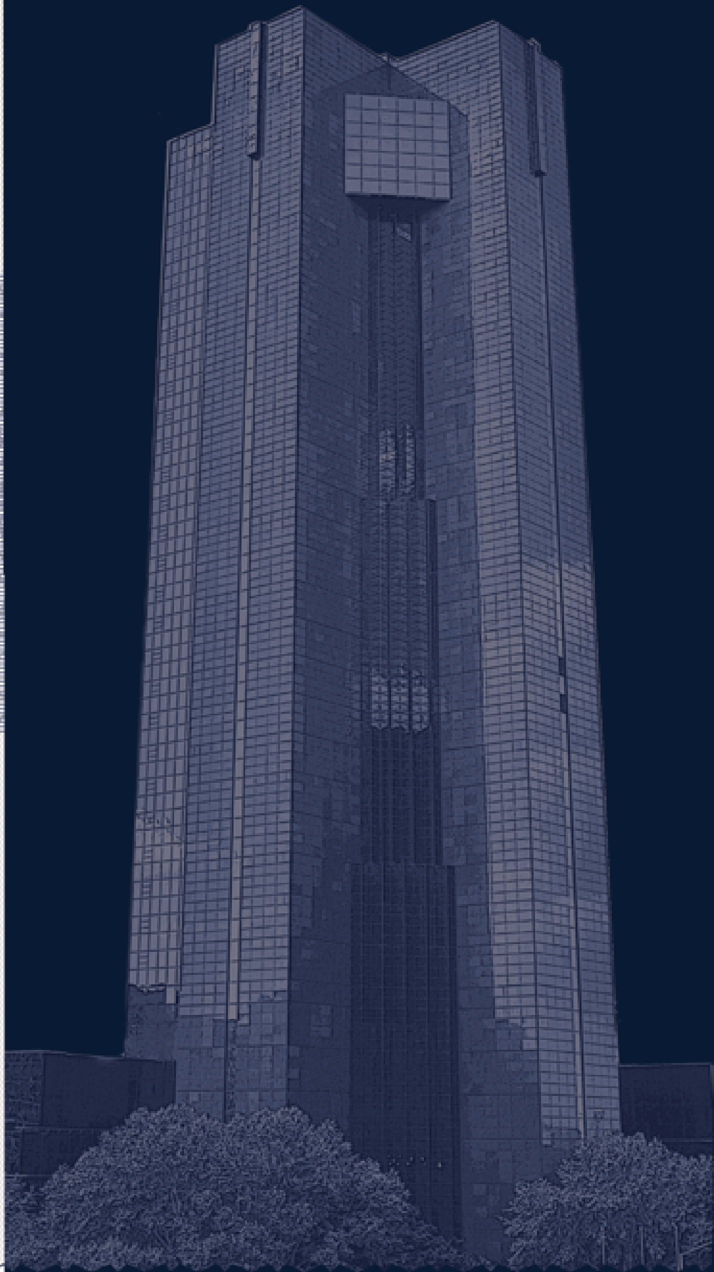

Annual Economic Report

2011

South African Reserve Bank

90th Anniversary

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Introduction

This document reviews the broader economic context within which the South African Reserve Bank (the Bank) conducted its operations in 2010/11, focusing on international and domestic economic developments. The emphasis is on the year 2010 and the first half of 2011. On the occasion of the Bank's 90th Anniversary, the *Annual Economic Report* also includes a number of brief analyses covering the period from 1921 to the present, in the form of boxes.

Over the past 18 months the global economy continued on its course of recovery. The strongest growth momentum was provided by the emerging-market and developing economies, led by Asia, while the advanced economies registered a more subdued performance. The major advanced economies, having been impacted most by the financial crisis, continued to support activity levels with accommodative monetary policies. At the same time, policy-makers in these countries had to engage in fiscal consolidation, as the quantum and cost of public debt had escalated to levels that raised concern about sustainability in the public finances. In peripheral Europe the economic crisis transmuted into a sovereign debt crisis which remained unresolved despite large support packages from the European Union (EU), European Central Bank (ECB) and International Monetary Fund (IMF), and the adoption of austerity measures by the countries involved.

Further impediments to a smooth global recovery included the high levels of international commodity prices, fuelled by strong demand growth in the emerging-market economies. In the case of oil in particular, fears about the security of supply following the political turmoil and conflict in a number of countries in the Middle East and North Africa (MENA) region buoyed prices further. The earthquake and tsunami that hit Japan on 11 March 2011 disrupted global supply chains, further weighing down activity. Nevertheless, the recovery in the advanced economies appears to be broadly on track, although significant risks remain.

The strong demand for and prices of commodities favoured many countries in sub-Saharan Africa, and growth prospects for the continent have brightened, along with greater emphasis on the improvement of infrastructure and sound economic policies.

In South Africa the business cycle reached a lower turning point in August 2009. The recovery that followed was well synchronised with the global economic cycle. In the subsequent six quarters activity strengthened in all the main sectors of the economy, albeit from a low base. A contraction of 1,7 per cent in real gross domestic product in 2009 made way for an expansion of 2,8 per cent in 2010, with annualised growth rates of more than 4 per cent in the final quarter of 2010 and first quarter of 2011. Of particular significance is that employment also started increasing from the second quarter of 2010.

From an aggregate demand perspective, the major driving force behind the recovery has been final consumption expenditure by households. Real spending by households came from a low base, having contracted up to the middle of 2009, but has since risen at annualised rates of around 5 per cent. The recovery in households' expenditure was especially strong in the area of durable goods such as motor vehicles. While lower interest rates have given indebted consumers a reprieve, rising real disposable income has been driving the expenditure, as opposed to a rapid increase in debt levels. Household debt has been rising moderately but disposable income has been increasing more forcefully, resulting in a declining household debt ratio. While the debt ratio remains high, its downward trend suggests more sustainable behaviour so far in the current phase of economic expansion.

Real final consumption expenditure by government has also risen steadily, except for purchases of military equipment, which is understandably quite volatile.

Real fixed capital formation tends to lag the economic cycle, and continued contracting throughout 2009 and early 2010. However, it subsequently resumed an upward trend. The major element supporting capital expenditure in the past two years has been infrastructure-related capital spending by public corporations. By contrast, private-sector capital expenditure has been subdued over the past two years, particularly as far as residential buildings are concerned.

Following two years of decline to exceptionally low levels, inventories started recovering from late 2010, responding to higher levels of production and sales.

With all the domestic expenditure components rising, the volume of imports has also risen notably since the final quarter of 2009. Over the same period, the increase in the volume of South Africa's exports has been more subdued, raising concerns about the country's ability to take advantage of more favourable export commodity prices. While export volumes have been slow to respond, the higher export prices helped to reduce the deficit on the current account of the balance of payments to around 3 per cent of gross domestic product in 2010 and the first quarter of 2011.

The well-contained deficits on the current account of the balance of payments were readily financed by capital inflows. This came in various forms, although inward portfolio investment has made the largest contribution to the inflows since the beginning of 2010.

The authorities continued with the accumulation of foreign currency reserves during the past 18 months, raising the level of gross gold and foreign-exchange reserves from US$40 billion at the end of 2009 to US$50 billion most recently and thereby reducing South Africa's vulnerability, should the international headwinds change direction. The liquidity created through the Bank's purchases of foreign exchange was drained through a combination of instruments which involved significant costs to the authorities. This resulted in the Bank incurring a loss in the past financial year. Despite the scale of the reserve accumulation, the effective exchange rate of the rand was higher at the end of May 2011 than at the end of 2009.

The strengthening of the exchange rate over this period was helpful in moderating inflation in the face of higher international oil and food prices. Surplus capacity in most areas of the economy also dampened inflation, so that consumer price inflation decelerated and has remained consistently within the target range of 3 to 6 per cent from March 2010 – in fact, well below the midpoint of the range for most of the time. This created room for the Monetary Policy Committee (MPC) of the Bank to reduce the repurchase rate on three occasions during 2010, by 50 basis points each time, bringing the level of the repurchase rate to 5,5 per cent from mid-November 2010. At these levels money-market interest rates are at 30-year lows.

Growth in banks' credit extension picked up slowly from the second quarter of 2010, indicating caution on the part of both borrowers and lenders. Mortgage lending remained weak and, partly as a result, subdued conditions also characterised the housing market during the past 18 months.

Share prices fluctuated sideways in the first seven months of 2010 but thereafter trended strongly upwards, partly buoyed by rising commodity prices and an improvement in economic activity and profit expectations. However, share prices declined temporarily in response to the tragic events in Japan.

Government continued with its countercyclical fiscal policies within a framework of fiscal sustainability in the period under review. Given the high rate of unemployment and substantial surplus capacity in the economy, government maintained relatively large deficits, thereby supporting economic activity. With economic growth picking up, however, tax collections improved and the actual deficit for 2010/11 was smaller than earlier budgeted estimates. Government also adjusted its expenditure priorities in order to put the economy on a new course in line with government's New Growth Path, an economic strategy in which employment creation is paramount and which has set the bold target of creating 5 million additional jobs by 2020.

Box 1: Ninety years of central banking in South Africa

Legislation to establish a central bank in South Africa was enacted in August 1920 and the Currency and Banking Act was promulgated on 17 December 1920. The South African Reserve Bank (the Bank) commenced operations in June 1921, after the height of post-war inflation, and at a time of deflation and depression. The Bank's sole right to issue currency in terms of the Currency and Banking Act expired in 1945 and this necessitated the passing of the South African Reserve Bank Act in 1944.

Core to central banking are two principal functions, namely controlling the currency, by virtue of having the sole right to issue notes and coin; and maintaining the purchasing power of the monetary unit. These functions are linked, since excessive issuing of notes and coin results in erosion of the purchasing power of the national currency. Therefore, the issuing of currency should be controlled well, either directly by limiting quantities or indirectly through interest rates.

In the 1920s, control over currency meant uniformity, elasticity and security. Uniformity was attained because central banks had the monopoly to issue notes rather than several banks each issuing its own notes. Elasticity was obtained by basing currency in issuance partly on gold and partly on trade bills. Security was obtained by the cover afforded by gold and interest-bearing securities, and by giving the holders of notes a priority claim on all the assets of a central bank. By 1929, the gold standard no longer provided stability and elasticity.

The need for a central bank to issue currency in the Union of South Africa (the Union) was argued as far back as 1890. At its inception, the Bank was granted the sole right to issue banknotes in the Union, and these notes were legal tender. The Bank started issuing notes on 19 April 1922 and other issuers ceased doing so on 30 June 1922. The notes of other banks were withdrawn and on 30 June 1924 the liability of commercial banks in terms of outstanding notes was transferred to the Bank.

The Bank set the discount rate to protect the currency against inflation. The main objective of credit policy was the stabilisation of the Union's exchange rates with other gold standard countries, rather than the stabilisation of either the general price level or economic activity and employment. The Bank was required to fix and publish its discount rates on various classes of bills. In the absence of well-developed money and capital markets, the Bank managed to make the policy interest rate effective as banks promptly followed the changes in interest rates.

Between November 1924 and August 1929 the Bank's discount rate for prime trade bills was, with the exception of a short period, 5,5 per cent, before being increased to 6 per cent in August 1929 as imports increased relative to exports. The discount rate was again lowered to 5,5 per cent in September 1930 as the balance between imports and exports improved, and as the ratio of bank lending to deposits decreased. In March 1931 the Bank reduced the discount rate further to 5 per cent as both liquidity in the banking system and the trade balance improved. Then, as a consequence of Great Britain's departure from the gold standard, rates were raised in 1931 and 1932 based on the grounds already mentioned and in an attempt to keep money in South Africa. Rates were again lowered as from October 1932.

On 21 September 1931, during the Great Depression, Great Britain suspended the gold standard and the sterling depreciated. However, South Africa continued to maintain the gold standard for 15 more months. Circumstances induced the Union to abandon the gold standard on 28 December 1932.

The abolition of the gold standard marked a turning point in the Bank's history, and significantly affected economic conditions and monetary policy in South Africa. The Bank at first withdrew from the market, allowing the South African pound to find its own level in the foreign-exchange market, only to re-enter the market on 21 January 1933, fixing exchange rates and linking the South African pound to sterling at parity in London.

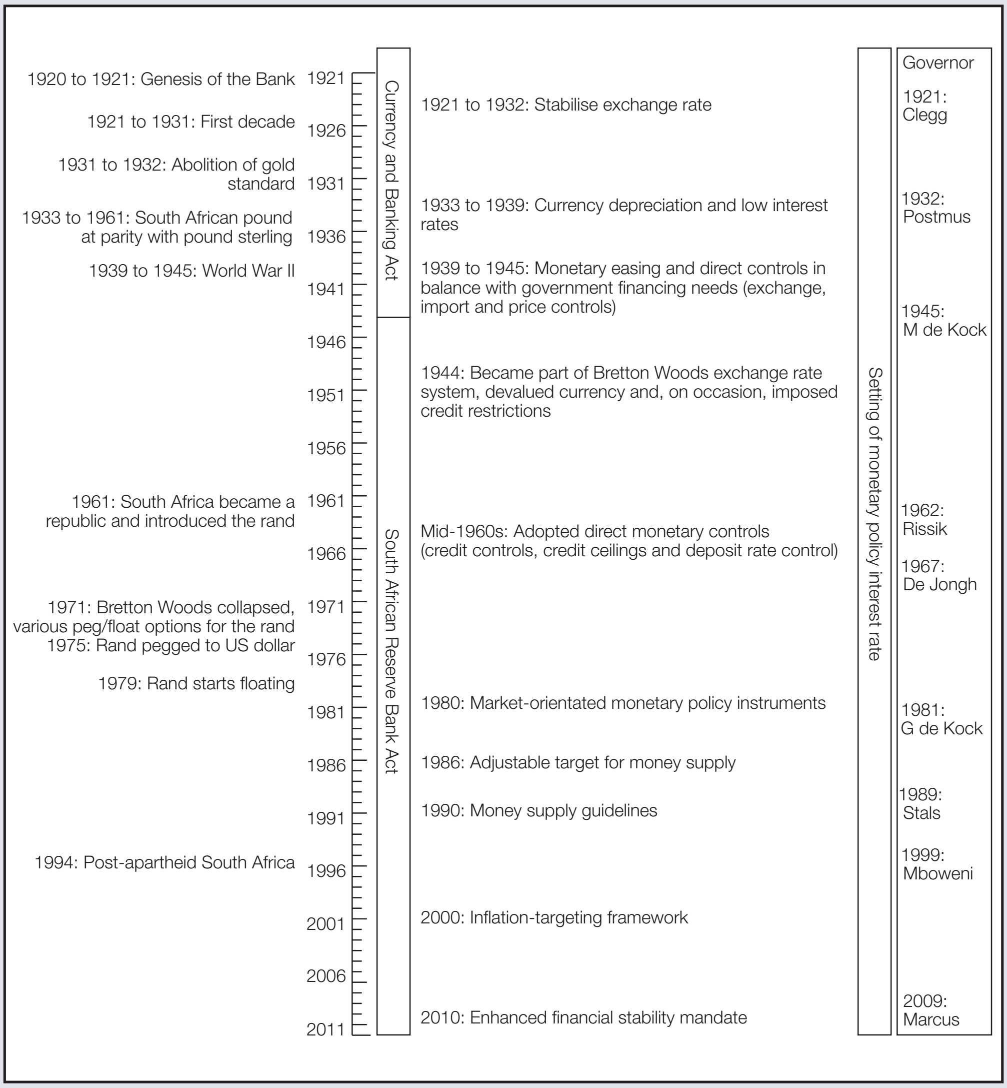
The Bank's credit policy changed from 1933 as the South African pound depreciated to the level of the sterling. A favourable balance-of-payments position increased liquidity, and market interest rates declined with monetary policy easing following as from February 1933 with reductions in the Bank's discount rate to April 1934. Thereafter, the major money-market rates remained unchanged. The currency depreciation and low interest rates led to an improvement in economic conditions with a change from depression to prosperity amid low inflation.

The outbreak of World War II in September 1939 affected economic conditions in the Union and ended the period of a managed floating currency regime. The Bank's wartime policy operations, although the Bank was not a full member of the sterling area, were characterised by exchange and import controls.

In response to increased monetary liquidity, the Bank led the money market by reducing the basic discount rate in June 1941 to 3 per cent – its lowest level since the inception of the Bank – with commercial banks lowering the prime rate to 5 per cent. Wartime inflation was partly imported and partly due to excess demand. Government responded with direct control measures such as price and rent controls; partial control of wages; building controls; allocation of steel and iron; and with food subsidies.

At the end of World War II the South African economy was fairly sound despite suffering from inflation, and the Union was on the threshold of significant economic development. Exchange and import controls were virtually abolished, while remaining within the Sterling Area, only to be reimposed and extended in 1949 due to a deterioration in South Africa's overall balance-of-payments position.

Evolution of exchange rate and monetary policy dispensation



At the end of World War II, South Africa became part of the international Bretton Woods fixed (but adjustable) exchange rate system while remaining a member of the Sterling Area. In September 1949 the United Kingdom devalued the pound sterling and South Africa decided to follow sterling immediately and to the same degree, thereby improving the balance-of-payments position but exacerbating inflation. In the post-war period credit policy gradually gained new significance as monetary policy revived globally and economic conditions posed greater challenges. To deal with inflation and balance-of-payments deficits, the authorities resorted to measures such as credit restrictions and higher interest rates. In October 1949 the Bank increased the discount rate to 3,5 per cent – the first change since 1941 – before raising it further in 1952.

In February 1961 South Africa introduced a decimal currency system with R2,00 equal to £1,00, shortly before becoming a Republic on 31 May 1961 and exiting the Commonwealth. South Africa adopted direct monetary controls in the mid-1960s such as credit controls, credit ceilings and deposit rate control. The Bretton Woods agreement collapsed in 1971 following inflationary pressures in the United States (US) in the wake of the Vietnam War, and it was succeeded by a system of floating exchange rates. South Africa at first pegged the rand to (1) the pound sterling, (2) the US dollar, (3) a basket of currencies, (4) the US dollar, and then (5) introduced a managed float in January 1979. During this period, the rand was devalued in December 1971 and again in September 1975.

From 1 September 1980 the Bank changed its instruments of monetary policy from direct controls to market-orientated instruments with the level of interest rates reflecting the true cost of borrowed funds. Initially considerable use was also made of cash reserve and liquid asset requirements. In 1986 the Bank adopted an adjustable target for growth in broadly defined money supply, which was replaced in the early 1990s with money supply growth guidelines, evolving into an eclectic approach to monetary policy. As from 1995, exchange controls were gradually abolished and on 13 March 1998 Bank rate was replaced with the repurchase rate. In 2000 the Bank adopted an inflation-targeting monetary policy framework. While some changes have been made to the inflation target, the policy framework has largely remained unchanged to date.

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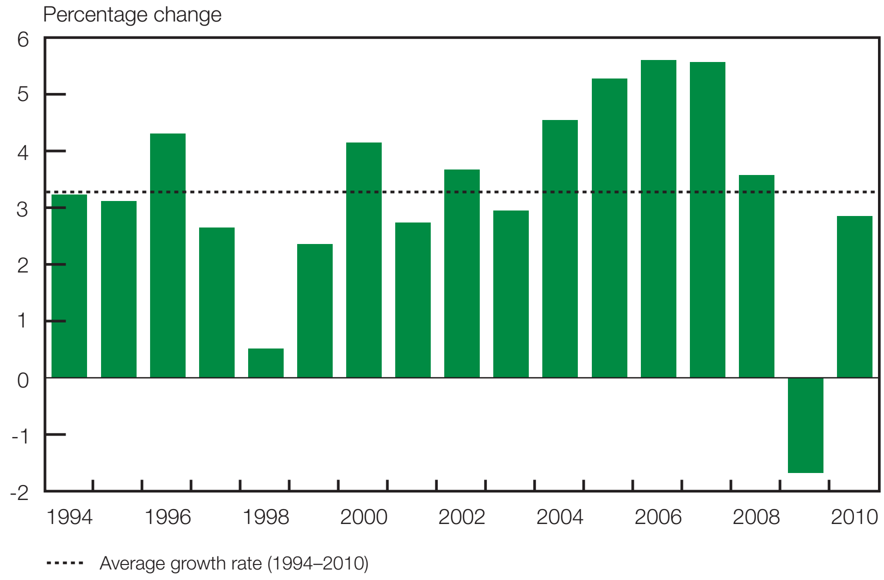
Domestic economic developments

Domestic output

The recovery in the South African economy broadened substantially in 2010 and the early part of 2011. For 2010 as a whole, the economy grew by 2,8 per cent following a contraction of 1,7 per cent in 2009 – the worst annual performance since 1992. Consistent with the upper turning point in the business cycle in November 2007, domestic demand moderated meaningfully throughout 2008, exacerbated by the global financial crisis that led to a sharp and almost synchronised contraction in merchandise trade. In real terms, production in the South African economy recovered to its pre-recession levels (i.e., in the third quarter of 2008) in the second quarter of 2010. Growth estimates for 2010 indicated that domestic economic activity expanded in all the major sectors of the economy over the period. This upward momentum was maintained in the first quarter of 2011 when real gross domestic production increased at a seasonally adjusted and annualised rate of 4,8 per cent.

Real gross domestic product



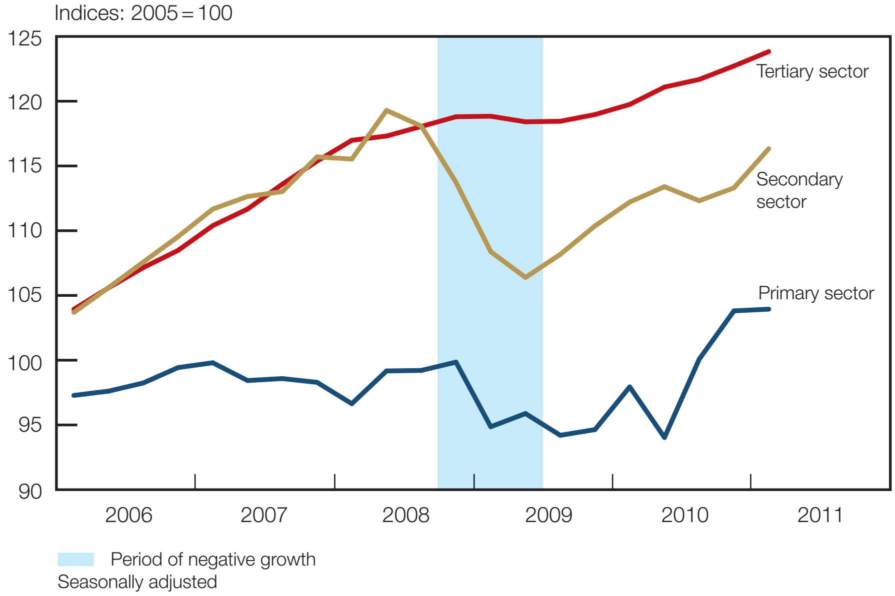
The South African economy benefited during 2010 from the notable pick-up in global economic activity as well as the successful hosting of the 2010 FIFA World Cup™ tournament. Regardless of these developments, the pace of domestic economic recovery continued to be held back by various structural deficiencies.

The economic growth rate, on average, amounted to roughly 5 per cent per annum in the three-and-a-half year period prior to the start of the recession in the fourth quarter of 2008. During the three-quarter recession in the domestic economy, activity contracted at an annualised rate of 3,5 per cent, but subsequently recovered to post an average growth rate of 3,4 per cent from the third quarter of 2009 to the first quarter of 2011.

The real value added by the *primary sector* increased by 4,3 per cent in 2010 following declines in the preceding two years. This turnaround in growth was largely attributable to a meaningful rebound in mining output, alongside a modest recovery in agricultural production. Production in the primary sector surpassed its pre-recession peak in the third quarter of 2010.

The real output of the *agricultural sector,* which increased markedly at a rate of 16,1 per cent in 2008, contracted by 3 per cent in 2009 before increasing by 0,9 per cent in 2010. This turnaround could mainly be ascribed to increased field crop and horticultural production over the period.

Real gross domestic product by main sector



Having declined for four consecutive years, the real value added by the *mining sector* increased by 5,8 per cent in 2010. The dismal performance of the mining sector prior to 2010 mainly reflected the secular decline in the output of the gold-mining sector. Following a sharp decline of about 14 per cent in 2008, gold production shrank by around 5 per cent in both 2009 and 2010. Apart from power outages which adversely affected total mining production from the beginning of 2008, mining production was also held back by a number of safety-related mine and shaft closures. By contrast, production in the non-gold mining industry expanded in 2010, largely in response to the relatively firm increase in global demand for especially platinum and coal. In the first quarter of 2011 mining production advanced at a somewhat slower pace, mainly due to a decline in the production of gold and coal.

