodity prices peaked in 2008, but thereafter decreased rapidly as the financial crisis affected the real economy with its concomitant inflation-containing effects. During 2009, commodity prices recovered somewhat as global economic activity gained momentum. This contributed to an appreciation in the exchange value of the rand, which, in turn, assisted in suppressing imported goods price inflation. These inflation-containing factors were assisted by declining producer prices in South Africa's main trading-partner countries, decreasing the inflation trajectory in the domestic economy through lower prices of imported goods. Following the pick-up in global economic activity during the latter half of 2009 and into the first half of 2010, these inflation-containing effects diminished in part. Domestic consumer price inflation moderated considerably from August 2008 to the first seven months of 2010, with the targeted measure of inflation re-entering and remaining within the 3 to 6 per cent inflation target range during the six months to July 2010.



Boosted by international commodity prices, headline producer price inflation accelerated to a peak year-on-year rate of 19,1 per cent in August 2008, thereafter decelerating substantially to a rate of *decrease* of 4,0 per cent in August 2009. The decline in producer prices of domestic output resulted primarily from lower commodity prices, including the lower international price of Brent crude oil during the latter part of 2008 and into 2009, as global demand contracted. As already mentioned, producer prices of South Africa's main trading-partner countries decreased significantly from mid-2008 to the end of 2009 following a contraction in domestic demand in these countries. The year-on-year rate of change in the composite foreign wholesale price index of South Africa's main



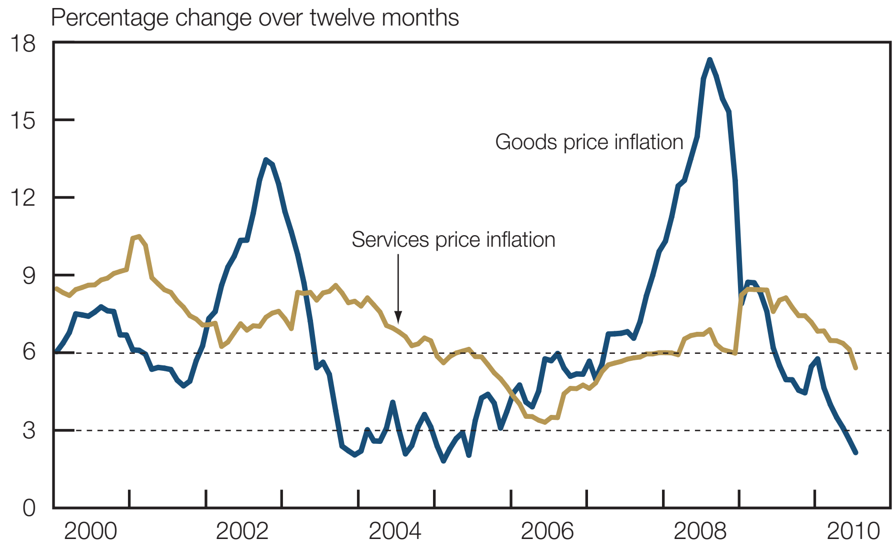
trading-partner countries subsequently moved from -7,4 per cent in July 2009 to 4,0 per cent in June 2010. In the ensuing months, domestic producer price increases accelerated to a rate of 9,4 per cent in June 2010 and moderated to 7,7 per cent in July.

The annual rate of increase in the producer prices of domestic output decelerated from 14,3 per cent in 2008 to zero in 2009. The subsequent increase in the prices of domestically produced output resulted primarily from higher prices of mining and quarrying products, as well as of manufactured goods, electricity, gas and water. As a partial offset to these price increases, lower producer prices of agricultural and manufactured food products assisted in restraining producer price inflation in recent months.

When analysing price changes in the mining category of the headline producer price index during 2008, it is evident that those price changes mirrored price developments in the imported mining category, stemming from escalating international commodity prices in the period leading up to the third quarter of that year combined with the appreciation in the external value of the rand. As international economic developments deteriorated in response to the global economic recession, commodity prices fell precipitously in the fourth quarter of 2008. In the subsequent period, the global economic recovery contributed to an increase in commodity prices and hence imported producer prices.

Changes in producer prices of domestic output traced those of imported producer prices, but remained below them during the period from 2006 to June 2009. Thereafter, both producer price measures were in deflation. Base effects and a revival in commodity price increases from the final months of 2009 led to producer price changes of domestic output moving from a decrease of 4,0 per cent in the year to August 2009 to an increase of 9,4 per cent in the year to June 2010. The price increases of Brent crude oil from a low of around US$35 per barrel in early 2009 to an average of US$77 per barrel in the first half of 2010, coupled with the rise in industrial commodity prices, propelled imported and domestic producer prices over the period.

Prices of consumer goods and services



Year-on-year consumer food price inflation averaged 15,8 per cent in 2008, decelerating to 9,2 per cent in 2009 and further to 1,1 per cent in the year to July 2010. Producer price decreases of food at both the agricultural and manufactured levels were translated into a considerable moderation in consumer food price increases in the early months of 2010.

Stats SA introduced a re-engineered headline consumer price index in February 2009 which also served as the new inflation target measure for the South African economy. In the course of 2009, headline consumer price inflation moderated as both goods and services price inflation decelerated. The deceleration in goods price inflation was, however, more pronounced than in services price inflation.

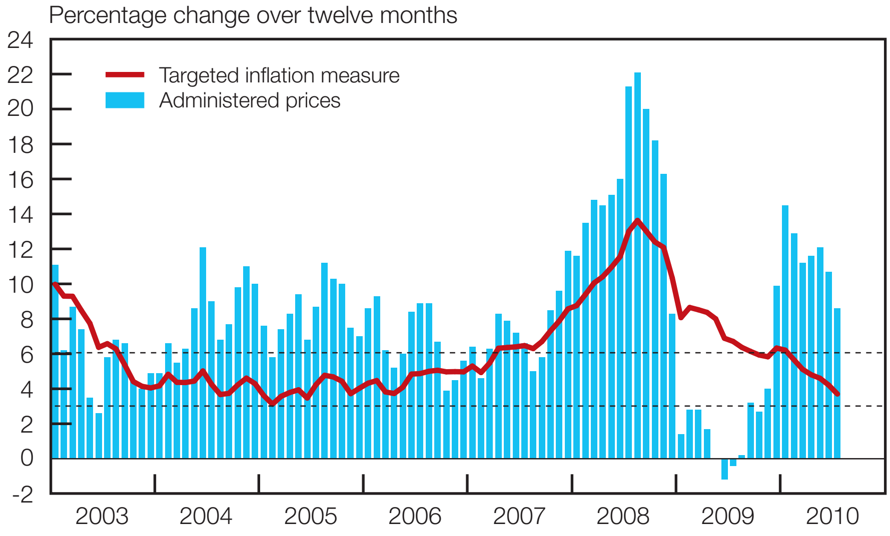
After having accelerated markedly during 2008, *consumer goods price inflation* declined substantially in 2009 and during the first half of 2010, amounting to 2,1 per cent in the year to July 2010. The moderation in goods price inflation was brought about by a notable deceleration in food price inflation in particular, aided by lower rates of price inflation in clothing and footwear products, recreation and cultural products, as well as in miscellaneous goods. In addition, the prices of communications products receded sharply, decreasing at a year-on-year rate of 28,2 per cent in July 2010. Conversely, the prices of alcoholic beverages and tobacco products as well as electricity kept on increasing apace, while year-on-year petrol price changes reversed their deflationary trend from December 2009 and increased at a rate of 18,8 per cent in the year to May 2010 and moderated sharply to 4,9 per cent in July.

Services price inflation has edged up slowly since 2006, peaking at a year-on-year rate of 8,5 per cent in February 2009. The ensuing gradual decline in services price inflation to a rate of 5,4 per cent in the year to July 2010, resulted largely from a moderation in the price increases of transport services, communication services, and of rent on dwellings. Although moderating somewhat, price inflation of educational services, restaurant and hotel services, household maintenance, miscellaneous services, and health services remained at elevated levels, with price inflation of insurance services being particularly high at a double-digit rate in the year to July 2010.

When the more volatile prices of food and petrol are omitted from the calculation of targeted consumer price inflation, the underlying twelve-month consumer price inflation rate exceeded the upper limit of the inflation target range for the twenty-fourth consecutive month in January 2010, when it amounted to a year-on-year rate of 6,2 per cent. Subsequently, this rate entered the inflation target range in February 2010 and remained within the target range in subsequent months, amounting to 4,0 per cent in July. When also excluding electricity prices from the calculation, headline consumer price inflation amounted to a year-on-year rate of 3,6 per cent in July 2010.

The pronounced decrease in petrol prices during the second half of 2008 led to a swift deceleration in *administered price inflation*, from a peak of 17,5 per cent in the year to August 2008 to a decline of 1,2 per cent in the year to June 2009. Despite headline consumer price inflation continuing to decelerate to within the inflation target range in the first half of 2010, administered price inflation accelerated briskly to double-digit rates as petrol prices again began to increase gradually from February 2009. Petrol price increases largely accounted for the recent acceleration in administered price inflation. With the exception of communication services prices, all other categories of administered prices continued to increase at twelve-month rates of close to or above 10 per cent in the first half of 2010. Despite moderating somewhat, year-on-year electricity prices nevertheless still increased at an average rate of 26,8 per cent in the seven months to June 2010 and moderated to 20,7 per cent in July.

Targeted inflation and administered prices



Consistent with the deceleration in overall consumer price inflation, inflation expectations have also decreased notably during the past year and a half. In the second quarter of 2009 participants in the BER *Inflation Expectations Survey* expected headline consumer price inflation to amount to 8,1 per cent in 2010. By the second quarter of 2010, the BER expected inflation to moderate to 6,3 per cent in 2010 before increasing marginally to 6,5 per cent in 2011 and further to 6,8 per cent in 2012. Inflation expectations therefore remained above actual inflation outcomes, while wage demands continued to exceed inflation expectations by a fair margin.

Foreign trade and payments

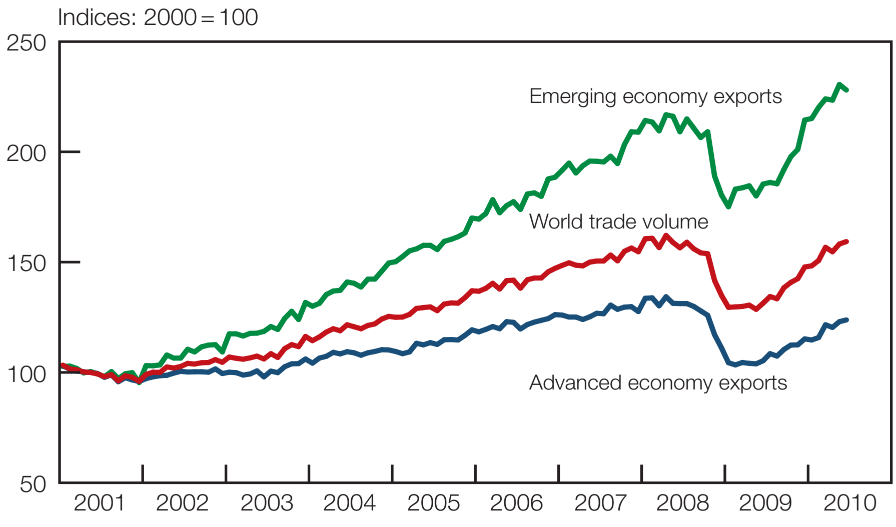
International economic developments

The 2007–09 global financial and economic crisis started with the collapse of the United States (US) sub-prime mortgage market in 2007. The crisis intensified significantly in September 2008 following the bankruptcy of Lehman Brothers. The failure of this large investment bank in the US unsettled investor confidence worldwide and financial sector problems started to escalate in the US and Europe, disrupting credit extension, trade and economic activity in general. Countries affected by the crisis responded rapidly to the downturn in output by adopting expansionary monetary and fiscal policies in a highly synchronised manner. Central banks lowered policy rates during the crisis to stabilise the financial system and support economic activity. With policy rates approaching levels close to zero, monetary authorities also started to explore unconventional policy measures to ease credit conditions and provide liquidity. In addition, the severity of the recession prompted governments to provide massive fiscal stimulus programmes and large financial rescue packages to support the economy.

Emerging-market economies had only limited exposure to the troubled financial assets plaguing several advanced economies, and managed to weather the initial phase of the crisis relatively well. However, as the recession in advanced economies took hold, emerging-market economies became increasingly affected. Global trade volumes contracted sharply towards the end of 2008 following the decline in demand from advanced economies, adversely impacting exports and economic growth in emerging-market economies. The recession, covering a large number of advanced and emerging-market economies in a synchronised manner, made itself felt in a marked contraction in global output in the fourth quarter of 2008 and the first quarter of 2009. The downturn in economic activity sharply increased unemployment in a number of countries.

In September 2009 the G-20 countries launched the Framework for Strong, Sustainable and Balanced Growth. The member countries agreed to work together to ensure that their fiscal, monetary, trade and structural policies were collectively supportive of sustainable and balanced global growth. They also agreed to promote macroeconomic stability by implementing macroprudential and regulatory policies to help prevent credit- and asset-price cycles from becoming destabilising.

Developments in world trade and export volumes



Source: CPB Netherlands Bureau for Economic Policy Analysis

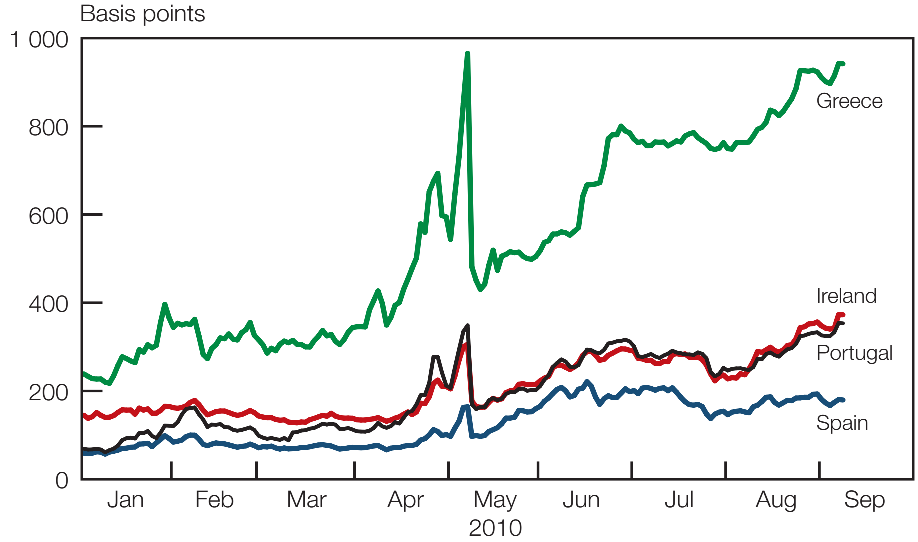
Global economic growth started to turn around in the second quarter of 2009 and improved further in the second half of that year following unprecedented and co-ordinated macroeconomic policy support, as well as strong growth in emerging-market economies, particularly in China and India. Although the recovery in global economic growth was stronger than expected in the first quarter of 2010, growth remained relatively fragile and uneven between advanced and emerging-market groupings, and between countries within the same group. Recent data suggest that global growth moderated somewhat in the second quarter of 2010. Real output growth in most advanced economies was positive in the first and second quarters of 2010, but remained below pre-crisis levels.

Output growth in the US gained momentum in the fourth quarter of 2009, but moderated in the first and second quarters of 2010. Economic growth in the second quarter was mainly underpinned by positive contributions from non-residential fixed investment, personal consumption expenditure, exports, federal government spending and private inventory investment. Following a period of contraction, economic activity in the euro area started to expand from mid-2009, albeit at a modest pace. Real output in the euro area increased marginally from the fourth quarter of 2009 to the first quarter of 2010, before expanding robustly in the second quarter of 2010. Economic growth was driven mainly by positive contributions from exports and investment in Germany. The state of public finances, coupled with the vulnerability of the banking system, remains some of the key challenges in several euro area countries. Financial markets, however, reacted positively to the results of the recent European Union (EU) bank stress tests. In Japan, real output growth accelerated further in the first quarter of 2010 before slowing significantly in the second quarter. Real output was supported by buoyant exports, while inventories and government expenditure made negative contributions. A deterioration in exports and domestic demand conditions, combined with the phasing out of government support measures and a moderation in economic growth in China, are expected to restrain the economic performance of Japan in the next year.

A number of emerging-market economies, including China, India and Indonesia, managed to avoid a recession as output growth merely slowed before recovering to pre-crisis levels. The strong performance registered by emerging-market economies in the first quarter of 2010 was mainly underpinned by Asian emerging markets, notably China and India. Growth in emerging-market economies, however, moderated in the second quarter of 2010, mainly due to a deceleration of economic activity in Asian emerging markets, especially China.

The IMF revised its growth outlook upwards in the July 2010 *World Economic Outlook Update* to 4,6 per cent in 2010 (previously 4,2 per cent in April 2010) and 4,3 per cent in 2011 (unchanged), mainly on account of the better-than-expected economic performance in the first half of 2010. Commodity-exporting countries, among others in Africa, benefited from high commodity prices due to strong Chinese demand. Real output growth in sub-Saharan Africa is expected to be around 5 per cent in 2010. The downside risk to the global growth outlook has increased notably due to the unsustainable increase in government fiscal deficits and debt burden. Serious concerns about the sustainability of the global economic recovery re-emerged in mid-April 2010, following the downgrading of the sovereign debt of Greece by international credit-rating agencies. The yield spreads of Greek benchmark 10-year government bonds over German government bonds increased sharply in April 2010 and reached margins of more than 950 basis points in early May 2010. Financial markets worldwide became increasingly volatile as rating agencies continued to downgrade the sovereign debt ratings of other euro area countries (Ireland, Portugal and Spain) with vulnerable public finances. These events consequently fuelled concerns that the contagion effects could derail the global recovery. The yield spreads of these countries also increased, although not as rapidly as compared to Greece.

Sovereign yield spreads of selected countries vis-à-vis German government bonds



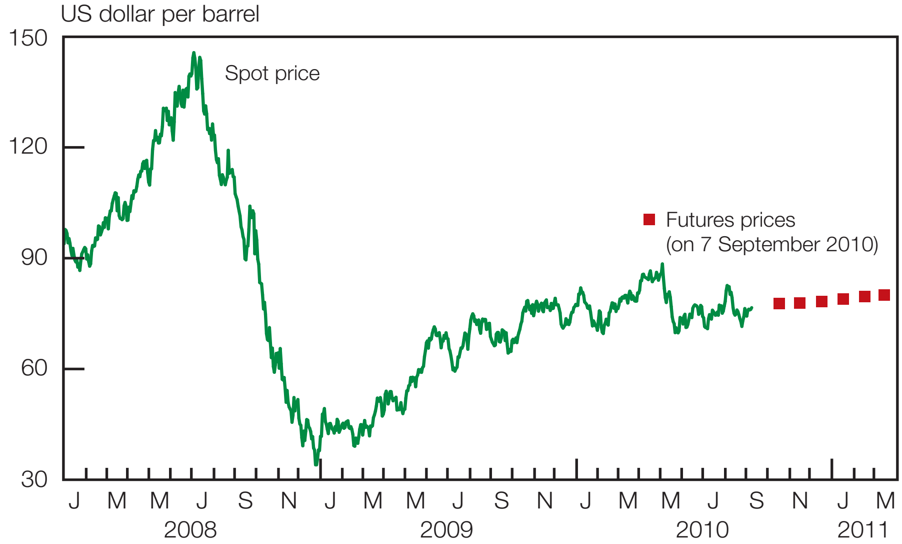
Source: Bloomberg

The immediate risk of a Greek sovereign default was avoided in May 2010 after an agreement was reached with the IMF and European Commission on an emergency loan package amounting to €110 billion. In return, Greece announced fiscal austerity measures undertaking to reduce government spending. Although this agreement initially calmed financial markets, concerns over contagion and the possible impact on the sustainability of global growth later resulted in further financial market turbulence. However, financial markets became more stable and sovereign bond spreads narrowed substantially after an additional loan package of €750 billion had been approved by the EU for member countries experiencing solvency problems. Concerns regarding sovereign risk impacted negatively on the banking sector, especially banks with high exposure to the public sectors of Greece, Portugal and Spain. This deterioration of financial market conditions in May 2010 resulted in another round of unconventional policy measures being introduced by central banks. The European Central Bank, for instance, decided to buy sovereign bonds from euro area member states to provide liquidity to the market.

The latest Organisation for Economic Co-operation and Development (OECD) composite leading indicators suggest global growth may have reached a peak. The leading indicator for Germany remains relatively robust, while the euro area, Japan and Russia may experience a slowdown in the pace of expansion in the near future. The United Kingdom (UK) and possibly also Brazil, Canada and the US, however, have reached a peak in the pace of expansion. The leading indicators for China, France, India and Italy suggest that these economies could experience a slowdown in the coming months.

The moderation in global economic activity and the contraction in world trade volumes led to lower commodity prices, especially crude oil, and resulted in a sharp deceleration in consumer price inflation around the world. Continued concerns over Europe's increasing sovereign debt risks and further signs of a moderation in the pace of economic growth in the US and China weighed heavily on oil prices. The spot price of Brent crude oil declined to levels below US$70 per barrel in May 2010 from a 19-month high of US$85 per barrel in April 2010. Although sentiment continued to be dominated by equity markets and global financial developments in June and July 2010, oil prices partially recovered to levels around US$81 per barrel at the beginning of August. The oil price has since moderated to levels around US$76 per barrel in early September 2010, due to concerns about the sustainability of global growth. The oil market developments continue to be influenced by increasing production and excess inventories. World oil demand is projected to grow by 1,3 million barrels per day to 87,9 million barrels per day in 2011 led by increasing demand from non-OECD countries, mainly China, India, the Middle East and Latin America. Futures prices suggest that Brent crude oil prices will be around US$77 per barrel in the fourth quarter of 2010, edging higher to US$80 per barrel in the first quarter of 2011.