Real gross domestic product

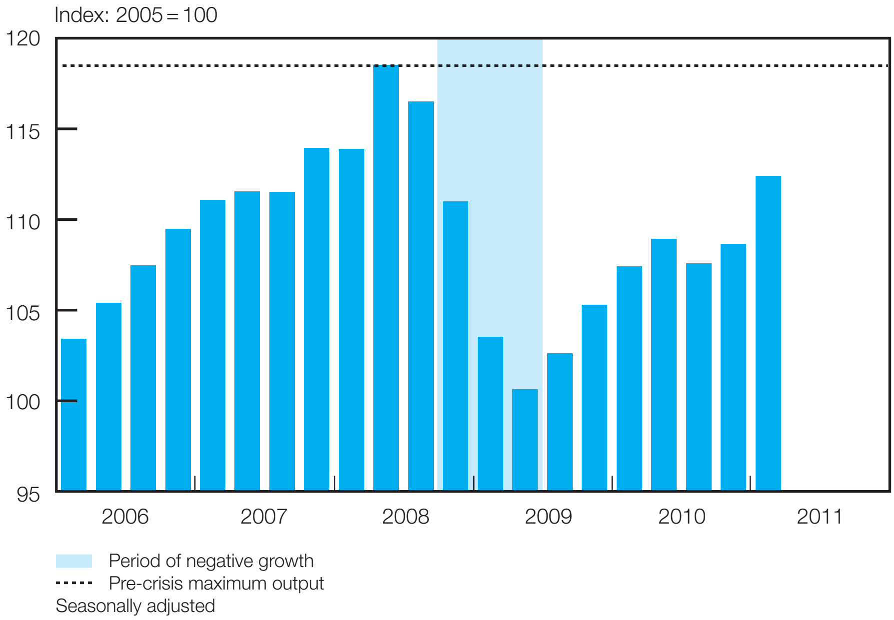
Percentage change at seasonally adjusted annualised rates

Sectors	2008	2009	2010					2011
	Year	Year	1st qr	2nd qr	3rd qr	4th qr	Year	1st qr
Primary sector	-0,1	-3,9	14,7	-15,0	28,3	15,8	4,3	0,5
Agriculture	16,1	-3,0	4,9	13,6	16,3	12,5	0,9	-2,6
Mining	-5,6	-4,2	18,7	-24,5	33,7	17,1	5,8	1,8
Secondary sector	3,0	-7,1	6,9	4,3	-3,8	3,6	4,1	11,1
Manufacturing	2,6	-10,4	8,3	5,7	-4,9	4,1	5,0	14,5
Electricity, gas and water	-3,1	-1,6	4,9	-1,7	-2,2	5,7	2,0	3,3
Construction	9,5	7,4	1,3	1,0	0,8	0,2	1,5	0,0
Tertiary sector	4,5	0,7	2,6	4,6	2,0	3,5	2,2	3,7
Commerce	0,8	-2,5	3,1	6,0	3,3	3,5	2,2	4,4
Transport and communication	3,4	0,6	2,4	4,5	3,0	4,2	2,9	3,6
Financial and other services	7,3	0,9	3,2	4,0	1,4	1,7	1,9	4,8
Non-primary sector	*4,1*	*-1,3*	*3,7*	*4,5*	*0,5*	*3,5*	*2,7*	*5,5*
Total	3,6	-1,7	4,8	2,8	2,7	4,5	2,8	4,8

Affected by the spill-over from the global recession and the subsequent contraction in merchandise trade, the real value added by the *secondary sector* declined by 7,1 per cent in 2009, subtracting 1,5 percentage points from overall economic growth in the year. Pronounced declines were registered in manufacturing and electricity output, whereas activity in the construction sector slowed further over the period. Consistent with the revival in global and domestic economic activity, growth in the real value added by the secondary sector accelerated to 4,1 per cent in 2010, buoyed by a rebound in manufacturing production that continued into the first quarter of 2011. Despite the improved performance of the manufacturing sector, production levels in the secondary sector remained well below the recent peak attained in the second quarter of 2008.

Growth in the real value added by the *manufacturing sector* slowed from 5,2 per cent in 2007 to 2,6 per cent in 2008. In 2009, the real value added by the manufacturing sector contracted by 10,4 per cent – the largest annual decline since 1947. The performance of the manufacturing sector in 2009 was severely influenced by the global recession and the simultaneous slowdown in domestic demand. Owing to the revival in economic activity, growth in the real value added by the manufacturing sector rebounded and accelerated to 5 per cent in 2010, a rate of increase broadly comparable with growth rates attained prior to the recession although output levels were still well below pre-recession levels. The faster growth mainly reflected firm increases in the real output of the subsectors for motor vehicles, parts and accessories and other transport equipment. This growth momentum was maintained in the first quarter of 2011 and became even more broad-based. Notwithstanding a steady increase in the utilisation of production capacity in manufacturing throughout 2010 and the first quarter of 2011, ample spare capacity still existed in the domestic manufacturing sector as capacity utilisation, on average, amounted to 80 per cent in 2010 compared with a recent peak of 86,1 per cent in the second quarter of 2007.

Real value added by manufacturing



The real value added by the sector supplying *electricity, gas and water* contracted in 2008 and 2009, severely suppressing domestic production capacity as power outages occurred throughout the country. Electricity supply constraints were exacerbated by, among other factors, increased demand, abnormally high rainfall that affected the quality of coal as well as reserve margins of less than 10 per cent. These limitations abated somewhat in 2010 when the real value added by the sector accelerated to a rate of 2,0 per cent. The demand for electricity increased in the latter part of 2010 and the first quarter of 2011 alongside rising activity levels in the mining and manufacturing sectors.

The *construction sector* was characterised by robust growth in real value added during the period 2005 to 2009, with the strongest growth in 32 years registered in 2007. This performance could mainly be attributed to booming housing construction activity and infrastructural developments involving the civil construction industry, including the building of a number of football stadiums, the upgrading of infrastructure surrounding the stadiums and SANRAL's Gauteng Freeway Improvement Project. With housing construction subdued and some projects related to the football tournament coming to an end, real output growth slowed to 1,5 per cent in 2010.

Growth in the *tertiary sector*, which constitutes around 65 per cent of the total gross domestic product, decelerated steeply from 4,5 per cent in 2008 to less than 1 per cent in 2009, with the trade sector in fact contracting during the period. From this low base, growth in the tertiary sector recovered notably in 2010, with the acceleration continuing into the first quarter of 2011.

Growth in the real value added by the *trade sector* was marginally positive in 2008, but became negative in 2009 in the wake of the global financial crisis. The real value added by the trade sector recovered in 2010, consistent with increased consumer spending, and registered growth of 2,2 per cent. The strong growth momentum in the real value added by the trade sector continued in the first quarter of 2011.

Activity in the *transport, storage and communication sector* lost momentum from 2008 and growth in real value added gradually slowed to a mere 0,6 per cent in 2009 as the contraction in the trade sector was mirrored in lower transport volumes. In 2010, growth in real value added accelerated again to 2,9 per cent as activity in land freight transport revived in response to improved consumer demand and the associated higher volume of goods transported across the country. However, the communication subsector maintained lively growth momentum from 2008 throughout the first quarter of 2011, driven by technological advances and improved affordability.

Growth in the real value added by the *finance, insurance, real-estate and business services sector* continued at a firm pace up to 2008, primarily driven by high trading volumes in the domestic securities market and the performance of the banking industry which was buoyed by robust growth in credit extension. The pace of increase in the real value added by security dealers, however, decelerated sharply in 2009, before regaining some momentum in 2010. Consistent with the moderation in credit extension, growth in the real value added by the banking sector also decelerated in 2009 and 2010. Activity in the financial sector, however, regained some momentum in the first quarter of 2011.

Growth in the real value added by *general government* moderated from 4,5 per cent in 2008 to 4,1 per cent in 2009 and further to 3,0 per cent in 2010. The slower growth in 2010 could partly be attributed to prolonged industrial action during the third quarter of 2010. In the first quarter of 2011, the real value added by the government sector increased at a slower pace.

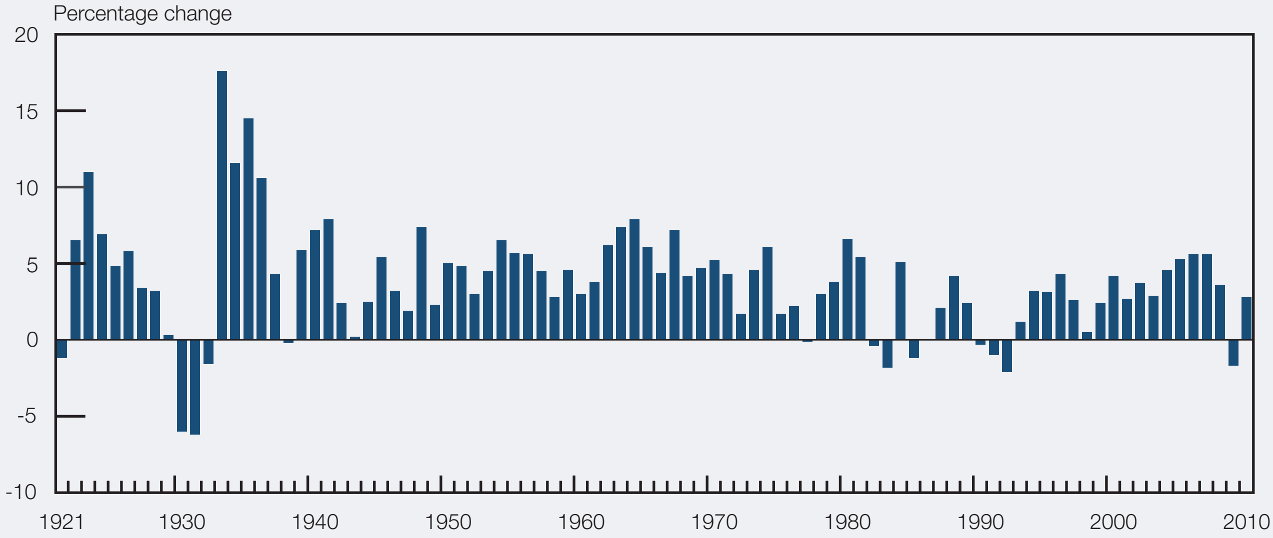
Box 2: Economic growth

South Africa's growth record over the past 90 years has been varied. When the South African Reserve Bank (the Bank) started operations, the economy was in the final throes of a severe contraction in global activity. From 1922 onwards growth improved, but was held back by the return by Britain to the gold standard at pre-war parity, implying that the price of gold and wages needed to adjust to pre-war levels. The Great Depression brought stagnation in 1929 and a contraction in activity from 1930 to 1932.

At the end of 1932 South Africa abandoned the gold standard and as the price of gold nearly doubled, it created a boom for the gold-mining sector and the industries supplying it. Growth was brisk in the subsequent years, and with a few exceptions remained firm up to the 1970s. In the 1970s stability deteriorated as the Bretton Woods system collapsed, the prices of commodities such as gold and oil started fluctuating, and inflation worsened considerably. Economic growth became more volatile and in the 1980s financial sanctions also impacted significantly on growth, resulting in a decline in real per capita income during the decade.

Growth picked up with the successful transition to democracy and improved frameworks for monetary and fiscal policy in the 1990s. The Southeast Asian crisis of 1997–1998 and the financial crisis of 2008–2009 nevertheless left their scars on South Africa's growth rate.

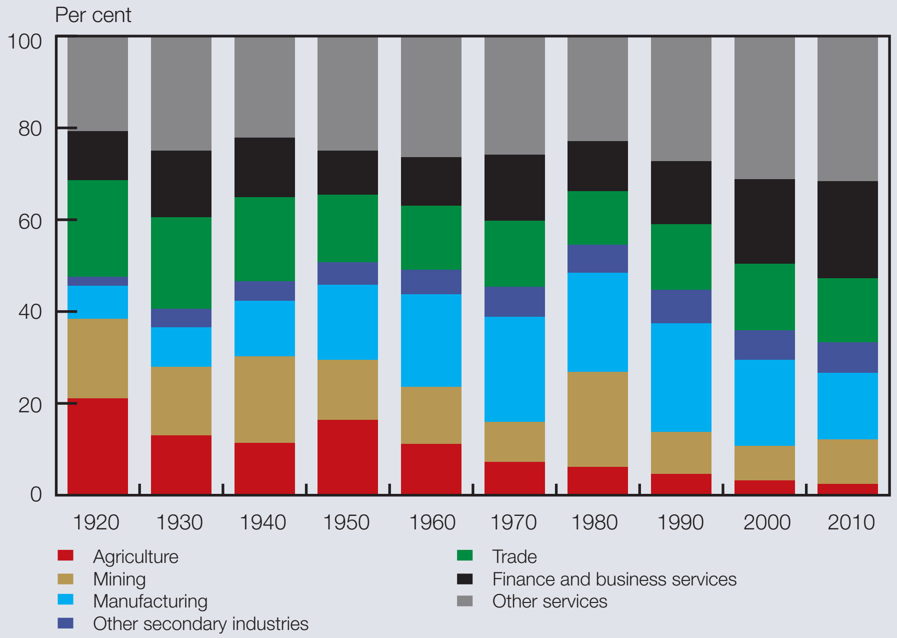
Real gross domestic product



Box 3: The structure of production

In 1920 the production structure of the South African economy differed radically from that of today. Agriculture was responsible for approximately 20 per cent of total value added and mining for more than 17 per cent, driven by gold and diamonds. Manufacturing had a share of 10 per cent in value added. The tertiary sectors combined produced half of the value added, with the trade sector alone producing 21 per cent.

Composition of gross domestic product by main sector



Structural changes have been gradual but significant. The primary sectors have declined considerably in importance, with agriculture in 2010 contributing 3 per cent to value added and mining, despite high product prices, only 10 per cent. In 1980 the share of mining was 20 per cent, but that was with a much higher volume of gold production and an exceptionally high gold price.

Manufacturing gained in importance and at times contributed up to 25 per cent of value added. However, its share has fallen over the past two decades, to around 15 per cent most recently.

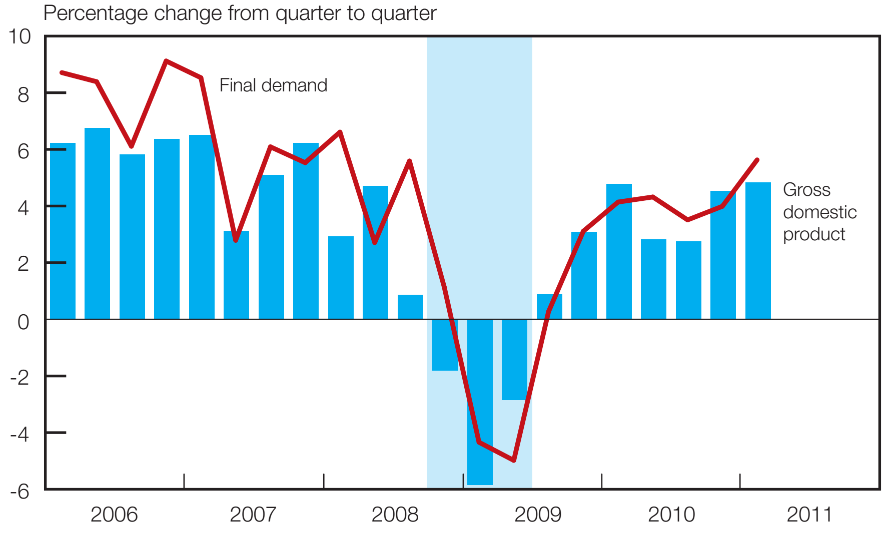
The tertiary sector has increased its share in overall activity around the world, and that sector in South Africa is no exception. It currently produces two thirds of gross value added. Approximately 21 per cent of value added now originates with the finance, insurance, real-estate and business services sector – twice its contribution at the time when the Bank started its operations. Included in "Other services" is government services, which similarly increased its relative size considerably over the past 90 years.

Domestic expenditure

Growth in *real gross domestic expenditure* outpaced growth in real gross domestic product in 2010; subsequent to the global financial crisis, both aggregates contracted by 1,7 per cent in 2009.

Real gross domestic product and final demand

Percentage change from quarter to quarter



Seasonally adjusted annualised rates

Growth in real gross domestic expenditure accelerated to 4,2 per cent in 2010. This solid performance was largely underpinned by firm growth in spending by households – the primary driver of domestic expenditure – and a much slower pace of decline in real inventories.

Real gross domestic expenditure

Percentage change at seasonally adjusted annualised rates

Components	2008	2009	2010					2011
	Year	Year	1st qr	2nd qr	3rd qr	4th qr	Year	1st qr
Final consumption expenditure								
Households	2,2	-2,0	5,5	4,4	5,7	4,8	4,4	5,2
General government	4,7	4,8	7,1	7,1	-0,8	3,9	4,6	9,5
Gross fixed capital formation	14,1	-2,2	-2,8	1,2	1,0	1,5	-3,7	3,1
Domestic final demand	**4,9**	**-0,8**	**4,1**	**4,3**	**3,5**	**4,0**	**2,8**	**5,6**
Change in inventories (R billions)*	-12,4	-34,5	-7,9	-7,6	-0,9	1,1	-3,8	9,3
Gross domestic expenditure	**3,4**	**-1,7**	**10,9**	**3,2**	**6,6**	**2,4**	**4,2**	**8,3**

* At constant 2005 prices

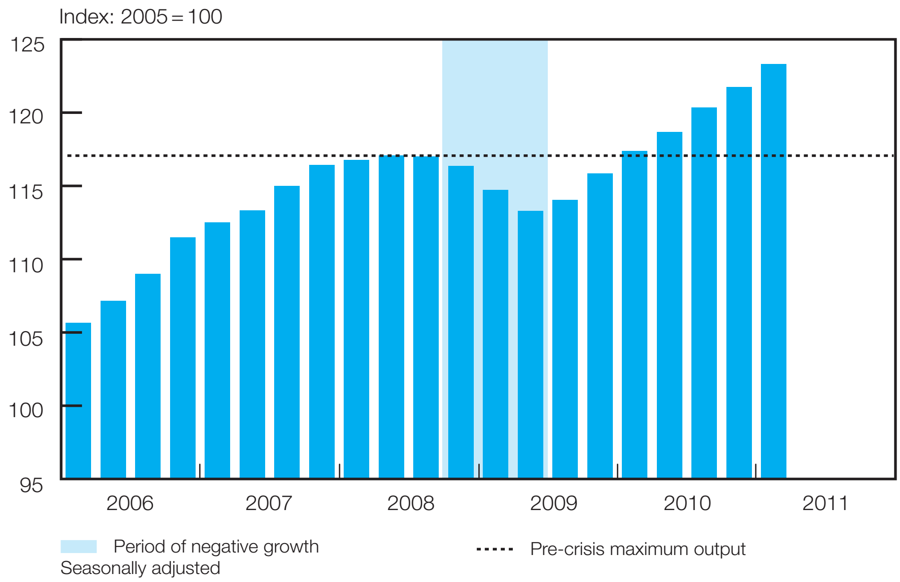
These two aggregates together contributed more than 4 percentage points to growth in real gross domestic expenditure in 2010. At the same time, spending by general government expanded at a brisk pace while fixed capital formation contracted notwithstanding a modest recovery in investment activity in the last three quarters of the year. The pace of increase in real gross domestic expenditure gained further momentum in the first quarter of 2011. Real final demand similarly increased more strongly than real gross domestic product in 2010 and the first quarter of 2011.

Real final consumption expenditure by households

Having increased at a rate of 8,3 per cent in 2006 – the highest annual growth rate registered in 26 years – growth in real *final consumption expenditure by households* moderated in 2007 and 2008 before turning negative, for the first time in 17 years, in 2009. However, real expenditure by households rebounded from a decline of 2 per cent in 2009 and increased at a rate of 4,4 per cent in 2010, gaining further momentum in the first quarter of 2011. The recovery in household spending reflected firm growth in the real disposable income of households primarily driven by strong real wage increases, and an improvement in the net wealth of households along with a moderation in consumer price inflation which augmented the purchasing power of households. In addition, the low interest rate environment probably encouraged households to spend more.

Concurrent with the contraction in real gross domestic production from the fourth quarter of 2008, real private consumption expenditure also declined in the period up to the second quarter of 2009. Consumer spending, however, picked up thereafter and by the first quarter of 2010 surpassed the real level recorded in mid-2008, immediately prior to the contraction in domestic economic activity.

Real final consumption expenditure by households



Subsequent to negative growth of around 9,5 per cent in 2008 and 2009, real outlays by households on *durable goods* improved in 2010, growing at a rate of 24 per cent – the strongest since 1980.

Real final consumption expenditure by households

Percentage change at seasonally adjusted annualised rates

Components	2008	2009	2010					2011
	Year	Year	1st qr	2nd qr	3rd qr	4th qr	Year	1st qr
Durable goods	-9,4	-9,6	39,2	45,4	13,4	5,0	24,0	21,5
Semi-durable goods	4,2	-1,8	30,2	9,8	-4,8	4,6	6,5	8,6
Non-durable goods	0,8	-2,7	12,1	-2,3	2,9	0,2	2,1	3,4
Services	5,9	0,2	-10,3	0,7	9,3	8,8	1,9	1,9
Total	2,2	-2,0	5,5	4,4	5,7	4,8	4,4	5,2

Prior to the financial crisis, spending on durable goods peaked in the first quarter of 2007 whereafter it moderated steadily to a low in the second quarter of 2009. Owing in part to the low base, the subsequent recovery in expenditure on durable goods was characterised by brisk increases which only tapered off in the second half of 2010. The higher level of spending on durable goods was supported by robust income growth experienced by those in gainful employment. In addition, relatively high consumer confidence levels helped to maintain the momentum in durables purchases in the first quarter of 2011 when pronounced increases in spending on furniture and household appliances as well as recreational and entertainment goods were noted.

One of the main drivers of the increased expenditure on durable goods in 2010 was the robust growth in motor vehicle sales. The acquisition of new motor vehicles was encouraged by the improved affordability of new vehicles and solid growth in the disposable income of households alongside the low interest rate environment during the past two years. Spending on durable recreational and entertainment goods, especially television sets, increased notably in part associated with the hosting of the 2010 FIFA World Cup™ tournament in South Africa. Advances in technology and a moderation in prices of durable recreational goods added further impetus to such expenditure.

Following a recent high increase of 17,3 per cent in 2006, real spending on *semi-durable goods* slowed throughout 2007 and 2008 before declining by 1,8 per cent in 2009. In 2010 purchases of semi-durable goods resumed an upward trend and rose by 6,5 per cent. This increase was evident across the board in all sub-categories of semi-durable goods, with the strongest growth registered in the clothing and footwear, household textiles, furniture and glassware and the miscellaneous goods sub-categories. Real outlays on semi-durable goods increased further by 8,6 per cent in the first quarter of 2011, buoyed primarily by increased spending on clothing and footwear.

Real spending by households on *non-durable goods* tends to be more resilient and stable than expenditure in the other goods categories. As in the case of spending on semi-durable goods, expenditure on non-durable goods peaked in 2008 prior to the general decline in domestic economic activity and thereafter contracted until the end of 2009. In 2010 non-durable purchases recovered and picked up further in the first quarter of 2011. Meaningful increases in the price of food products, which contributes more than 50 per cent of the category, alongside higher automotive fuel prices, resulted in a slower pace of recovery in these categories.

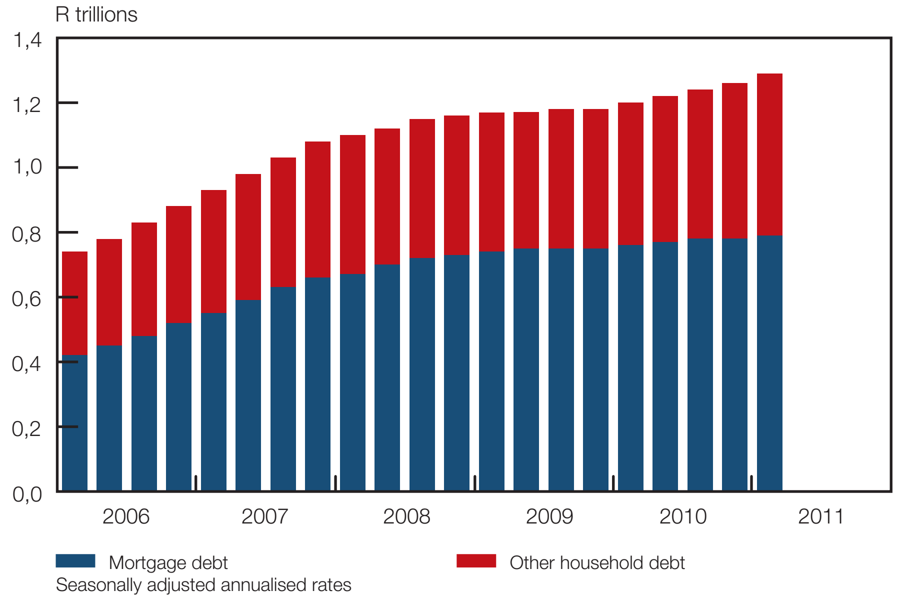
Real spending by households on *services* increased by 1,9 per cent in 2010, well above the 0,2 per cent increase registered in 2009, but still comparatively subdued. Real outlays on most categories of services increased in 2010 with the exception of spending on recreational, entertainment and educational services.

Financial stress and a steady increase in the number of credit-active persons with impaired records contributed to slower growth in household debt, following rapid increases in the pre-crisis period. Growth in household debt slowed from an annualised rate of 22,8 per cent between 2005 and the third quarter of 2008 (i.e., the period prior to the recession in the domestic economy) to 5 per cent during the subsequent period to the first quarter of 2011.

With the nominal level of household debt rising slowly, the household debt-to-income ratio nevertheless edged lower due to firm increases in the nominal disposable income of households. As a result, the household sector's debt-to-income ratio receded from 81,7 per cent in the third quarter of 2008 to 76,8 per cent in the first quarter of 2011. Consistent with a lower interest rate environment, the debt-service cost of households decreased from 12,6 per cent of disposable income in the third quarter of 2008, to 6,9 per cent in the first quarter of 2011 – a level previously observed in 2005. In addition, the ratio of households' debt to total assets increased from 15,5 per cent in the second quarter of 2007 to 17,1 per cent in the first quarter of 2011.

Increased household expenditure since the third quarter of 2009 was also driven by an improvement in the net wealth of the household sector which benefited mainly from rising prices of financial assets. Households gained from the improved performance of the bond and equity markets over this period, directly and also through their interest in pension funds and long-term insurers which recovered from negative growth rates earlier on.

Household debt

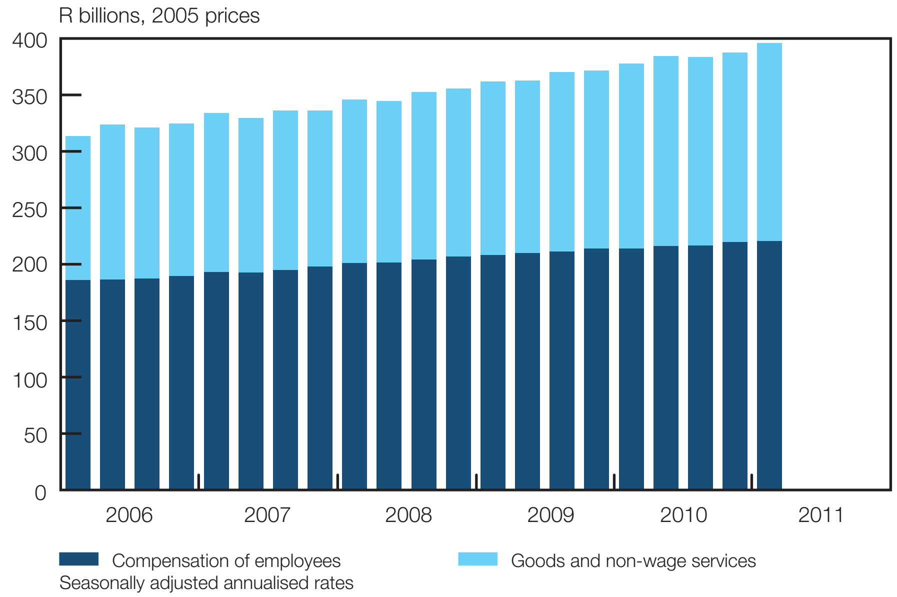


Although household debt has increased at a steady annual rate after the recession, it is comforting that these elevated debt levels were associated with a simultaneous increase in assets and net wealth of the household sector.

Final consumption expenditure by general government

Real final consumption expenditure by *general government* maintained its upward momentum throughout the global financial crisis, consistent with the government's countercyclical fiscal policy that gave rise to lower debt levels and healthy fiscal conditions prior to the time of the crisis. Government could maintain a relatively high level of spending throughout 2009 and 2010 despite a decline in revenue. Simultaneously, consumption expenditure was boosted by higher spending on non-wage goods and services during the hosting of the football tournament, the acquisition of aircraft as well as the ongoing expanded public works programme emphasising labour-intensive infrastructure projects.

Real final consumption expenditure by general government



Growth in real expenditure by government on salaries and wages moderated from 3,6 per cent in 2009 to 2,8 per cent in 2010 before re-accelerating in the first quarter of 2011. The moderation in the pace of growth in 2010 could partly be attributed to the extended public-sector strike in the second half of the year. During 2009 and 2010 a number of aircraft were acquired in accordance with government's arms procurement programme. Excluding these aircraft, the pace of spending by government slowed from 4,9 per cent in 2009 to 4,6 per cent in 2010 and even further to 4,3 per cent in the first quarter of 2011.

Real gross fixed capital formation

Having expanded in each consecutive year from 2000, real *gross fixed capital formation* surged by roughly 14 per cent in both 2007 and 2008. This high rate of growth contributed significantly to the increase in aggregate demand and consequently raised the contribution of gross fixed capital formation to gross domestic product to 23,1 per cent in 2008, the highest ratio since 1985.

The worsening of the global financial crisis in 2008 visibly impacted the South African economy from the fourth quarter of 2008 and adversely affected capital formation soon thereafter. Capital spending contracted considerably in the subsequent five quarters and, despite having started to inch higher, has remained well below its previous peak registered in the fourth quarter of 2008.

Real gross fixed capital formation

Percentage change at seasonally adjusted annualised rates

Components	2008	2009	2010					2011
	Year	Year	1st qr	2nd qr	3rd qr	4th qr	Year	1st qr
Private business enterprises	9,2	-8,9	-2,9	2,2	2,0	1,6	-4,4	2,7
Public corporations	36,2	26,1	2,6	2,9	0,7	3,3	3,5	6,6
General government	16,1	-4,0	-10,3	-5,3	-3,0	-1,9	-10,9	-0,5
Total	14,1	-2,2	-2,8	1,2	1,0	1,5	-3,7	3,1

Following the global financial crisis and the subsequent setback to domestic economic activity from the fourth quarter of 2008, private-sector capital spending contracted throughout 2009 and in the first quarter 2010, alongside low levels of business confidence and significant surplus capacity in the economy.

Increased spending by especially the public corporations in preparation for the 2010 football tournament provided some impetus, but was not enough to uphold the annual growth rates recorded in 2007 and 2008. From the second quarter of 2010 both the private sector and public corporations have consistently recorded increases in capital expenditure.

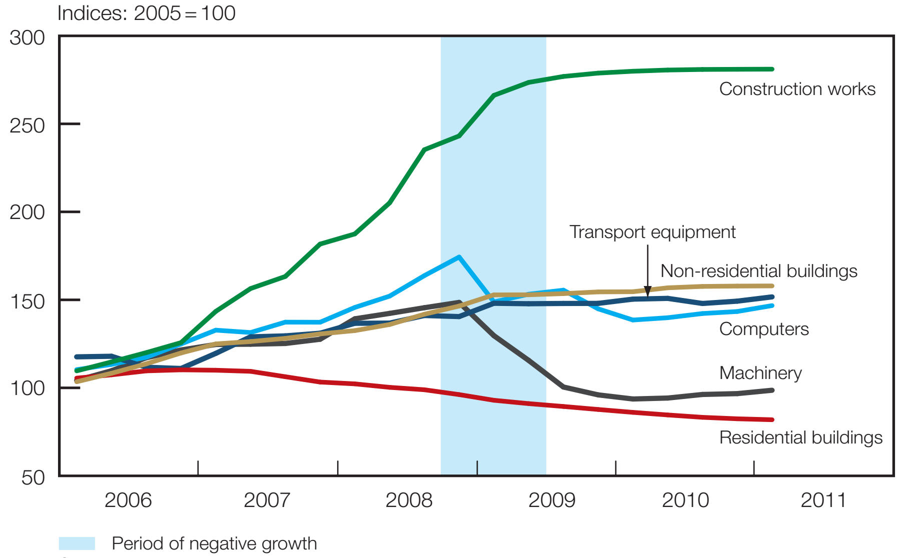
Accounting for about two-thirds of total fixed investment, real gross fixed capital formation by the *private sector* increased from the second quarter of 2010, following five consecutive quarters of contraction. However, the combination of fairly low business confidence levels, uncertainty about the sustainability of the global and domestic recovery, and ample spare capacity available in the domestic economy was not conducive to large-scale capital spending in the domestic economy.

Robust double-digit growth in capital formation by *public corporations* prior to the recession made room for single-digit growth rates from the third quarter of 2009. The recession compelled public corporations to revise project plans downwards and postpone some projects, partly due to higher borrowing costs and delays in the allocation of funds from international creditors. Apart from this impact, the completion of 2010 FIFA World Cup™ infrastructure-related projects also contributed to lower levels of growth in capital formation. Moderate growth was maintained due to capital spending by Transnet, Eskom, SANRAL and TCTA.

Real gross fixed capital formation by *general government* contracted throughout 2009 and 2010, largely due to the completion of infrastructure projects related to the football tournament. Underspending by national and provincial authorities contributed to the contraction of real capital outlays by general government. Nevertheless, capital spending by national and provincial government contracted at a somewhat slower pace in the first quarter of 2011.

An analysis of real gross fixed capital formation by *type of asset* indicates that construction works contributed meaningfully to the growth in capital investment from 2007. Driven by spending on infrastructure and power stations, capital spending on construction works increased on average by 32,7 per cent between 2007 and 2009, before levelling off in 2010. Consistent with lower levels of business confidence in 2008 and 2009, capital outlays on machinery and other equipment waned somewhat from the second quarter of 2008 and declined in 2009 and 2010, as businesses scaled down on expansion plans.

Real gross fixed capital formation by asset type



Seasonally adjusted

Change in inventories

Real inventory holdings were accumulated uninterruptedly between 1998 and the 2007/08 global financial crisis. From 2008 to 2010 this made way for a decline in inventories, which could mainly be ascribed to the depletion of inventories in the manufacturing sector. Real inventory holdings declined by R51 billion between 2008 and 2010, with the manufacturing sector contributing R45 billion to the decline. Faced by very weak demand, inventory holdings were reduced by R34,5 billion in 2009 alone.

During the calendar year 2010 economic growth improved, and with interest rates low the pace of contraction in inventory holdings slowed to R3,8 billion, adding 1,7 percentage points to growth in real gross domestic expenditure. The contraction in inventory investment ceased in the third quarter of 2010 with the accumulation of inventories amounting to R9,3 billion in the first quarter of 2011. However, the ratio of industrial and commercial inventories to non-agricultural gross domestic product declined from 12 per cent in 2010 to 11,4 per cent in the first quarter of 2011.

Factor income

Growth in aggregate *nominal factor income* slowed from a year-on-year increase of 14,4 per cent in 2008 to 6,3 per cent in 2009. However, growth in total nominal factor income recovered to 10,5 per cent in 2010 as a result of the continued global economic recovery, supported by stronger growth in the gross operating surplus of business enterprises as well as compensation of employees. Measured over one year, growth in the first quarter of 2011 accelerated to an annualised rate of 11 per cent as gross operating surpluses continued to expand further.

The year-on-year change in *compensation of employees* decelerated from a rate of 13,3 per cent in 2008 to 8,4 per cent in 2009 but regained some momentum in 2010 as growth increased to 10,5 per cent. Although the deceleration in 2009 was evident in almost all sectors of the economy, it was more pronounced in the mining and manufacturing sectors, consistent with large-scale job shedding during the period. During 2010 real compensation of employees increased due to wage increases in excess of inflation. Growth in compensation of employees continued to increase in the first quarter of 2011 at a year-on-year rate of 10 per cent. The share of compensation of employees in factor income inched higher from 49,5 per cent in 2008 to 50,5 per cent in 2009 and remained at this level in 2010 before slipping to 49,9 per cent in the first quarter of 2011.

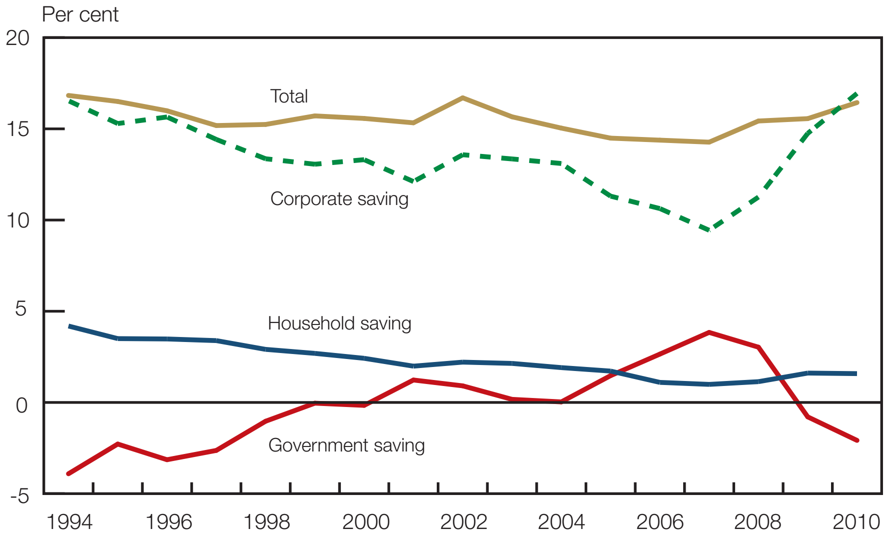
Growth in the total *gross operating surplus* decelerated from 15,5 per cent in 2008 to 4,2 per cent in 2009 due to a decline in mining and manufacturing production. The mining sector was specifically influenced in the first half of 2009 by the recession and concerns about the global economic recovery. In addition, a combination of domestic factors, including the subdued performance of commodity prices, the electricity crisis, regulatory red tape, infrastructure constraints, safety-related mine closures, rapidly rising costs and volatility in the exchange value of the rand, all affected the ability of the sector to increase output. However, in the latter part of 2009 and in 2010, the gross operating surplus of the mining sector improved as commodity prices started to recover. By the end of 2010 commodity prices had surpassed the levels achieved at the end of 2008. Profitability in the manufacturing sector was also negatively affected, particularly in 2009, by subdued demand and the resultant decline in production levels. In order to survive the global economic crises, many companies had to restructure while activity levels also recovered in 2010. As a result, increases in the gross operating surplus improved from 4,2 per cent in 2009 to 10,4 per cent in 2010. Gross operating surpluses of business enterprises continued to increase in the first quarter of 2011.

Gross saving

The *national saving ratio* increased from 14,3 per cent of gross domestic product in 2007 to 16,4 per cent in 2010 mainly related to higher corporate saving. In the first quarter of 2011 the saving ratio amounted to 16,3 per cent. The increased domestic saving ratio supported the financing of gross capital formation and, as indicated by the decreasing deficit on the current account from 2008, lessened the need for foreign financing during this period.

Gross saving by *households* increased from 1,1 per cent of gross domestic product in 2008 to 1,6 per cent in 2009 and remained at that level in 2010. Household saving was underpinned by continuous steady growth in disposable income from the second half of 2009 to the first quarter of 2011.

Gross saving as a percentage of gross domestic product



Gross saving by the *corporate sector* as a percentage of gross domestic product has increased steeply since the financial crisis of 2007 and 2008. The financial crisis impacted negatively on economic growth, resulting in recessionary conditions which led to a change in the corporate savings performance. Corporate business enterprises went into cash preservation mode as revenues fell and dividend and tax payment growth turned negative, with some major companies forfeiting dividend payments. The corporate saving ratio increased to 11,3 per cent in 2008, 14,7 per cent in 2009 and 16,9 per cent in 2010. In 2010 stronger growth in the operating surpluses of incorporated business enterprises reflected the recovery of the domestic economy and high export prices, contributing to the strengthening of the corporate saving ratio.

After three years of positive saving outcomes, government slipped into dissaving from 2009. *Government* saving as a percentage of gross domestic product deteriorated from 3 per cent in 2008 to rates of dissaving of 0,8 per cent in 2009 and 2,1 per cent in 2010. Although the annual growth rate of taxes on production and imports increased from 2009 to 2010, the growth rate of taxes on income and wealth, government's biggest revenue component, decreased over the period. In addition, government expenditure on social benefit payments in 2010 remained high, indicating national government's continued social support, since even when the economy showed signs of recovery, unemployment remained elevated.

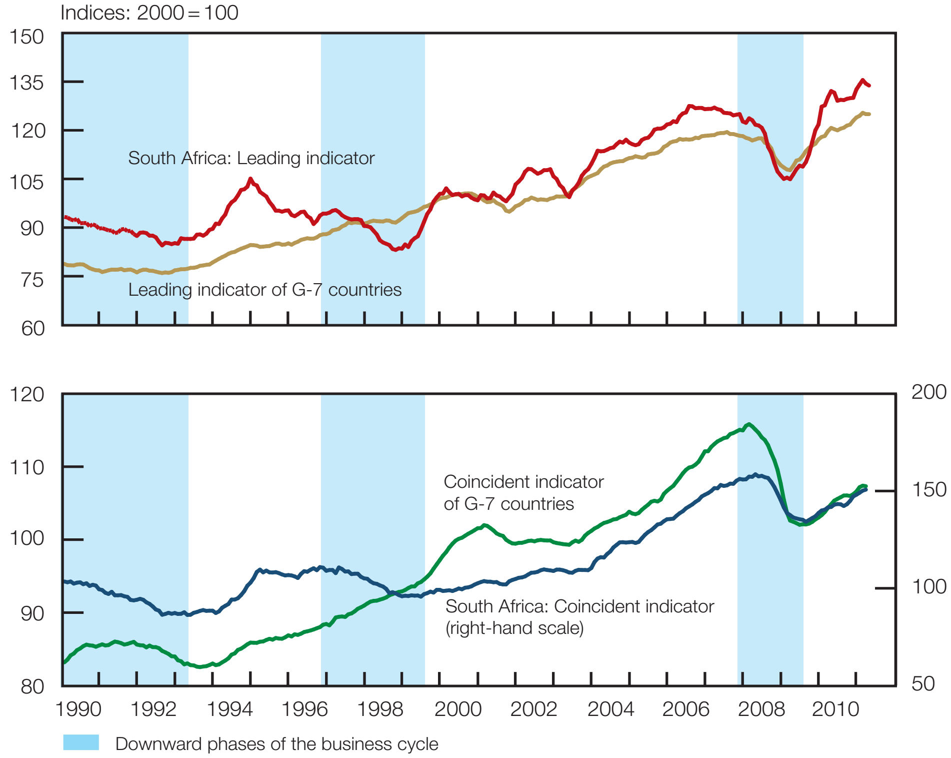
In the first quarter of 2011 general government's saving ratio increased, mainly as a result of higher tax revenue. Improved tax compliance, the shift towards electronic tax submissions and higher value-added tax (VAT) and customs revenue following improved demand and higher imports, all contributed to government's increased tax income.

Business cycle developments

The downward phase in the South African business cycle that commenced in December 2007 lasted 21 months and reached a lower turning point in August 2009.[1] The latest downturn in the South African economy coincided with the global economic recession and was closely synchronised with the global business cycle, as illustrated in the accompanying graph.

1 An article elaborating on the dating of the latest turning point in the business cycle is contained in the South African Reserve Bank *Quarterly Bulletin,* of June 2011.

Business cycle indicators



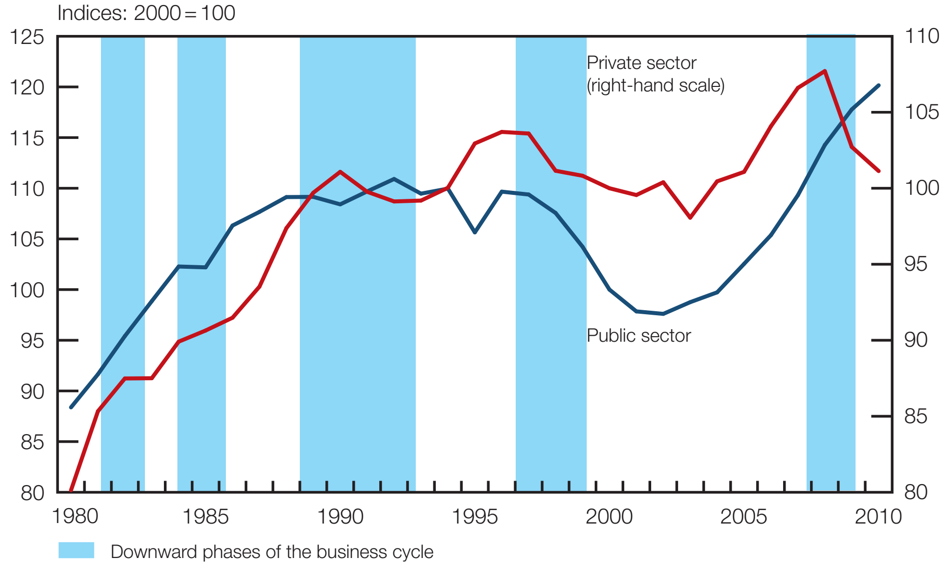
Following a period of marked decline, the composite leading business cycle indicators for South Africa and the Group of Seven (G-7) countries reached their respective lower turning points in March 2009. Both indicators thereafter rose steeply during the subsequent 13 months, moderated somewhat during the middle months of 2010 and resumed their upward trend in the opening months of 2011.

The G-7 countries' composite coincident business cycle indicator reached a lower turning point in June 2009, while the domestic composite coincident business cycle indicator reached a lower turning point two months later, in August 2009. Both indicators then rose fairly briskly up to the middle of 2010, hesitated for a month or two, but then resumed their upward trend.

Employment

Before the latest recession in the South African economy, employment growth accelerated more or less in tandem with output growth, with the former averaging 2,2 per cent per annum and the latter 5,0 per cent from 2004 to 2007. Real gross domestic product increased by 2,8 per cent in 2010, following a decline of 1,7 per cent in 2009, while employment contracted by 0,7 per cent in 2010 compared with a decline of 3,0 per cent in 2009. From a peak in the level of formal non-agricultural employment in the third quarter of 2008, employment levels started to contract, shedding a cumulative 383 000 employment opportunities up to the first quarter of 2010.

Formal non-agricultural employment



According to Statistics South Africa's *Quarterly Employment Statistics (QES)* survey, the level of enterprise-surveyed formal non-agricultural employment was 4,6 per cent or 202 300 persons higher in the quarter ended March 2011 than at the trough of the employment cycle in the first quarter of 2010. Changes in the level of private-sector employment tend to follow general economic activity. Lagging the recovery in the business cycle which registered a trough in August 2009, employment creation only became visible from the second quarter of 2010 and showed steady increases up to the first quarter of 2011. Employment levels in most sectors in the private sector were, however, still below the relatively high levels reached in the third quarter of 2008.

In the four quarters to the first quarter of 2011, increases in employment were registered in the non-gold mining; electricity; trade, catering and accommodation services; and the finance and insurance sectors. These employment gains were, however, partly neutralised by decreases in employment in the construction; gold-mining; manufacturing; and transport, storage and communication sectors. Labour shedding in these sectors can primarily be attributed to the prolonged recession in the construction industry, particularly the building sector, the high cost of mining technologies needed to mine gold at ever-increasing depths, and the continuing process of mechanisation in the manufacturing sector.

As shown in the accompanying table, the increase in the number of private-sector employment opportunities in the year to the fourth quarter of 2010 in part reflected the fairly robust recovery in domestic expenditure as employment gains were especially pronounced in the trade, catering and accommodation and the finance and insurance sectors.

Change in enterprise-surveyed formal non-agricultural employment

Sectors	Year on year				
	Dec 2008	Dec 2009	Dec 2010	Mar 2011	Mar 2011 (Per cent)
Mining	12 900	-31 400	16 100	19 300	3,9
Gold mining	-6 900	-5 300	-7 500	-8 100	-5,0
Non-gold mining	19 900	-26 100	23 700	27 400	8,2
Manufacturing	-40 700	-89 500	-21 300	-21 800	-1,8
Electricity supply	3 000	-2 900	2 600	2 900	5,2
Construction	6 900	-58 000	-16 000	-8 900	-2,1
Trade, catering and accommodation	-23 500	-81 000	23 100	20 200	1,2
Transport, storage and communication	4 800	-1 700	-700	-2 200	-0,8
Financial intermediation and insurance	45 700	-121 700	15 900	51 600	2,9
Community, social and personal services	1 800	14 500	6 500	13 400	3,2
Total private sector	**11 000**	**-371 900**	**26 100**	**74 500**	**1,2**
National, provincial and local government	67 700	47 700	54 900	64 500	3,9
Public-sector enterprises	27 500	-28 300	11 400	63 300	26,8
Total public sector	**95 200**	**19 500**	**66 400**	**127 800**	**6,7**
Grand total*	**106 200**	**-352 400**	**92 500**	**202 300**	**2,5**

* Numbers may not add up to totals due to rounding

Employment in the non-gold mining sector, which comprises almost 70 per cent of total mining employment, increased by 8,2 per cent in the year to March 2011. The level of employment in the total mining sector advanced by 3,9 per cent in the year to March 2011, consistent with the surge in international commodity prices from early 2009. According to the Commodity Research Bureau's (CRB) commodity price index, commodity prices rose by 87 per cent in US dollar terms between February 2009 and April 2011. Notwithstanding the persistent decrease in employment numbers in the gold-mining sector, overall employment in the mining sector, on average, edged higher by 1,6 per cent in 2010, following a decline of 5,3 per cent in 2009.

Employment numbers in the electricity sector increased by 5,2 per cent in the year to the first quarter of 2011. Capital spending in accordance with the capacity expansion programmes of public-sector enterprises contributed to higher employment levels in this sector, with the construction of the Medupi, Kusile and Ngula power stations well under way.

Job creation in the trade, catering and accommodation services sector increased by 1,2 per cent; and in the finance, insurance, real-estate and business services sector by 2,9 per cent in the year to the first quarter of 2011. A revival in household consumption expenditure on especially durable and semi-durable goods, along with relatively contained consumer price inflation, created a positive environment for employment growth in these sectors.

In the construction sector, employment losses were consistently registered up to the first quarter of 2011. Year on year, employment levels receded by 2,1 per cent in the first quarter of 2011. Employment in the civil construction sector was affected to an important extent by government's infrastructure expenditure programme including the construction of stadiums for the 2010 FIFA World Cup™ tournament. The share of employment in the civil engineering subsector of the overall construction sector subsequently fell from 62 per cent in the second quarter of 2008 to roughly 55 per cent in the final quarter of 2010. In addition, the prolonged 42-month recession in the building sector also gave rise to notable job-shedding in other subsectors.

Employment by the public sector expanded consistently during the past six years and was particularly robust during the economic downturn. When measured over a four-quarter period, public-sector employment increased by 127 800 opportunities or 6,7 per cent in the first quarter of 2011. Employment at the general government level, especially at the provincial and local government levels, increased meaningfully. Capacity expansion at these two levels of government was necessitated by the need and urgency to step up service delivery in accordance with the country's development objectives. Temporary workers appointed to assist with local government elections lifted public-sector employment in the first quarter of 2011.

According to the 2010/11 *Global Wage Report* of the International Labour Organisation (ILO) the global economic crisis of 2008/09 gave rise to the most severe downturn in economic activity since the 1930s, meaningfully affecting the labour market. Globally, the unemployment rate increased from 5,7 per cent in 2007 to 6,4 per cent in 2009, implying that roughly 29 million people had lost their jobs over the 24-month period. Further, according to the ILO's *Global Employment Trends 2011* report, global employment losses are estimated to have risen by a further 6,7 per cent in 2010. The report suggests that the high level of unemployment is in conflict with the pace of global economic recovery in 2010, substantiating the notion that employment creation lags economic growth.

Results from the household-based *Quarterly Labour Force Survey* indicated that employment in the South African economy peaked at 13,8 million in the fourth quarter of 2008, whereafter it gradually decreased to 13,1 million in the fourth quarter of 2010. As a consequence, the official unemployment rate rose from 21,9 per cent to 24,0 per cent over the same period. Simultaneously, the labour force (both employed and unemployed) decreased from 17,7 million in the fourth quarter of 2008 to 17,3 million in the fourth quarter of 2010. This decline can be explained by the fact that the non-economically active component of the working-age population, that is, people between the ages of 15 and 64 years, rose as especially the category *discouraged work-seekers* increased by almost one million during the period.

Key labour market indicators

Thousands

	Average for 2008	Average for 2009	Average for 2010	Mar 2011	Actual change 2009 on 2008	Actual change 2010 on 2009
Population: 15–64 years	30 967	31 494	32 007	32 314	527	513
Labour force	17 971	17 670	17 393	17 482	-301	-277
Employed	13 867	13 455	13 061	13 118	-411	-394
Formal sector (non-agricultural)	9 572	9 453	9 123	9 219	-119	-330
Informal sector (non-agricultural)	2 298	2 129	2 159	2 179	-169	30
Agriculture	787	687	639	603	-100	-48
Private households	1 209	1 187	1 140	1 118	-22	-47
Unemployed	4 104	4 215	4 332	4 364	111	117
New entrants to the job market	1 739	1 705	1 840	1 896	-34	135
Job losers	1 223	1 439	1 393	1 325	217	29
Other	1 142	1 070	1 100	1 143	-42	29
Not economically active	12 995	13 824	14 614	14 832	829	790
Discouraged work-seekers	1 129	1 532	1 998	2 223	403	466
Other	11 867	12 292	12 617	12 609	426	324
Rates	Per cent				Percentage points	
Unemployment rate	22,9	23,5	24,9	25,0	0,6	1,4
Youth unemployment (15–24 age group)	45,5	48,1	50,5	49,7	2,6	2,4
Employed/Population ratio (absorption rate)	44,8	43,7	40,9	40,9	-1,1	-2,8
Labour force participation rate	58,1	57,1	54,3	54,1	-1,0	-2,8

Sources: Statistics South Africa, *Quarterly Labour Force Survey,* and various quarterly releases adjusted according to the July 2010 *Mid-year Population Estimates*

Numbers may not add up to totals due to rounding

The number of unemployed people increased between 2009 and 2010 as a result of new entrants to the labour market and further job losses, highlighting the challenges facing policy-makers. The number of discouraged work-seekers, predominantly consisting of younger people, continued to rise, numbering almost 2 million in 2010. Furthermore, the employment-to-population ratio, which indicates whether the employment-generating capacity of the economy is improving, declined on average. However, in the case of South Africa, other factors such as HIV/AIDS could have a negative bearing on the denominator. Youth unemployment continues to pose a challenge for policy-makers globally as well as in South Africa. The country's youth unemployment rate for the age group 15 to 24 years improved only slightly from 51,3 per cent in June and September 2010 to 49,7 per cent in March 2011.