Brent crude oil prices

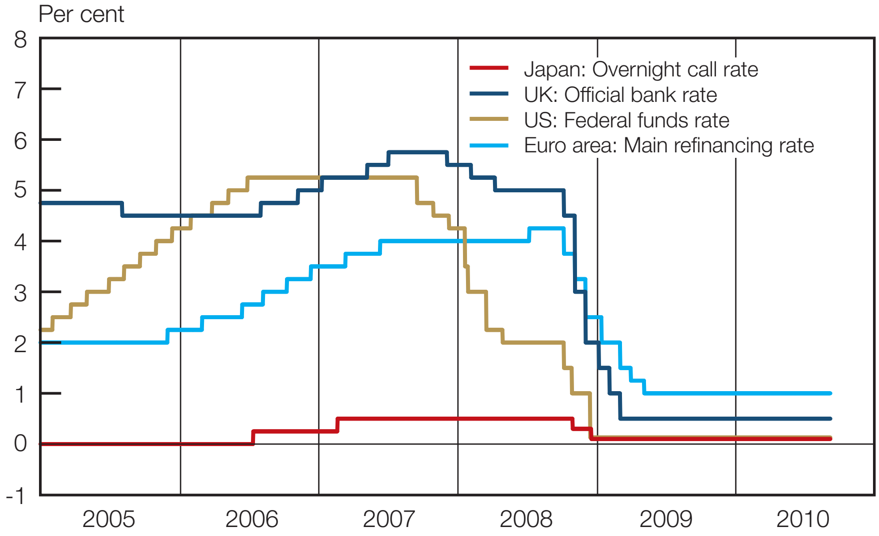


Source: Bloomberg

Headline inflation in most advanced economies eased marginally during the second quarter of 2010, after accelerating during the second half of 2009 due to higher commodity prices. Core consumer prices in most advanced countries remained subdued in July 2010, after trending downwards since October 2008 as a result of weak demand, unemployment and excess capacity. Headline inflation started to accelerate in the second half of 2009 in a number of emerging Asian economies, but remained stable in the first half of 2010. Inflationary pressures have continued to dissipate since mid-2008 in emerging European markets. Consumer price inflation in Latin American economies accelerated from the beginning of 2010, but became more stable in the second quarter of 2010.

Many central banks reduced policy rates and adopted unconventional policy measures during the crisis to stabilise the financial system and limit the duration and extent of the downturn in economic activity. Policy rates in most major advanced economies remain at record-low levels, in some cases close to zero. However, central banks in some of the other advanced and emerging-market economies that managed to recover faster from the global recession have started withdrawing monetary stimulus. Several central banks in advanced economies (including Australia, Canada, New Zealand, Israel, Norway and Sweden) and in a number of emerging-market economies (including Brazil, Chile, India, Malaysia, Korea, Taiwan Province of China and Thailand) have started to exit from their accommodative monetary policy stances, while others are expected to keep policy rates at low levels for at least the remainder of the year. The Bank of China has left its policy rate unchanged, but has increased its cash reserve requirement on several occasions. A similar step was taken by the Reserve Bank of India and Bank Indonesia.

Central bank interest rates



Source: Various central banks

Current account[3]

3 The current account transactions referred to in this section are all seasonally adjusted and annualised.

Early signs of a global economic recovery became apparent in the second half of 2009 when international trade volumes between commodity-producing economies and the Asian region, in particular, gained momentum. The sustained strong growth in economic activity in especially China and India favoured South African export volumes and helped to transform the country's trade balance from a deficit to a surplus in the second half of 2009. In addition, the trade balance also benefited from the fairly subdued domestic demand for foreign-produced goods and the continued depletion of inventories. The traditional deficit on the services, income and current transfer account with the rest of the world narrowed over the same period mainly due to a reduction in net income payments to non-resident investors.

Balance of payments on current account

Seasonally adjusted and annualised
R billions

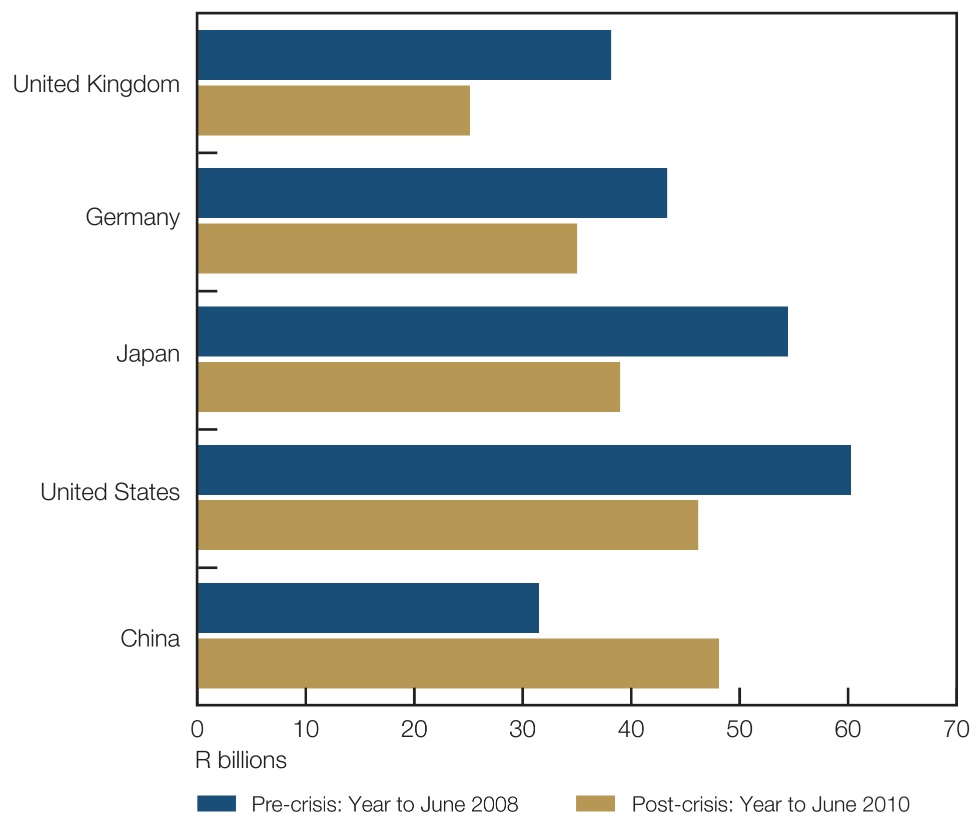
	2008	2009			2010
	Year	1st half	2nd half	Year	1st half
Merchandise exports	655,8	504,2	503,1	503,7	535,3
Net gold exports	48,5	49,2	56,3	52,8	54,3
Merchandise imports	-739,9	-572,5	-535,8	-554,2	-589,4
Trade balance	-35,6	-19,1	23,6	2,3	0,2
Net service, income and current transfer payments	-126,1	-100,8	-96,8	-98,9	-91,7
Balance on current account	-161,7	-119,9	-73,2	-96,6	-91,5
As a percentage of gross domestic product	*-7,1*	*-5,1*	*-3,0*	*-4,0*	*-3,6*

In the first half of 2010 the trade surplus, however, contracted markedly as domestic expenditure picked up, leading to higher imports. Consumption expenditure rose significantly and, at the same time, accumulated inventory holdings had been depleted to such an extent that they no longer provided much of a buffer. Consequently producers were obliged to start raising imports in order to meet rising demand and to complete infrastructural investment projects associated with the 2010 FIFA World Cup™ tournament. At the same time, the recovery in global economic activity appeared to be uneven and fragile, while the exchange value of the rand appreciated, thereby partially constraining growth in South African export volumes over the period.

Owing primarily to developments in the balance on the trade account, the deficit on the current account of the balance of payments narrowed markedly in the second half of 2009 before widening again to 3,6 per cent of gross domestic product in the first half of 2010. This deterioration in South Africa's current-account balance, despite increased receipts emanating from trade in services associated with the hosting of the football tournament, closely resembled those of other commodity-producing economies such as Brazil and Chile.

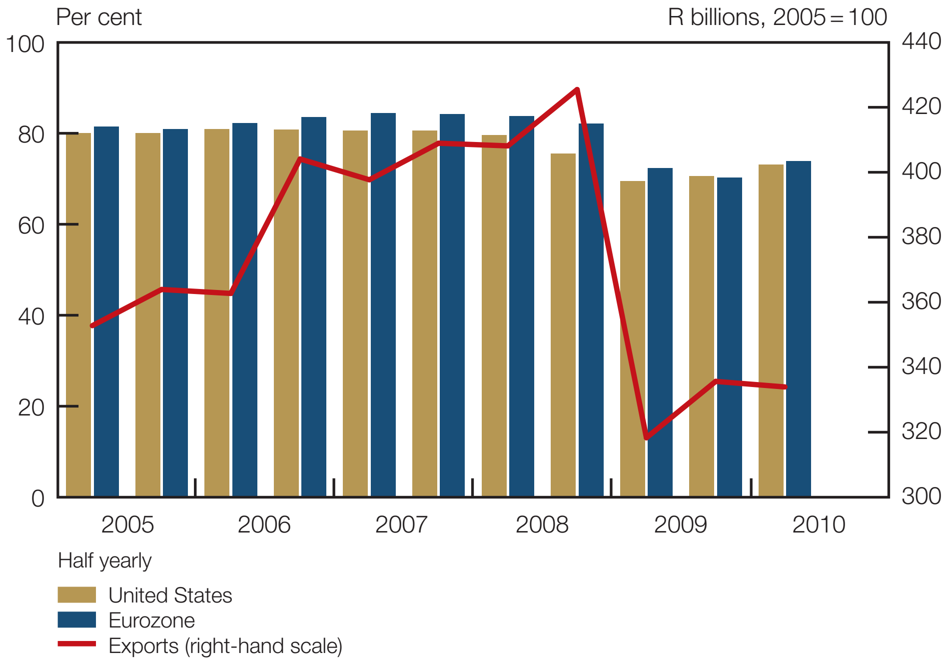
Although the second half of 2009 was marked by a fairly broad-based increase in economic activity, growth among emerging-market economies tended to outpace the rate of increase in economic expansion in developed economies. As a consequence, South Africa's trade pattern with the rest of the world changed somewhat over the period – China moved from being the country's fifth most important export trading-partner country to become the country's most important export destination. Furthermore, the US was ranked the second most popular destination for South African exports, followed by Japan and Germany. Before the financial crisis, Japan was South Africa's second most important export destination. Despite the change in export patterns, export volumes – with the exception of goods destined for China – remained relatively subdued compared with pre-crisis levels.

South African exports by destination



The realignment of South Africa's export destinations was timely for domestic exporters of mining products, given the increase in capacity utilisation in the manufacturing sector in some of the country's trading partners. More specifically, the volume of mining exports to China and India rose significantly in the year to June 2010, despite tightening fiscal and monetary policy measures introduced by the Chinese authorities in the opening months of 2010 to slow the pace of economic expansion. Capacity utilisation in the US economy also revealed a steady upward trend since the middle of 2009, boding well for mining exports to the region.

Capacity utilisation abroad and the volume of South African exports

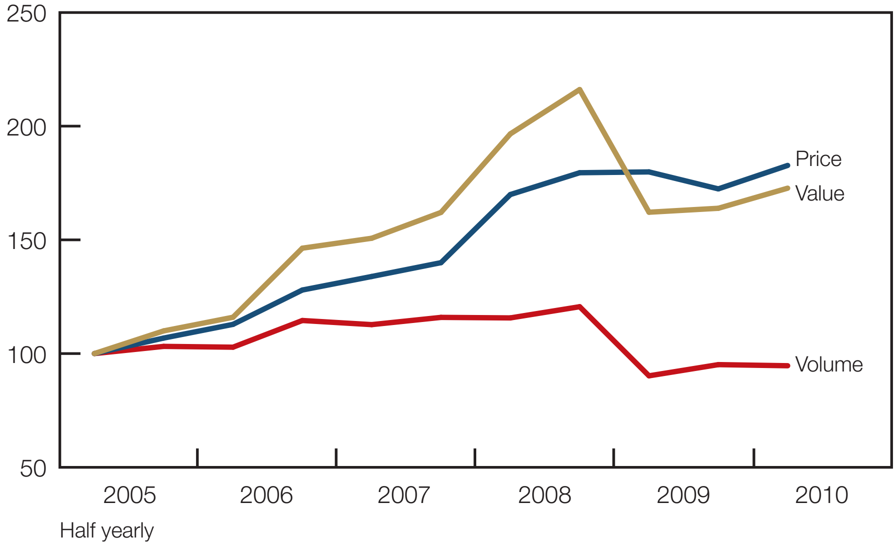


The performance of the manufacturing sector in the euro area improved in the year to June 2010 with exports of base metals and related products destined for the region advancing solidly over the period. The high demand for domestic base metals was consistent with the increase in the utilisation of production capacity in the region.

Despite relatively subdued demand conditions in the euro area, the export of domestically manufactured vehicles and transport equipment to Germany and the UK increased over the period as South African vehicle manufacturers honoured their contractual agreements with their European counterparties. The higher volume of exported vehicles was, however, countered by subdued growth in the other subcategories of manufactured goods, which ultimately restrained the growth in manufactured exports from the second half of 2009 to the first half of 2010. Overall, the volume of merchandise exports advanced by 4,6 per cent in the second half of 2009, before moving broadly sideways in the first half of 2010. This broadly unchanged volume of exports coincided with an increase in the export prices of such goods and, accordingly, in the export proceeds of domestic producers. Relative to the country's gross domestic product, export values declined marginally from 21,4 per cent in the first half of 2009 to 20,7 per cent in the first half of 2010, still well below the average ratio of 24,4 per cent registered between 2005 and 2008.

South African exports

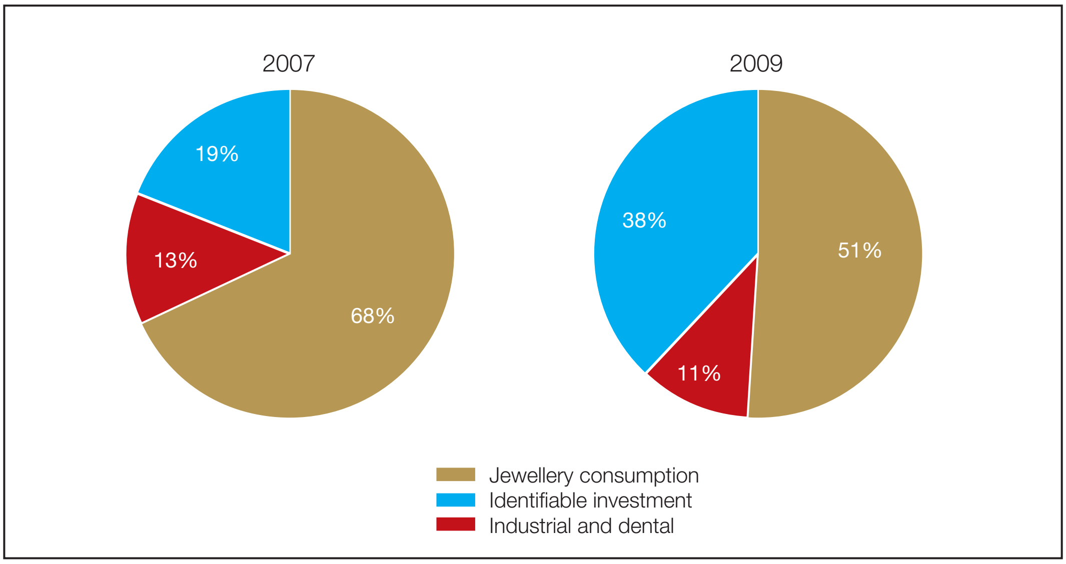
Indices: 2005 = 100



The upward trend in the rand price of exports reflected a similar trend in international commodity prices that resumed in the early months of 2009. In dollar terms, international commodity prices rose, on average, by 14,4 per cent from the first to the second half of 2009 – by the end of June 2010, the prices of most precious metals had recovered the largest part of the losses suffered during the financial crisis. Pronounced increases were noted in the fixing price of gold on the London market which rose by almost 12 per cent from an average of US$1 030 per fine ounce in the second half of 2009 to US$1 152 per fine ounce in the first half of 2010.

Structure of global gold demand

Percentage of total

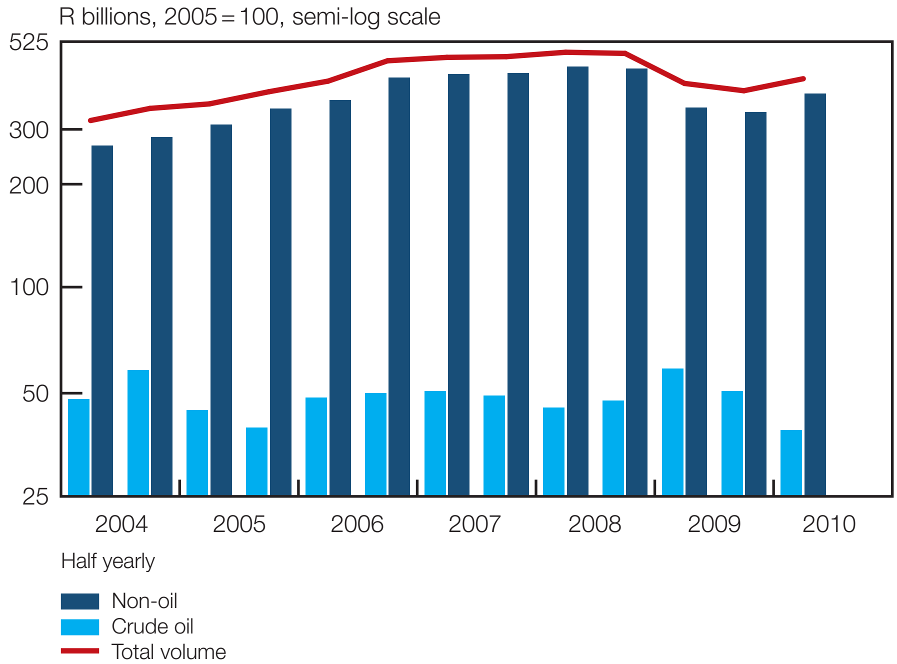


Source: World Gold Council

As uncertainties about the sustainability of the economic recovery mounted in some economies during the opening months of 2010, international investors tended to accumulate more gold in an attempt to hedge their portfolios against the volatility in financial markets. The demand for gold as an investment asset relative to the supply of gold subsequently doubled from 19 per cent in 2007 to 38 per cent in 2009; this ratio came to about 40 per cent in the first half of 2010 when investors engaged more in bar hoarding activities while simultaneously increasing their acquisition of official coins. By contrast, the demand for jewellery, which constituted the bulk of gold demand in 2007, contracted substantially in 2009 as buyers found it too costly alongside tight liquidity. Despite the firm appetite for the precious metal, gold production continued to decline during the 18-month period to June 2010. Nonetheless, export proceeds increased noticeably in the year to June 2010 as larger quantities of gold were sold to non-resident parties.

The increase in domestic demand in the first half of 2010, which coincided with a slower rate of decline in inventory holdings, led to an increase in import volumes over the period. The pick-up in global economic activity furthermore encouraged domestic producers to accumulate intermediate goods in order to meet the expected increase in international demand. During the first half of 2010, the import penetration ratio amounted to 21,4 per cent from a record high of 26,5 per cent in the second half of 2006.

Volume of merchandise imports



As the inventory cycle had most probably reached a lower turning point, domestic manufacturers had to step up importing capital and intermediate goods in the first half of 2010 in order to satisfy rising consumer demand and complete some of the infrastructural projects related to the 2010 FIFA World Cup™ tournament. A large portion of these imports consisted of machinery and electrical equipment as well as vehicles and transport equipment, the latter category including the military aircraft acquired by general government during the period. After reaching a peak in the first quarter of 2009, the volume of crude oil imports trended downwards throughout the first half of 2010. More refined petroleum products were imported in the first half of 2010, partly on account of the need for maintenance of crude oil refineries.

With both the rand price and the volume of merchandise imports edging lower, the value of goods purchased abroad declined in the second half of 2009 before advancing again in the first half of 2010, as both prices and quantities started recovering. The muted movements in the rand price of merchandise imports over the past year could partly be ascribed to the relatively subdued increase in the international price of crude oil, the appreciation in the exchange rate of the rand and the low rate of imported inflation. Contrary to most export commodities, the international price of crude oil remained well below its pre-crisis peak levels between the second half of 2009 and the first half of 2010, as world demand for oil moderated.

South Africa's terms of trade improved in the first half of 2010 after remaining broadly unchanged in the second half of 2009. The rapid increase in the rand price of merchandise exports compared with that of merchandise imports compensated for the subdued growth in the volume of merchandise exports and supported the country's trade balance in the first half of 2010.

The deficit on the services, income and current transfer account with the rest of the world shrank by almost 22 per cent in 2009 and by a further 5½ per cent in the first half of 2010, representing the most sizeable annual contraction in more than 40 years. This primarily reflected fragile domestic conditions that forced companies to utilise internally generated funds more cautiously.