Despite the high level of unemployment and the slow pace of recovery in the creation of new employment opportunities, the number of working days lost due to strike action actually rose from 2,9 million in 2009 to 14,6 million in 2010, largely on account of prolonged industrial action in the public service.

The impact of the economic crisis on the domestic labour market was unprecedented in severity compared with the impact it had on other countries' labour markets. That, combined with the persistently high structural unemployment rate in South Africa, in the past year prompted government and other social partners to table the following policy measures aimed at addressing this unemployment challenge:

– In an effort by government to address youth unemployment, initiatives are in progress to improve information services to help young people access jobs 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. Under consideration is a cash reimbursement to employers for a two-year period, operating through the South African Revenue Service's (SARS) payroll tax system, and subject to minimum labour standards, with a view to raising employment of young school-leavers by a further 500 000 by 2013.
– In April 2011 the 2010/11 Industrial Policy Action Plan, which builds on the National Industrial Policy Framework, was reviewed and new focus areas were identified.
– A loan facility of R2 billion was launched between the Industrial Development Corporation (IDC) and the Unemployment Insurance Fund, aimed at creating and sustaining jobs.
– The Congress of South African Trade Unions (Cosatu) tabled a policy document entitled *A Growth Path Towards Full Employment* which emphasises job creation, among other suggested interventions, through the *Extended Public Works Programme* with a particular focus on youth employment creation.
– Cabinet unveiled its *New Growth Path* initiative which aims to accelerate economic growth, create five million jobs, reduce the unemployment rate from 25 per cent to 15 per cent over the next ten years and alleviate poverty. The private sector is expected to play a pivotal role in the attainment of these goals as infrastructure development is targeted in a number of sectors, including agriculture, manufacturing and tourism. In his October 2010 *Medium Term Budget Policy Statement (MTBPS*), the Minister of Finance elaborated further on the *New Growth Path*.
– Following the presentation of the *New Growth Path*, the President of the Republic announced in his *2011 State of the Nation Address* the creation of a jobs fund to the value of R9 billion to assist industries in financing job creation, in order to meet the objectives outlined in the policy document. In addition, the IDC has set aside an amount of R20 billion to assist business enterprises with a high potential for employment creation in expanding their operations.

Labour cost and productivity

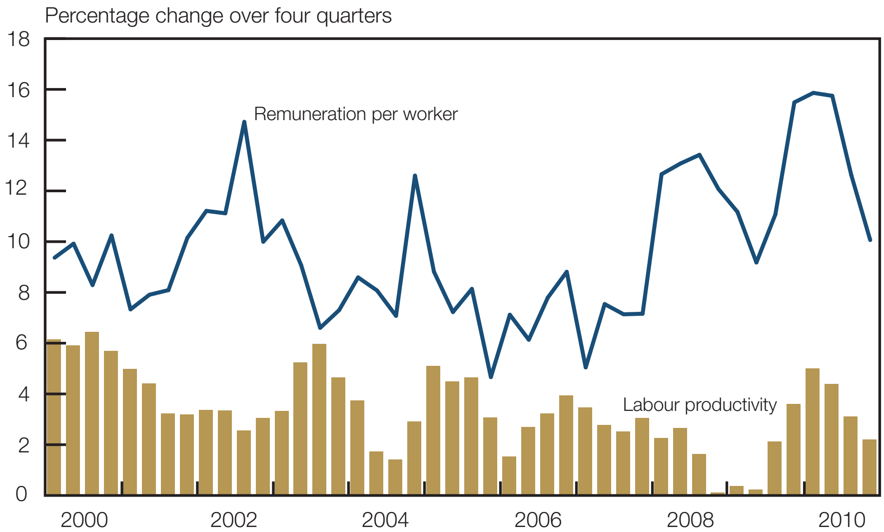
Growth in nominal remuneration per worker in the formal non-agricultural sectors of the economy accelerated from 11,8 per cent in 2009 to 13,5 per cent in 2010. By contrast, headline consumer price inflation moderated from 7,1 per cent to 4,2 per cent over the same period, increasing the real take-home pay of those gainfully employed.

Nominal wage growth in the public and private sectors amounted to 13,5 per cent and 13,1 per cent respectively in 2010; higher than in the preceding year. In the private sector, remuneration growth remained above the upper limit of the inflation target range, and varied widely from a single-digit rate of 8,7 per cent in the non-gold mining sector to double-digit rates in a number of sectors, including manufacturing. In the *public sector*, remuneration per worker in 2010 rose briskly, with increases in excess of 15 per cent in public-sector enterprises.

Wage moderation has been reflected in the wage settlement rates in collective bargaining agreements, which decelerated from 9,8 per cent in 2008 to 8,2 per cent in 2010, remaining at this rate in the first quarter of 2011, according to Andrew Levy Employment Publications.

The rate of increase in labour productivity in the formal non-agricultural sector accelerated from 1,5 per cent in 2009 to 3,7 per cent in 2010 and was lower in the year to March 2011 when it amounted to 1,0 per cent.

Productivity and average remuneration: Formal non-agricultural sector



In 2009 manufacturing output fell by more than manufacturing employment, resulting in a decline in manufacturing labour productivity at a rate of 6,6 per cent. Against this background of labour hoarding, labour productivity in manufacturing increased at a rate of 8,7 per cent in 2010. The increase in manufacturing production also contributed meaningfully towards the moderation in unit labour cost increases from a high of 19,4 per cent in 2009 to 4,5 per cent in 2010.

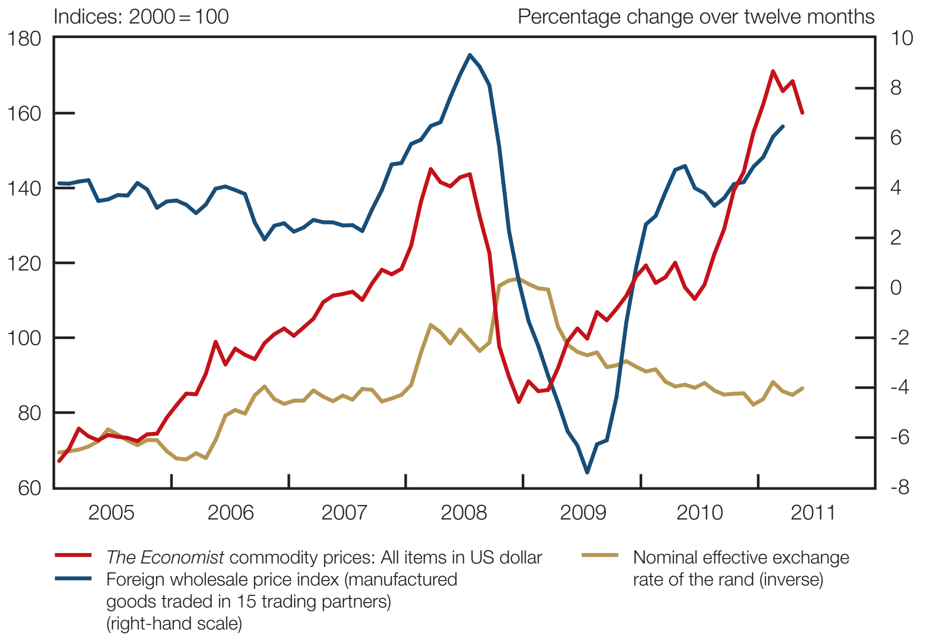
The inflationary consequences of accelerating nominal wage growth from 2009 to 2010 were moderated by the higher rate of increase in labour productivity, resulting in the rate of increase in *nominal unit labour cost* slowing from 10,0 per cent in 2009 to 9,6 per cent in 2010. This rate of increase, despite being the lowest in the past three years, was substantially in excess of the targeted inflation rate and therefore contributed to domestic price pressures in 2010.

Prices

International inflationary pressures eased in the aftermath of the financial market turmoil and the subsequent global economic downturn towards the end of 2008, assisting in the containment of inflation in the domestic economy from 2009 onwards to the opening months of 2011. Domestic consumer price inflation moderated to lower-than-expected levels on account of relatively weak domestic demand conditions, excess production capacity and the appreciation in the exchange value of the rand.

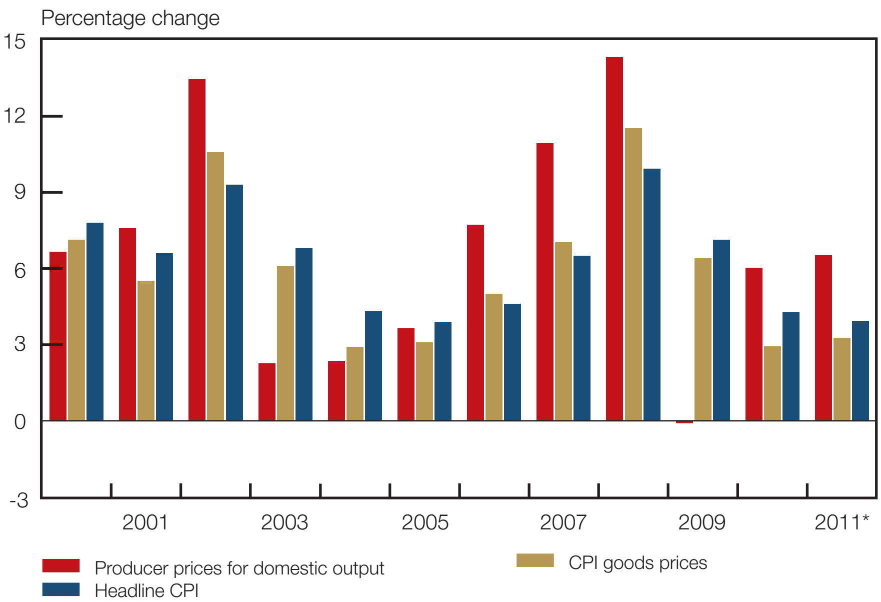
As the global economic recovery gathered momentum and the pace of increase in international commodity prices quickened, inflation began to accelerate in advanced and emerging-market economies, particularly on account of higher food and oil prices. The offsetting directions of

Nominal effective exchange rate, and commodity and foreign wholesale prices



international prices and the exchange value of the rand are illustrated in the graph at the top of page 24. Headline producer price inflation accelerated consistently from an annual rate of 0,7 per cent in December 2009 to 9,4 per cent in June 2010. This acceleration in producer price inflation of domestic output was driven by elevated increases in the prices of especially the mining, forestry and electricity categories.

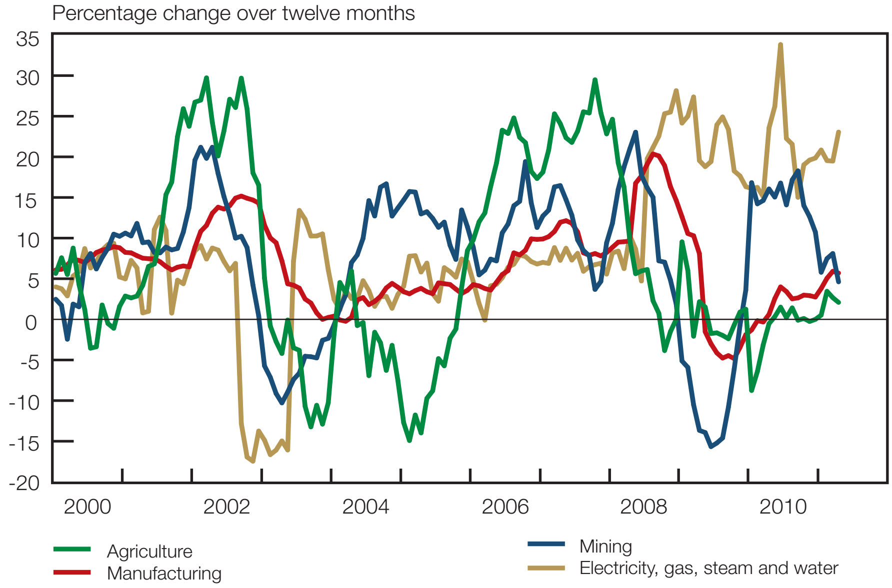
Consumer and producer prices



* First four months of 2011 compared with the same period in 2010

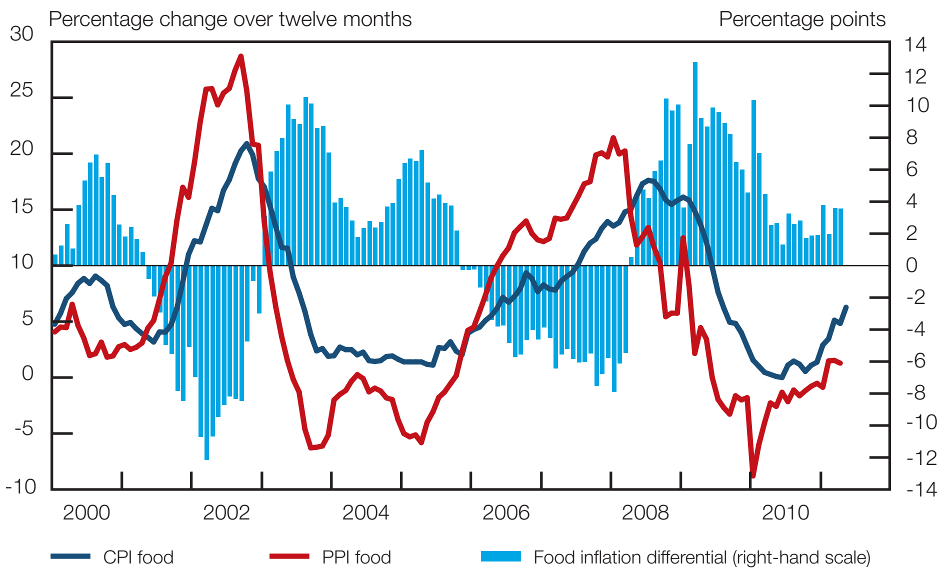
In the ensuing months producer price inflation decelerated on account of the appreciation in the exchange value of the rand and dampened price increases in the mining category, assisting in moderating overall producer price inflation to a twelve-month rate of 5,5 per cent in January 2011. This deceleration in the year-on-year rate of producer price inflation turned to an acceleration in the subsequent months due to reasonably broad-based price pressures developing within the index.

Producer prices



Domestic agricultural food prices decreased sharply over the past year following consecutive bumper harvests and declining international maize prices. Overall food prices at the producer level continued to register rates of deflation for the twenty-fourth consecutive month in February 2011, led by declines in the producer prices of food at especially the agricultural level. Price changes of food at the manufactured level reverted to inflation from November 2010 onwards.

Food prices



Subsequently, year-on-year consumer food price inflation decelerated meaningfully from a rate of 16,1 per cent in January 2009 to zero per cent in June 2010, as the lower food prices at the producer level impacted favourably on food prices at the retail level. Driven by tight food supplies and changing weather patterns, international food price inflation accelerated notably in the closing months of 2010 and the opening months of 2011, contributing to a marked acceleration in domestic consumer food price inflation in recent months.

Targeted CPI inflation declined to within the inflation target range of 3 to 6 per cent since February 2010 and decelerated continuously in ensuing months, reaching a low of 3,2 per cent in the year to September 2010. Thereafter, consumer price inflation accelerated to a year-on-year rate of 4,6 per cent in May 2011.

Consumer prices of goods and services

* CPIX up to December 2008; CPI for all urban areas from January 2009 onwards

The moderation in headline consumer price inflation up to September 2010 resulted mainly from lower rates of increase in the prices of consumer goods. The moderation in goods price inflation was brought about by a notable deceleration in food price inflation in particular, aided by moderating petrol price increases. In fact, consumer goods price inflation breached the lower limit of the inflation target range in June 2010 and remained below this level for eight consecutive months. Driven by higher food and petrol prices, consumer goods price inflation accelerated again and breached the lower limit of the inflation target range in February 2011. In the goods category, durable goods prices registered twelve-month rates of decrease, while semi- and non-durable goods price inflation increased.

Headline consumer services price inflation remained above the upper limit of the inflation target range throughout the first half of 2010, but fell to below the upper limit of the range for the first time in 43 months in July 2010 and decelerated gradually in ensuing months. In the services basket, elevated rates of increase were recorded in the prices of most categories.

Over the past year underlying inflation pressures have also been subdued. When the impact of the more volatile food and petrol prices is omitted from the calculation of the targeted headline consumer price index, twelve-month CPI inflation has subsided to below the upper limit of the inflation target range in February 2010 and has remained within the inflation target range in subsequent months, mirroring the movement in the targeted measure of inflation.

While targeted headline consumer price inflation remained within the inflation target range in 2010, administered price inflation recorded rates well above 6 per cent. Elevated petrol and electricity price increases largely accounted for these above-target increases in administered price inflation throughout 2010 and the opening months of 2011. When the effect of the aforementioned petrol and electricity price increases is excluded from the calculation of administered prices, the increase still amounted to rates in excess of the upper limit of the inflation target range of 6 per cent.

The biggest risk to the inflation outlook in the near future remains international food and oil prices. International oil prices had already accelerated in the latter part of 2010 in response to relatively strong global demand, and this upward trend has been reinforced by the geopolitical events in the MENA region, which have raised concerns about the security of oil supplies from these countries. Underlying demand pressures are likely to keep oil prices at relatively elevated levels.

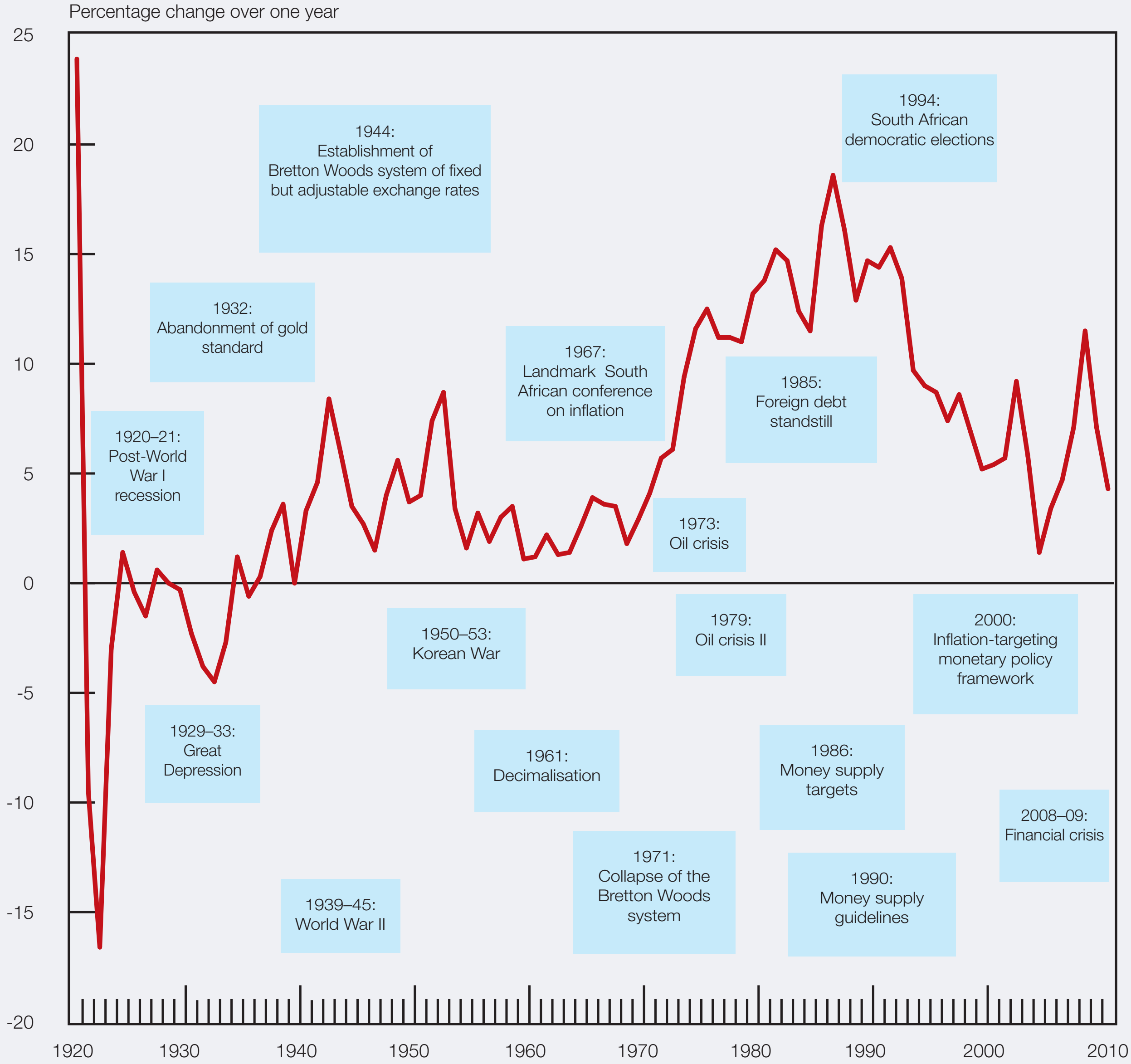
Box 4: Consumer price inflation

The level of consumer prices is currently 105-fold higher than 90 years ago (although subject to qualification). The first decade after the South Afican Reserve Bank had started with its operations, consumer price changes were characterised more by deflation than by inflation, as the recession of 1920–21 and the Great Depression made themselves felt. Inflationary pressures emerged during and after World War II and the Korean War, but were generally contained, partly through direct controls. The discipline of the South African pound's peg to the pound sterling and the Bretton Woods system of fixed but adjustable exchange rates moderated policy-makers' degrees of freedom during the first 50 years of the Bank's existence.

In 1971 with the collapse of the Bretton Woods system, some discipline was lost. Various forces triggered a bout of inflation, which soon became entrenched. Double-digit inflation was recorded from 1974 to the beginning of the 1990s, despite several attempts to curtail inflation. From the end of the 1980s, monetary policy adopted a consistent anti-inflationary approach. In the early 1990s this started to bear fruit, with inflation receding to single-digit levels. With the adoption of formal inflation targeting in 2000 the framework for monetary policy was clarified and discipline was entrenched. Although shocks may derail the inflation trajectory from time to time, appropriate monetary policy will – implemented with flexibility – bring inflation back to within the target range, as evidenced in 2003 and 2010.

Consumer prices

Percentage change over one year



Based on the headline consumer price index

Foreign trade and payments

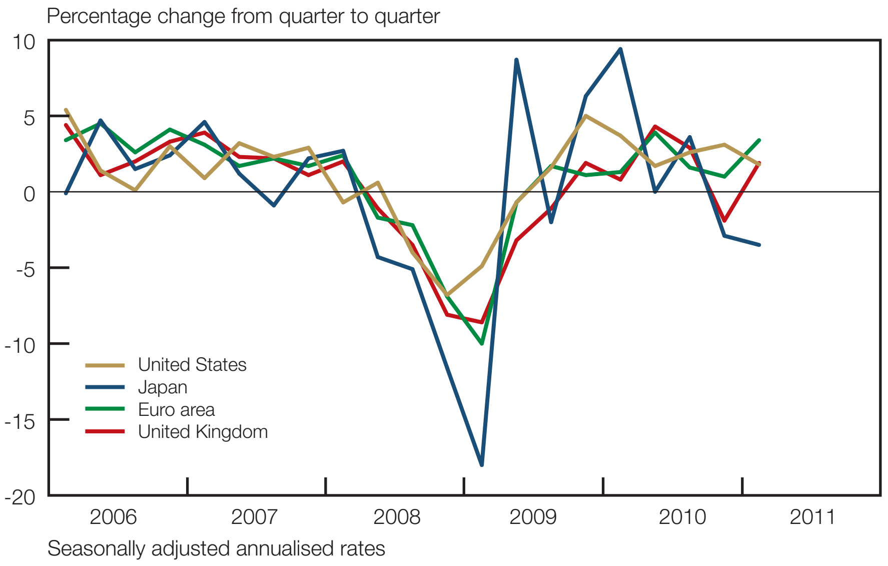
International economic developments

The world economy continued to recover in 2010 and in the first quarter of 2011 following the severe recessionary conditions brought about by the global financial crisis. Global economic activity continued to be supported by strong monetary policy stimulus, with central banks having reduced policy interest rates aggressively during the crisis, in some instances to close to zero, in order to stabilise the financial system and bolster growth. However, as the crisis intensified, central banks also implemented unconventional monetary policy measures to ease credit conditions and increase liquidity. In addition, governments also supported financial institutions and provided substantial fiscal stimulus.

The international economic upturn from the second quarter of 2009 was in many instances initially driven by fiscal outlays. This was followed by the rebuilding of inventory holdings and private consumption expenditure, as fiscal stimulus started to wane due to austerity measures implemented in several countries to address concerns about the sustainability of public finances. The global recovery, however, proceeded unevenly with advanced economies expanding at modest growth rates, while emerging-market economies experienced more robust growth rates.

Economic activity in the United States (US) softened in the first part of 2010, raising concerns about the sustainability of the recovery. The Federal Open Market Committee (FOMC) took steps in the second half of 2010 to provide additional monetary policy stimulus in order to promote economic growth. Real output expanded moderately in the second half of 2010, before slowing to 1,9 per cent in the first quarter of 2011. Real output in the euro area expanded in the course of 2010, predominantly supported by a sharp increase in exports and inventories. The underlying growth momentum in the euro area continued in the first quarter of 2011 with output expanding by 3,4 per cent. The economic recovery in Japan continued during the first three quarters of 2010, underpinned by an accommodative monetary policy stance and fiscal stimulus. However, real output contracted in the fourth quarter of 2010, mainly due to declining domestic demand. Economic activity contracted again in the first quarter of 2011, following the earthquake and tsunami that hit Japan in March 2011. The Japanese government estimated the damage to the capital stock due to the disaster to be between 3 and 5 per cent of annual gross domestic product. Economic activity in the United Kingdom (UK) contracted in the fourth quarter of 2010, partly due to bad weather, but recovered in the first quarter of 2011.

Real output growth in major advanced economies



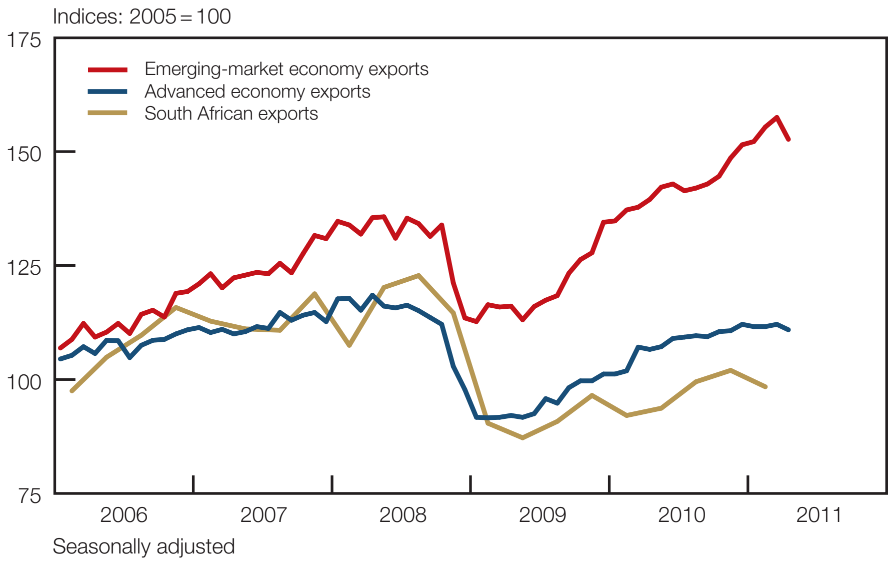
Source: Various national statistical offices

The direct impact of the financial crisis on economic activity in emerging-market economies was initially relatively limited, but the loose monetary and fiscal policies internationally, as well as the expansionary domestic policies, have supported growth to a point where some emerging-market economies are facing the risk of overheating. Emerging-market and developing economies as a group recorded robust growth in 2010, reaching a rate of growth in excess of 7 per cent for the year as a whole. The main driver of world economic growth has been emerging Asia, especially China. Economic activity in emerging-market economies moderated somewhat in the third quarter of 2010, mainly due to slower growth in Brazil, Mexico and Argentina, and to output declining in Russia, Thailand and Colombia. The growth momentum, however, bounced back to more solid rates in the fourth quarter of 2010 before slowing again in the first quarter of 2011. The Chinese authorities were concerned about the overheating of the economy and started tightening monetary policy in 2010, increasing interest rates and banks' reserve requirements.

The latest growth projections of the IMF released in the June 2011 *World Economic Outlook Update* provides for the world economy to expand by 4,3 per cent in 2011 and 4,5 per cent in 2012, with growth rates in advanced economies of around 2,4 per cent and in emerging-market and developing economies at around 6,5 per cent over this period. The IMF is expecting a mild slowdown in the second quarter of 2011, before accelerating in the second half of the year.

The improved global economic conditions and the subsequent recovery in economic activity resulted in a strong rebound in world trade volumes, reflecting high import and export growth rates, especially since the beginning of 2010. This sharp recovery in world trade was mainly due to emerging-economy export volumes increasing at year-on-year growth rates averaging more than 30 per cent towards the end of 2009 and at the beginning of 2010. It is concerning that the upturn in South Africa's export volumes has been slow when compared with other emerging-market economies, but it is even more alarming that the pace of recovery since the recession was also weaker than that seen in advanced economies.

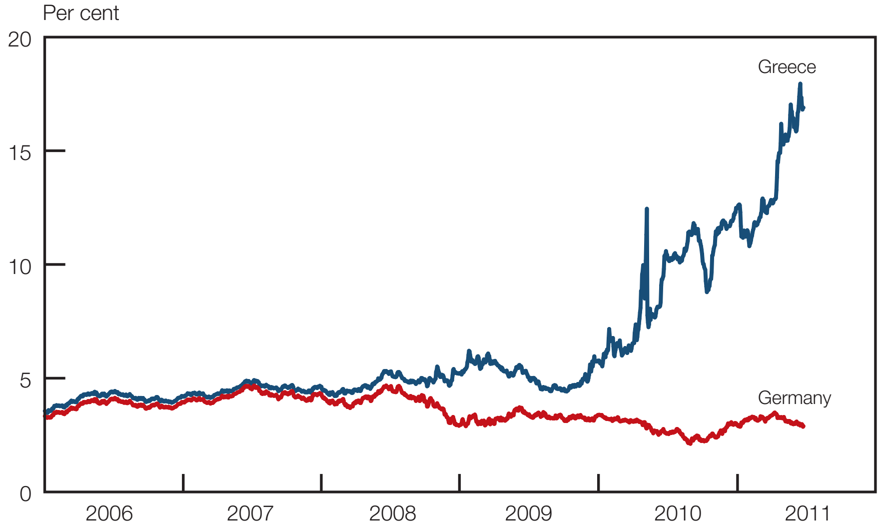
Developments in merchandise export volumes



Sources: CPB Netherlands Bureau of Economic Policy Analysis and South African Reserve Bank

In early 2010 it seemed that the worst part of the financial crisis was over, with advanced economies starting to consider phasing out their crisis measures. Although financial markets already showed concerns over high government deficits and increasing debt towards the end of 2009, severe tension in some euro area government bond markets only erupted in May 2010. Spreads for ten-year government bonds of euro area countries relative to German government bonds widened rapidly due to concerns about the sustainability of public finances, and reached record-high levels in some euro area countries, especially Greece. Financial tensions eased somewhat after the EU and the IMF announced a €110 billion financial support package for Greece. The EU also created a lending facility of €500 billion for member countries experiencing solvency problems and the ECB started purchasing sovereign debt securities to stabilise the euro area debt markets. Towards the end of 2010 the sovereign bond spreads of peripheral European countries, especially Ireland, widened further due to concerns about the Irish banking sector. In November 2010 Ireland agreed to a €67,5 billion financial support package from both the EU and the IMF, with additional funding of €17,5 billion from Ireland to stabilise and recapitalise the banking sector. The current rescue package received by Greece in 2010 has failed to restore the country's financial health. The Greek government has announced further spending cuts in addition to the austerity package agreed to in May 2011. The European Commission and the IMF are insisting on the austerity measures as a prerequisite for a crucially needed aid payment from the current bailout package. New discussions are underway on a second bailout package which could also include a deal with private bondholders to roll over maturing Greek bonds.

Long-term government bond yields



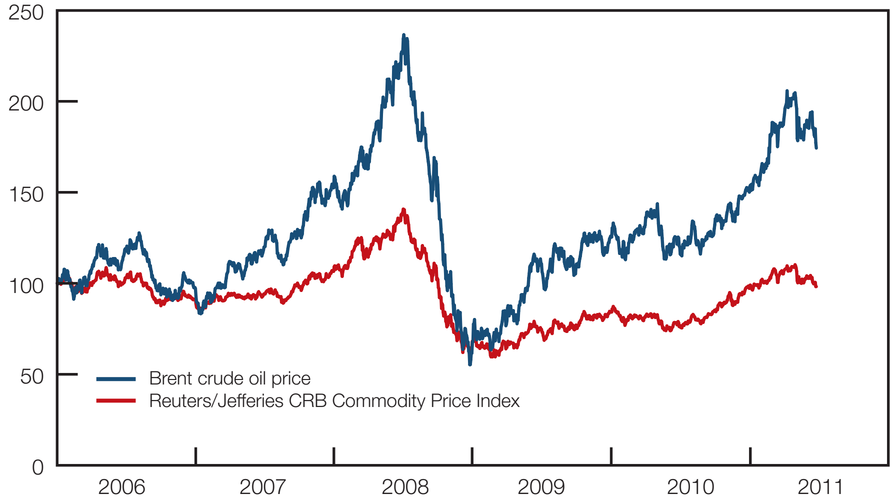
Source: Bloomberg

Crude oil prices started increasing significantly in the second half of 2010. The prices of non-energy items such as food commodities also increased during 2010. Brent crude oil prices rebounded from around US$70 per barrel in the middle of 2010 to a two-and-a-half year high of US$127 per barrel in early April 2011. Oil price increases were underpinned by relatively strong global oil demand, cold weather conditions in the northern hemisphere during the second half of 2010 and geopolitical tensions in several MENA countries. The decision by the Organization of the Petroleum Exporting Countries (OPEC) in early June 2011 not to increase output quotas also added further upward pressure on oil prices. However, oil prices have fallen to levels of around US$114 per barrel in mid-June 2011 due to concerns about global growth and the sovereign debt crisis in Greece. Brent crude oil prices declined sharply on 23 June 2011 to levels of around US$108 per barrel after the International Energy Agency agreed to release 60 million barrels of oil to offset the daily production loss of 1,5 million barrels from Libya.

Inflation pressures in advanced economies remained relatively subdued in 2010, notwithstanding higher commodity prices. Headline consumer prices in the Organisation for Economic Co-operation and Development (OECD) area trended upwards from mid-2010 before reaching 2,9 per cent in April 2011. Energy and food prices in the OECD area rose by 13,8 per cent and 3,1 per cent respectively. Inflation was, however, more pronounced in several emerging-market economies due to higher energy and food prices, as well as rising capacity constraints.

Brent crude oil and commodity prices

Indices: 3 Jan 2006 = 100



Source: Bloomberg

Central banks in the major advanced economies maintained their policy rates at historically low levels in 2010 and the opening months of 2011. The ECB, however, increased its main refinancing rate by 25 basis points in April 2011 to 1,25 per cent. According to the ECB, higher energy and food prices alongside surplus liquidity are presenting upside risks to price stability in the euro area. Several central banks in emerging-market economies tightened their monetary policy stance in 2010 and the first half of 2011 due to concerns about overheating economies and inflation.

Current account[2]

In South Africa periods of strong economic growth tend to be accompanied by high imports and large deficits on the current account of the balance of payments as, for instance, observed from 2005 to 2007. The continuation of a large shortfall on the current account in 2008 reflected the adverse impact of the global financial crisis and an almost synchronised contraction in merchandise trade volumes, both on the import and on the export side.

2 Unless stated to the contrary, the current-account transactions referred to in this section are all seasonally adjusted and annualised.

Balance of payments on current account

Seasonally adjusted and annualised
R billions

	2009		2010			2011
	2nd half	Year	1st half	2nd half	Year	1st qr
Merchandise exports	503,1	503,7	532,4	599,3	565,9	620,4
Net gold exports	56,3	52,8	56,8	62,2	59,5	63,3
Merchandise imports	-535,8	-554,2	-587,0	-609,3	-598,2	-661,7
Trade balance	23,6	2,3	2,2	52,2	27,2	22,0
Net service, income and current transfer payments	-97,3	-99,4	-96,1	-108,2	-102,2	-109,8
Balance on current account	-73,7	-97,1	-93,9	-56,0	-75,0	-87,8
As a percentage of gross domestic product	*-3,0*	*-4,1*	*-3,6*	*-2,0*	*-2,8*	*-3,1*

The revival in global economic activity in the aftermath of the financial crisis, the subsequent recovery in external demand for domestically produced goods from mid-2009 and a generally favourable trend in the terms of trade have narrowed the deficit on the current account of South Africa's balance of payments in 2009 and 2010. Although it is of some concern that South

African export volumes have not recovered fully, the strengthening of the terms of trade has played a major role in the moderation of the magnitude of the deficit.

The improvement in the current-account balance throughout 2009 gained momentum in the latter part of 2010 when South African producers gained meaningfully from the fairly strong recovery in external demand, resulting in a marked increase in the trade surplus in the second half of 2010. The deficit on the services, income and current transfer account with the rest of the world narrowed in 2009 before widening again in 2010.

Balance on current account

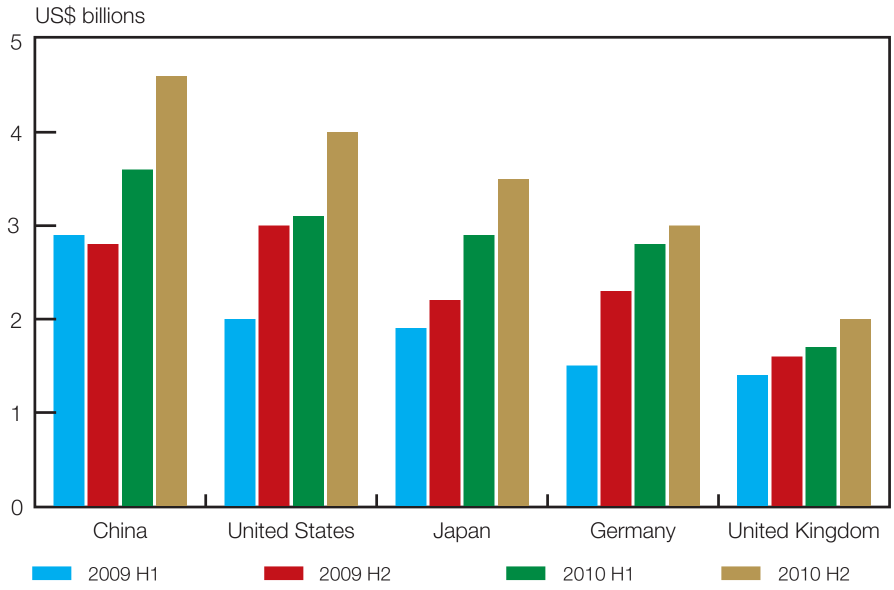
* First quarter

In the first half of 2010 the deficit on the current account widened primarily due to a weaker trade balance following a sizeable increase in import demand. The relatively slower pace of increase in the value of merchandise exports followed the recurrence of sovereign debt risk in some euro area peripheral countries, which affected the foreign demand for domestically produced goods. The weakening of the balance on the current account was, however, partly cushioned by increased receipts from foreign travellers who visited the country for the 2010 FIFA World Cup™ tournament during the middle quarters of 2010. While the magnitude of the improved deficit on the current account in 2010 was largely influenced by developments in exports, the significant narrowing of the trade surplus in the first quarter of 2011 was due to stronger domestic demand which was satisfied largely by imports, leading to a worsening of the current-account deficit over the period. The return to a larger deficit on the current account in the first quarter of 2011 corresponded with an acceleration in real domestic growth and higher imports.

In the wake of the uneven global economic recovery, the volume of merchandise exports decreased somewhat in the first half of 2010 but advanced notably in the second half of 2010, underpinned by a strong recovery in demand from China, the US, Japan and to a lesser extent, the UK. As a result, the ratio of the volume of merchandise exports relative to gross domestic product was 0,6 per cent higher in 2010 compared with 2009, before moderating marginally in the first quarter of 2011.

An analysis of exports of goods according to country of destination confirmed that China, despite signs of overheating its economy, remained South Africa's top export destination in 2010 followed by the US, Japan and Germany. The composition of exports to these countries remained broadly unchanged from 2009 to 2010, with mineral products continuing to lead exports to China. Despite policy measures taken by the Chinese government to slow economic activity, South African producers sold 38,3 per cent more mineral products, particularly iron ore, to China in 2010. The exports of goods to the US and Japan were largely dominated by platinum group metals, while Germany imported more South African-produced vehicles and platinum for the production of catalytic converters.

Exports to selected destinations

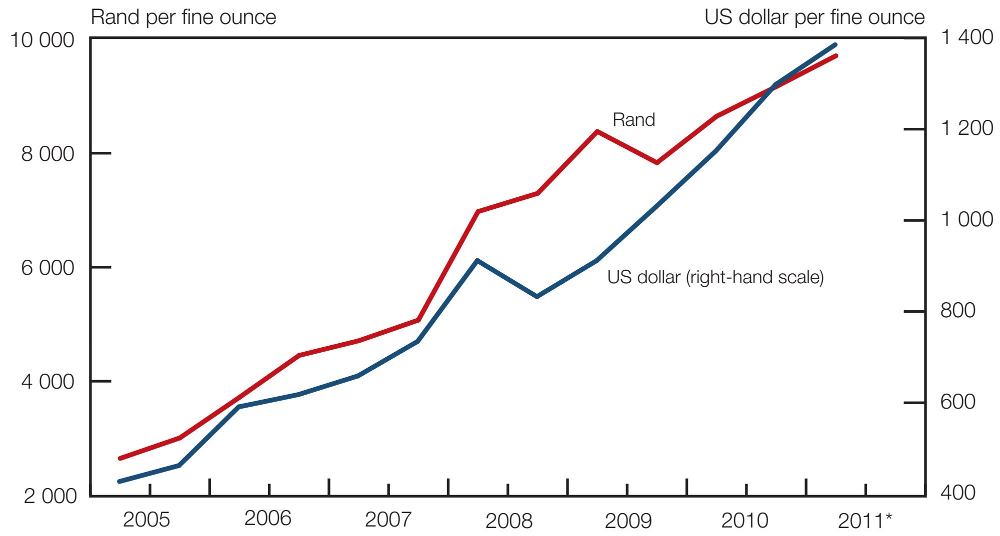


The rising volume of merchandise exports coincided with higher rand prices of such goods, raising the earnings of domestic producers by 12,4 per cent in 2010. The rand price of merchandise exports continued to be supported by the sustained upward trend in international commodity prices since the beginning of 2009. In US dollar terms, the international price of a South African basket of export commodities rose by 20,9 per cent from the second half of 2009 to the first half of 2010, and by a further 8,4 per cent in the second half as the global economic recovery supported demand for commodities and the revival of sovereign debt risk in some European countries encouraged international investors to seek safe-haven assets like gold. Despite a further rise in international commodity prices in the first quarter of 2011, the value of merchandise exports increased at a somewhat slower pace, mainly suppressed by the contraction in export volumes over the period.

Lacklustre export volumes could be ascribed to several factors, including
– the composition of South Africa's export partners, with a relatively high concentration of mature economies that are still experiencing the after-effects of the global crisis;
– setbacks to purchasing power in Botswana, Lesotho, Namibia, Swaziland and Zimbabwe, that are all traditionally importers from South Africa;
– logistical problems with the transportation of exportable goods;
– the higher price and constrained availability of electricity;
– time-consuming processes required to open or expand mining ventures;
– the depletion of more readily accessible, high-yielding ore or mineral bodies;
– highly competitive factor prices in a number of competitor countries; and
– the relative strength of the exchange value of the rand.

As international investors continued to acquire gold for wealth preservation purposes during periods of uncertainty, the London fixing price of gold surged by 11,8 per cent and 12,6 per cent in the first and second half of 2010, respectively. The robust escalation in the gold price lifted the price of the precious metal to new heights, buoyed by the ongoing uncertainty in global financial markets regarding sovereign debt risk in certain peripheral euro countries. The increase in the rand price of gold was, however, partially dampened by the strengthening in the exchange value of the rand over the same period. Political tension in the MENA region helped to sustain the firm level of the dollar price of gold in the first quarter of 2011.

Gold price

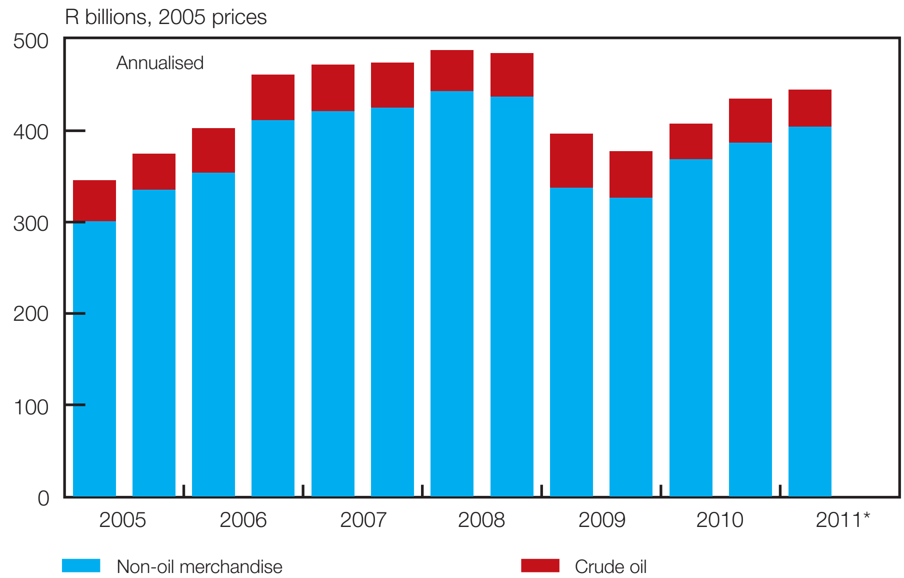


* First quarter

Despite the surge in the price of gold in 2010, the volume of South Africa's net gold exports increased only marginally due to the ongoing production and logistical challenges faced by the domestic mining industry. South Africa nevertheless maintained its position as the fourth-largest producer of gold in the world, with the earnings of domestic gold producers increasing by 12,7 per cent in 2010, before rising marginally further in the first quarter of 2011.

The volume of merchandise imports contracted almost throughout 2009, but turned around and advanced by 8,9 per cent in 2010. The stronger demand for imported goods reflected the recovery in global and domestic economic conditions, including more optimistic business and consumer confidence levels. In addition, the country's manufacturing Purchasing Managers' Index, which remained below the neutral level of 50 basis points for most of 2009, moved to above the neutral level of 50 in 2010, portraying some optimism about potential new orders. These positive developments encouraged domestic producers to step up imports. For 2010 as a whole, the volume of non-oil merchandise imports increased by about 13,5 per cent, while that of imported crude oil declined by 20 per cent.

Volume of merchandise imports



* First quarter

Consistent with the anticipated increase in demand, the volume of imported intermediate and capital goods increased notably in the subcategories for imported machinery and electrical equipment; vehicles and transport equipment; and chemical products during the first half of 2010. During the second half of 2010, the pace of increase in the volume of non-oil merchandise imports tapered off somewhat before it accelerated again in the first quarter of 2011.

The sustained low level of inflation in South Africa's most important trading-partner countries in 2010 and the strengthening in the exchange value of the rand gave rise to a slight downward movement in the rand price of merchandise imports during the year. This marginal decline in the rand price of imports changed abruptly in the first quarter of 2011 when political tension in the oil-producing countries in the MENA region intensified, causing international crude oil prices to rise to new heights. The higher volume of merchandise imports overshadowed muted decreases in the rand price of imports, causing the value of merchandise imports to rise visibly from 2009 to 2010, especially in the first half of 2010. The steep increase in import prices lifted the value of imports in the first quarter of 2011.

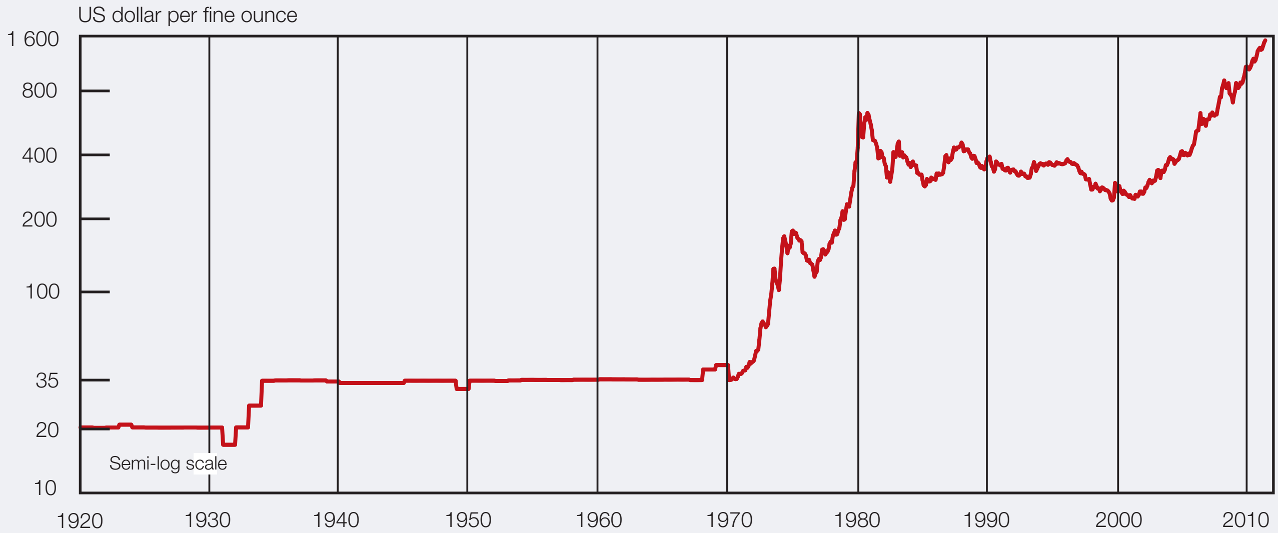
The muted decrease in the rand price of merchandise imports as a consequence of the aforementioned factors occurred alongside a rapid increase in international commodity prices and led to a further improvement in South Africa's terms of trade in 2010. However, the country's terms of trade deteriorated somewhat in the first quarter of 2011 as political tension in some oil-producing countries raised the price of crude oil. The decline in South Africa's terms of trade in the first quarter of 2011 was accompanied by a deterioration in the balance on the current account over the period.

Box 5: The gold price

For most of the past 90 years, gold was South Africa's most important export product. Although South Africa abandoned the gold standard towards the end of 1932, the precious metal continued to play a central role in the international monetary system up to 1971 when the United States (US) formally abolished the convertibility of the dollar into gold. While the monetary role of gold was reduced by this landmark event, central banks continue to hold significant amounts of gold as a reserve asset that is no other party's liability.

In the era of "dollar convertibility" the gold price was kept at US$35 per fine ounce for more than three decades. Thereafter it started fluctuating and, on balance, rose considerably over the past 40 years to levels recently in excess of US$1 500 per fine ounce. Its movements have had a marked impact on South Africa's balance of payments, economic policies and fortunes in general. South African gold production has, however, declined considerably since reaching a peak in 1970, decreasing the importance of gold in setting the tone for the country's economic performance.