Balances: Components of services, income and current transfer account

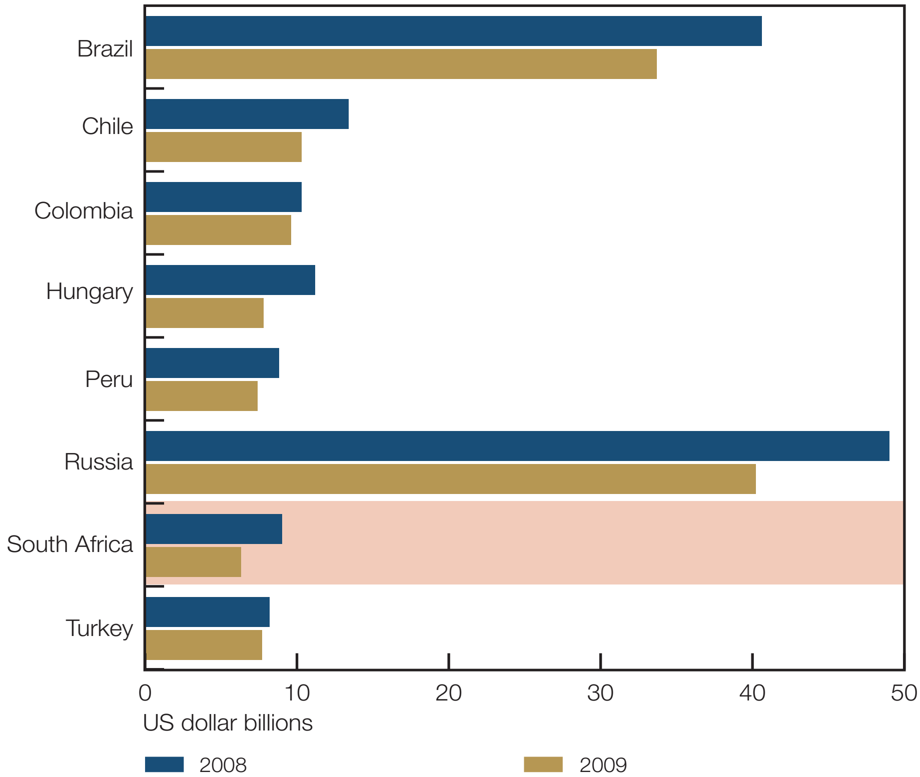
Percentage of gross domestic product

	2007	2008	2009	2010*	40-year annual average
Net services payments	-0,9	-1,5	-1,0	-0,9	-0,8
Net income payments	-3,4	-3,2	-2,2	-1,9	-3,2
Of which: Net dividend payments	-3,1	-2,5	-1,6	-1,5	-1,1
Net current transfer payments	-0,8	-0,8	-0,9	-0,7	-0,3
Total deficit	**-5,1**	**-5,5**	**-4,1**	**-3,5**	**-4,3**

Deficit – surplus +
* First half of 2010

As illustrated in the accompanying table, the narrowing of the deficit on the services, income and current transfer account in 2009 could mainly be attributed to lower net income payments to the rest of the world. Although domestic economic activity expanded in the third and fourth quarters of 2009, growth originated from a low base, which constrained the declaration of dividends to shareholders. The reluctance to declare dividends could primarily be attributed to relatively low profit margins, uncertainty regarding the sustainability of the economic recovery, as well as the need to recapitalise balance sheets. Gross dividend payments accordingly shrank by almost 30 per cent in 2009. However, in the first half of 2010 dividend payments increased at a meagre pace. As indicated in the graph on page 38, other emerging-market economies also registered a reduction in net income payments to the rest of the world during 2009, emphasising the adverse effects that the global financial crisis had on economic activity. Moreover, relatively low interest rates internationally led to a reduction in gross interest payments on outstanding debt to the rest of the world.

Net income payments for selected emerging economies



Apart from lower net income payments to the rest of the world, net payments for other international trade in services transactions remained almost unchanged from the second half of 2009 to the first half of 2010, thereby contributing to the smaller deficit on the overall services account. Gross payments for services rendered by non-resident parties were partly neutralised by non-resident spending associated with the hosting of the 2010 FIFA World Cup™ tournament. Inflows associated with the local spending of foreign tourists during the football tournament gave rise to record-high travel receipts. Net payments for services such as transportation and freight displayed little change, consistent with the relatively subdued increase in merchandise trade volumes. Elevated payments in the category "other services" relating to payments for technical services associated with the completion of certain infrastructural transport-related projects such as the first phase of the Gautrain project prevented the deficit on the services account from improving further in the first half of 2010.

As a result of the contraction in international trade volumes and lower customs duty collections on imports into the Southern African Customs Union (SACU) during the past 18 months, net current transfer payments by South Africa to the other SACU member countries edged noticeably lower during the first half of 2010.

Financial account

The rebound in global economic activity since 2009 has been underpinned by historically low interest rates in developed economies and ongoing macroeconomic support measures which, *inter alia*, led to capital flows to emerging-market economies in search of higher yield. During the 18-month period to June 2010, South Africa experienced a continuous inflow of financial capital due in part to the country's well-structured capital markets that play a key role in attracting foreign portfolio investment. Despite concerns about the sustainability of the global economic recovery in the first half of 2010, the inflow of capital into the domestic economy rose to 5,5 per cent of gross domestic product in the first half of 2010; in 2009 this ratio came to 4,7 per cent.

Net financial transactions not related to reserves

R billions

	2008	2009			2010
	Year	1st half	2nd half	Year	1st half
Liabilities					
Direct investment	74,4	36,0	12,3	48,3	5,4
Portfolio investment	-71,5	39,7	67,5	107,2	72,5
Other investment	47,7	-34,4	-7,9	-42,3	-13,2
Assets					
Direct investment	25,9	-1,2	-12,3	-13,5	-3,3
Portfolio investment	-63,3	-1,3	-13,3	-14,6	-8,4
Other investment	83,0	2,4	18,3	20,7	8,4
Financial transactions*	**187,5**	**62,6**	**50,8**	**113,4**	**70,4**
As a percentage of gross domestic product	*8,2*	*5,3*	*4,1*	*4,7*	*5,5*

* Including unrecorded transactions

Foreign-owned assets in South Africa

Foreign direct investment is generally viewed as less volatile and more resilient than portfolio flows during financial crises. However, in South Africa the inward movement of *direct investment capital* tapered off significantly in the year to June 2010 following a sizeable inflow in the first half of 2009. Inward direct investment transactions in the course of 2009 were mainly recorded in the telecommunications, pharmaceutical and mining industries. Although smaller transactions were concluded in the first half of 2010, long-term investment decisions were most probably affected by concerns about the sustainability of the global economic recovery.

Portfolio investment into the country constantly recorded sizeable capital inflows throughout the 18-month period to June 2010 compared with capital outflows in 2008. The fairly steady capital inflow into South African issued equity and debt securities primarily reflected foreign investors' increased risk appetite for assets of those emerging-market economies where economic growth was expected to proceed at a somewhat faster pace than in developed countries. South Africa's sound macroeconomic policies, which, among other factors, paved the way for the economy's emergence from the most recent recession by the end of 2009, along with rising commodity prices, contributed meaningfully to the enhanced performance of the domestic equity market after reaching a lower turning point in March 2009.

Although the bulk of inward portfolio flows into South Africa was in the form of equity securities, the country also benefited from the non-resident investors' net acquisition of domestic debt securities in the course of 2009 and the first half of 2010. Notwithstanding fairly stringent lending criteria in international capital markets, the South African government successfully issued three international bonds to a total value of US$4 billion during the period. In total, the South African government became a net issuer of bonds during the 18-month period up to the end of June 2010. In the first half of 2010, non-resident investors were predominantly net purchasers of South African debt securities as the acquisition of debt securities accounted for 71 per cent of portfolio inflows.

In contrast to portfolio investment inflows, other foreign investment into South Africa changed from continuous inflows since 2002 to an outflow of capital in 2009. The net outward movement of capital could mainly be ascribed to the redemption of foreign short-term loans by the domestic private and banking sectors, as well as the withdrawal of foreign investors' rand and foreign currency-denominated deposits with South African banks. The decline in non-resident deposits with South African banks probably reflected, in part, tighter global liquidity conditions in 2009. In the first half of 2010 non-resident investors continued to reduce their deposit holdings with the South African banking sector.

South African-owned assets abroad

Having recorded a small outflow of capital in the first half of 2009, South African enterprises increased the acquisition of foreign direct investment assets in the second half of 2009, consistent with the recovery in global economic activity. The largest transaction of this kind during 2009 involved the acquisition of mining assets abroad by a South African mining company. The sustained accumulation and geographic diversification of foreign direct investment assets, however, tapered off somewhat in the first half of 2010.

South African institutional and individual investors increased their holdings of foreign portfolio assets significantly in the year to June 2010. The accumulation of portfolio assets could partly be attributed to South African investors making use of the relative strength of the external value of the rand to diversify their investment portfolios geographically. Furthermore, depressed valuations in international financial markets during 2009 and the first half of 2010 contributed to the opportunities prevailing in these markets.

Other foreign investment assets, which had decreased considerably in 2008, continued to decline throughout 2009 and in the first half of 2010, albeit at a slower pace in the first half of 2010. The decline in other foreign investment assets in 2009 mainly reflected a decrease in the offshore rand-denominated deposits of South African banks. In the first half of 2010 South African banks reduced their offshore foreign-currency denominated deposits.

Foreign debt

South Africa's outstanding foreign debt remains well within prudent levels compared to international standards, notwithstanding quarter-on-quarter increases throughout 2009 and the first half of 2010. As a ratio of gross domestic product, South Africa's total outstanding external debt increased from 26,3 per cent at the end of 2008 to 27,8 per cent at the end of 2009; relative to total export earnings, total external debt increased from 70,1 per cent to 96,7 per cent over the same period. The large increase in total external debt as a ratio of total export earnings occurred mainly as a result of the sharp contraction in the value of exports in 2009.

Having declined in 2008, the country's external debt commitments on balance rose by US$6,4 billion in 2009 and by a further US$2,5 billion up to the end of March 2010. The higher debt levels at the end of 2009 mainly reflected non-resident investors' improved sentiment towards South African fixed interest securities; foreign currency-denominated debt declined over the period despite an increase in international bond issues. The further increase in the country's foreign debt during the first quarter of 2010 could mainly be attributed to non-resident investors' continued accumulation of domestic rand-denominated bonds over the period.

South Africa's foreign debt

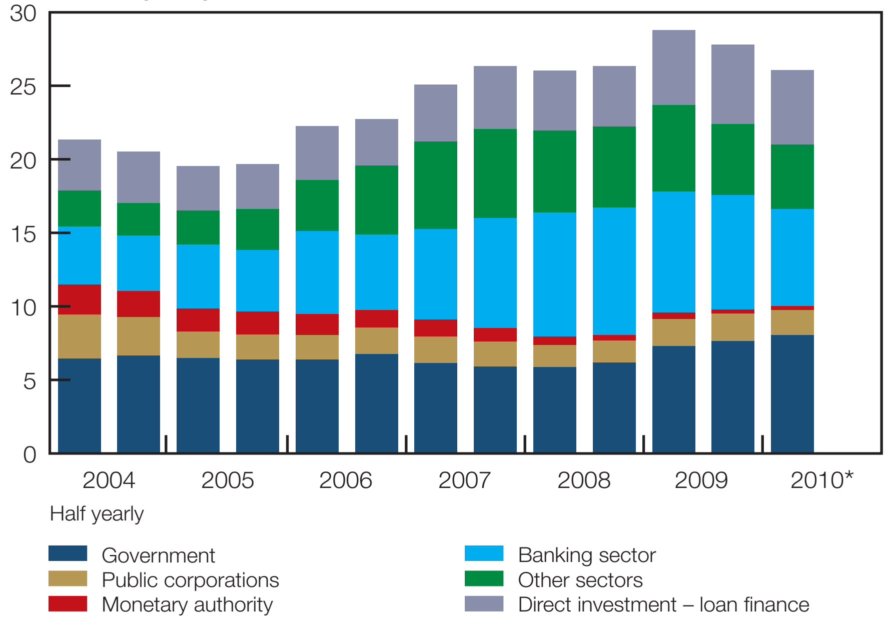
US$ billions at end of period

	2005	2006	2007	2008	2009	1st qr 2010
Foreign currency-denominated debt	**28,1**	**35,8**	**45,1**	**44,1**	**42,3**	**42,2**
Bearer bonds	9,1	10,5	15,2	14,0	15,4	16,8
Public sector	4,6	5,2	5,6	5,3	5,7	5,4
Monetary sector	7,9	10,3	12,7	12,8	10,6	9,2
Non-monetary private sector	6,5	9,8	11,6	12,1	10,6	10,8
Rand-denominated debt	**20,5**	**23,6**	**30,2**	**28,8**	**37,0**	**39,5**
Bonds	6,3	7,5	7,9	8,0	11,6	13,5
Other	14,2	16,1	22,3	20,8	25,4	26,0
Total foreign debt	**48,6**	**59,4**	**75,3**	**72,9**	**79,3**	**81,7**
As a percentage of gross domestic product	*19,7*	*22,7*	*26,3*	*26,3*	*27,8*	*26,0*

As a result of the increase in the outstanding foreign debt commitments of the South African government, its foreign debt rose to 7,6 per cent of gross domestic product at the end of 2009 and further to 8,0 per cent at the end March 2010. At the same time, the private banking sector's outstanding external debt relative to the country's gross domestic product decreased from 8,7 per cent in 2008 to 7,8 per cent in 2009, consistent with the declining trend in the outstanding debt of other sectors.

External debt by sector

Percentage of gross domestic product



* March 2010

Whereas the relative high government debt ratios of Greece, Portugal and Spain led to a downgrading of these economies by major credit ratings agencies, South Africa's sovereign rating has remained unchanged. Standard & Poor's (S&P) has downgraded Portugal's sovereign risk by two notches from A+ to A-, while Spain was relegated to AA from AA+. S&P also downgraded Greece's sovereign debt by three notches, from BBB+

to BB+, a sub-investment grade that immediately increased Greece's debt cost in the first half of 2010. By contrast, South Africa successfully issued a US$2 billion bond in March 2010 at a relatively favourable yield of 5,5 per cent per annum.

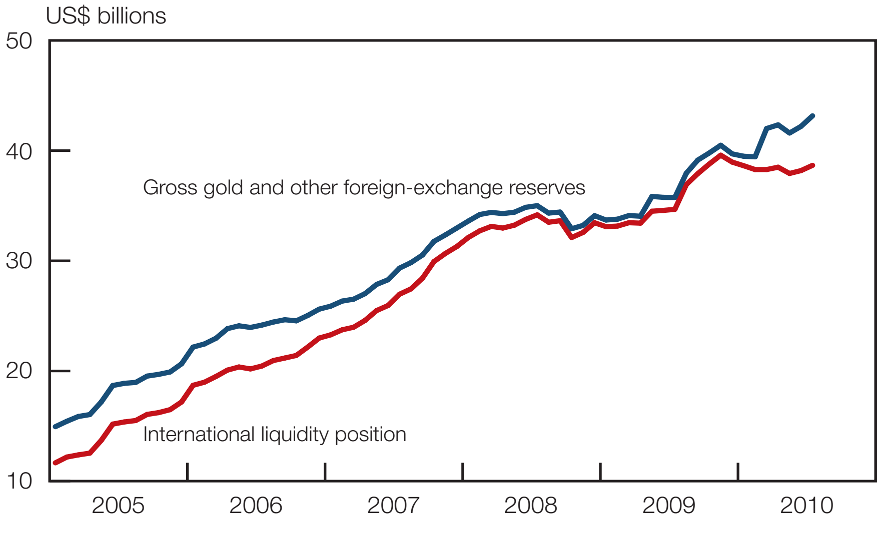
Despite the increase in the level of foreign debt denominated in US dollars, the country's total foreign debt, measured in rand, decreased from R678 billion at the end of 2008 to R584 billion at the end of 2009, before increasing to R599 billion at the end of March 2010. The decline from the end of 2008 to the end of 2009 can be ascribed to the appreciation of the exchange value of the rand against South Africa's main trading-partner countries.

South Africa's short-term foreign currency-denominated debt (i.e., debt with an original maturity of less than one year and other foreign currency-denominated debt maturing within the next twelve months) came to 31,4 per cent of total foreign currency-denominated debt at the end of 2009, compared with 40,7 per cent at the end of 2008. This improvement in the maturity structure of South Africa's foreign currency-denominated debt is mainly due to a decline in the monetary and private sectors' short-term debt.

International reserves and liquidity position

South Africa's net international reserves rose by R26,1 billion in 2008 and by a further R17,0 billion in 2009 on account of balance of payments transactions, as net capital inflows on the financial account of the balance of payments exceeded the deficit on the current account by a substantial margin. The accumulation of reserves, which had been evident in each half-year period since the start of 2004, was evenly spread over the first and second halves of 2009. In the first half of 2010, the country's net international reserve position improved by a further R30,2 billion.

Gross reserves and international liquidity position of the South African Reserve Bank



The gross international reserves of the Bank improved by US$5,6 billion from the end of 2008 to US$39,7 billion at the end of 2009. Of this increase an amount of $2,4 billion arose from an allocation of SDRs to South Africa by the IMF. As a result of the significant accumulation of gross reserves during 2009 as well as a narrowing of the current-account deficit, the ratio of foreign-exchange reserves of the Bank to the annual current-account deficit improved from 2 to 1 in 2008 to 3 to 1 in 2009. The Bank's gross international reserves amounted to US$42,2 billion at the end of June 2010.

The level of imports of goods and services covered by gross official international reserves increased from 16,6 weeks' worth at the end of December 2008 to 20,7 weeks' worth at the end of June 2010.

The Bank's international liquidity position also continued its gradual improvement, rising from US$33,5 billion at the end of December 2008 to US$39,0 billion at the end of December 2009, but declined to US$38,2 billion at the end of June 2010.

Exchange rates

After having increased by 18,5 per cent in the first half of 2009, the nominal effective exchange rate of the rand appreciated, on balance, by a more subdued 3,7 per cent in the second half of the year. During the first half of 2009 the exchange rate of the rand benefited mainly from an increase in commodity prices, net capital inflows into the country, and an improvement in the deficit on the current account of the balance of payments. During the second half of 2009 the exchange rate of the rand was supported by a continuation of the rise in international commodity prices and positive sentiment towards the country in anticipation of the hosting of the 2010 FIFA World Cup™ tournament. In addition, the acceleration in real economic growth and an improved inflation outlook gave further support to the exchange value of the rand during this period.

Exchange rates of the rand

Percentage change

	30 Dec 2008 to 30 Jun 2009	30 Jun 2009 to 31 Dec 2009	31 Dec 2009 to 30 Jun 2010	30 Jun 2010 to 31 Aug 2010
Weighted average*	**18,5**	**3,7**	**3,1**	**1,2**
Euro	19,6	3,3	13,5	0,0
US dollar	19,7	5,5	-3,6	3,7
Chinese yuan	19,8	5,4	-4,2	4,0
British pound	4,0	8,8	3,3	1,1
Japanese yen	26,6	2,0	-7,4	-1,4

* Against a basket of 15 currencies

Although further capital flows into South Africa and a sustained steady increase in commodity prices supported the exchange rate of the rand during the first half of 2010, the domestic currency showed increased volatility against the currencies of its main trading partners as a result of the uncertainty created by large fiscal deficits and weakened sovereign debt positions of some European countries.

The increase in international commodity prices during 2009 and the first half of 2010 resulted in real currency appreciation and a deterioration in the competitiveness of the manufacturing sector in most commodity-producing economies. South Africa counts among the countries recording the largest appreciation in their real effective exchange rate in the 18 months to June 2010. Conversely, developed countries have broadly gained competitiveness compared to emerging-market economies over the period.

Real effective exchange rates of selected countries*

Indices: 2005 = 100

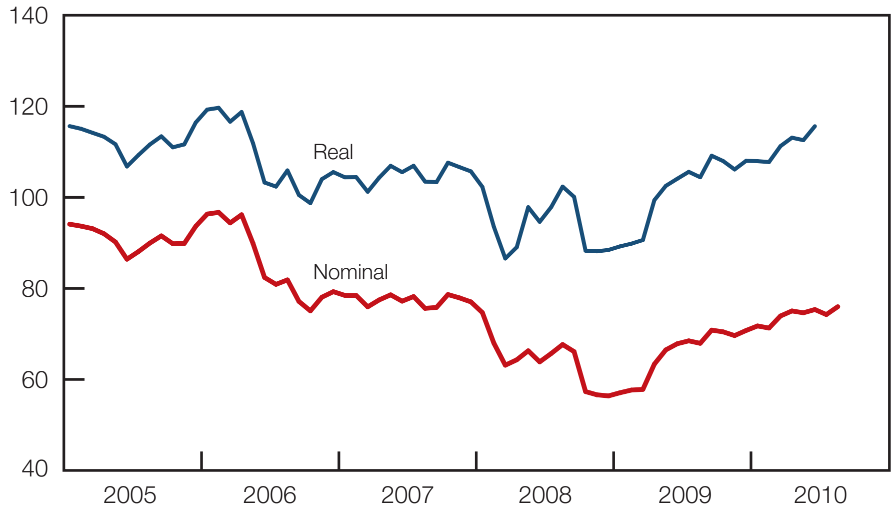
	Dec 2008	May 2010	Percentage change
Brazil	104,3	144,0	38,1
South Africa	**69,8**	**95,9**	**37,3**
Australia	86,2	110,9	28,7
Canada	94,1	110,8	17,8
New Zealand	79,0	92,9	17,6
Chile	90,9	105,7	16,3
India	94,3	108,2	14,6
Turkey	102,9	113,8	10,6
United Kingdom	77,6	79,6	2,6
Hungary	103,8	103,2	-0,6
China	121,2	120,0	-1,0
United States	95,7	92,9	-2,9
Japan	107,4	98,0	-8,7
Euro area	104,0	94,3	-9,3
Argentina	99,6	85,4	-14,3

* Source: Bank for International Settlements
** Calculations based on consumer price data

Although South Africa's equity and debt securities attracted inflows during 2009 and the first half of 2010, this was not reflected in an increase in turnover in the domestic market for foreign exchange as the average daily turnover declined from US$16,4 billion in 2008 to US$14,3 billion in 2009. The decline in the turnover data from 2008 to 2009 may be ascribed to the contraction in international trade, the uncertainty surrounding the health of the global economy and the decline in global liquidity. However, the turnover in the domestic foreign-exchange market increased to US$15,1 billion in the first half of 2010. Non-residents' share in the activity on the domestic market for foreign exchange decreased marginally from 75,6 per cent in 2008 to 75,2 per cent in 2009, and declined further to 73,5 per cent in the first half of 2010.

Effective exchange rates of the rand

Indices: 2000 = 100



Monetary developments, interest rates and financial markets

Structural and regulatory issues

The South African banking sector operated under challenging economic and financial circumstances in the twelve months to June 2010. Banks' balance sheets stagnated and the quality of loans deteriorated alongside the downturn in the domestic economy that gathered momentum in the course of 2008. As the demand for credit waned in conjunction with the slowdown in economic activity, the growth in impaired advances also gave rise to a tightening of banks' lending standards, which further prevented bank lending. Notwithstanding the difficult circumstances, the banking sector remained stable and profitable, maintaining its capital at levels well above the minimum regulatory requirements.

The four large banks continued to dominate; together they comprised 84 per cent of the total assets of the South African banking sector during the year under review. The number of locally registered banks in South Africa declined from 34 at the end of June 2009 to 32 at the end of June 2010 when final regulatory approval was obtained for the acquisition of two smaller banks by two of the largest banks, enabling them to entrench their positions in underdeveloped areas and bolster their retail and corporate finance business. The number of branches of foreign banks in South Africa declined to 13 at the end of June 2010 due to the conversion of one banking branch into a representative office, while the number of foreign banks with approved local representative offices in South Africa decreased to 42 at the end of June 2010, compared with 43 at the end of June 2009.

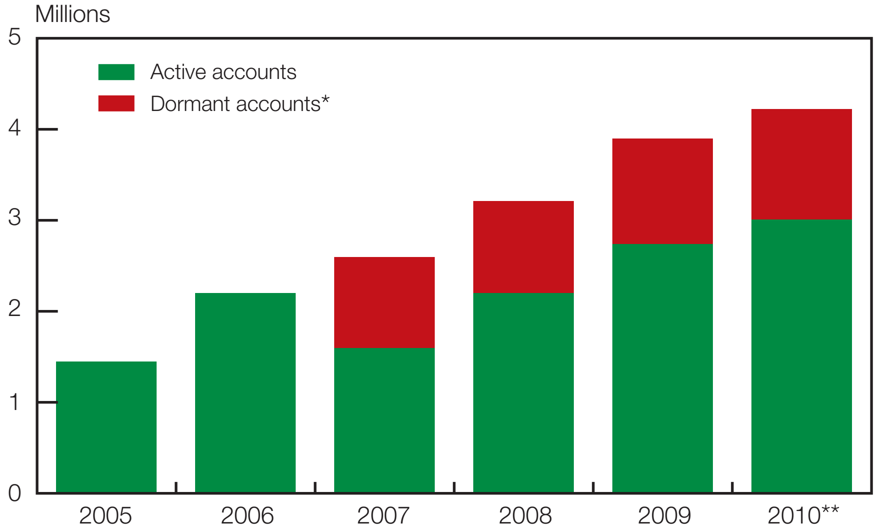
Size of the South African private banking sector

	June 2009		June 2010	
	Number of institutions	Total assets R billions	Number of institutions	Total assets R billions
Locally controlled banks	13	2 825	12	2 826
Foreign-controlled banks	5	11	5	13
Mutual banks	2	1	2	1
South African branches of foreign banks	14	183	13	167
Total registered banks	**34**	**3 021**	**32**	**3 006**

Deposits constituted the largest portion of total banking-sector funding, although it remained constrained during the period under review, while banks further boosted their capital base through issuance of new debt securities in the capital market. Issuance of bonds by banks picked up noticeably in the year to June 2010, after it had been relatively subdued in the preceding period, while reliance on short-term funding through commercial paper dwindled. No funds were raised through the securitisation of assets during the year under review, as the market segment remained inactive.

Provision of broad-based financial access has been at the forefront of the banking industry since the launch of entry-level Mzansi bank accounts in 2004. It is estimated that by the end of June 2010 more than 4 million Mzansi accounts had been opened, even though a fair number of accounts are not actively utilised. Banks also introduced new products, and engaged with key partners to improve market share and the product base available to customers. Furthermore, banks assisted clients in distress to restructure their debt obligations, in accordance with the debt review initiative imposed by the National Credit Act.

Number of Mzansi accounts opened



* Data on dormant accounts only available from 2007
** June 2010

Source: The Banking Association of South Africa

Having surpassed their original target of R42 billion for the provision of affordable housing in terms of the Financial Sector Charter (FSC), banks made further strides to enhance access to housing finance. Among other things, a guarantee fund of R1 billion was made available to the banking sector by the government to accelerate the delivery of housing to lower-income earners.

The banking industry responded favourably to the recommendations of the Banking Enquiry Panel of the Competition Commission. At a meeting between the Finance Minister and senior management of seven of the largest banks on 31 May 2010, the banks agreed to implement 19 of the 28 recommendations. These included the lowering of penalty fees on dishonoured debit orders; improving the management of the debit order system; greater transparency of automated teller machine (ATM) fees and charges; simplifying the switching of accounts between banks; and improving customer education. The remaining nine recommendations on interchange and entry into the payment systems required policy guidance from the the Bank and National Treasury, and could not be implemented by the banks unilaterally. Other issues discussed at the meeting included the impact of the global financial crisis on the South African economy, the decline in credit extension, and the implications of the proposed international regulatory reform on the banking sector by the G-20 member states and the Financial Stability Board. As regards the current status of the FSC, banks indicated their continued commitment to preserving and improving the broad-based financial access targets.

Regulations governing the Co-operative Banks Act, 2007 (Act No. 40 of 2007) were published in July 2009 and Supervisors' Rules, containing the administrative requirements to be met and providing supervisory authority to elected representatives of the Bank and the Co-operative Banks Development Agency, were finalised during January 2010. The Co-operative Banking Supervision Unit located in the Bank will be responsible for the supervision of larger co-operative banks, while the agency will be responsible for the rest. Applications for registrations are currently being reviewed by the supervisors concerned and the first registrations are expected to be finalised before the end of 2010.

During April 2010, the joint technical subcommittee of the Bank and the Banking Association of South Africa released the main findings of the comprehensive study on the role of the prime rate and the prime-repurchase rate spread in the South African banking system. The study concluded that the size of the spread between the repurchase and prime rate was immaterial to the setting of lending rates, as the prime rate is primarily used as a reference rate or benchmark for pricing loans. According to the report, changing the fixed spread would not change the methodology by which banks calculate their actual lending rates, although it could cause some short-term problems and disruption with existing agreements. A uniform spread encourages competition between banks, since consumers are able to choose between products and effectively compare bank lending rates.

At the end of August 2010 the Bank implemented certain changes to its monetary policy operational procedures. This included the use of longer-term foreign-exchange swaps with maturities of up to twelve months as an instrument to manage money-market liquidity more effectively. The consequence of conducting longer-term foreign exchange swap transactions to drain liquidity from the market is that the Bank will reflect an overbought forward position on its monthly releases of official gold and foreign-exchange reserves. In addition, the practice of announcing the estimated ranges of the weekly liquidity requirement was discontinued, and the spread between the rates for standing facilities and the repurchase rate was widened from 50 basis points to 100 basis points below and above the prevailing repurchase rate.

The Consumer Protection Act, 2008 (Act No. 68 of 2008), which was signed into law in April 2009, is to become fully operational from October 2010. The aim of the Act is to ensure that consumers are able to make well-informed buying decisions; are able to access a wide range of products and services based on honest and fair marketing and selling practices; have access to efficient and effective redress; and are educated about their rights and responsibilities.

New enhancements and innovative products were introduced to the South African bourse, meeting investor requirements and improving its international profile. A number of key developments warrant discussion.

In 2009 the requirement for auditors of listed companies to register with the JSE Limited (JSE) was changed to a system of accreditation, and registration for the purpose of providing audit and advisory services is now administered by the Independent Regulatory Board for Auditors (IRBA). Contraventions of the listing requirements by an auditor are now submitted to the IRBA for investigation and disciplinary action, as the JSE is no longer responsible for these actions.

Owing to changes to the Industry Classification Benchmark (ICB), the FTSE/JSE Africa Real Estate Index was discontinued and replaced with the FTSE/JSE Africa Real Estate Development & Services, and FTSE/JSE Africa Real Estate Investment Trusts indices, effective from 1 December 2009. Furthermore, a new index, the FTSE/JSE Africa Alternative Energy Index, was launched.

The JSE implemented a dark pool block-trading system, Block X, in July 2010 which will ensure that large share trades do not have an impact on prices. Dark pools are anonymous trading venues that allow buyers and sellers of large stock orders to refrain from revealing prices publicly beforehand and signalling their intentions to the rest of the market.

The JSE introduced an online financial reporting portal in June 2010 called the 'eXtensible Business Reporting Language' (XBRL) to enable companies to file their financial reports according to a global electronic reporting standard. Among the benefits of XBRL are improved accuracy and quality, faster and simpler access to company information, and cost reduction.

In 2009 the JSE's Equity Derivatives Division (EDD) introduced futures on the FTSE/JSE Africa Banks and General Retailers indices, providing investors with an opportunity to trade and gain exposure to shares constituting the Africa Banks and General Retailers' indices.

Grain South Africa applied to the International Trade Administration Commission of South Africa (ITAC) for an increase in the protective duty on wheat and wheat products to protect local farmers against market competition arising from cheap imports from other wheat-producing countries. ITAC recommended a higher reference price, and an import duty of R140,70 per ton on wheat products was implemented by the South African Revenue Service on 30 April 2010 following the approval by the Minister of Trade and Industry. Subsequently, the import duty was raised to R260,90 per ton on 15 July and discontinued on 27 August.

In the past year the JSE's Agricultural Products Division (APD), rebranded to the JSE Commodity Derivatives Division (CDD), expanded its commodity product range by adding cash-settled foreign-referenced energy and precious metal commodities, namely crude oil, gold and platinum, as well as grain commodities such as soybean, soybean meal and oil contracts. The CDD also introduced physically settled sweet sorghum futures contracts in May 2010.

Product offerings on Yield-X were broadened with the introduction of currency, index and interest-rate futures contracts during the past year. Futures contracts on the All Bond Index term split 7–12 year, 3-month Jibar instrument, R208 and R155 bonds were introduced, enhancing the current product range. Similarly, currency products on offer were enhanced as trading was extended to include Japanese yen/rand and Canadian dollar/rand futures contracts.

The equity market of the JSE listed currency reference warrants for the first time in November 2009, in order to allow investors the opportunity to take positions on future movements in the local currency.

On 1 May 2010 the National Treasury increased the percentage of the government bond auction amount available on a non-competitive basis after the auction from 15 per cent to 30 per cent, as suggested by the Primary Dealers of South Africa Association. The time allowed for such participation in the primary market was also extended from the previous 24 hours to 48 hours.

Other relevant legislative changes affecting financial markets announced in the national Budget for fiscal 2010/11 include the raising of the annual domestic interest and dividend income-tax exemption threshold from R21 000 to R22 300 for taxpayers under the age of 65, and from R30 000 to R32 000 for taxpayers aged 65 and over, effective from 1 March 2010. The exemption applicable to foreign interest and dividend income was raised from R3 500 to R3 700 per annum.

In response to financial-sector innovations and other developments, as well as the recent financial crisis, the non-bank financial intermediaries' legislative and regulatory environment was reviewed. This review occurred as part of the continuous effort to improve compliance, enforcement, accountability and consumer protection.

In March 2009 National Treasury released draft amendments to Regulation 28 issued under the Pension Funds Act of 1956. The proposed amendments would align definitions, asset categories and investment limits in Regulation 28 with other Acts and regulations that have been altered since 1998, and keep abreast of innovations and developments in the financial sector. For instance, Regulation 28 would be extended to deal with derivatives, structured products and foreign investments, the scope of Islamic-compliant pension funds to diversify risks and the investment channels in which pension funds can invest. Following these proposed changes, the Financial Services Board (FSB) released a draft circular PF133, set to provide guidance on investment in derivative instruments and disclosure for purposes of Regulation 28.

In 2009 the FSB released a notice on regulatory reporting requirements for retirement funds when preparing annual financial statements. This is in line with the continual revision of international financial reporting standards. Historically, the financial statements of South African retirement funds were prepared on the basis of Generally Accepted Accounting Practice (GAAP). The regulatory reporting requirements for retirement funds are applicable to all retirement funds registered under the Pension Funds Act of 1956.

Minimum standards and requirements for the advice process were introduced, which impacts on financial advisers. The Financial Advisory and Intermediary Services Act of 2002 was amended effective from May 2009 to include the need to check the financial adviser's authority in rendering a financial product service prior to accepting any new business.

New regulations regarding commissions came into effect on 1 January 2009. These regulations stipulate that financial intermediaries will receive a maximum commission of 5 per cent, half of which will be paid upfront and the rest of which will be spread over the term of the policy on a monthly basis.

The Government Employees Pension Fund (GEPF) has undertaken a process of transferring ownership of its assets from the Public Investment Corporation (PIC) to the GEPF. This transfer of assets aims to improve governance, the oversight role of trustees, compliance with relevant rules and the ability of the GEPF to play an active role as a shareholder.

In May 2010 the Association for Savings and Investment South Africa (ASISA) introduced a new statistical system for collective investment schemes (CIS) to correct double counting caused by hybrid funds that invest in both securities and in other unit trust funds.

A set of draft regulations under the South African Companies Act of 2008 was released for public comment in December 2009. The new Companies Act aims to provide some recourse for companies in distress, reduce the cost of establishing a business and promote corporate governance and transparency.

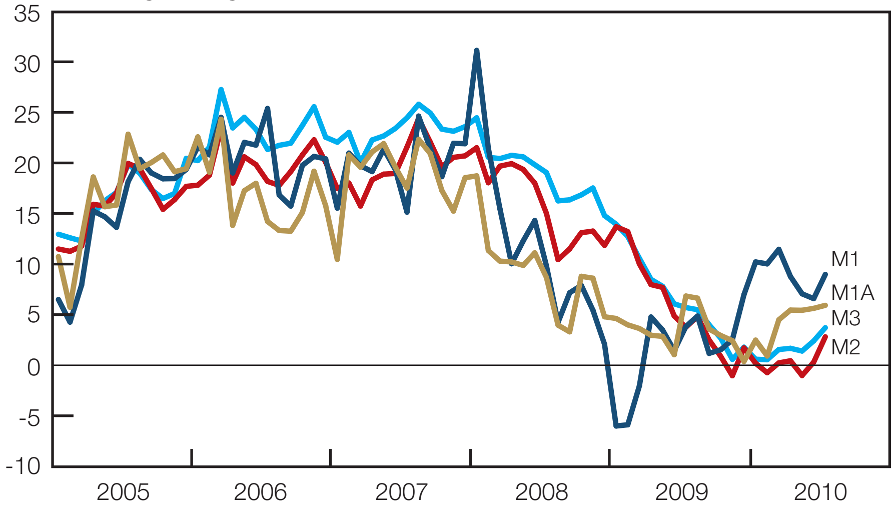
Money supply

The deceleration in growth in the broadly defined money supply (M3), which started in 2008, continued during 2009 and reached an all-time low growth rate in February 2010. The slower growth in nominal output and expenditure, together with uncertain employment prospects, probably resulted in an attempt by households and companies to consolidate their financial positions. This, together with the low returns on monetary deposits relative to those on other asset classes, probably contributed to the weak growth in M3 during the 18 months to June 2010. However, early signs of a hesitant recovery in the demand for money became evident in recent months when year-on-year growth in M3 rebounded to 3,7 per cent in July, from 0,5 per cent in February 2010.

Twelve-month growth in the narrower monetary aggregates broadly mirrored the changes in M3 and slowed down markedly. After decelerating into negative territory in the first three months of 2009, year-on-year growth in M1 recovered to positive growth in the subsequent months to July 2010. Growth in M1 was boosted by a strong rise in call and overnight deposits, partly reflecting a shift in investor sentiment towards liquid, interest-earning monetary assets following the turmoil in financial markets, the related tightening of credit conditions and the nascent fiscal imbalances of some countries in the euro area. Growth in M1A, which consists of notes and coin in circulation and cheque and transmission deposits, also picked up moderately in the first half of 2010 in line with the recovery in domestic economic activity.

Monetary aggregates

Percentage change over twelve months



Growth in the deposits of both the household and corporate sectors waned during the past twelve months. While the corporate sector deposits accounted for 80 per cent of the overall increase of R46,5 billion in M3 deposits during the twelve months to June 2010, these deposits slowed significantly, and negative growth rates were recorded towards the end of 2009 and early 2010. At the same time, the growth over twelve months in deposits of the household sector also declined, although it remained positive throughout the period under review.

As reflected in the table on page 51, the main statistical counterparts of change in M3 in the twelve months to June 2010 were net foreign assets. The increase in net foreign assets could be attributed to an increase in the foreign assets held by the banking sector. Having dominated the other counterparts of change in M3 in the previous two periods, claims on the private sector increased only moderately, reflecting the slower growth in banks' extension of loans and advances.

The slow pace of money-supply growth led to a turnaround in the income velocity of circulation of M3. After a protracted and rather consistent decline since the third quarter of 2000, the velocity at which the broadly defined money supply circulated in the economy increased from a record low of 1,22 in the first quarter of 2009 to 1,34 in the second quarter of 2010 when growth in M3 was outpaced by growth in nominal gross domestic product.

Statistical counterparts of change in M3

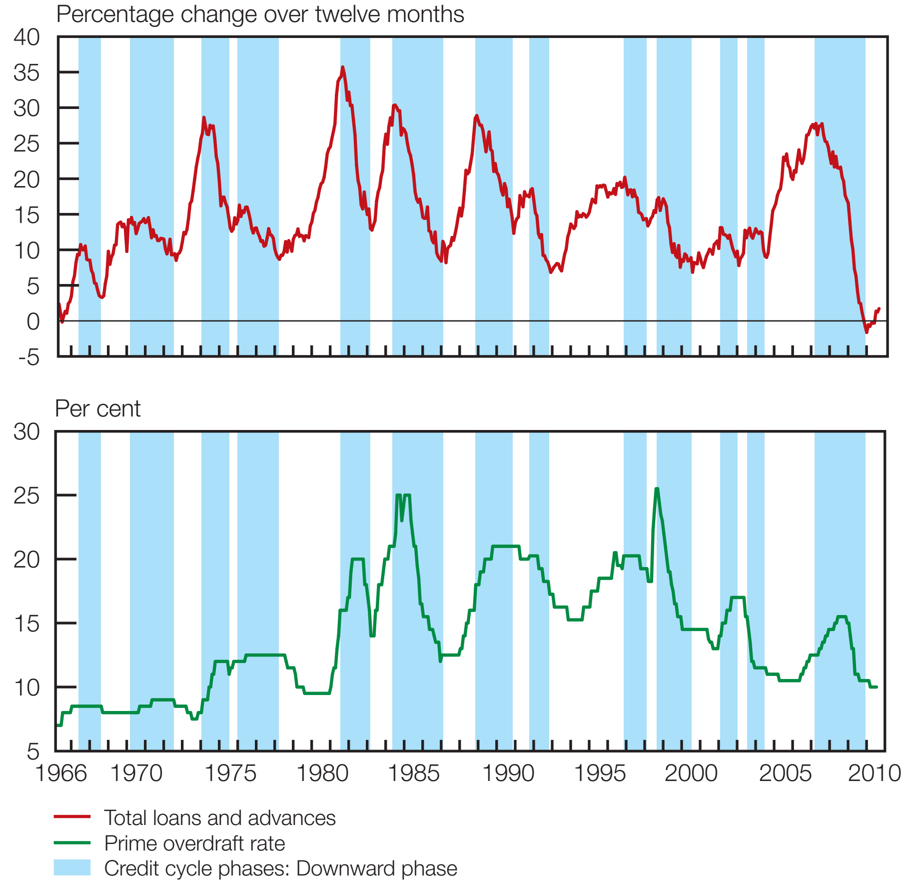
R billions

	Twelve months to June		
	2008	2009	2010
Net foreign assets	-2,9	13,1	54,0
Net claims on the government sector	31,3	31,2	-4,3
Claims on the private sector	330,2	82,1	17,8
Net other assets and liabilities	-56,5	-15,8	-20,9
Total change in M3	302,0	110,8	46,5

Credit extension

The downward phase of the current credit cycle, which started in the second half of 2007, has been one of the longest in recorded history. Despite some short-term interruptions in early 2008, growth in banks' total loans and advances extended to the private sector has been on a declining path for almost two-and-a-half years. A similar occurrence was recorded in the 1980s when total loans and advances declined for a period of 29 months. However, during that period the deceleration in the year-on-year growth in total loans and advances was less pronounced, and the rate of growth remained in positive territory

Total loans and advances to the private sector and prime overdraft rate



throughout. The high level of household debt and a moderation in corporate income, coupled with high debt-servicing costs between 2006 and 2008, placed downward pressure on the growth in credit extension during recent years.

Tentative evidence of a recovery in credit extension emerged towards the end of 2009 when twelve-month growth in total loans and advances picked up from a nadir of minus 1,6 per cent in November and gained momentum thereafter to reach a positive growth rate of 1,7 per cent in July 2010. The rebound was partly the result of an improvement in the corporate sector's demand for credit, but also reflected the low base values recorded in 2009.