London gold price in US dollar



The deficit on the services, income and current transfer account narrowed considerably in 2009, but widened again in 2010 as the improved domestic growth performance led to increased net service payments to non-residents. The increase in gross service payments to the rest of the world more than offset higher tourism receipts from non-residents who visited South Africa for, among other reasons, the football tournament hosted in the middle of 2010. The widening of the deficit on the services, income and current transfer account marked, in part, a return to more normal conditions in the domestic and global economic environment, following the global financial crisis.

Balances: Components of services, income and current transfer account

Percentage of gross domestic product

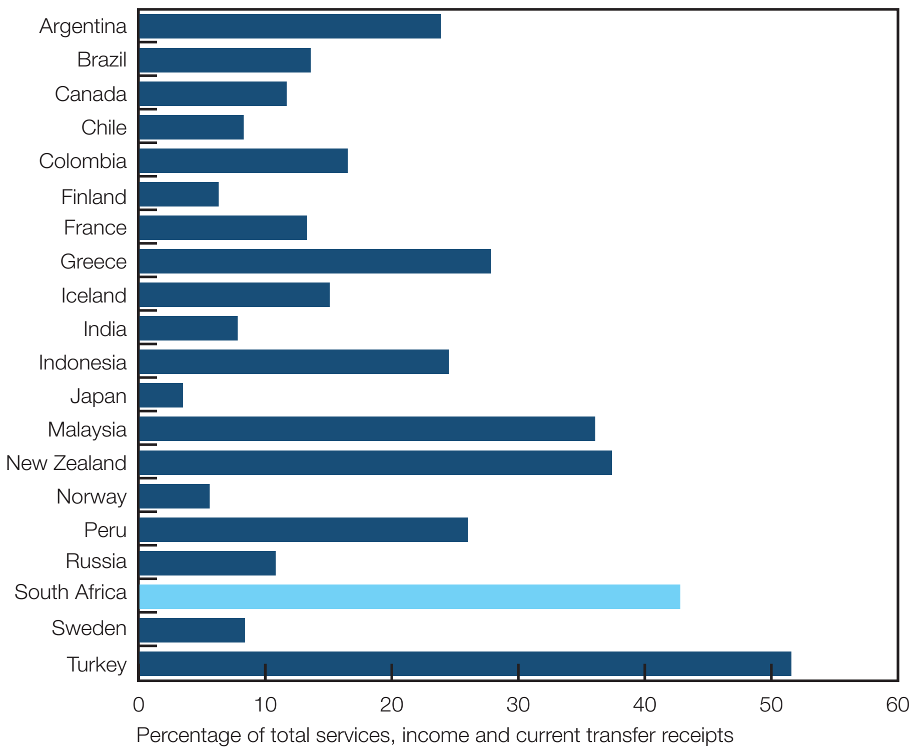
	2008	2009	2010			40-year annual average
	Year	Year	1st half	2nd half	Year	
Net services payments	-1,5	-1,0	-1,0	-1,4	-1,2	-0,8
Net income payments	-3,3	-2,2	-2,1	-1,9	-2,0	-3,2
Of which: Net dividend payments	-2,6	-1,6	-1,6	-1,5	-1,5	-1,1
Net current transfer payments	-0,8	-0,9	-0,7	-0,6	-0,6	-0,3
Overall balance	-5,6	-4,1	-3,8	-3,9	-3,8	-4,3
Memorandum item:						
Balance excluding travel receipts	-8,4	-6,8	-6,4	-6,3	-6,3	-6,4

Deficit – surplus +

Despite the marginal widening of the deficit on the services, income and current transfer account in 2010, the ratio of the deficit relative to gross domestic product decreased to 3,8 per cent – a ratio well below the 40-year annual average of 4,3 per cent.

Most countries, including South Africa, recorded a decline in travel receipts in 2009 as the financial crisis constrained the disposable income and, ultimately, the ability of individuals to travel.

Travel receipts in selected countries
Average, 2005–2010



Source: International Monetary Fund

This trend was, however, partly reversed in 2010, as economies recorded a renewed pickup in economic activity. During the middle quarters of 2010, the ratio of travel receipts relative to total service, income and current transfer receipts for South Africa improved to almost 48 per cent, buoyed by foreign tourists' spending during the 2010 FIFA World Cup™ tournament.

Nonetheless, net service payments as a percentage of gross domestic product increased somewhat in 2010 compared with 2009. This development could, to some extent, be attributed to an increase in travel-related payments by South Africans temporarily travelling abroad amid an improved exchange value of the rand and a recovery in the local economic environment.

In addition, trade-related payments for services rendered by non-residents also increased somewhat, more so in the second half of 2010, as import trade volumes picked up from record-low levels in 2009. This was complemented by higher payments for services of a technical nature rendered by non-residents relating to infrastructural projects.

The ratio of net income payments to gross domestic product moderated to 2 per cent in 2010, notwithstanding an increase of almost 5 per cent in the level of gross dividend payments in the period. The relatively small increase in the declaration of gross dividend payments to non-resident investors partly reflected the cautious distribution of internal resources by companies amid uncertainty regarding the underlying strength of the economic recovery. In addition, lower net current transfer payments, specifically those applicable to the transfer payments by South Africa to the other members of the South African Customs Union (SACU) also assisted in containing the deficit in 2010.

Financial account

In 2010 and the first half of 2011 global economic conditions remained supportive of investment in emerging-market economies, including South Africa. Attractive risk-adjusted returns were signalled by stronger output growth in emerging-market economies relative to developed economies, an improved perception of relative risk in emerging-market economies, and global monetary policy settings in which interest rates in emerging-market economies were higher than the exceptionally low policy rates in most advanced economies.

Net financial transactions not related to reserves

R billions

	2009		2010			2011
	2nd half	Year	1st half	2nd half	Year	1st qr
Liabilities						
Direct investment	12,9	45,4	6,0	5,4	11,4	5,0
Portfolio investment	67,5	107,2	72,5	35,4	107,9	20,8
Other investment	-3,0	-40,0	-17,5	28,4	10,9	1,9
Assets						
Direct investment	-8,2	-9,8	-3,2	-0,1	-3,3	-11,2
Portfolio investment	-12,1	-13,4	-7,8	-20,5	-28,3	22,1
Other investment	21,2	23,6	6,8	-24,5	-17,7	31,7
Total financial transactions*	51,1	113,9	73,9	31,2	106,0	55,1
Financial transactions as a percentage of gross domestic product	*4,2*	*4,8*	*5,8*	*2,3*	*4,0*	*7,8*

* Including unrecorded transactions

Capital inflows on the financial account of South Africa's balance of payments moderated in 2008 and 2009 as the financial crisis impacted negatively on global liquidity. However, the flow of capital into the country rebounded markedly in the first half of 2010 amid the supportive financial environment before roughly halving in the second half, resulting in a slight reduction in the annual cumulative inflows. During the first quarter of 2011, the net inward movement of capital was much higher as domestic banks repatriated part of their foreign currency held with non-resident banks. This inflow was, however, partly countered by net portfolio outflows which resumed since October 2010 throughout the first three months of 2011.

Global liquidity has continued to flow to a number of emerging-market economies since the start of the global economic recovery in 2009. A comparison of capital flows to a selection of these economies suggests that while South Africa has recorded sizeable capital flows over the period more than fully financing the current-account deficit, capital inflows into Brazil and Turkey have been considerably higher, alongside large current-account deficits in these countries.

The accompanying table indicates that fairly subdued net foreign direct investment capital inflows were not unique to South Africa, but also prevailed in other emerging-market economies, such as Turkey and Thailand. A fair amount of volatility characterises capital flows across all countries.

External financial transactions of selected emerging-market countries

US$ billions

	South Africa			Brazil			Turkey			Thailand		
	2008	2009	2010	2008	2009	2010	2008	2009	2010	2008	2009	2010
Liabilities												
Direct	9,0	5,4	1,6	45,1	25,9	48,4	19,5	8,4	9,1	8,5	5,0	5,8
Portfolio	-8,7	12,7	14,7	-0,8	46,2	67,8	-3,8	2,9	19,6	-2,5	2,4	8,1
Other	5,8	-4,7	1,5	8,1	14,1	41,3	36,4	-8,3	26,6	-3,7	-2,8	11,9
Assets												
Direct	3,1	-1,2	-0,5	-20,5	10,1	-11,5	-2,5	-1,6	-1,8	-4,1	-4,1	-5,3
Portfolio	-7,7	-1,6	-3,9	1,9	4,1	-4,8	-1,2	-2,7	-3,5	0,4	-8,3	1,4
Other	10,1	2,8	-2,4	-5,3	-30,4	-42,6	-12,1	11,0	9,0	13,5	5,1	-5,9
Unrecorded	11,1	0,1	3,4	1,8	-0,3	-3,2	4,7	5,1	4,6	10,3	5,0	0,6
Total capital flows	22,7	13,5	14,5	28,6	70,0	98,7	41,0	14,8	63,6	22,5	2,3	16,5

Source: International Monetary Fund and South African Reserve Bank

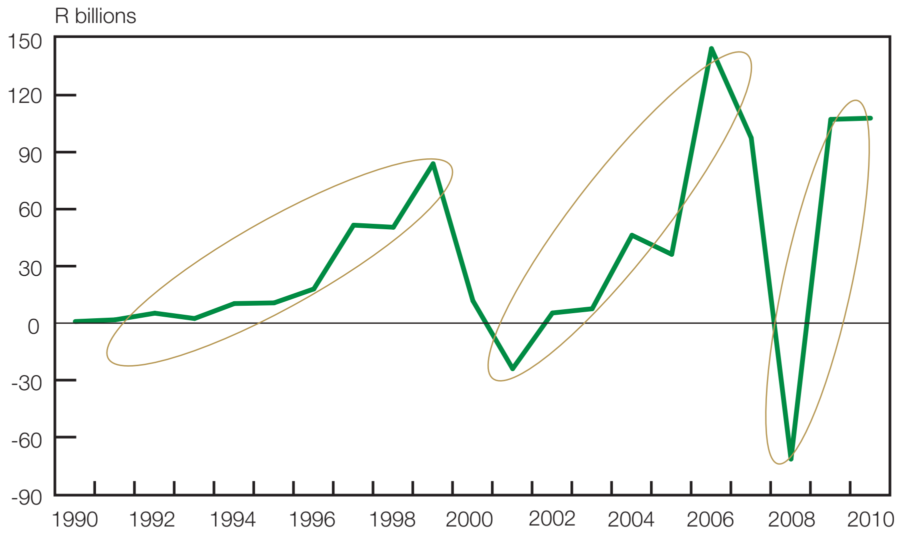
Foreign-owned assets in South Africa

Foreign direct investment into South Africa shrank in 2010 compared with 2009. Nonetheless, South African companies operating in the resources, industrial and food-manufacturing industries sold part of their equity holdings to foreign direct investors during the year. Capital inflows in the form of long-term loans granted to some of these companies were also recorded, while a reduction in short-term financing was registered over the period. Inward direct investment was fairly evenly spread between the first and second halves of 2010. During the first quarter of 2011, the country's direct investment liabilities increased further.

The momentum and magnitude of *portfolio investment into South Africa* during 2009 was maintained in 2010, despite a moderation in the pace of inflows in the second half of the year. The capital inflows during 2010 marked the second consecutive annual inflow, following an outflow related to the global financial crisis in 2008. While in 2009 the largest inflow of capital into South Africa was in the form of equity securities, this shifted to debt securities in 2010, especially in the first half of the year. The change in the composition of portfolio flows in favour of debt securities during 2010 probably reflected foreign investors' expectation of domestic inflation and interest rate differentials between advanced and emerging-market economies over the period.

The accompanying graph suggests that South Africa may be in the middle of the third upswing in portfolio capital flows since the early 1990s when the country liberalised its financial account and gained entry into international capital markets. The expansion phases of the two previous cycles seem to have had a longer duration of eight years and four years respectively, while the contraction phase tended to be rapid and short, particularly in 2008. In addition, the increase in equity investment liabilities was more pronounced during the first two upswings, as foreign investors took advantage of relatively cheap domestic assets and positioned themselves for further positive economic developments. By contrast, the capital flows into the country during the current upward cycle rebounded sharply and were led by the acquisition of debt securities by non-resident investors during 2010. The prospects of a further increase in the expansion cycle was clouded by the uncertainty related to the development of the sovereign risk profiles of some developing economies. Nonetheless, the inward movement of portfolio investment continued in the first quarter of 2011, suggesting a continuation of the upward trend in portfolio investment liabilities.

Portfolio liabilities: Investment flows



Other foreign investment into South Africa changed from an outflow in 2009 to an inflow in 2010 mainly due to long- as well as short-term loans extended by foreign parties to South African entities in the second half of 2010. A significant part of the long-term loan finance was granted to domestic public corporations to finance infrastructural projects. As a result, outstanding foreign long-term liabilities of the public sector increased visibly during 2009 and 2010. Foreign creditor banks extended short-term loans largely to the domestic banking sector during the second half of 2010, consistent with the moderate positive growth in loans and advances granted to the domestic private sector over the period. Collectively, these inflows more than countered the outflow of capital originating from the withdrawal of non-resident investors' rand and foreign currency-denominated deposits from the domestic banking sector, probably partly in response to a decline in interest rates during 2010.

South African-owned assets abroad

Although South African enterprises continued to diversify their operations during 2010, the acquisition of *foreign direct investment* assets in the rest of the world occurred at a slower pace than in the preceding two years. The smaller outflow of capital could most probably be associated with concerns regarding the sustainability of the global economic recovery which encouraged South African companies to delay the implementation of their long-term investment strategies in other countries. The outflow of capital in 2010 was, to a large extent, countered by a South African company's disposal of its equity interest in an offshore information and communications technology company. The further expansion of the offshore interest of domestic companies increased markedly in the first quarter of 2011.

The appetite of South African institutional and individual investors to acquire *foreign portfolio investment* assets increased in 2010. This increase could partly be attributed to the strength of the rand which encouraged institutional investors to diversify their investment portfolios geographically. The further relaxation of exchange controls applicable to both institutional and individual investors in 2010 and at the start of 2011 furthermore accommodated the outward diversification of portfolio assets.

Capital outflows associated with *other foreign investment* assets changed from an inflow in 2009 to an outflow in 2010. The investment in other foreign investment assets occurred predominantly in the second half of 2010 and mainly took the form of an increase in the offshore foreign currency-denominated deposits of the South African banking sector. The level of deposits placed abroad largely coincided with the reduction in domestic policy rates and resembled the behaviour of non-residents investors with regard to their foreign currency deposits held with local banks. In the first quarter of 2011 South African banks withdrew part of their foreign currency deposits in order to provide foreign currency liquidity to the domestic market in foreign exchange, resulting in an inflow of capital during the period following capital outflows in the preceding two quarters.

Foreign debt

South Africa's outstanding foreign debt increased by US$20,4 billion from the end of 2009 to the end of 2010. This substantial increase was driven mainly by a rising level of rand-denominated foreign debt and marked a switch in the contribution of rand-denominated debt and foreign currency-denominated debt over the period. The contribution of foreign currency-denominated debt to total foreign debt, which at the end of 2008 amounted to almost 60 per cent, declined gradually to 54 per cent and 46 per cent in 2009 and 2010 respectively.

Foreign debt of South Africa

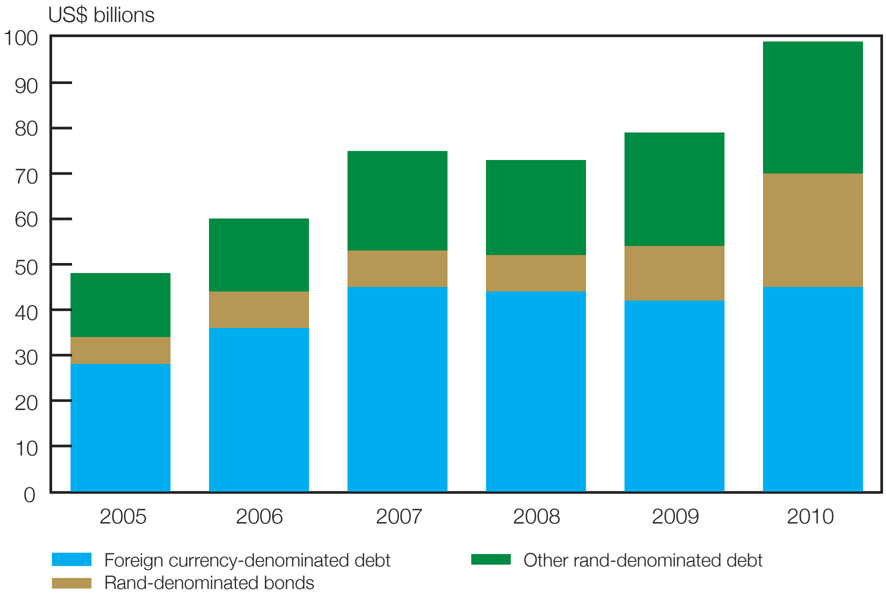
US$ billions at end of period

	2006	2007	2008	2009	2010
Foreign currency-denominated debt..................	35,8	45,1	44,1	42,1	45,2
Bearer bonds..	10,5	15,2	13,9	15,4	16,5
Public sector	5,2	5,6	5,3	5,7	6,5
Monetary sector	10,3	12,7	12,8	10,6	10,3
Non-monetary private sector	9,8	11,6	12,1	10,4	11,9
Rand-denominated debt	23,6	30,2	28,8	36,5	53,8
Bonds...	7,5	7,9	8,0	11,6	24,6
Other	16,1	22,3	20,8	24,9	29,2
Total foreign debt	59,4	75,3	72,9	78,6	99,0
As a percentage of gross domestic product.....	*22,7*	*26,4*	*26,4*	*27,7*	*27,2*
As a percentage of total export earnings..........	*70,3*	*77,8*	*70,1*	*95,9*	*95,2*

The increase in the rand-denominated debt during 2010 occurred largely as a result of non-resident interest in South African rand-denominated bonds. After gradually increasing their acquisition of domestic government bonds in 2009, international investors more than doubled their holdings of such bonds in 2010.

The level of foreign currency-denominated debt increased somewhat in 2010 as long-term foreign funding for infrastructure development flowed to parastatals, alongside an international bond issue by the central government. This countered a reduction in foreign currency deposits of non-resident investors. As a result of a decline in the monetary sector's short-term debt, 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) contracted to 26,6 per cent of total foreign currency-denominated debt at the end of 2010, compared with a ratio of 35,8 per cent at the end of 2009.

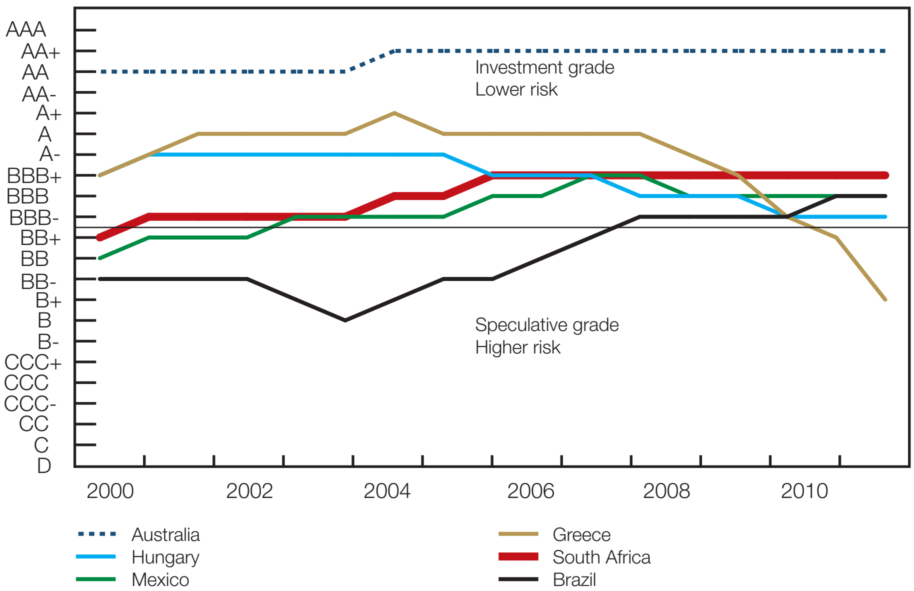
Foreign debt



Despite the sharp increase in the level of foreign debt expressed in US dollar terms, South Africa's total outstanding foreign debt as measured in rand increased at a more subdued pace from R579 billion at the end of 2009 to R655 billion at the end of 2010.

A review of the outcome of the credit ratings since the start of the global economic recovery in early 2009 shows that South Africa's sovereign debt credit rating, like that of Australia, was not affected by the spill-over effects from the global financial crisis. South Africa has been rated BBB+ by Standard & Poor's and Fitch rating agencies throughout the period 2005–2010, while Moody's awarded South Africa an A3 rating. Owing to sound macroeconomic policies and governance, South Africa's sovereign assets have been found to be safer than those of Brazil, Hungary, Mexico and Greece.

Fitch sovereign credit ratings for selected economies



International reserves and liquidity position

South Africa's net international reserve position owing to balance-of-payments transactions improved by R17,0 billion in 2009 and increased by a further R31,3 billion in 2010 as the accumulation of foreign reserves by the Bank accelerated following the global financial crisis. This improvement was further observed in the first quarter of 2011 when the net reserves rose by R32,2 billion.

The gross international reserve position of the Bank increased by US$4,1 billion during 2010 to a level of US$43,8 billion at the end of December 2010 and further to US$50,1 billion at the end of May 2011. The level of imports of goods and services covered by gross official international reserves decreased from 19,9 weeks at the end of December 2009 to 18,3 weeks at the end of December 2010 as a result of the recovery in the value of imports. At the end of March 2011, this ratio had improved to 19,4 weeks of import cover. The international liquidity position of the Bank also continued its gradual improvement from US$39,0 billion at the end of December 2009 to US$43,4 billion at the end of December 2010 and further to US$45,9 billion at the end of May 2011.

According to the IMF's *Report on Currency Composition of Foreign Exchange Reserves* (*COFER*), the world's foreign-exchange reserves increased by 420 per cent from the end of 1999 to the end of 2010. The largest contribution was made by emerging-market and developing countries which, at the end of 2010, owned 67 per cent of the world's foreign-exchange reserves compared with 37 per cent at the end of 1999. South Africa's foreign-exchange reserves increased by 502 per cent from the end of 1999 to the end of 2010, a somewhat faster pace than the growth in the world's foreign-exchange reserves, but lower than the 834 per cent growth rate of emerging-market and developing economies' reserves.

Exchange rates

After increasing, on balance, by 3,1 per cent in the first half of 2010, the nominal effective exchange rate of the rand increased by 8,6 per cent during the second half of the year. The increase in the nominal effective exchange rate of the rand during the first half of 2010 was induced by weakness of the euro as the sovereign debt crisis in Europe exerted downward pressure on the common currency, while further strength of the rand in the second half of 2010 partly reflected US dollar weakness brought about by the second round of quantitative easing in the US. During 2010, the exchange rate of the rand also benefited from an increase in commodity prices, sustained inflows of portfolio capital into the country, an improvement in the country's deficit on the current account of the balance of payments and positive sentiment towards the country following the successful hosting of the 2010 FIFA World Cup™ tournament. National Treasury relaxed exchange controls by raising the limit on the amount institutional investors may invest abroad as a percentage of their total assets by five percentage points in December 2010; this could over time improve liquidity and perceptions of two-way risk in the market for foreign exchange.

Exchange rates of the rand

Percentage change

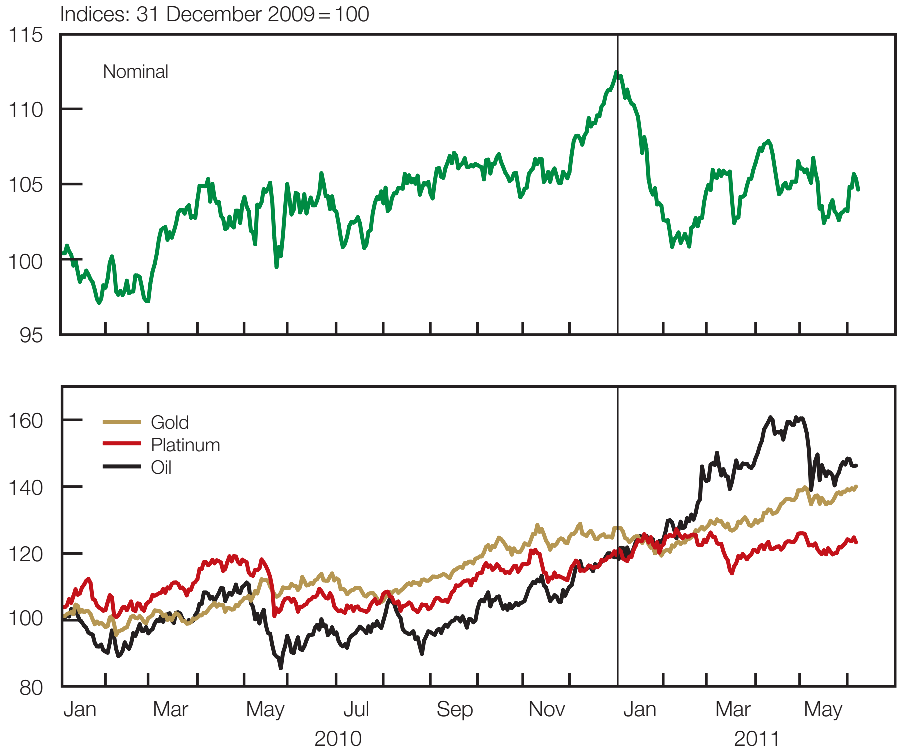
	31 Dec 2008 to 30 Jun 2009	30 Jun 2009 to 31 Dec 2009	31 Dec 2009 to 30 Jun 2010	30 Jun 2010 to 31 Dec 2010	31 Dec 2010 to 20 Jun 2011
Weighted average*	**18,5**	**3,7**	**3,1**	**8,6**	**-6,2**
Euro	19,6	3,3	13,5	5,9	-8,8
US dollar	19,7	5,5	-3,6	15,5	-2,9
Chinese yuan	19,8	5,4	-4,2	12,2	-4,6
British pound	4,0	8,8	3,3	12,2	-6,8
Japanese yen	26,6	2,0	-7,4	6,1	-4,4

* Against a basket of 15 currencies

The nominal effective exchange rate of the rand declined by 6,2 per cent from the end of 2010 to 20 June 2011, amid a weakening of the trade balance and terms of trade. Uncertainty in currency markets was also fuelled by political turmoil in North Africa, concerns regarding the sovereign debt crisis in peripheral European countries, the economic impact of the natural disaster in Japan and the change in the outlook of the US sovereign debt credit rating by Standard & Poor's.