The deceleration in growth in banks' loans and advances occurred across all the major credit categories during 2009, but more pronounced declines were recorded in *instalment sale credit and leasing finance, and other loans and advances*, which decelerated into negative territory. A breakdown of total loans and advances by category and sector is presented in the accompanying table:

Credit aggregates

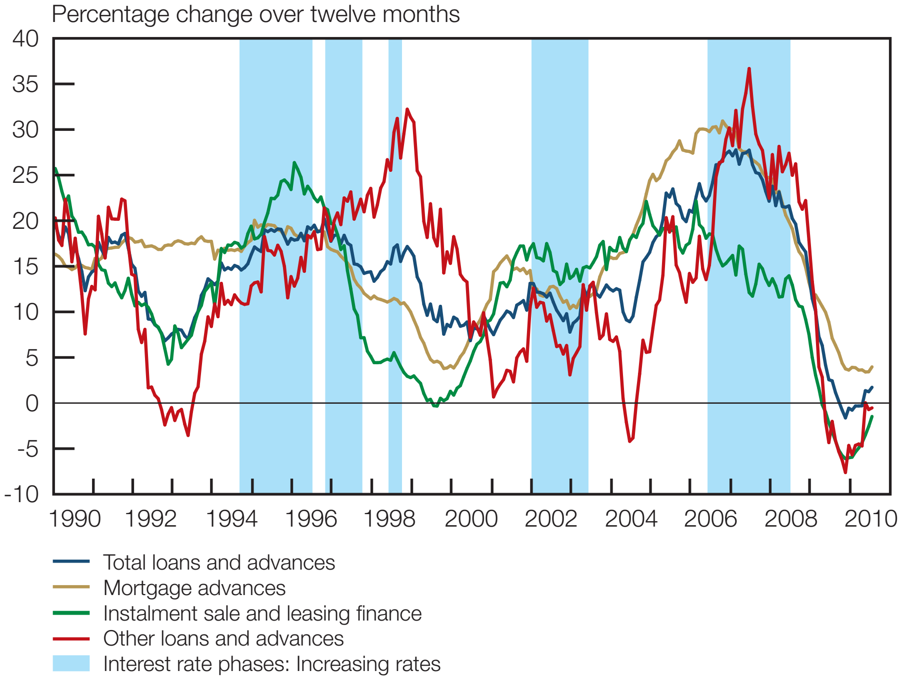
Component	June 2009 R billions	June 2010 R billions	Change Per cent*
Mortgage advances	989	1 023	3,4
Instalment sale and leasing finance	243	237	-2,6
Of which: New passenger cars	67	67	0,9
Other passenger cars	63	69	9,6
Other assets financed	113	101	-11,4
Other loans and advances	633	629	-0,7
Overdrafts	136	124	-9,3
Credit card advances	56	56	-0,8
General advances	441	449	1,9
Total loans and advances	1 866	1 889	1,2
Of which: To household sector	1 018	1 062	4,3
To corporate sector	847	827	-2,4

* Percentage change calculated on full rand amounts

Mortgage advances remained the core driver of bank credit over the twelve months to June 2010, contributing R33,9 billion to the overall increase in total loans and advances. The bulk of this increase occurred in residential mortgage advances to the household sector. Twelve-month growth in mortgage advances stabilised during the first half of 2010, as banks gradually relaxed their lending criteria and activity in the real-estate market steadily improved.

While growth in *leasing finance* continued to shrink, *instalment sale credit* by the banking sector gradually improved from a contraction of R2,6 billion in the first half of 2009 to R0,4 billion in the latter half, and returned to positive growth of R4,5 billion in the first six months of 2010. Traditionally seen as an early indicator of an economic upswing, the substantial surge in this credit category may, to a large extent, be the result of the replacement and expansion of the rental fleets of car companies ahead of the 2010 FIFA World Cup™. Measured over twelve months, growth in this credit category increased from minus 1,6 per cent in November 2009, the lowest rate recorded since August 1977, to 2,0 per cent in June 2010 and accelerated further to 2,9 per cent in July.

Growth in the main categories of bank loans and advances



Somewhat contradictory to the first quarter 2010 National Association of Automobile Manufacturers of South Africa (NAAMSA) new vehicle sales report, instalment sale credit by banks did not fully mirror the recovery in new vehicle sales. A possible explanation might be an increase in market share of motor vehicle finance companies. Recent figures show that motor vehicle finance companies are responsible for about 25 per cent of total instalment sale transactions. The year-on-year percentage change in hire-purchase contracts extended by motor finance companies recorded a growth rate of 7 per cent in March 2010, compared to negative year-on-year growth in instalment sale credit extended by the banking sector during this period. These companies generally obtain their financing through foreign funding, and the issuance of bonds and bills in the domestic capital market.

Other loans and advances, which consist of *general loans, credit card advances and bank overdrafts*, contracted by R4,5 billion in the twelve months to June 2010. The consistent deceleration in the year-on-year growth in this credit category was mainly driven by the slowdown in demand for credit by the corporate sector.

The household sector increased its usage of bank loans and advances by R43,4 billion in the twelve months to June 2010, while the corporate sector's use of such advances declined by R20,3 billion over the same period.

Interest rates and yields

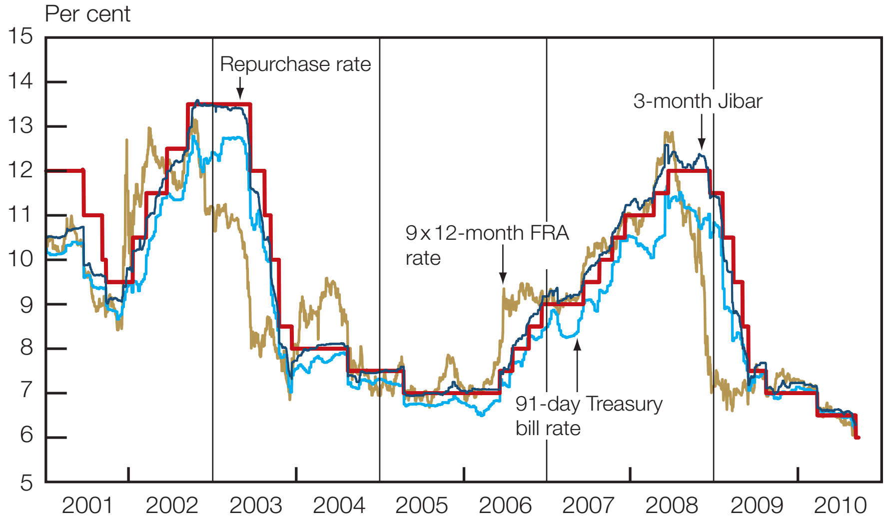
Against the backdrop of subdued inflationary pressures and a cooling of economic activity, which resulted in a large output gap, an accommodative monetary policy stance was adopted by the Monetary Policy Committee (MPC) from the end of 2008. Between December 2008 and May 2009 the MPC reduced the repurchase rate by a cumulative total of 450 basis points, 400 of which were implemented in four consecutive monthly meetings to May 2009 when the magnitude of repurchase rate reductions was increased from 50 to 100 basis points. In the 15 months to September 2010, the monetary policy easing cycle continued, albeit at a slower pace. As the economy slowly emerged from one of its deepest recessions on record, domestic cost pressures resurfaced, emanating in particular from high wage settlements and rising administered prices. Nevertheless, with the risks of inflation overshooting remaining low, the MPC reduced the repurchase rate further by 50 basis points on each occasion at its meetings in August 2009, March 2010 and September 2010. At 6,00 per cent, the repurchase rate is currently at its lowest level since October 1980.

Repurchase rate

Date effective	Repurchase rate	Change
13 June 2008	12,00	
12 December 2008	11,50	50
6 February 2009	10,50	100
25 March 2009	9,50	100
4 May 2009	8,50	100
29 May 2009	7,50	100
14 August 2009	7,00	50
26 March 2010	6,50	50
10 September 2010	6,00	50

Other money-market interest rates declined considerably and reached levels comparable to those prevailing before the onset of monetary policy tightening in June 2006. The Johannesburg Interbank Agreed Rate (Jibar) drifted lower from its cyclical high of 12,58 per cent on 29 May 2008 to reach 6,38 per cent on 9 September 2010, consistent with the changes in the monetary policy stance. The 91-day Treasury bill rate reached a low of 6,21 per cent on 9 September 2010, despite increased issuance of Treasury bills by the national government.

Money-market rates



Rates on forward rate agreements (FRAs) have been displaying a declining trend since June 2008. This downward trend was briefly interrupted around the middle of 2009 when evidence of further monetary policy easing faded, and towards the end of 2009 and early months of 2010 when uncertainty in the financial markets intensified as a result of fiscal imbalances in some countries in the euro area. Nevertheless, the expectations of interest rate reductions previously displayed by FRA rates seem to have moderated, with current movements in FRA rates more closely aligned with the prevailing short-term interest rates. However, FRA rates declined markedly towards the end of August 2010 when market participants started discounting the possibility of a further decline in interest rates on account of the release of better-than-expected inflation.

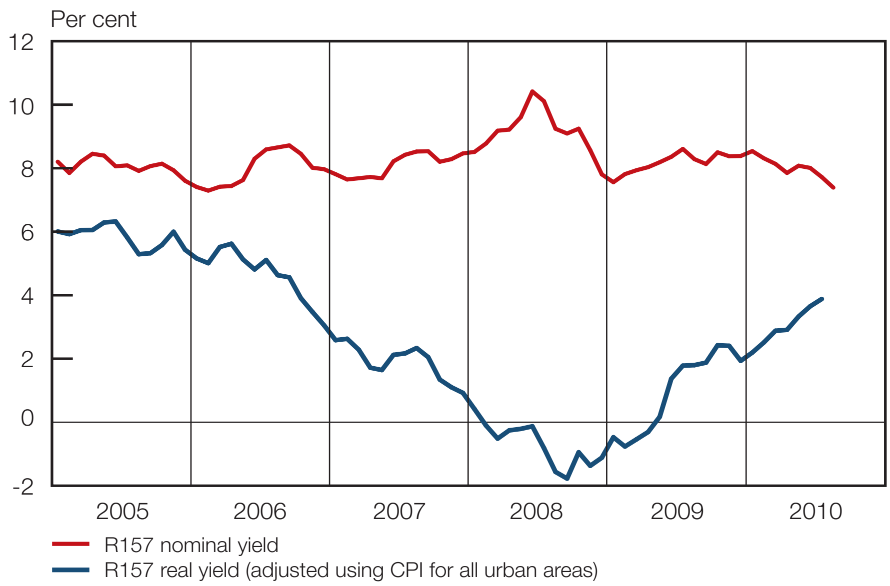
The South African interbank market functioned well and retained its efficiency during the fourteen months to August 2010, with interbank lending interest rates declining to 30-year lows. The South African Benchmark Overnight Rate (Sabor) on deposits, in particular, fluctuated well within the standing facility rate limits, and responded accordingly to repurchase rate changes. The implied rate on one-day rand funding in the foreign-exchange swap market (overnight FX rate) displayed some volatility, particularly in December 2009 and the early months of 2010 amid liquidity pressures in the foreign exchange market.

Both the *prime overdraft rate* and the *predominant rate on mortgage loans* of the private-sector banks followed the movements in the repurchase rate. Having stood at 10,0 per cent since March 2010, these rates were reduced to 9,50 per cent in September following the MPC decision to lower the repurchase rate.

Interest rates on the 2-, 3- and 5-year *RSA government fixed-rate retail bonds* declined by 75 basis points from July 2009 to August 2010, while the interest rates on the 3-, 5- and 10-year *RSA government inflation-linked retail bonds* remained broadly unchanged over the past twelve months, in line with the movements of the government yield curve.[4]

The *daily average yield on the R157 government bond* (maturing in 2014/15/16) fluctuated lower on a volatile path from a high of 8,78 per cent on 3 July 2009 to 7,26 per cent on 6 September 2010. This followed the notable increase in the supply of government bonds and concerns regarding the European sovereign debt problems, which were both offset by the appreciation in the exchange value of the rand, the release of better-than-expected outcomes in consumer price inflation and strong foreign demand for domestic bonds. The deceleration in inflation from late 2008 benefited real returns on fixed-interest securities. Using historical inflation to adjust nominal yields, the real yield on the R157 bond turned positive in May 2009 from a negative real return of 1,77 per cent in September 2008 and increased to 3,88 per cent in July 2010.

Bond yields



From September 2009 to the beginning of January 2010, the short end of the *yield curve* remained broadly anchored to the unchanged repurchase rate while the medium-to-long-term portion of the curve moved upwards in response to the increased supply of government bonds. However, from January 2010 to August, the yield curve moved

4 Interest rates on the RSA government fixed-rate and inflation-linked retail bonds are priced off the government yield curve on a monthly and semi-annual basis respectively.

5 The differential between the yields at the extreme long and short ends of the curve.

6 The differential between the nominal yield on conventional bonds and the real yield on inflation-linked bonds within the three-year maturity range.

7 The differential between South African government bond yields on rand-denominated debt issued in the domestic market and on dollar-denominated debt issued in the United States in the four-to-five-year maturity range.

lower across all maturities as bond yields declined alongside the appreciation in the exchange value of the rand, the decline in the repurchase rate and lower inflation. The *yield gap*[5] widened from 158 basis points on 30 September 2009 to 168 basis points on 6 September 2010.

The *break-even inflation rate*[6] fluctuated higher from a low of 3,88 per cent on 10 February 2009 to a recent high of 6,82 per cent on 27 October. Subsequently, this proxy for expected inflation declined to 5,48 per cent on 6 September 2010 as the nominal yield on the conventional government bond declined more than the real yield on the inflation-linked government bond, on lower inflation expectations.

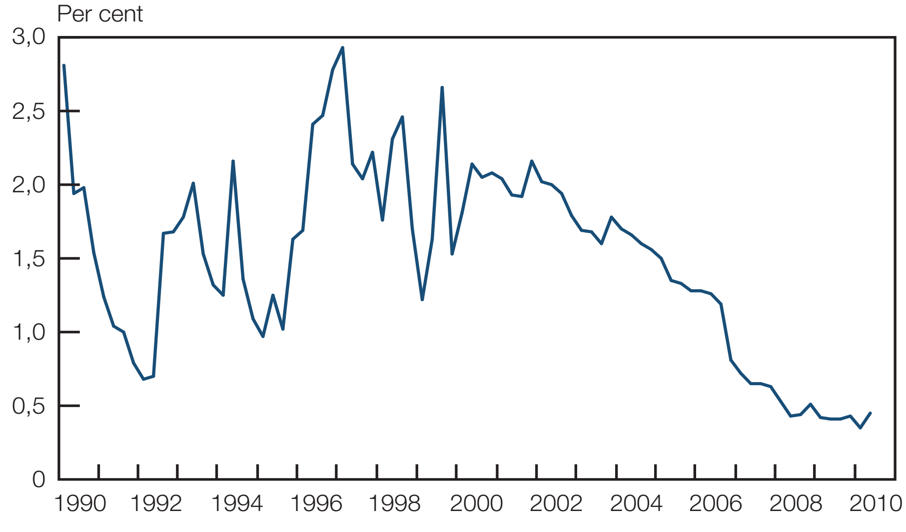
The *currency risk premium*[7] on South African government bonds widened sharply from 34 basis points in January 2009 to 477 basis points in June 2010. This was a result of an overall increase in the yield on the South African rand-denominated bond, while the yield on the dollar-denominated South African bond declined notably during this period. Thereafter the currency risk premium narrowed to 454 basis points in August as the rand-denominated yield reverted to a downward trend that exceeded the decline in the dollar-denominated yield.

Investors' sentiment towards emerging-market financial assets improved considerably from the peak of the financial crisis in 2008. This is evidenced by the JPMorgan Emerging Markets Bond Index Plus (EMBI+) spread which narrowed significantly from a high of 718 basis points in November 2008 to 251 basis points in March 2010. Subsequently, the spread widened to 337 basis points in June, reflecting greater risk aversion, before narrowing again to 303 basis points in August. The *sovereign risk premium* on the South African government US dollar-denominated bonds in the four-year maturity range trading in international markets also narrowed considerably from a recent high of 720 basis points in November 2008 to 102 basis points in April 2010, before widening to 219 basis points in June following concerns about sovereign debt issues in the euro area. Subsequently, the spread narrowed to 183 basis points in August.

Money market

Underlying money-market conditions remained fairly stable during the second half of 2009, with occasional, but short-lived, over- and undershooting in the liquidity requirement evident during the first half of June 2010. The daily liquidity requirement of the private-sector banks fluctuated within a narrow range of R5,7 billion and R11,3 billion during the

Liquidity requirement as a percentage of M3 money supply



second half of 2009, compared with a somewhat broader range of between R2,6 billion and R12,6 billion during the first half of 2010. The liquidity provided by the Bank at the weekly main refinancing auctions varied between R6,7 billion and R14,5 billion during the period under review. Expressed as a percentage of M3 money supply, the liquidity requirement has remained relatively low and stable over the past two years.

Banks utilised their cash reserve accounts, standing facilities and supplementary repurchase transactions intermittently to accommodate variations in daily liquidity. The statistical counterparts influencing money-market liquidity over the period under review are illustrated in the accompanying table.

Money-market liquidity flows

R billions (easing+ tightening-)

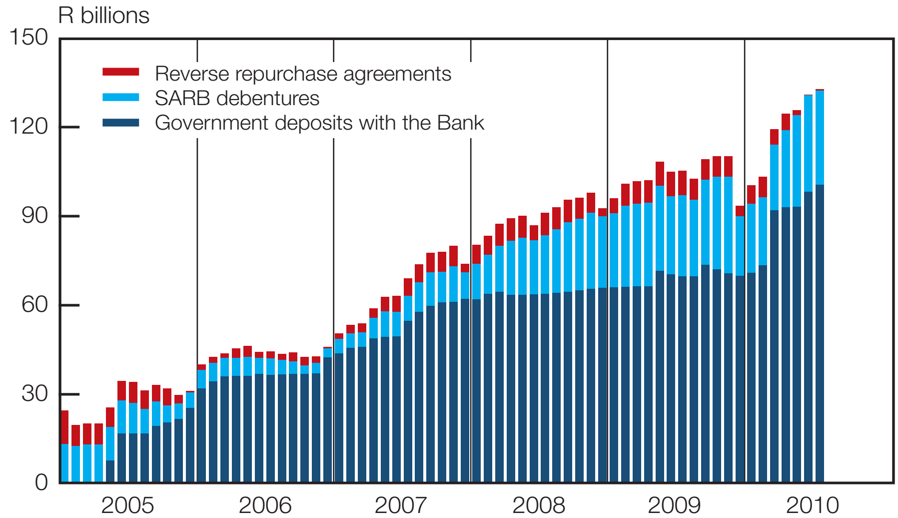
	Jul–Dec 2009	Jan–Jun 2010	Net total
Notes and coin in circulation	-9,2	4,1	-5,1
Required cash reserve deposits	-0,3	-2,0	-2,3
Money-market effect of SARB* foreign-exchange transactions	10,6	18,1	28,7
Government deposits with the SARB	0,5	-28,3	-27,8
Use of liquidity management instruments	11,0	-9,1	1,9
Reverse repurchase transactions	4,6	3,6	8,2
SARB debentures	6,4	-12,7	-6,3
Other items net**	-10,2	13,6	3,4
Banks' liquidity requirement (decrease + increase -)	**2,4**	**-3,6**	**-1,2**

* SARB: South African Reserve Bank
** Mainly comprising public deposits

In the twelve months to June 2010, notes and coin in circulation and required cash reserve deposits drained liquidity to the tune of R7,4 billion from the money market. This absorption of liquidity alongside a R27,8 billion increase in government deposits with the Bank, was mainly neutralised by a sizeable injection of R28,7 billion worth of liquidity resulting from the purchase of foreign currency by the Bank for reserves accumulation purposes.

Through utilisation of its liquidity management instruments, namely SARB debentures and reverse repurchase transactions, the Bank injected liquidity to the amount of R11,0 billion

Liquidity-draining operations: Outstanding balances



between July and December 2009, before reducing it by R9,1 billion between January and June 2010.

The capital redemption and coupon interest payments on various government bonds amounted to R64,2 billion during the period under review, with only R0,9 billion of this amount having been paid to the Bank.

Bond market

Net issues of fixed-interest securities in the South African primary bond market more than doubled from R43,4 billion in 2008 to an annual record high of R118 billion in 2009. The activity in this market was largely driven by the *public sector*, as public corporations' and national government's demand for funding increased alongside the widening in government's fiscal deficit and increased investment expenditure on infrastructural development programmes. National government supplemented its funding base by net issues of R2,7 billion in the retail bond market during 2009, after registering net redemptions of R92,1 million in 2008. Along with the increased government borrowing requirement, the amount of conventional and inflation-linked government bonds made available at weekly auctions increased from R1,9 billion in August 2008 to R8,7 billion in August 2009 and further to R13,5 billion in August 2010.

Public-sector issuances remained at elevated levels in the first seven months of 2010, with net issues amounting to R111 billion, compared with net issues of R52,4 billion in the same period of 2009. Increases in net issues by national government were more pronounced in bonds with maturities of seven years and above. The outstanding nominal value of all public-sector debt securities listed on the JSE amounted to R764 billion at the end of July 2010, representing 73 per cent of total loan stock listed. National Treasury also supplemented its funding by raising R14,8 billion through the issuance of a US$2 billion ten-year bond in the international bond market in March 2010.