An international comparison suggests that countries that experienced the largest appreciation against the US dollar during 2010 were all significant commodity producers. The appreciation in the exchange value of these currencies was uneven as the initial strength of the US dollar in the first half of 2010 turned to weakness during the second half. International commodity prices, which languished during the first half of 2010, accelerated during the second half of 2010 as the US dollar depreciated and demand from emerging Asia exerted upward pressure on commodity prices.

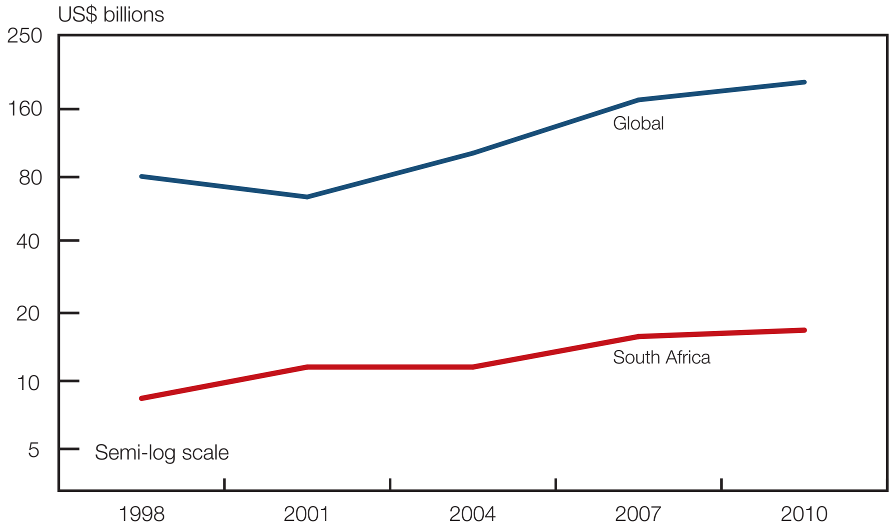
Nominal effective exchange rate and selected commodity prices



While the nominal effective exchange rate of the rand tracked the platinum and gold price up to the end of the third quarter of 2010, the increase in these prices has not been reflected in the trade-weighted exchange rate since then. This could partly be explained by the sharp increase in the oil price – South Africa being an importer of oil. The real effective exchange rate of the rand increased by 10,1 per cent in the twelve months to December 2010, but declined by 4,1 per cent from December 2010 to March 2011.

The net average daily turnover in the domestic market for foreign exchange rebounded by 15,7 per cent to US$16,5 billion from 2009 to 2010. This growth coincided with the economic recovery following the global financial crisis and the subsequent recovery in global liquidity. The outcome of the Triennial Foreign Exchange and Derivative Market Survey conducted on behalf of the Bank of International Settlements (BIS), showed that the average daily spot foreign-exchange turnover in April 2010 was 24,0 per cent higher than the value recorded in 2007 and 154,0 per cent above the 2004 value. The turnover in the forward market was 11 per cent less than in 2007 but higher than those recorded in 2004. Turnover in the swap market edged 3 per cent higher than in 2007.

Net average daily turnover in the foreign-exchange market



In comparison with other emerging-market currencies the rand was the sixth most traded currency in April 2010, down from the third most actively traded in 2007.

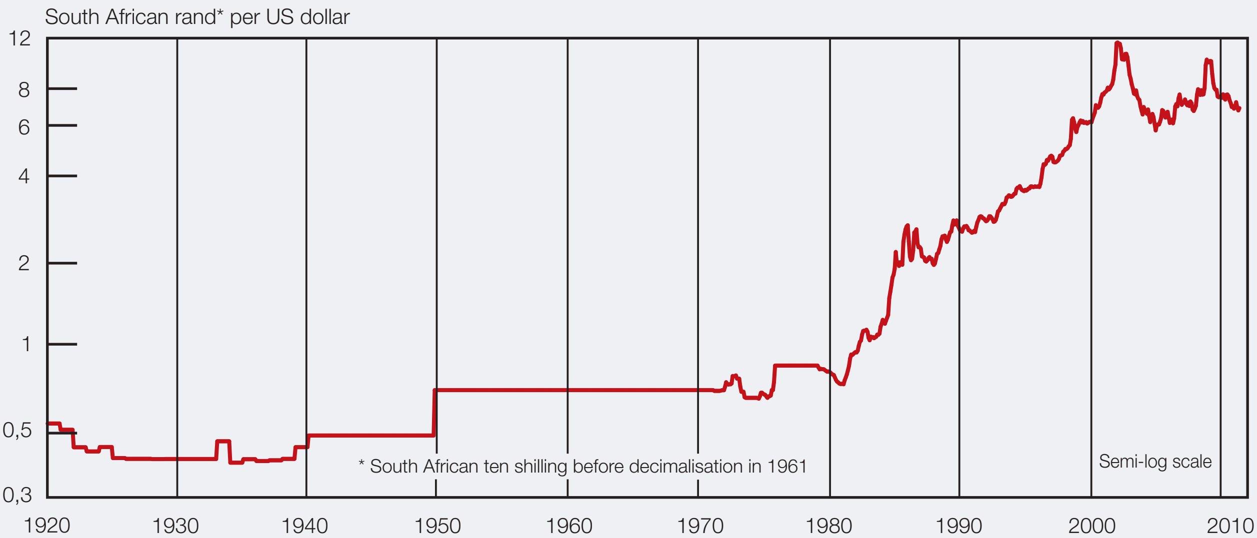
Box 6: Exchange rate of the rand

Exchange rate stability was a high priority in the international monetary system throughout the first five decades of the South African Reserve Bank's existence. During this period, the South African currency was essentially pegged to the British pound sterling, first on a one-to-one basis involving the South African pound, and then, following decimalisation in 1961, on a two-to-one basis involving the rand. For trade and financial relations with South Africa's most important economic counterparty at that time, the United Kingdom, full exchange rate stability therefore reigned.

After the breakdown of the Bretton Woods system of stable but adjustable exchange rates in 1971, the South African authorities adopted a number of exchange rate dispensations in succession, eventually linking to the United States (US) dollar from 1975 to early 1979. Thereafter, a floating regime was adopted. Largely because inflation in South Africa was higher than in the US, the rand depreciated considerably during the ensuing 22 years. The rand displayed particular weakness in the mid-1980s when a debt standstill was called and in 2001 when currency speculation had a major impact. After the 2001 episode, the rand recovered, and the perception that it was a perpetually depreciating currency was proven to be wrong.

The containment of domestic inflation largely holds the key to maintaining the external value of the currency in the long run.

Exchange rate of the rand



Monetary developments, interest rates and financial markets

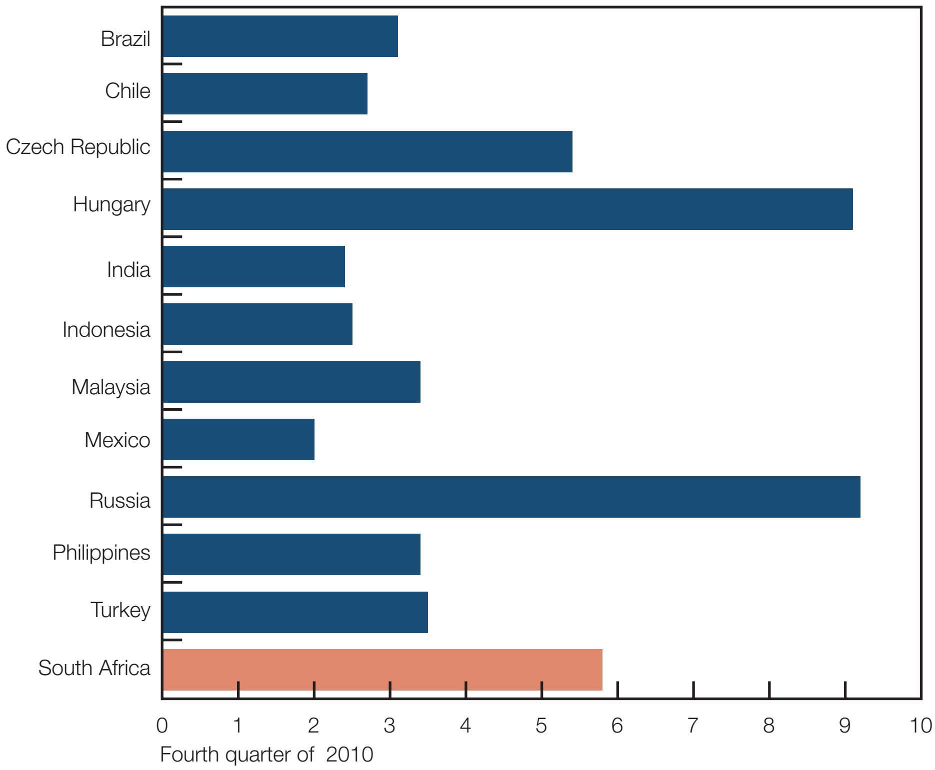
Structural and regulatory issues

The South African banking sector recovered gradually from the severe slump in economic activity experienced in the latter part of 2008 and early part of 2009. Following six quarters of near-stagnation, the turnaround was signalled by a modest recovery in credit growth in the second half of 2010, coupled with a moderate improvement in the level of impaired advances. Despite the challenging international financial conditions that existed during the past year, the banking sector remained relatively stable, with capital and liquidity ratios exceeding regulatory requirements.

The level of impaired advances, which grew quite rapidly in 2008 and 2009, levelled off and maintained a fairly flat trajectory in 2010 and the early months of 2011. The ratio of impaired advances to total gross loans and advances, which peaked at 6,1 per cent in December 2009, declined moderately to 5,8 per cent in April 2011. This reflected the improving credit environment as households and companies benefited from the lowest interest rates in more than three decades and an improvement in the quality of assets, aligned with appropriate risk pricing of loans and advances by banks. Nonetheless, the ratio of impaired advances in South Africa remained relatively high when compared with other emerging-market countries.

Non-perfoming loans* in selected emerging-market countries

Percentage of total gross loans and advances



Source: International Monetary Fund, *Financial Soundness Indicators*
* Definitions of asset quality in loan portfolios may vary across countries

While the banking sector continued to unbundle none-core assets and invest in core assets where growth opportunities had been identified, banks' balance sheets continued to reflect the impact of the recession and its after-effects. After declining by 0,5 per cent between June 2009 and June 2010, total assets of the South African banking sector increased by a subdued 2,9 per cent between June 2010 and April 2011. These rates were far below the year-on-year growth rates in excess of 20 per cent that were recorded in the period leading up to the financial crisis in 2007 and 2008.

Four large banks continued to dominate the banking scene; together they comprised 84 per cent of the total assets of the South African banking sector during the period under review. The number of locally registered banks in South Africa declined from 32 at the end of June 2010 to 30 at the end of April 2011. The number of branches of foreign banks in South Africa declined to 12 at the end of April 2011, while the number of foreign banks with approved local representative offices in South Africa decreased to 41 at the end of April 2011, compared with 42 at the end of June 2010.

Size of the South African private banking sector

	June 2010		April 2011	
	Number of institutions	Total assets (R billions)	Number of institutions	Total assets (R billions)
Locally controlled banks	12	2 825	11	2 904
Foreign-controlled banks	5	13	5	13
Mutual banks	2	1	2	1
South African branches of foreign banks	13	167	12	175
Total registered banks	32	3 006	30	3 093

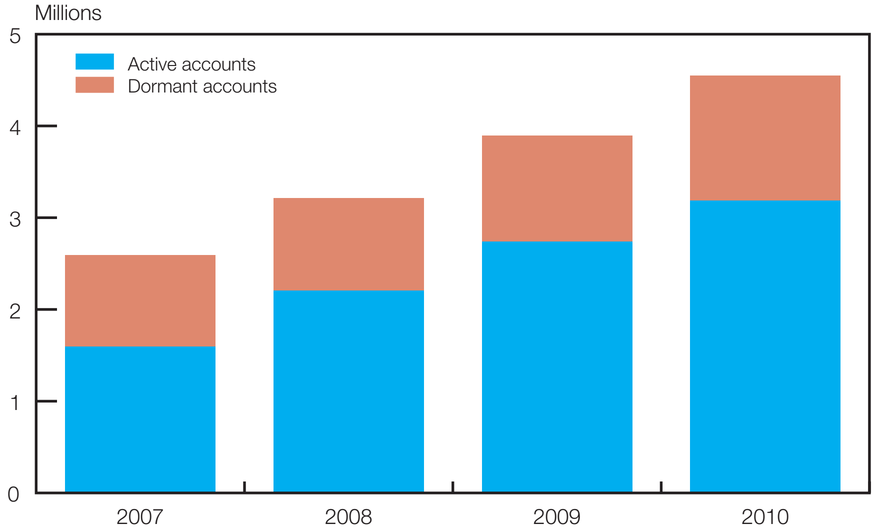
The banking sector continued to diversify its funding base, lengthen the maturity of its funding profile and maintain appropriate liquidity buffers. Between June 2010 and April 2011 the banking sector successfully raised its long-term funding through increased issuances of new debt securities in the domestic and international capital markets despite the periodic episodes of turbulence in the financial markets. Furthermore, the liquidity position of banks was supported by an improvement in deposit growth and a low reliance on short-term funding through commercial paper issuance. An issuer successfully tested the investor appetite in the securitisation market when mortgage advances amounting to R4,5 billion were securitised in December 2010; the market resurfaced after 23 months of abstinence, induced by the global financial crisis.

Competition for banking customers intensified during the period under review, particularly in the lower income segment of the market. For instance, in September 2010 legislation was approved for the corporatisation of Postbank, a division of the South African Post Office. The Postbank will, among other things, conduct the business of a bank with the aim to encourage and attract savings; render transactional services and lending facilities; and provide affordable banking services in the near future once regulatory approval has been obtained from the South African Reserve Bank. In another development, Teba Bank, which has traditionally provided banking services to the mineworker population, was rebranded and relaunched as Ubank in December 2010, with the main objective of broadening its customer base.

Banks have made significant progress in providing banking services to the previously unbanked members of the population, partly through the low-cost Mzansi bank account launched in 2004. However, progress with these accounts has not fully met expectations and the total number of dormant accounts has been trending upwards. To address this dilemma, banks have responded by introducing their own innovative products which offer a wider range of banking services to customers since the functionality of the Mzansi account is limited to quite basic savings and related services.

In response to the shortcomings that were identified during the recent global financial crisis, the Group of Governors and Heads of Supervision – the oversight body of the Basel Committee on Banking Supervision – agreed to several measures for strengthening capital and liquidity regulation in the banking sector during meetings in July and September 2010. The agreement, endorsed by the Group of Twenty (G-20) leaders at the Seoul Summit in November, culminated in the adoption of the Basel III regulatory framework. The capital and liquidity reforms will be phased in gradually over a period of eight years, with the enforcement date set for January 2019, to ensure that the banking sector will be able to meet the higher capital standards through reasonable earnings retention and the raising of capital, while still supporting lending activity.

Number of Mzansi accounts



The first phase of the Financial Sector Code was gazetted for public comments in December 2010. The draft code is based on the Financial Sector Charter and seeks to align the Charter with the Codes of Good Practice for black economic empowerment. The Draft Financial Sector Code commits all participants to actively promoting a transformed, vibrant and globally competitive financial sector that reflects the demographics of South Africa.

The Consumer Protection Act, 2008 (Act No. 68 of 2008) came into effect on 1 April 2011. The Act is primarily aimed at promoting a fair, accessible and sustainable marketplace for consumer products and services, and applies to contracts entered into after 1 April. Among other things, the Act provides the consumer with the power to cancel contracts, including fixed-term agreements, provided that they give 20 business days' formal notice. The Banking Association is working with both the Department of Trade and Industry and the South African Reserve Bank to have bank deposits exempted from this provision of the Consumer Protection Act to avoid a possible liquidity risk in the banking system if depositor behaviour changes unexpectedly.

A number of enhancements and new products were introduced by the JSE Limited (JSE), in order to meet investor requirements and improve the bourse's international profile. These are discussed in the following paragraphs.

The Commodities Derivatives Division of the JSE expanded its product range in 2010 to include various new commodity contracts. Futures contracts on second-grade white and yellow maize were reintroduced in May 2010. The JSE launched the FTSE/JSE Equally Weighted Top 40 Index in July 2010 in which each share price has a weight of 2,5 per cent, unlike the Top 40 Index where the constituents are weighted according to market capitalisation. The Equity Derivatives Division also introduced futures and options on the FTSE/JSE Equally Weighted Top 40 Index (ETOP) and All-Share Index (BIGI), providing investors with an opportunity to trade and gain exposure to shares constituting the Top 40 and Alsi indices. The JSE introduced single-stock futures on precious metals-linked exchange-traded notes, which offer further investment access to mineral commodities.

New product listings on the interest rate derivatives market of the JSE, Yield-X, were introduced during the past eighteen months, as the currency, interest and index product ranges were broadened. In response to market demand and in an effort to enhance the available currency product offerings, Swiss franc/rand and US dollar/rand Maxi futures – aimed at enhancing trade on larger contracts – were included.

In August 2010 the JSE extended its licensing agreement with the CME Group to add cash-settled foreign-referenced copper and silver futures contracts, and options contracts on crude oil, platinum and gold futures, in order to provide investors with greater exposure to the international metals and oil market.

In February 2011 the JSE launched the Black Economic Empowerment (BEE) Board, offering a facility for BEE-compliant parties to list and trade BEE scheme shares. Only one BEE share scheme has thus far been listed in 2011. In February and March 2011 the Yield-X market continued to extend its currency segment in an effort to introduce more trading flexibility, by adding new Can-Do dollar/rand and Can-Do euro/rand futures and options contracts. Futures contracts on the R202, R210, R211 and R212 inflation-linked bonds were also added. Similarly, the new Inflation Linked Index (IGOV) Futures Contract was listed on Yield-X. In March 2011 the JSE converted the FTSE/JSE Resources 20 Index to the FTSE/JSE Resources 10 Index and the number of constituents was reduced from 20 to the 10 largest resources companies ranked by market capitalisation.

Pursuant to the amalgamation of the Bond Exchange of South Africa (BESA) and the JSE, it has been resolved that the two interest rate markets operated by the JSE, namely the Yield-X market and the BESA market, will be integrated in 2011. As a result, the old BESA BTB system was decommissioned and the reporting of bond transactions migrated onto the JSE Nutron platform on 9 May 2011. The rules and directives covering the integrated markets (Yield-X and BESA) known as the 'JSE Interest Rate and Currency (IRC) rules and directives' also came into effect on 9 May 2011, thus repealing the old rules and directives previously applicable to the BESA market.

Legislative and regulatory changes affecting financial markets announced in the Budget of the national government for fiscal 2011/12 included the following:

– Confirmation was given that any change in the classification of JSE-listed foreign companies would be forward-looking and not affect the current status of foreign companies listed on the JSE. This ended the speculation on classification of the existing dual-listed companies, which will continue to be treated as domestic companies despite their foreign domicile.
– The annual domestic interest and dividend income tax exemption threshold was raised from R22 300 to R22 800 for taxpayers under the age of 65, and from R32 000 to R33 000 for taxpayers aged 65 and over, effective from 1 March 2011.
– The transfer duty exemption threshold was raised from R500 000 to R600 000, effective from 1 March 2011.
– As from 1 March 2011, the tax-free lump sum benefit on retirement and involuntary retrenchments was increased from R300 000 to R315 000, while the capital gains exclusion for individuals and special trusts was increased from R17 500 to R20 000 annually.
– The secondary tax on companies will be replaced with a dividends tax from March 2012.
– The Minister of Finance outlined further steps to be taken to enhance the domestic regulatory framework and improve financial services, in line with global developments. The proposed reforms include a shift to a "twin peak" system of financial regulation, with market conduct assigned to the Financial Services Board (FSB) and prudential regulation to the South African Reserve Bank. An inter-agency financial stability oversight committee will be formed, as well as a Council of Financial Regulators. A policy discussion paper entitled "A safer financial sector to serve South Africa better" was released by the National Treasury in February 2011 and provides a range of proposals to strengthen South Africa's financial regulatory system.

Following the global financial crisis, the South African non-bank intermediaries sector has undergone considerable regulatory and structural reviews against the backdrop of the elevated importance of effective governance and prudential regulation. The main changes are outlined in the following paragraphs.

National Treasury released final amendments to Regulation 28 of the Pension Fund Act of 1956 (Act No. 24 of 1956), which prescribes investment limits for retirement funds. The broad aims of this regulatory reform are, among others, protecting pension savings and ensuring that funds are channelled in a way that supports economic development and growth; closing regulatory loopholes in the current asset allocation system; and reducing systemic risks that might emanate from unregulated areas such as hedge funds and private equity investments.

Under the revised regulation, a look-through principle will be applied to all pension fund assets – a fund should report the underlying assets backing its investment and not merely a linked structure, unless exempted by the regulation itself. When applying these rules, any direct or indirect exposure to foreign assets must be disclosed as such. Moreover, all retirement products, including retirement annuity funds, are required to be Regulation 28-compliant at both member and fund level. The FSB released draft notices that prescribe the conditions for securities-lending transactions, and for investment and disclosure of derivative instruments for pension funds in terms of Regulation 28.

In order to improve diversification across asset classes, the investment limit for bank, corporate- and public entity-issued debt was raised to 75 per cent of total value of the pension fund, while the maximum aggregate exposure to alternative asset classes (including hedge funds and private equity) was increased from 2,5 per cent of total assets to 15 per cent. The changes in the regulation apply from 1 July 2011.

The government announced that the National Health Insurance (NHI) system would require funding over and above the current revenues allocated for public health. The current funding options available to the National Treasury include phasing in a payroll tax (payable by employers), increasing VAT, and introducing a surcharge on individuals' taxable income. However, specific funding instruments will be tabled in the 2012 budget. It is expected that the NHI will be phased in over a period of 14 years.

In September 2010 the Government Employees Pension Fund (GEPF) released a new draft code for responsible investing by institutional investors for public comment. The purpose of the code is, together with other applicable governance standards such as the *King Report on Governance for South Africa 2009 (King III)*, to provide a voluntary framework that can be used to ensure that sound governance is practised. The code consists of four principles: the first two encourage institutional investors to formulate policies that will guide their approach to being responsible shareholders, while principles three and four require of them to ensure that policies are implemented, upheld and disclosed.

In order to improve operational efficiency and in line with best practice in the retirement funds industry, the administration component of the GEPF was separated from the fund as from March 2011. The newly formed administration, known as the 'Government Pensions Administration Agency (GPAA)', will fall under the Ministry of Finance, while the fund retained the name Government Employees Pension Fund and will continue to operate under a board of trustees.

The foreign-exchange limits for institutional investors were increased by 5 percentage points across the board in December 2010. Foreign investment allowances on collective investment schemes, investment managers and investment-linked policies of long-term insurers were increased to 35 per cent of total assets, while those of retirement funds and non-investment-linked policies of long-term insurers were increased to 25 per cent. The increase in the prudential limits is also a mechanism to accommodate the current holdings of inward-listed instruments without a domestic classification. Two important discussion papers, "Prudential Regulation of Foreign Exposure for South African Institutional Investors" and "A Review Framework for Cross-border Direct Investment in South Africa" have been released to stimulate debate on South Africa's desired investment environment.

The FSB released a roadmap document on the implementation of Solvency Assessment and Management (SAM), a prudential regulatory regime for long- and short-term insurers. It is based on the European risk-based Solvency II regime of capital-adequacy requirements, risk governance and disclosure. Its objectives include protecting policyholders and beneficiaries; aligning the capital requirements of insurers with underlying risks; developing a risk-based approach to the supervision of insurers; and maintaining overall financial stability. The regime is based on a three pillar structure, namely (i) quantitative requirements, (ii) qualitative assessment, and (iii) supervisory reporting and disclosure. The adoption of SAM by the South African insurance industry is expected to be in full progress by 1 January 2014.

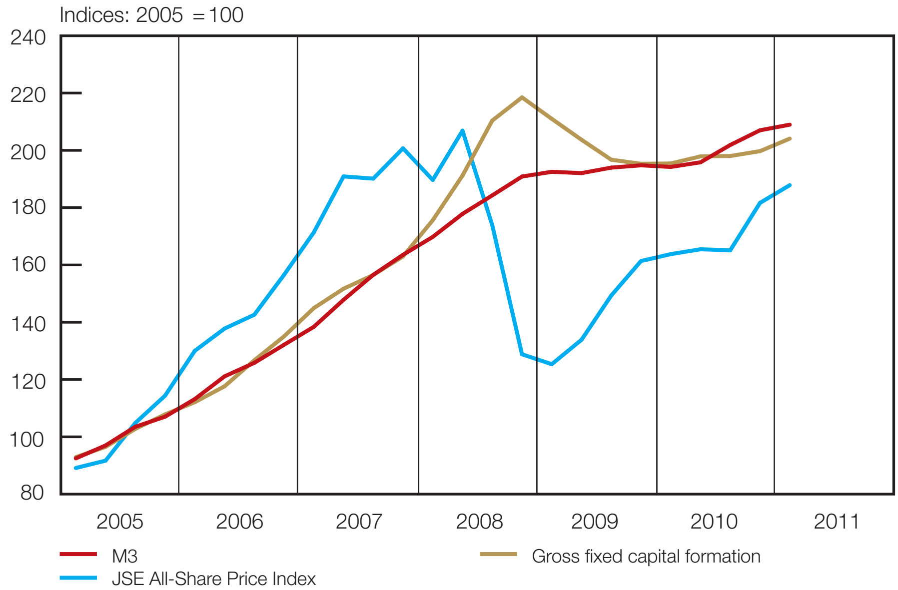
In strengthening market conduct oversight in the financial sector, the FSB released a roadmap document entitled Treating Customers Fairly (TCF) in South Africa. TCF is a regulatory approach that is meant to ensure that retail customers of financial products and services are protected and treated fairly through the product life cycle: from product design to marketing, advice, point-of-sale and after-sale stages. Some of the intermediate outcomes of TCF are improved customer confidence, ensuring supply of appropriate products and services; and enhancing transparency and discipline in the financial sector. The TCF initiative should also be in full operation from 1 January 2014.