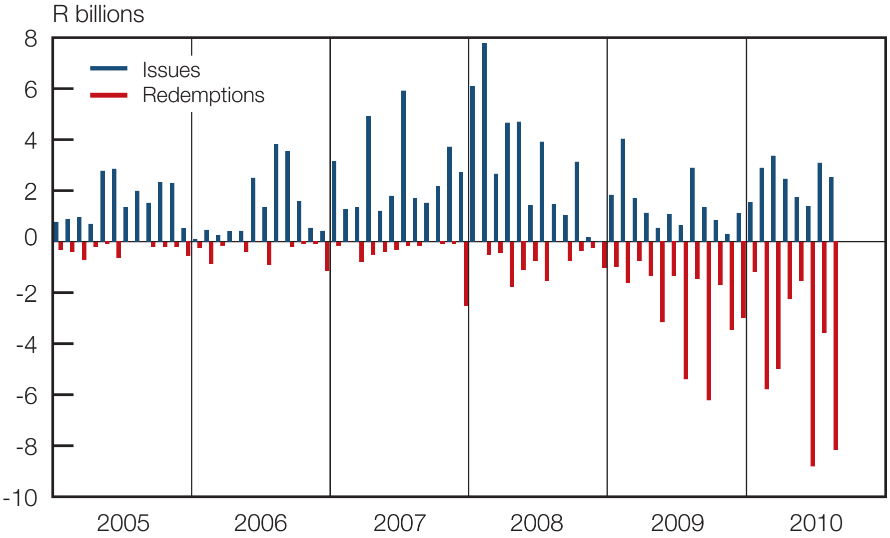
Notwithstanding the possible crowding-out effects due to increased funding by the public sector, *private-sector borrowers*' demand for funds rebounded as reflected by net issues of R18,1 billion in 2009, compared with net redemptions of R2,3 billion in 2008. Funding activity in the private sector was buoyed by private banks, which registered net issues of R30,4 billion in 2009 in response to, among other things, strained foreign funding opportunities, improved market conditions, the need to refinance near-term debt maturities and to raise additional capital as impaired advances continued to have a negative impact on the books of banks.

Growth in *securitisation* remained depressed as net redemptions increased from R20,9 billion in 2008 to R22,5 billion in 2009. Investors' appetite for private corporate debt instruments abated somewhat from May 2010, amid some resurgence of risk aversion in the financial markets following concerns regarding sovereign debt problems in the euro area. Private-sector net issues of R4,5 billion in the first seven months of 2010 contributed towards the outstanding nominal value of private-sector bonds listed on the JSE of R238 billion at the end of July – of which 74 per cent were issued by banks and 15 per cent by non-bank financial institutions.

Activity in *commercial paper* was largely subdued in 2009, with net redemptions amounting to R14,9 billion, compared with net issues of R16,5 billion in 2008. The decreasing use of short-term funding was more evident from banks, which recorded net redemptions of R10,4 billion in 2009. The outstanding nominal value of commercial paper listed on the JSE declined by R5,6 billion in the first seven months of 2010 to reach R41,4 billion at the end of July. The total outstanding nominal value of all debt listed on the JSE increased by 21 per cent in the past twelve months to July 2010. Supported by increases in issuance and movements in prices, the concurrent market capitalisation of all debt securities listed on the JSE increased by 24 per cent over the same period.

Reflecting a slowdown in global economic activity and market nervousness, the nominal value of rand-denominated bonds issued in the *European and Japanese Uridashi bond markets* declined from R37,0 billion in 2008 to R17,4 billion in 2009. The decline in activity was more noticeable in the Eurorand market as investors retained some appetite towards rand-denominated bonds issued in the Uridashi market. Along with the decline in the nominal value issued in 2009, high redemptions contributed to net redemptions of R12,9 billion in both markets, compared with net issues of R28,5 billion in 2008.

Rand-denominated bond activity in the Eurorand and Uridashi bond markets



In the eight months to August 2010 net redemptions in both markets amounted to R17,3 billion as a result of prolonged high redemptions, as indicated in the table below.

Rand-denominated bonds issued in international bond markets

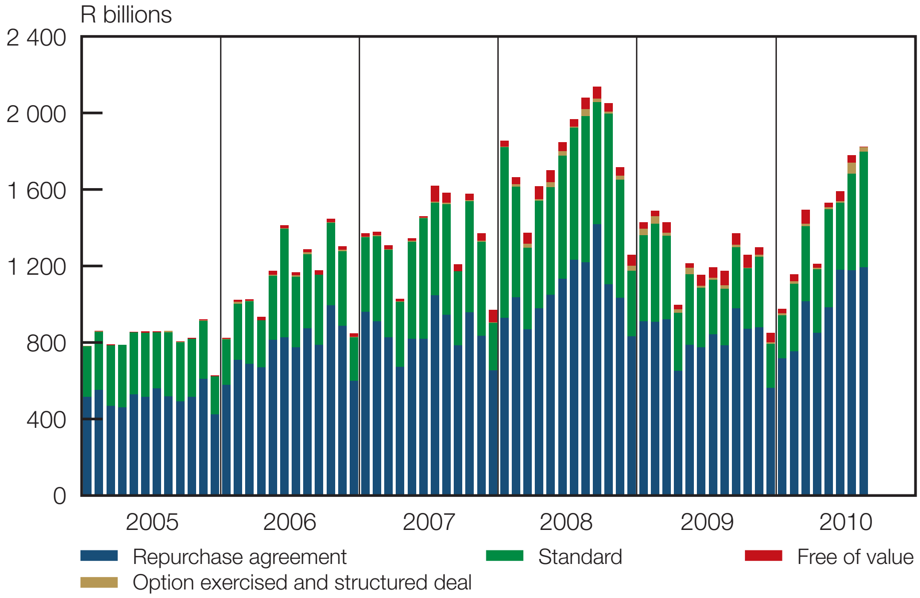
R millions

	Eurorand		Uridashi		Total	
	2009	Jan–Aug 2010	2009	Jan–Aug 2010	2009	Jan–Aug 2010
Issues	2 114	4 416	15 331	14 572	17 445	18 988
Redemptions	15 270	16 673	15 108	19 599	30 378	36 272
Net	-13 156	-12 257	223	-5 026	-12 933	-17 283

Turnover in the secondary bond market declined by 30 per cent from R21,3 trillion in 2008 to R14,9 trillion in 2009. The decline in turnover was, among other things, due to the lower number of transactions and the moderation in non-residents' participation, 8 The nominal value of bonds traded relative to the nominal amount in issue.

following the normalisation of the yield curve. Daily average turnover declined from a peak of R101,8 billion per day in September 2008 to R40,5 billion in December 2009, before increasing to R86,8 billion in August 2010. Spurred by higher bond prices and involvement by non-residents, the value of bonds traded on the JSE of R11,6 trillion in the first eight months of 2010 exceeded the value traded in the corresponding period of 2009 by 15 per cent. Liquidity[8] in the bond market declined from a ratio of 23 in 2008 to 14 in 2009, reflecting both lower turnover and a higher level of debt issued, and increased to an annualised ratio of 15 in the first eight months of 2010. Repurchase agreements and standard transactions dominated activity, accounting for 68 per cent and 28 per cent of total value traded in the first eight months of 2010.

Turnover in the secondary bond market by trade type



After consistently being net buyers, accumulating domestic debt securities of R53,6 billion from October 2009 to April 2010, *non-residents* switched temporarily to net sales of R2,4 billion in May 2010. This brief interruption was followed by non-residents' net purchases of local bonds amounting to R41,8 billion from June to August. Non-residents' net accumulation of domestic debt securities over the past year was accompanied by a rally in bond prices. The cumulative net purchases of domestic listed bonds by non-residents amounted to R68,6 billion in the first eight months of 2010, compared with net purchases of R2,5 billion in the corresponding period of 2009.

Share market

The total value of *equity capital raised* in the domestic and international primary share markets by companies listed on the JSE amounted to R107 billion in 2009, which was 40 per cent higher than the amount raised in 2008. The bulk of equity funding to the amount of R74 billion was raised in the first half of 2009, as funding slowed to only R33 billion in the second half of 2009. Although equity capital raised reached a recent peak of R15 billion in March 2010, total capital raised in the first seven months of 2010 remained subdued at R37 billion – of which companies with primary listings on the JSE accounted for more than half. The resources sector accounted for 66 per cent and the financial sector for 17 per cent of total equity capital raised in the first seven months of 2010.

The total *number of companies listed* on all boards of the JSE progressively declined from 425 in December 2008 to 410 in December 2009 and further to 407 in July 2010 as a result of, among other things, failure to comply with the JSE listing requirements and schemes of arrangement. The listings breakdown between the different boards is shown in the accompanying table.

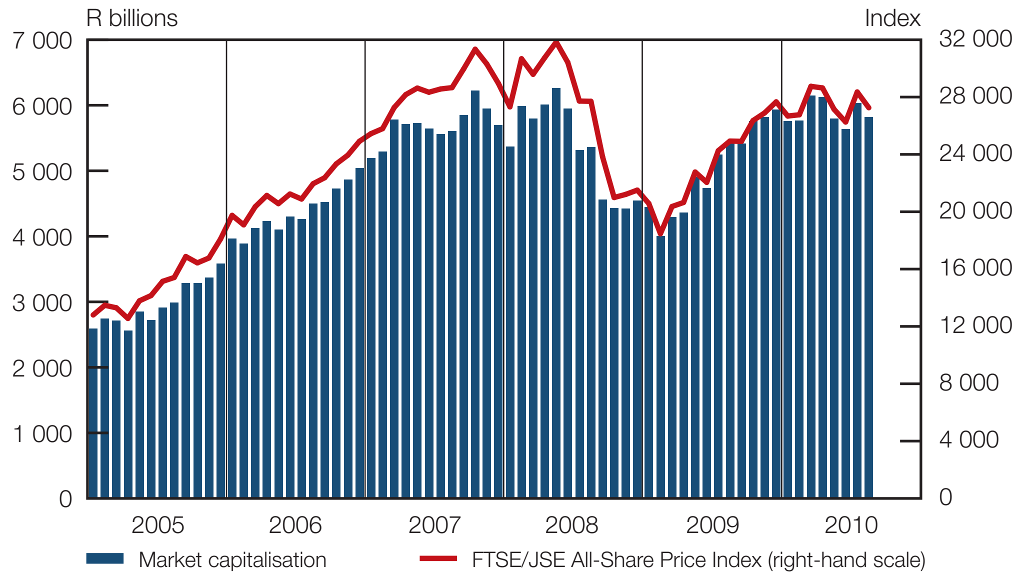
Listings breakdown on the JSE Limited, January to July 2010

	AltX	Venture and Development Capital boards	Main board	Africa board	Total
New listings	1	0	5	1	7
Transfers (in)	1		4		
Delistings	0	2	8	0	10
Transfers (out)	4		1		
Total (July 2010)	74	10	321	2	407

The *value of shares traded* on the JSE decreased by 14 per cent from R3,3 trillion in 2008 to R2,8 trillion in 2009. Heightened price volatility, however, spurred secondary trading on the JSE in 2010 and turnover in the first eight months of 2010 amounted to R2,0 trillion or on average R253 billion per month, representing an increase of 12 per cent over the average turnover in the corresponding period of 2009. Together with a steady increase in the number of shares issued as well as rising share prices, the total *market capitalisation* of the JSE increased from R4,0 trillion in February 2009 to R6,1 trillion in March 2010. Although the number of shares issued continued to rise, the JSE recorded a lower market capitalisation of R5,6 trillion in June as share prices subsided on uncertain future earnings prospects. The market capitalisation, however, rebounded again to R5,8 trillion in August. The resources and industrial sectors contributed nearly equally to constitute the bulk of the total JSE market capitalisation. The net result of these trends in turnover and market capitalisation was to raise the liquidity ratio[9] from 47 per cent in 2009 to an annualised ratio of 52 per cent in the eight months to August 2010.

9 The liquidity ratio on the JSE is calculated as the annualised secondary market turnover of shares as a percentage of market capitalisation.

Market capitalisation and share prices on the JSE Limited

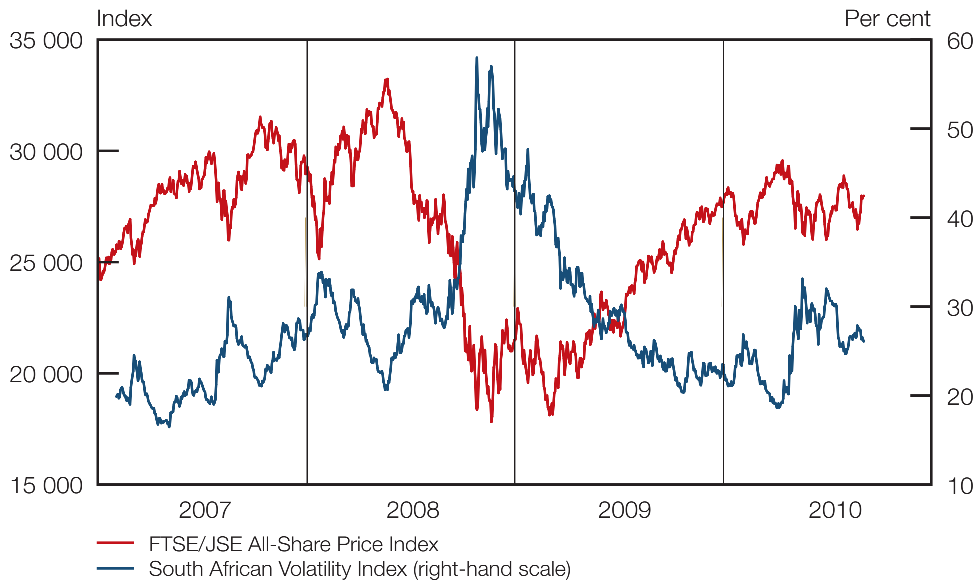


In 2009 *non-residents* preferred building up their investment in shares rather than bonds, as evidenced by the net accumulation of R75,4 billion in shares compared with R15,5 billion in bonds. By contrast, non-residents' level of trading activity in shares listed on the domestic secondary share market remained subdued for the most part of 2010 and volatility in share prices shifted non-resident investor sentiment towards bonds as they apparently sought safer assets. At only 13 per cent, May 2010 represented non-residents' all-time-low participation rate in the local share market, with a marginal improvement to 14 per cent in August 2010. In the first eight months of 2010 non-residents recorded net purchases of South African listed shares to the value of R25,7 billion, compared with net purchases of R59,9 billion in the corresponding period of 2009.

Non-resident activity and share prices on the JSE Limited

As a result of the financial crisis and recession, the South African Volatility Index (SAVI) reached a high of 52 per cent at the end of October 2008. Thereafter, the SAVI eased to 19 per cent on 6 April 2010, before rising to 26 per cent on 6 September. These movements were manifested in share prices as the *FTSE/JSE All-Share Price Index* (Alsi)

Share price and volatility index



improved steadily by 63 per cent from 3 March 2009 to 15 April 2010, tracking international equity markets and commodity prices higher. Subsequently, the momentum was interrupted by the European sovereign debt crisis which started in Greece and threatened to spill over to other European countries, prompting the EU and the IMF to establish an emergency stabilisation facility. The Alsi thereafter declined by 5 per cent from 15 April 2010 to an index value of 27 981 on 6 September as all major sectors recorded a decline.

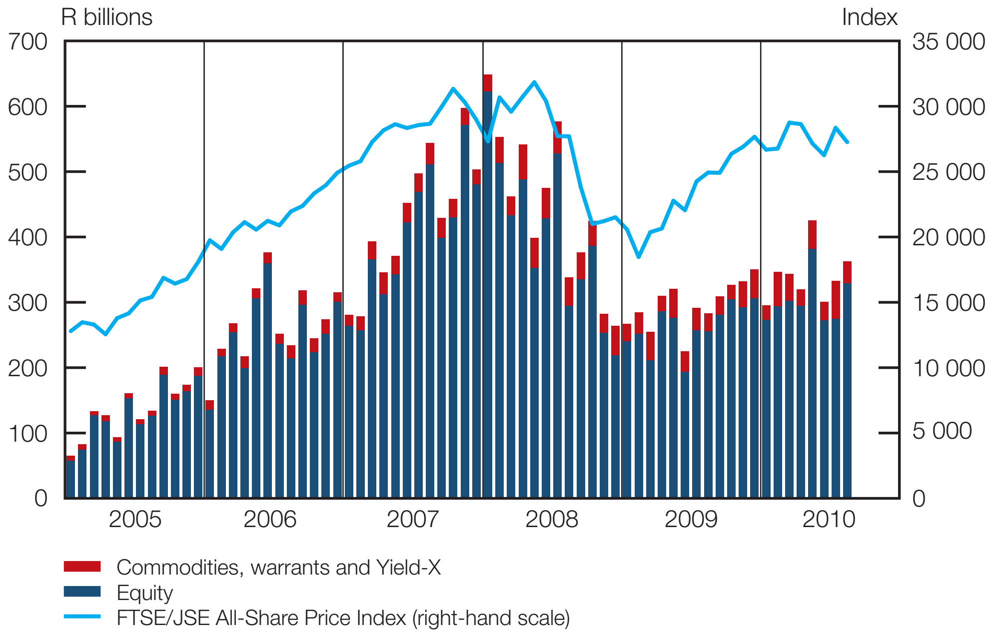
In US dollar terms, the Alsi declined by 3 per cent from 15 April 2010 to 6 September. Similarly, the S&P 500 Composite Index and Euro Stoxx Index both moved lower by 9 per cent over the same period as share markets globally remained volatile.

The strength in share market prices and lower past twelve-month earnings lifted the *price-earnings ratio* for all classes of shares from 8,4 in February 2009 to 20,7 in February 2010. Thereafter the ratio declined to 17,0 in August in reaction to lower share prices. Mirroring the movements of the price-earnings ratio, the average *earnings yield* declined from 11,8 per cent to 4,8 per cent before increasing to 5,9 per cent over the same period. The *dividend yield* broadly tracked the earnings yield and declined from 4,8 per cent in November 2008 to 1,9 per cent in April 2010, before increasing to 2,4 per cent in August.

Market for exchange-traded derivatives

In the wake of the financial turmoil in 2008, the global economy remained in recession as activity continued to decline in the first half of 2009. The domestic economy started to exit the recession from the third quarter of 2009 accompanied by the then evident recovery in the domestic equity market. The derivatives market tracked the movements in the underlying equities market. The value of trades on the EDD of the JSE increased by 16 per cent in the second half of 2009, following restored investor confidence levels. Subsequently, the total value of futures and options contracts traded on the EDD

Turnover in the derivatives market



Seasonally adjusted

increased by 24 per cent in the first eight months of 2010 compared with the same eight months of 2009, notwithstanding the ensuing fragile economic outlook as a result of the European sovereign debt problems. Equity index contracts dominated trade, accounting for 92 per cent of total turnover in the first eight months of 2010.

Turnover in *commodities* traded on the CDD of the JSE displayed a slowdown in 2009 relative to 2008 mainly as a result of subdued volumes following subdued demand, lower international commodity prices, the appreciation in the exchange value of the rand and favourable weather conditions. Turnover on the CDD continued to exhibit a downward trajectory in the first eight months of 2010 compared with the corresponding period of 2009. Trade in maize contracts accounted for the largest share at 62 per cent of the total number of contracts traded during the period under review.

Interest rate and foreign-exchange rate developments propelled trading on the JSE's *Yield-X* exchange in 2009, increasing by 1,4 times from 2008 to 8,5 million contracts in 2009. Similarly, turnover on Yield-X was strong, reaching a record annual level in 2009. Currency contracts registered a 38 per cent increase from 2008 to 2009. Currency futures and options contracts continued to dominate trade, accounting for 89 per cent of total trades in the first eight months of 2010. Turnover on Yield-X remained robust over the same period.

Notwithstanding the recovery in the underlying equity market in 2009, the number of *warrants* traded on the JSE decreased over the same period. Trading activity in the warrants sector was 41 per cent lower in the first eight months of 2010 when compared with the corresponding period of 2009, along with a significant decline in the number of warrants listed. Turnover in all derivatives traded on the JSE during 2009 and the first eight months of 2010 is indicated in the accompanying table.

Derivatives turnover on the JSE Limited

	Value		Change over one year	
	2009 R billions	Jan–Aug 2010 R billions	2009 Per cent	Jan–Aug 2010 Per cent
Financial futures and options on futures	3 157	2 282	-35	24
Warrants	3	1	-16	-43
Agricultural commodity futures and options	233	146	-36	-9
Interest rate derivatives	162	140	36	41

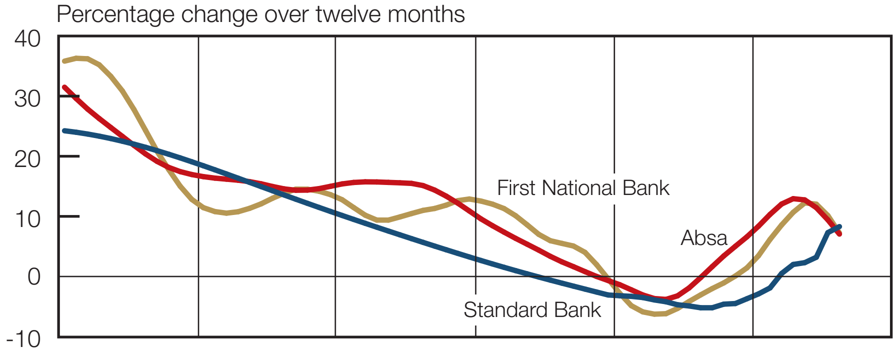
Real-estate market

Since bottoming out in 2009, South African house prices steadily improved, partly as a result of the stimulus from the cumulative 550 basis points interest rate reductions since December 2008 and the easier lending criteria adopted by banks. However, the pace of acceleration in the average price of domestic residential property started moderating from middle 2010 indicating that house price inflation may be peaking. This was confirmed by an increase in the length of time properties remain on the market from about 12 weeks in the first quarter of 2010 to 17 weeks in the second quarter. The property market will continue to be affected by the affordability of houses, which remains under pressure along with high levels of household debt and high unemployment.

The year-on-year rate of change in the average price of residential property in the middle segment of the market, as measured by Absa, improved from a negative 3,8 per cent in May 2009 to a positive 12,9 per cent in April 2010, before slowing to 7,1 per cent in August. The FNB Property Index posted a year-on-year improvement of 12,2 per cent in May 2010 from a deflation rate of 6,3 per cent in April 2009, before slowing to 7,2 per cent in August. The change in the Standard Bank median house price improved on a year-on-year basis from a negative 5,2 per cent in September 2009 to a positive 8,3 per cent in August 2010.

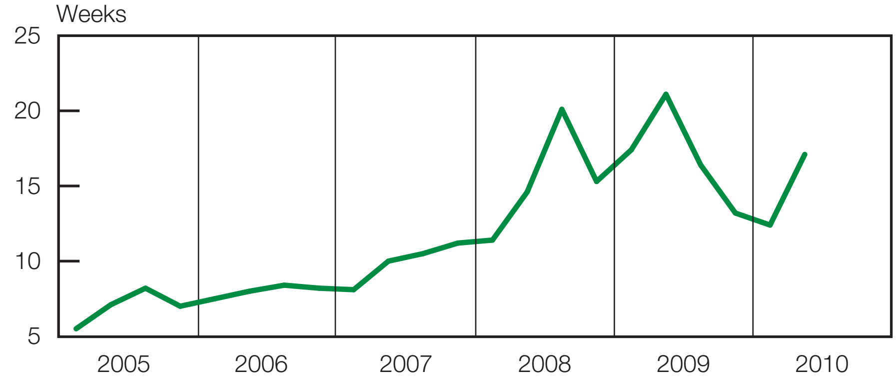
House prices

Percentage change over twelve months



Average number of weeks that residential properties remain on the market*

Weeks



* Source: First National Bank

Non-bank financial intermediaries

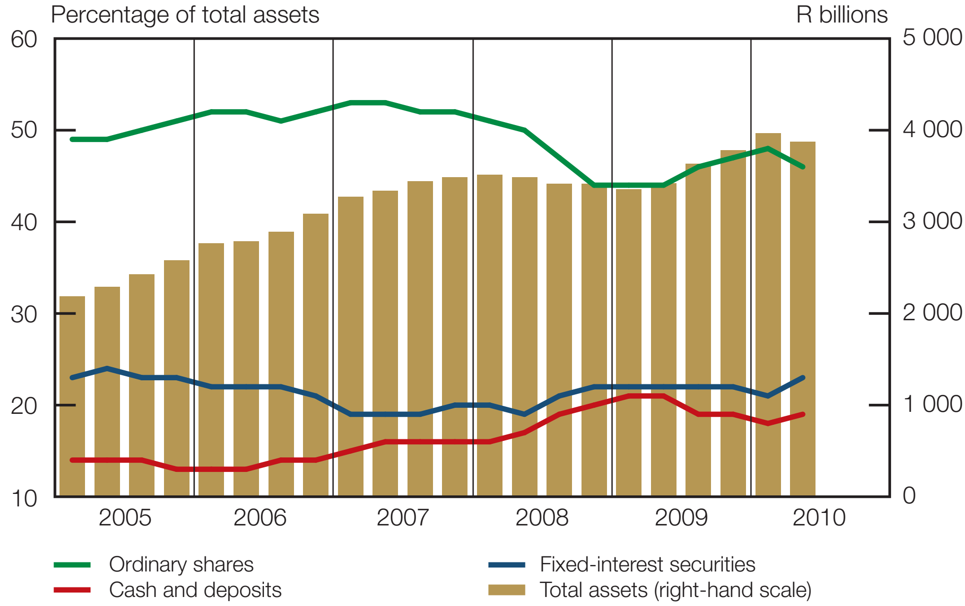
The recent gradual stabilisation of financial markets had a significant effect on the books of non-bank financial intermediaries[10] as their total balance sheet surpassed the pre-crisis level. Their total assets reached R3,8 trillion in December 2009 – an increase of 11 per cent from the amount registered in December 2008. The recovery in share prices and improved investor sentiment during the second half of 2009 boosted their holdings of ordinary shares from 44 per cent of total assets in 2008 to 47 per cent in 2009. During the second quarter of 2010, the intermediaries' total assets amounted to R3,9 trillion.

10 Consisting of unit trusts, insurers, and official and private pension and provident funds.

Non-bank financial intermediaries are the largest investors in the debt securities market, as these securities provide them with a stable investment income over time. Notwithstanding the substantial increase in the supply of government paper, the intermediaries' holdings of fixed-interest instruments remained unchanged at 22 per cent of total assets in both 2008 and 2009. However, allowing for revaluation effects, non-bank financial intermediaries were net buyers of shares and bonds of about R110 billion in 2009.

The return of investor confidence and some risk appetite during the latter part of 2009, along with the lower interest rate environment, prompted a switch to riskier and higher-yielding asset classes. This was evident in the marginal decline in holdings of cash and deposits from 20 per cent of total assets in 2008 to 19 per cent in 2009.

Asset holdings of selected non-bank financial intermediaries



The net inflow of funds[11] into these intermediaries declined by 19 per cent from 2008 to R169 billion in 2009, following relatively high policy surrenders and benefits paid over the same period. The decline in the amount of funds available for investment was more pronounced in funds channelled to long-term contractual savings,[12] with gross flows falling from 16 per cent of gross domestic product in 2008 to 14 per cent in 2009. Difficult economic conditions, continued job losses and subdued disposable income of households contributed to this decline. However, the current interest rate environment and positive growth prospects will most likely support flows.

11 Defined as the domestic current income surplus of long-term insurers, pension and provident funds, and the net sales of units by unit trusts.

12 These savings are measured as premiums and contributions received by long-term insurers and pension funds.

Public finance

Fiscal policy

Fiscal policy remained expansionary during the past year, both in South Africa and internationally. On 17 February 2010 the Minister of Finance presented his maiden Budget to Parliament, following his maiden *Medium Term Budget Policy Statement* to the same house on 27 October 2009. The 2010 Budget was presented in the context of immense global and domestic challenges for macroeconomic policy-makers and financial regulators, brought about by the global crisis.

Nevertheless, the global recession had subsided and the South African economy was on a recovery trajectory. Sound macroeconomic policies pursued prior to the recession had enabled the government to respond appropriately to the economic downturn. Going forward, a strong countercyclical fiscal policy would be maintained to support further economic recovery, moving the economy towards a new growth path. Government committed itself to a concerted effort to reduce joblessness among young people, support for labour-intensive industries, sustaining high levels of public and private investment, and raising the level of savings; and a range of further policies to achieve robust, inclusive growth.

Real growth in gross domestic product was projected to recover to 2,3 per cent in 2010 with supportive fiscal and monetary policies, a continued public-sector investment drive and lower inflation. Growth was expected to improve further, rising to 3,6 per cent by 2012. The tax policy would remain supportive of overall economic growth, thereby providing relief to vulnerable individuals through compensating for inflation, and the budget deficit would be brought back to a sustainable position over the medium term. Government aimed to reduce the deficit gradually, broaden the tax base and improve tax compliance to ensure an equitable distribution of the tax burden necessary to provide appropriate public services.

National government expenditure

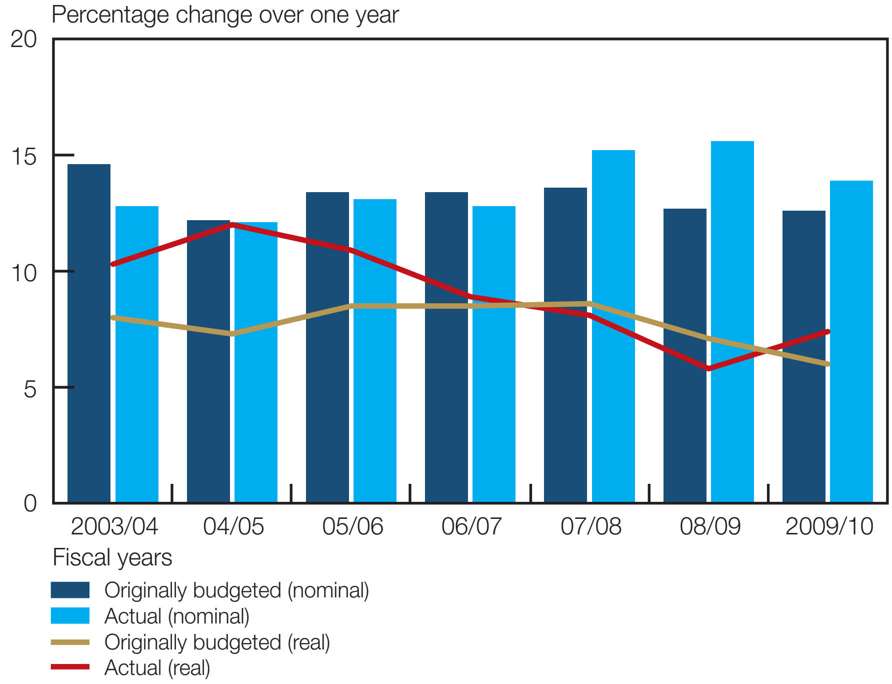
Expenditure by national government totalled R713 billion in fiscal 2009/10, some R8,3 billion more than the original budgetary provision of R704 billion anticipated in the *Budget Review 2009*. In nominal terms, this resulted in a year-on-year rate of increase of 13,9 per cent in national government spending; more than double the headline consumer price inflation rate, which averaged 6,5 per cent in 2009/10. During fiscal 2009/10, national government expenditure increased by 7,4 per cent in real terms, higher than the growth rate recorded in fiscal 2008/09. National government expenditure amounted to 29,0 per cent of gross domestic product in fiscal 2009/10, compared with 27,0 per cent in the previous fiscal year.

Strong growth in national government spending stemmed from higher current payments, together with transfers and subsidies, which underpinned the increase in voted expenditure. In the *Budget Review 2008* provision was made for an amount of R60,0 billion to be paid over three fiscal years as financial support for Eskom's capital investment programme. For fiscal 2009/10, an amount of R30,0 billion was paid as the second tranche of a subordinated loan.[13] To date, Eskom has received R40,0 billion and the third tranche of R20,0 billion will be paid during fiscal 2010/11. Current payments by the Justice and Protection Services cluster also grew strongly during fiscal 2009/10, mainly for security required for the 2009 elections and the 2010 FIFA World

13 These amounts were not included in total expenditure in the analysis by the Bank.

Cup™ tournament; revamping the criminal justice system; and inflation-related adjustments, primarily to cover the higher fuel price and salary increases granted in the public sector.

Expenditure by national government



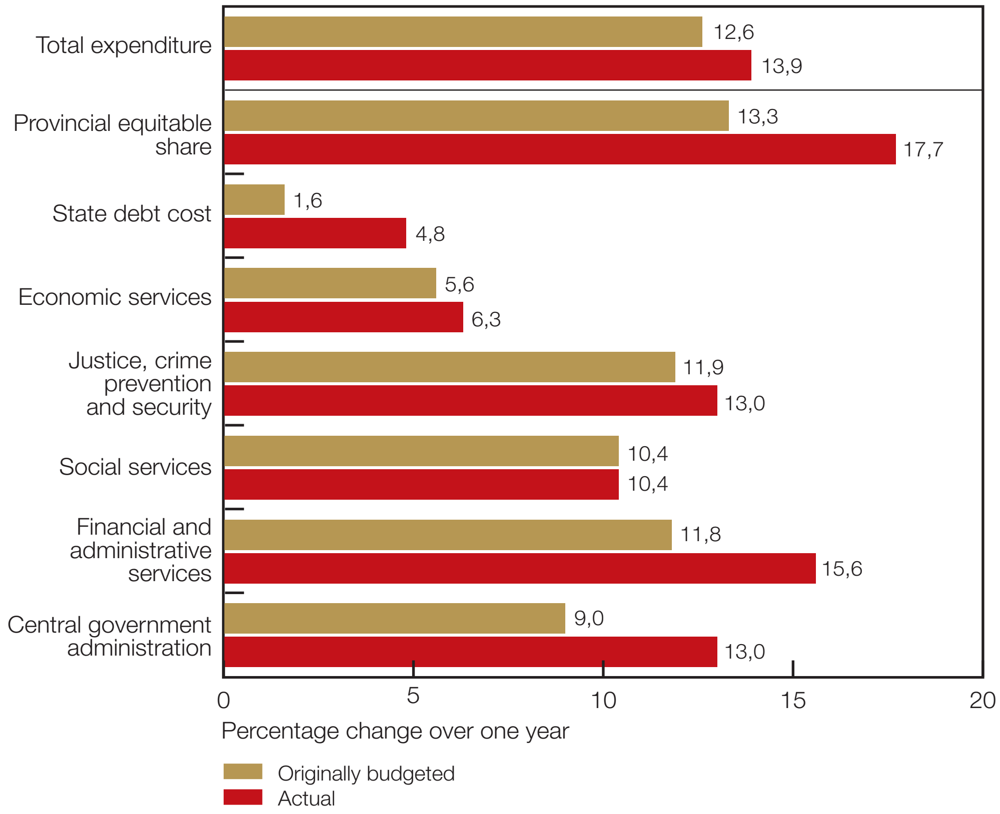
Further contributions to the higher spending were from the Social Services cluster, driven by the departments of Health and Social Development. Transfers and subsidies by the Department of Health increased by 16,2 per cent year on year because of grants paid to provincial governments for health professions training and development, national tertiary services, hospital revitalisation and comprehensive HIV/AIDS grants.

Furthermore, a significant part of the spending by the Department of Social Development were transfers to households, which increased by 12,1 per cent in fiscal 2009/10 partly to restore lost purchasing power caused by inflation. As a ratio of gross domestic product, social grants transferred to households amounted to 3,2 per cent in fiscal 2009/10, slightly higher than the previous fiscal year.

Interest paid on national government debt increased by 4,7 per cent to amount to R56,9 billion in fiscal 2009/10. This increase emanated from higher issuances of debt instruments to finance the higher-than-anticipated budget deficit. As a ratio of gross domestic product, interest payments remained unchanged at 2,3 per cent between fiscal 2008/09 and 2009/10.

Payments for capital assets amounted to R8,3 billion in fiscal 2009/10, or 13,0 per cent lower when compared with the previous fiscal year.

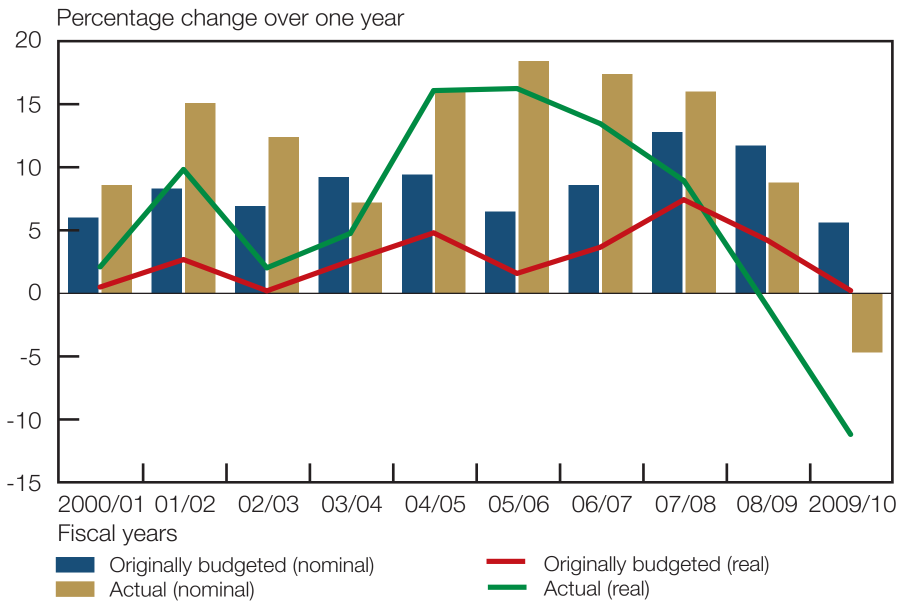
National government expenditure in 2009/10



National government revenue

The *Statement of National Revenue, Expenditure and Borrowing* indicated that unaudited national government revenue amounted to R580 billion in fiscal 2009/10 – some 4,7 per cent less than in the previous fiscal year and in contrast to the originally budgeted increase of 5,6 per cent.

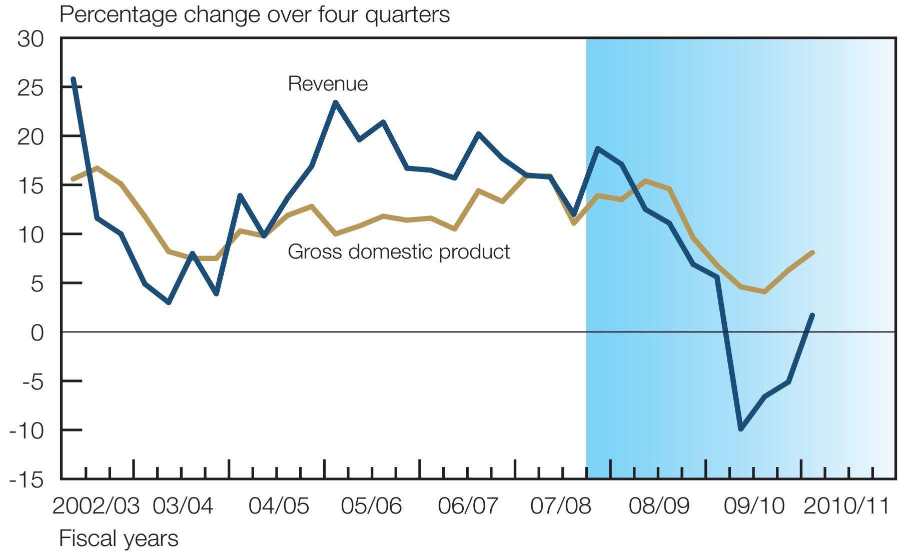
National government revenue



In the *Budget Review 2010* national government revenue was revised downwards, bringing the expected rate of *decrease* to 6,1 per cent, to a total of R571 billion in fiscal 2009/10. However, the outcome for fiscal 2009/10 was R8,5 billion more than the revised estimate in the *Budget Review 2010*, as a result of better-than-expected tax revenue collections in March 2010.

Reflecting recessionary conditions, national government revenue was lower than the originally budgeted projections for the second consecutive fiscal year in 2009/10. Prior to fiscal 2008/09, buoyant domestic economic conditions caused national government receipts to outperform originally budgeted projections in each of the fiscal years from 2000/01, with the exception of 2003/04. During fiscal 2003/04, the strength of the rand exchange rate had a ripple effect on mining companies, negatively affecting their export proceeds, profitability and thus their tax payments. National government revenue reached 23,6 per cent of gross domestic product in fiscal 2009/10, significantly lower than the 26,2 per cent recorded in the previous fiscal year. This was the lowest ratio recorded since fiscal 2003/04.

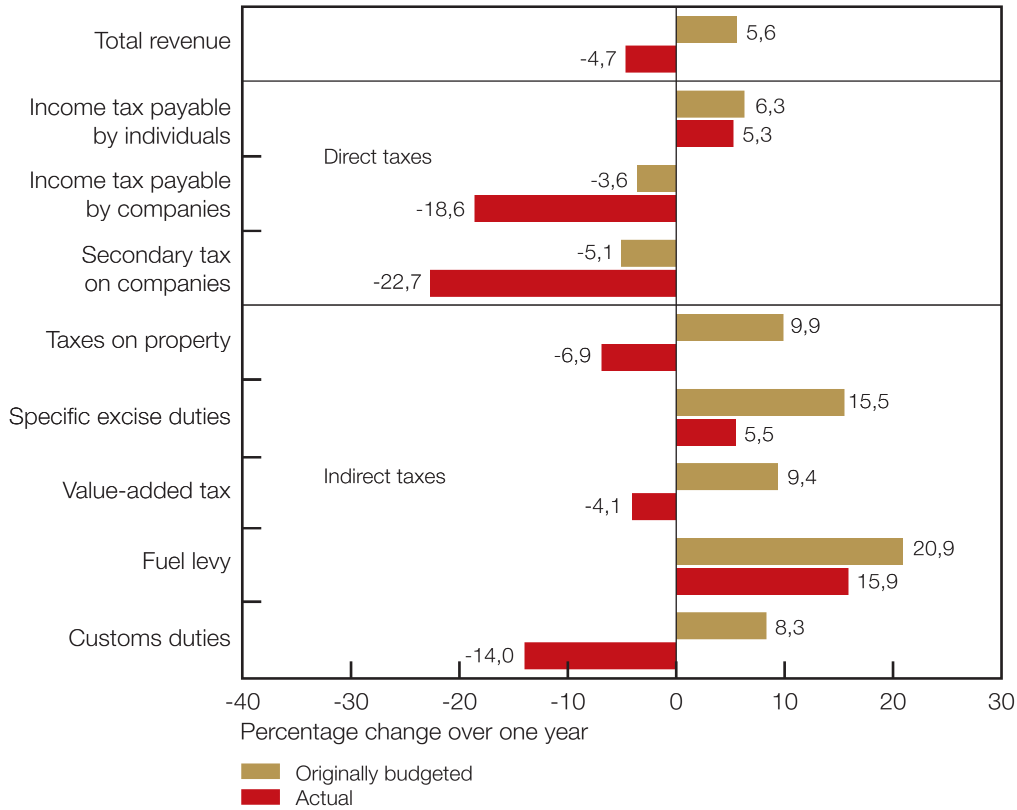
National government revenue and nominal gross domestic product



Although the South African economy might already have entered an upward phase of the business cycle, the lower turning point in the business cycle has not been determined yet

The decline in national government revenue in fiscal 2009/10 permeated most major tax categories, mirroring sluggish domestic economic conditions. Taxes on income, profits and capital gains were influenced by a steep drop of 18,6 per cent in corporate income taxes, signalling the decreased profitability of companies alongside weak domestic economic performance. This was in line with the trend in corporate dividend payments. Falling corporate income tax collections far outweighed the modest positive growth in personal income tax receipts. Collections from taxes on goods and services edged higher, rising by 1,1 per cent to an amount of R203 billion in fiscal 2009/10. Value-added tax collections no longer declined as forcefully as before but bottomed out, alongside growth in the fuel levy and excise duties. Quarterly data suggested an improvement in tax collections in the final quarter of the fiscal year, confirming the gradual turnaround in economic activity. This was consistent with benign developments in the domestic real estate and capital market activity, the stronger consumer sentiment and domestic demand, and a recovery in international trade and transactions.

National government revenue in 2009/10

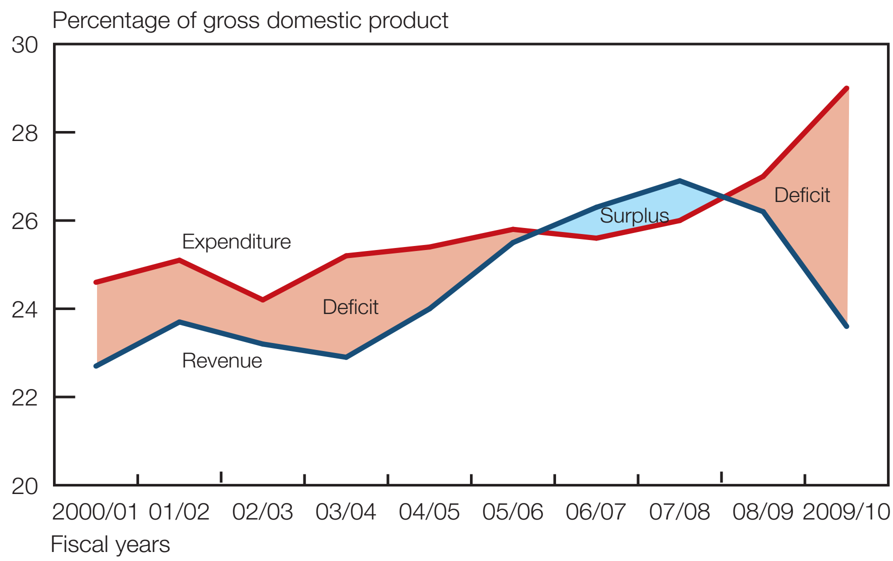


National government deficit

Netting national government revenue and expenditure yielded a cash-book deficit of R133 billion in fiscal 2009/10.[14] In absolute terms this cash-book deficit was the largest ever recorded and was almost eight times the cash-book deficit recorded in fiscal 2008/09, due to lower revenue collections and higher-than-budgeted expenditure. In fiscal 2009/10 the deficit as a ratio of gross domestic product amounted to 5,4 per cent, compared with a deficit ratio of 0,7 per cent recorded in the preceding fiscal year.

14 The deficit differs from that of National Treasury because the loans to Eskom and for the Gautrain project were excluded from expenditure in the analysis by the Bank.

National government finance

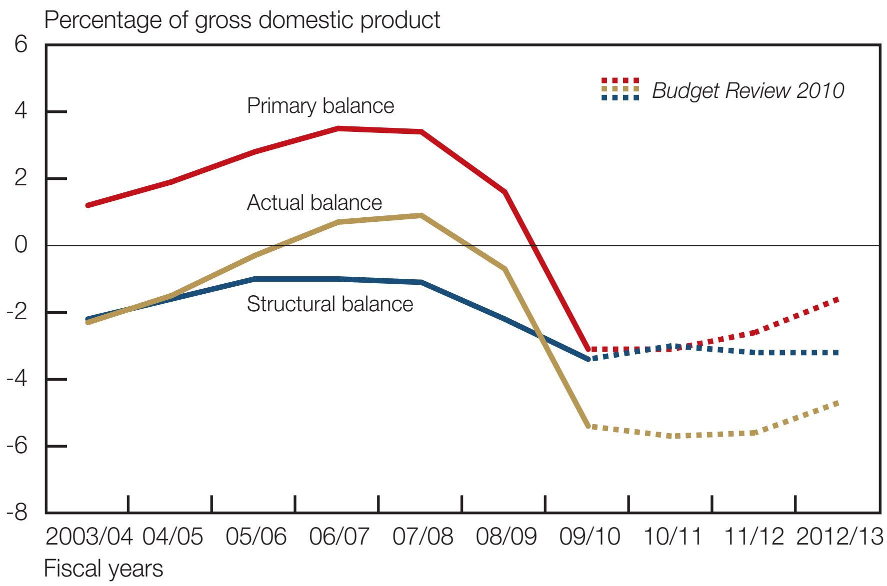


The global recession prompted government to pursue an expansionary fiscal policy. The fiscal space created in prior years, coupled with prudent fiscal management, allowed for a considerable increase in the budget deficit without exerting undue pressure on the fiscus. It was expected that the deficit would average 5,4 per cent of estimated gross domestic product over the medium term to fiscal 2012/13.

One key indicator of fiscal sustainability is the primary balance, which calculates the deficit by excluding the cost of servicing public debt from expenditure. In the *Budget Review 2010* it was projected that the primary deficit would amount to 3,5 per cent of gross domestic product in fiscal 2009/10.

The actual outcome for fiscal 2009/10 was a primary *deficit* of R75,7 billion, or 3,1 per cent of gross domestic product – in stark contrast to the *surplus* ratio of 1,6 per cent in fiscal 2008/09. However, the primary deficit was expected to narrow over the medium term due to projected declines in budget deficits despite higher debt-service cost.

National government primary balance



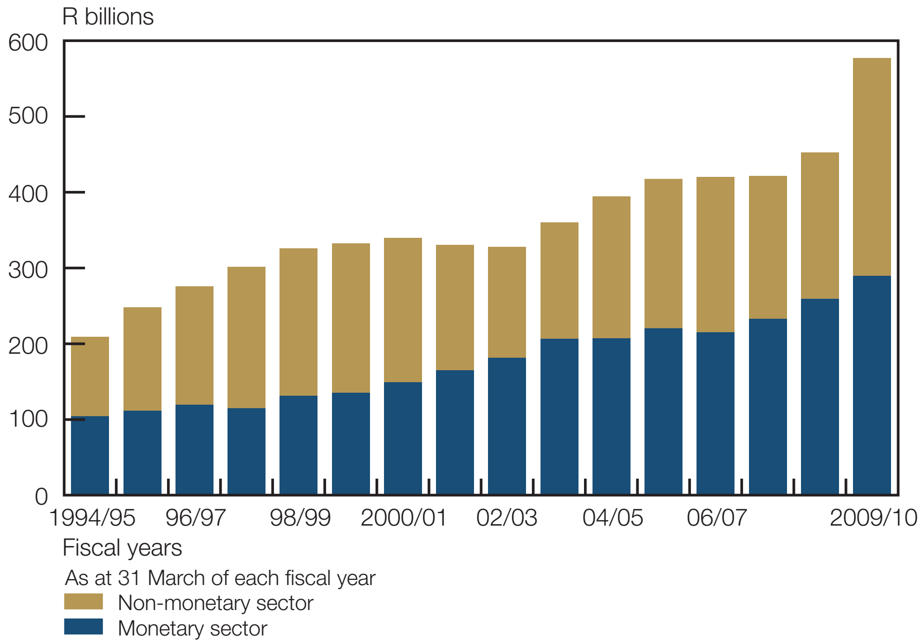
National government financing and debt

South Africa was in a more favourable position at the advent of the worldwide economic crisis, with low budget deficits and debt levels. Financial-market liquidity and sound debt management enabled government to finance the bulk of the higher-than-expected deficit domestically.

The net outcome of national government cash-flow revenue and expenditure was a cash-flow deficit of R144 billion in fiscal 2009/10 – more than six times higher than the cash-flow deficit recorded a year earlier. Extraordinary receipts included mainly proceeds from the sale of Telkom shares in Vodacom of R3,9 billion. Extraordinary payments consisted of losses on conversion of foreign-exchange transactions, losses on the Gold and Foreign Exchange Contingency Reserve Account (GFECRA) and R55 *million* as a final payment of government's liability in respect of Saambou Bank.

After accounting for extraordinary transactions and the cost on revaluation of maturing foreign debt, the net borrowing requirement amounted to R141 billion in fiscal 2009/10. This was significantly higher than the net borrowing requirement of R26,7 billion recorded in the preceding fiscal year. The net borrowing requirement was financed through the issuance of debt instruments, mainly in the domestic money and capital markets, which outstripped the originally budgeted projections. In fiscal 2009/10 national government raised R49,8 billion from Treasury bills and some R97,0 billion from long-term domestic government bonds, the latter including retail bonds. During the period under review, the holding of domestic government bonds was spread almost equally between the monetary and non-monetary sectors. Net issues of RSA Government Retail Savings Bonds amounted to R2,7 billion, bringing the total balance outstanding of such bonds to R4,2 billion at the end of March 2010.

Ownership distribution of national government bonds



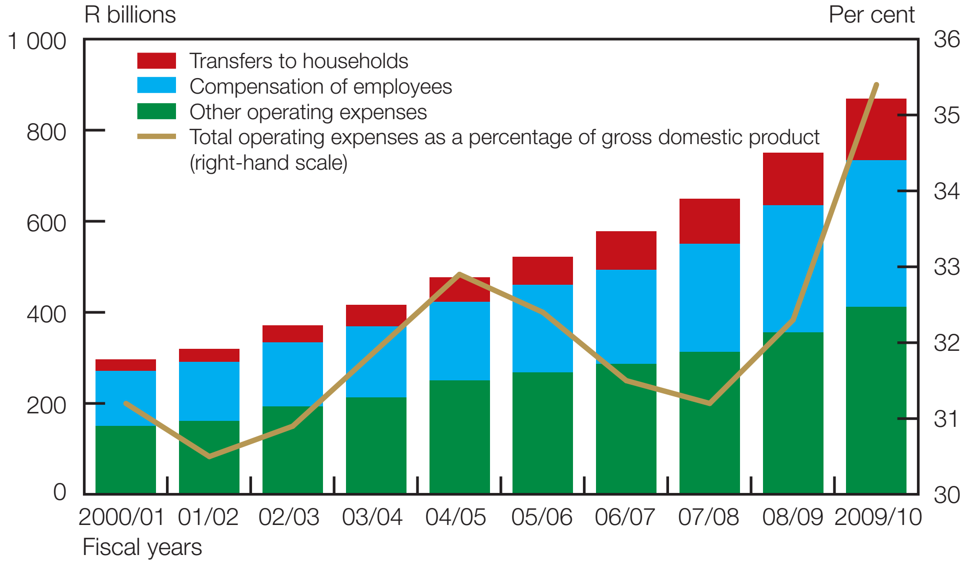
Despite the slow global economic recovery, national government managed to increase its foreign debt holdings by raising R14,8 billion from the issuance of a US$2 billion global bond in March 2010. This bond carries a coupon rate of 5,5 per cent, matures in March 2020 and was issued at a yield to maturity of 5,3 per cent per annum. Funding activities increased national government's available cash balances by R30,4 billion in fiscal 2009/10.

Total loan debt of national government as a ratio of gross domestic product increased from 26,6 per cent to 32,4 per cent between March 2009 and March 2010. This increase could be explained by the issuance of debt instruments, which includes discounts and premiums, revaluations, and, in particular, the impact of the exchange value of the rand on foreign debt. National government's domestic debt, as a proportion of total loan debt, increased from 84,2 per cent to 87,5 per cent between the respective dates, with foreign debt accounting for the remainder.

General government finance

In fiscal 2009/10 *consolidated general government* recorded an all-time high cash deficit of R142,8 billion, more than eight times the cash deficit recorded in the preceding fiscal year. National government accounted for the lion's share of this cash deficit, which was well above the originally budgeted projection, but remained R7,4 billion below the revised estimate stated in the *Budget Review 2010*. Increased government spending – as fiscal policy remained countercyclical due to uncertain economic conditions emanating from the recent global financial crisis – contributed to the substantial widening of the cash deficit. The crisis led to the country's first recession since the early nineties, which ushered in waning revenue collections, as domestic demand remained sluggish. For fiscal 2009/10, the cash deficit as a ratio of gross domestic product amounted to 5,8 per cent, moderately below the revised estimate of 6,1 per cent stated in the *Budget Review 2010*.

General government operating expenses

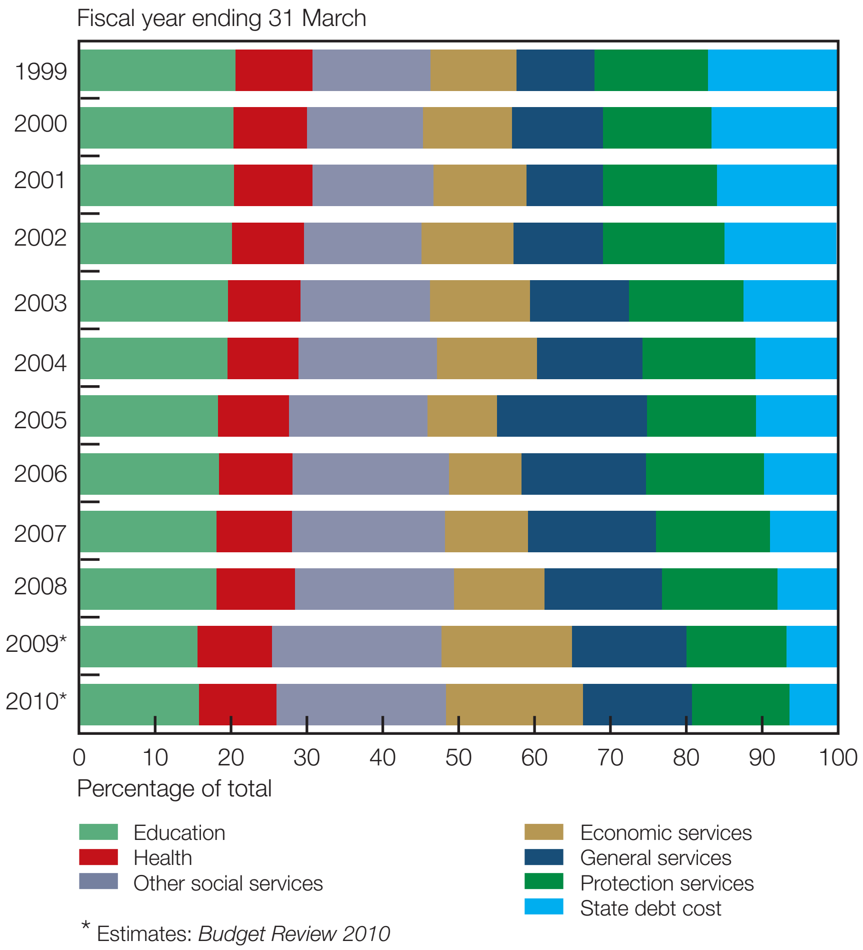


The sizeable cash deficit recorded by national government can be ascribed to an increase in spending – underpinned by transfers and subsidies earmarked for social spending and infrastructure development – together with below-budgeted revenue collections. In addition, sustained real growth in transfers to households over the past years contributed to wealth redistribution and poverty alleviation. Following the implementation of the occupation-specific dispensation and general salary increases for education and health practitioners, equitable share transfers to provinces increased by 17,7 per cent in fiscal 2009/10. Local governments received a total of R6,8 billion from national government as part of the general fuel levy sharing agreement with metropolitan municipalities, following the abolition of Regional Services Council levies. The cash deficit recorded by provincial governments in the period under review improved slightly when compared with the previous fiscal year. Expenditure by municipalities remained robust in response to the demand for basic services and provision of infrastructure related to the 2010 FIFA World Cup™ tournament.

In fiscal 2009/10, consolidated general government operating expense increased by 15,9 per cent to R869 billion. The growth rate was higher than in the previous fiscal year. Net investment in non-financial assets by consolidated general government declined and amounted to R82,4 billion, following the completion of 2010 FIFA World Cup™ projects. Growth in net investment was primarily supported by infrastructure-related spending by local government, which accounted for more than half of total investment by general government. This contribution by local government to gross fixed capital formation would also enhance the country's long-term economic growth potential. During fiscal 2009/10, consolidated general government expenditure relative to gross domestic product amounted to 38,8 per cent compared with 36,0 per cent recorded in the preceding fiscal year.

As a proportion of total operating expense, the compensation of employees accounted for 37,0 per cent during the period under review. Real growth in compensation of employees amounted to 8,9 per cent – higher than the 7,5 per cent recorded in the preceding fiscal year. In fiscal 2008/09 and 2009/10 growth in the wage bill was considerably higher than expected as a result of increased government employment, salary increases and wage adjustments for the implementation of improvement in the conditions of service for public servants. Relative to gross domestic product, compensation of employees increased from 12,0 per cent to 13,1 per cent between fiscal 2008/09 and 2009/10.

Consolidated general government expenditure: Functional classification



Over the past decade, government continued to shift its spending towards social services, with education remaining the highest priority. Transfers to households, which include direct welfare grants, housing subsidies and indirect transfers through non-profit institutions, totalled 15,6 per cent as a proportion of total operating expense in fiscal 2009/10. Receding state debt costs were supported by prudent debt management, enabling government to dedicate additional resources towards other priority areas.

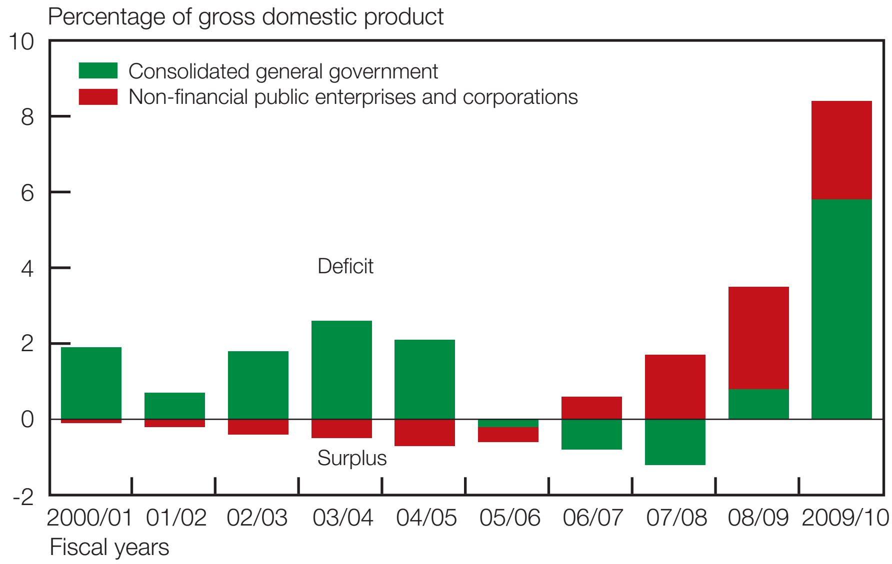
Spending per capita by general government increased significantly from about R7 000 in fiscal 2000/01 to R19 000 in fiscal 2009/10.

Non-financial public-sector borrowing requirement

The activities of the non-financial public sector resulted in a widening of the borrowing requirement, which more than doubled from R79,6 billion in fiscal 2008/09 to R188,1 billion in fiscal 2009/10. National government was the main contributor to the larger borrowing requirement, as the economic downturn impacted revenue negatively, while expenditure played a stimulatory role.

As a ratio of gross domestic product, the non-financial public-sector borrowing requirement amounted to 7,7 per cent in fiscal 2009/10, lower than the ratio of 10,4 per cent estimated in the *Budget Review 2010*. Previously, the all-time-high borrowing requirement amounted to 9,5 per cent of gross domestic product recorded in fiscal 1993/94 when the economy was exceptionally weak.

Non-financial public-sector borrowing requirement



Borrowing by non-financial public enterprises, such as Transnet and Eskom, is expected to support their capital expenditure programmes, which are projected to amount to R454 billion over the medium term. Improvement of co-ordination, oversight and governance of these entities, as well as enhanced monitoring of their financial performance and development impact, is a policy priority. The borrowing requirement of these entities is expected to decrease from R117 billion in fiscal 2010/11 to R77 billion in fiscal 2012/13.

National government finance in the April–June quarter of fiscal 2010/11

National government revenue and expenditure resulted in a cash-book deficit of R31,9 billion in the first three months of fiscal 2010/11, lower than the deficit of R45,9 billion recorded in the same period of the previous fiscal year.

After taking into account cash-flow adjustments, extraordinary transactions and revaluation of foreign debt at redemption, the net borrowing requirement amounted to R33,8 billion in the first quarter of fiscal 2010/11. The net borrowing requirement was financed mainly through Treasury bills and domestic government bonds, as indicated in the accompanying table.

National government financing in fiscal 2010/11

R billions

Item or instrument	Originally budgeted 2010/11	Actual Apr–Jun 2010	Actual Apr–Jun 2009
Deficit	**74,9**[1]	**33,8**[2]	**57,0**[2]
Plus: Extraordinary payments	-	0,1	0,0
Cost on revaluation of foreign debt at redemption	0,8	0,2	0,3
Less: Extraordinary receipts	-	0,2	4,1
Net borrowing requirement	**175,7**	**33,8**	**53,2**
Treasury bills	22,0	18,9	26,2
Domestic government bonds	137,7	35,3	19,3
Foreign bonds and loans	12,4	-0,7	6,3
Change in available cash balances[3]	3,6	19,6	1,5
Total net financing[4]	**175,7**	**33,8**	**53,2**

1 Includes a subordinated loan to Eskom
2 Cash-flow deficit
3 Increase – decrease +
4 Components may not add up to totals due to rounding