The amendments to the Companies Act, 2008 (Act No. 71 of 2008) were finalised and implemented from 1 May 2011.

Money supply

The recovery in real economic activity from the second half of 2009, together with a recovery in selected financial markets provided some impetus for growth in the broadly defined money supply (M3) during 2010 and the early months of 2011. However, growth in money supply remained modest, possibly signalling the uneven and protracted nature of the recovery in real and financial economic activity. After reaching an all-time low of 0,5 per cent in February 2010, twelve-month growth in M3 accelerated to a recent high of 8,2 per cent in January 2011, but moderated shortly thereafter to 6,5 per cent in March and 6,0 per cent in April.

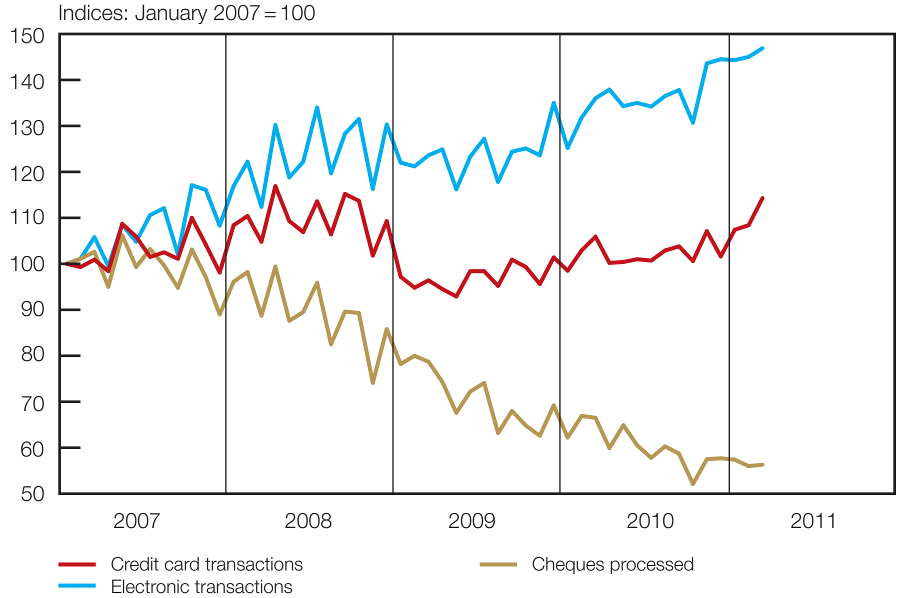
Money supply, capital formation and equity prices



The upward trend in money supply growth from around March 2010 was unevenly spread across the various deposit categories. Cheque and transmission deposits accelerated sharply during 2010, thereby recovering ahead of the other deposit categories. Growth in call and overnight deposits picked up somewhat later, followed by growth in the remaining short- and medium-term deposits. Most recently, long-term deposits increased at a slow pace amid a growing preference for short- and medium-term maturities, and comparatively higher returns offered by other financial asset classes. Notes and coin in circulation have remained subdued over the past two years, reflecting lower transactional demand for currency alongside lower inflation and the widespread use of alternative methods of payment.

While the role of cash remains important, electronic transactions far outweigh any other means of payment in terms of value. The value of credit card and electronic transactions rose in 2010 and the first part of 2011, exceeding the levels that prevailed before the downturn in economic activity in 2009. The value of cheques processed has continued to dwindle, influenced by risk reduction measures undertaken since 2002 to reduce settlement risk in the national payment system and the improved availability of electronic means whereby payment can be effected.

Value of transactions in various payment streams



Seasonally adjusted

The corporate sector was the main contributor to the increase in M3 deposits during the twelve months to April 2011, accounting for 85 per cent of the overall increase of R117,9 billion in money supply. After rebounding from close to zero growth rates in early 2010, twelve-month growth in the deposit holdings of the corporate sector improved significantly to 10,3 per cent in January 2011, before receding to 7,1 per cent in April. Within the corporate sector, deposits of financial companies outperformed those of non-financial companies during the period under review. Growth over twelve months in deposit holdings of the household sector remained relatively subdued and averaged around 2 per cent in 2010, down from 9 per cent in 2009, before improving moderately to growth rates in excess of 2 ½ per cent in the first four months of 2011.

As reflected in the accompanying table, the main statistical counterparts of the changes in M3 in the twelve months to April 2011 were rising claims on the private sector and an increase in net foreign assets. The increase in claims on the private sector could be attributed to increases in mortgage advances, other loans and advances and investments. Net foreign assets increased due to a combination of increasing assets and declining liabilities, coupled with valuation adjustments as the exchange value of the rand appreciated during the twelve months to April 2011. The rise in M3 was constrained by a decline in net claims on the government sector as government deposits with the banking sector increased.

The slow pace of money supply growth relative to growth in nominal gross domestic product led to a turnaround in the income velocity of circulation of M3. After remaining stagnant at record-low levels of 1,22 from the last quarter of 2008 through to the second quarter of 2009, the income velocity of circulation of M3 increased to 1,37 in the first quarter of 2011.

Statistical counterparts of change in M3

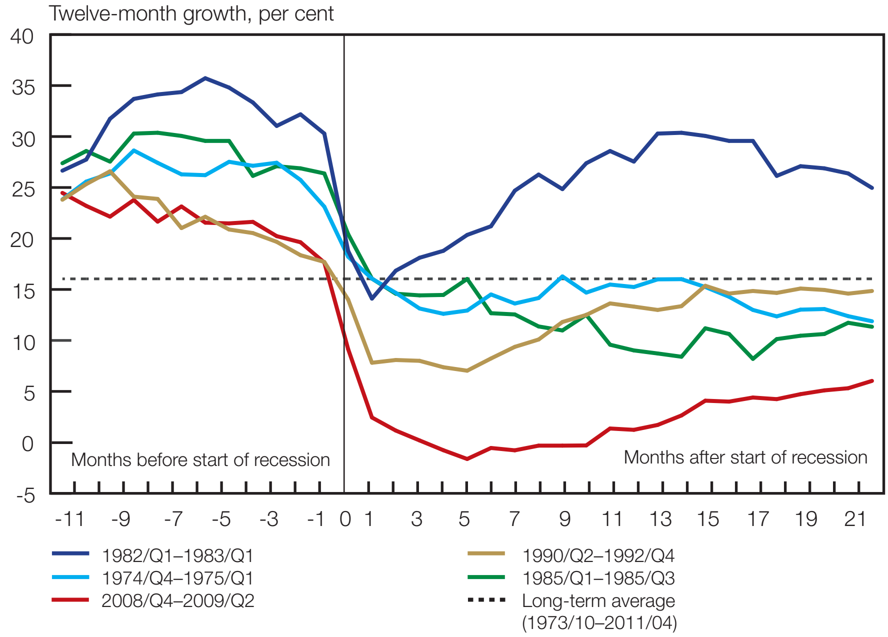
R billions

	Twelve months to:		
	June 2009	June 2010	April 2011
Net foreign assets	13,1	54,0	38,7
Net claims on the government sector	31,2	-4,3	-26,5
Claims on the private sector	82,1	18,0	123,1
Net other assets and liabilities	-15,8	-21,2	-17,4
Total change in M3	110,8	46,5	117,9

Credit extension

Banks' total loans and advances extended to the private sector first decelerated and then stagnated before progressing into a sustainable growth trend in the aftermath of South Africa's first recession in nearly two decades. Year-on-year growth in total loans and advances recovered gradually to levels slightly above 5 per cent from February 2011 – 21 months after the start of the contraction in domestic economic activity – and remained far below the growth rates encountered in any of the previous episodes. The current recovery in total loans and advances lagged similar recovery growth paths that prevailed after the previous five recessions recorded in the South African economy.

Historical trends in total loans and advances at times of recession



Although the severity of the current recession was not as intense as, for instance, the sharp fall in economic activity observed during the period 1982 to 1983, the subsequent contraction and slow recovery in credit extension was profoundly affected by record levels of household debt, weak labour market conditions and a fragile business environment. Greater caution in extending credit was also brought about by the National Credit Act, introduced in 2007. However, the combined effect of interest rates which were at 30-year lows, improved growth in real income, and the progressive easing of lending criteria of banks impacted positively on the growth in total loans and advances in the current recovery phase.

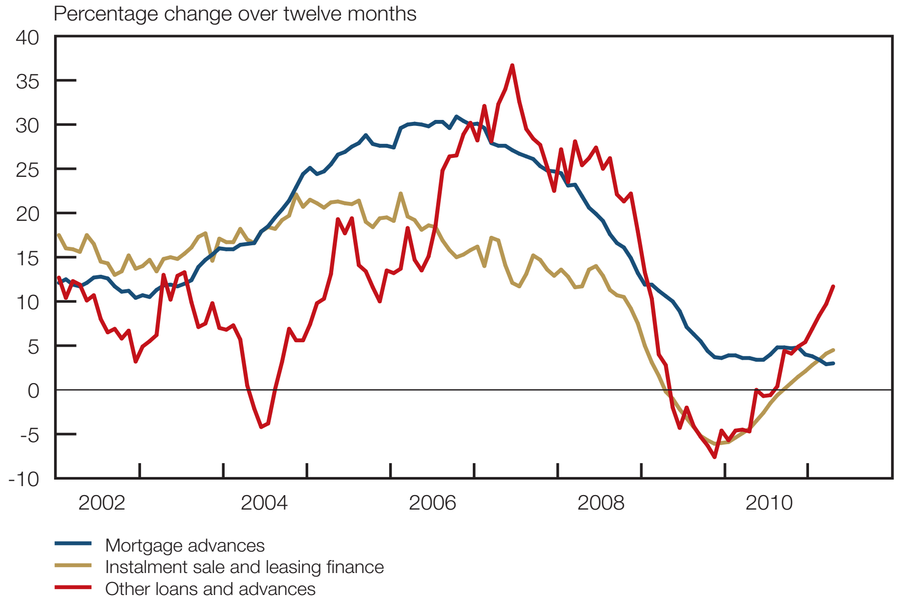
Credit aggregates: Outstanding balance

Components	April 2010 (R billions)	April 2011 (R billions)	Change (Per cent*)
Mortgage advances	1 018	1 048	3,0
Instalment sale credit and leasing finance	236	246	4,5
Of *which*: New passenger cars	66	75	14,4
Other passenger cars	67	74	10,3
Other assets financed	103	97	-5,8
Other loans and advances	620	692	11,7
Overdrafts	126	129	2,0
Credit card advances	56	58	3,9
General advances	438	505	15,4
Total loans and advances	1 873	1 986	6,0
Of *which*: To household sector	1 054	1 126	6,9
To corporate sector	820	860	4,9

* Percentage change calculated on full rand amounts

Mortgage advances, the only category that contributed positively to growth in total loans and advances throughout the economic downturn, lost its dominant role in the early stage of the economic recovery, alongside a weak property market. The year-on-year changes in mortgage advances showed weak but steady growth, averaging 4 per cent throughout 2010, and moderated somewhat to around 3 per cent in the first four months of 2011, well below the average of about 8 per cent recorded in 2009. Technical adjustments related to banks' acquisition of the home loan books of non-bank financial institutions, and the unbundling of a securitisation vehicle, boosted growth in mortgage advances during the second half of 2010.

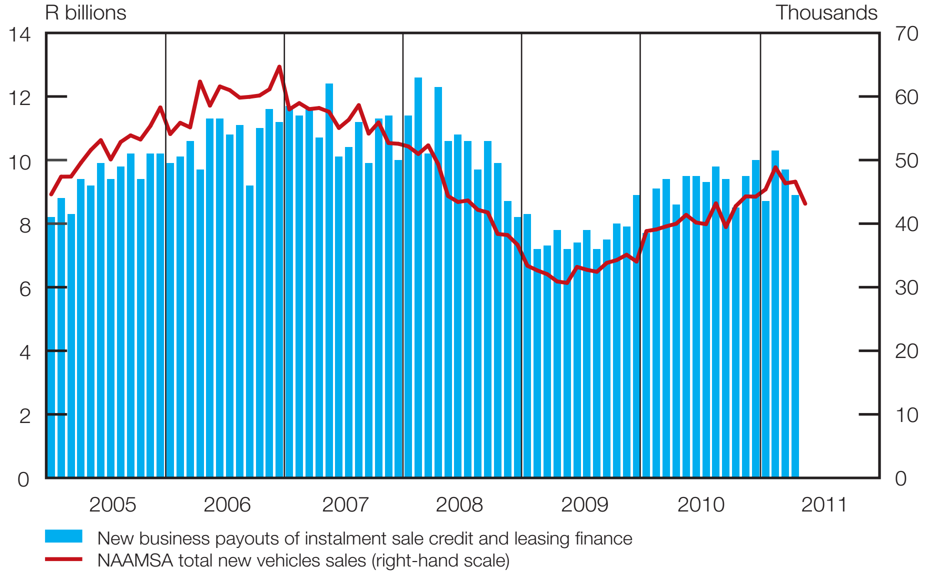
Bank loans to the private sector by type of credit



The *instalment sale credit and leasing finance* category went through an extended cyclical downward phase during and beyond the economic downturn before making a significant recovery towards the end of 2010. Twelve-month growth rebounded from a record low of minus 6,1 per cent in November 2009 and turned positive in September 2010, following 17 consecutive months of contraction, from where it accelerated at a steady pace to 4,5 per cent in April 2011.

The revival in this credit category was, to a large extent, the result of a robust improvement in vehicle sales following the lower debt-servicing costs, and the natural replacement cycle for vehicles, furniture and appliances.

Instalment sale credit and leasing finance, and vehicle sales

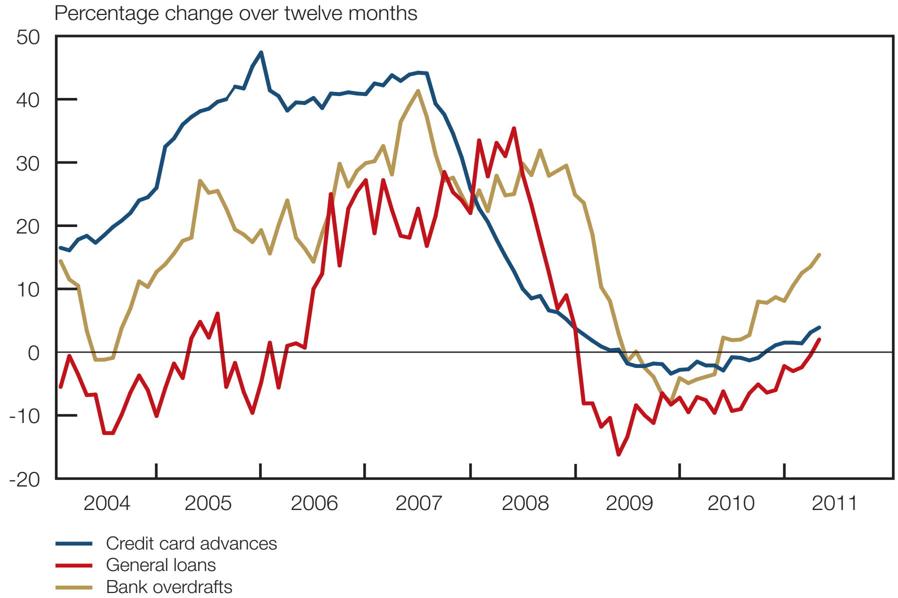


Seasonally adjusted

In 2010 hire-purchase contracts extended by finance companies displayed clear signs of contraction, in contrast with 2009 when their growth outpaced that of the banking sector. The year-on-year growth in hire-purchase contracts extended by finance companies decelerated significantly from 7,7 per cent in the second quarter of 2010 to negative growth rates in the last two quarters of 2010, while instalment sale credit and leasing finance by banks recovered significantly. The joint effect of improved marketing strategies by banks and the 100 basis point decrease in interest rates during the second half of 2010 probably contributed to reintermediation in favour of the banking sector.

The category for *other loans and advances*, which includes credit card advances, overdrafts and general loans and advances, was most severely affected by the downturn in domestic economic activity.

Other loans and advances to the private sector by type of credit



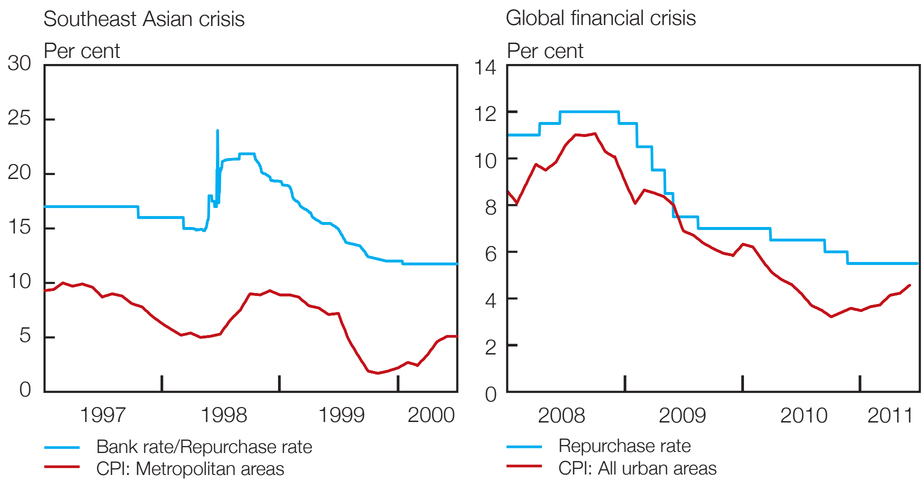
Following a severe deceleration, other loans and advances reached a lower turning point at the end of 2009 and started a modest recovery in the early months of 2010, which gained further traction in the period to April 2011. Among its subcategories, growth in other loans and advances continued to be underpinned by the use of general loans. Twelve-month growth in credit cards continued to improve at a modest pace, recording low single-digit growth rates in the first four months of 2011, while bank overdrafts recorded its first positive growth rate in over two years in April 2011.

The household sector dominated growth in banks' total loans and advances extended to the private sector during 2010, contributing R70,7 billion or 89,6 per cent to the overall increase in loans and advances. This was a significant improvement from the R29,3 billion increase recorded during the previous year. The corporate sector's use of bank loans and advances remained depressed for most of 2010, as companies continued to be wary of new capital expenditure in the current economic environment. Nevertheless, the earlier contractions in bank lending to the corporate sector slowly started to make way for renewed growth from the second half of 2010, albeit at muted levels. The turnaround in the inventory cycle to positive inventory investment from late 2010 should support corporate demand for credit.

Interest rates and yields

Against the backdrop of declining inflationary pressures and a large output gap, the Bank's MPC embarked on an easing cycle between December 2008 and November 2010, when it reduced the repurchase rate by a cumulative total of 650 basis points to 5,50 per cent. This brought nominal interest rates to 30-year lows and real money-market rates also to fairly low levels, consistent with the well-contained level of inflation and substantial surplus capacity in the economy. However, owing to the build-up of upside risks to the inflation outlook, mainly resulting from external cost–push factors such as the rising international oil price, the MPC decided to keep the repurchase rate unchanged at the first three meetings of 2011.

Policy rates and inflation during crisis periods

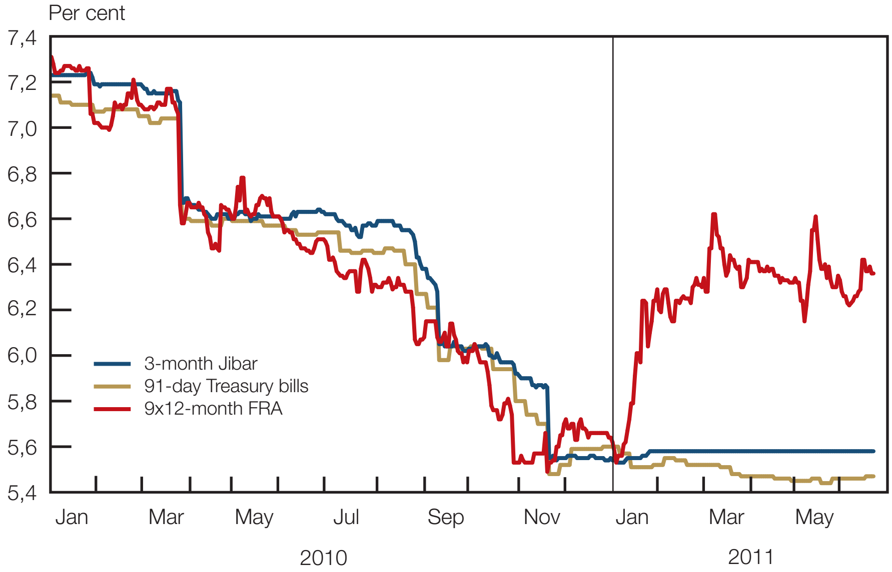


The broad direction of the monetary policy response to the after-effects of the recent global financial crisis did not differ substantially from the actions assumed in the aftermath of the Asian financial crisis during the previous decade. On both occasions the monetary authority reduced the policy rate aggressively to support the recovery in the domestic economy when conducive inflation outcomes prevailed. The one discernible difference pertains to the magnitude of the real policy rates.

Other money-market interest rates declined considerably and reached three-decade lows in the early months of 2011. The Johannesburg Interbank Agreed rate (Jibar) declined by a total of 700 basis points from a peak of 12,58 per cent at the beginning of June 2008 to 5,58 per cent on 23 June 2011, largely reflecting the 650 basis points reduction in the repurchase rate. However, the sharp downward trend in the Jibar was interrupted between June and August 2010 when it retreated by 45 basis points following mounting fiscal concerns pertaining to some countries in the euro area. The rate on 91-day Treasury bills also emulated the downward trend in the repurchase rate over the same period, and at the prevailing rate of 5,47 per cent in the fourth week of June 2011 it was at a 30-year low.

Rates on forward rate agreements (FRAs) have also generally followed a declining trend across the maturity spectrum since June 2008. The downward trend in these forward-looking rates reversed abruptly in early 2011, when inflation concerns started to accumulate alongside a sharp rise in international oil prices. At current levels, the FRA market is reflecting strong expectations that interest rates will start to rise towards the latter part of 2011.

Money-market rates



The domestic overnight interbank market was largely unaffected by the most recent episodes of turbulence in the global money markets during 2010 and early months of 2011. Both the South African Benchmark Overnight Rate on deposits (Sabor) and the implied rate on one-day rand funding in the foreign-exchange market (overnight FX rate) displayed limited volatility and fluctuated well within the standing facility limits, which were widened by 50 basis points to 100 basis points below and above the prevailing repurchase rate at the end of August 2010. On 23 June 2011, the Sabor and overnight FX rate were 334 basis points and 366 basis points below the levels that existed on 27 March 2007 when these benchmark overnight interbank rates were introduced.

The prime overdraft rate and the predominant rate on mortgage loans moved in tandem with the repurchase rate and have remained unchanged at 9,00 per cent since November 2010.

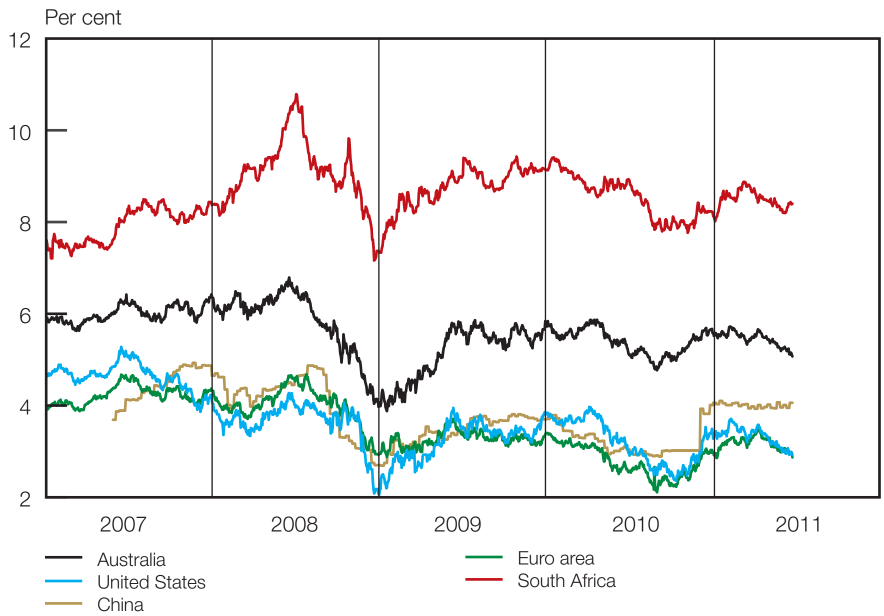
Interest rates on the 2- and 3-year *RSA government fixed-rate retail bonds* last increased in July 2009, after which they declined by 200 basis points to June 2011, while the interest rate on the 5-year bond last increased in July 2008, before declining by 325 basis points to June 2011. Interest rates on the 3-, 5- and 10-year *RSA government inflation-linked retail bonds* declined by 50 basis points over the past twelve months, tracking the movements of the government yield curve.[3]

3 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.

The daily average *yield on the R208 government bond* (maturing in 2021) declined from 8,98 per cent on 7 May 2010 to a recent low of 7,77 per cent on 5 November, following the release of better-than-expected consumer inflation data, the appreciation in the exchange value of the rand, the reduction in the repurchase rate and the firm demand for local bonds by non-residents. Subsequently, the bond yield increased to 8,88 per cent on 9 March 2011, following the political unrest in the MENA region, before fluctuating lower to 8,40 per cent on 23 June in response mainly to the appreciation in the exchange value of the rand. International bond yields similarly trended higher from late 2010 before receding somewhat in recent months. Given the movements in the domestic bond yield, the *currency risk premium* on South African government bonds[4] widened from 321 basis points in December 2010 to 369 basis points in May 2011, as the yield on the dollar-denominated bond decreased while the yield on the domestic rand-denominated bond increased.

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

Ten-year local currency government bond yields



The *yield gap*[5] narrowed from 276 basis points on 7 May 2010 to 217 basis points on 5 November, as the short end of the yield curve declined less pronouncedly than the medium to long end of the curve. Subsequently, the yield gap widened to 375 basis points on 8 March 2011, as the short end continued lower along with the decline in the repurchase rate, while the medium to long end of the yield curve increased as a result of, among other things, inflation concerns that emanated from rising oil and food prices. However, from the end of March the medium to long end of the yield curve moved downwards as bond yields declined, following mainly the appreciation in the exchange value of the rand, giving rise to a narrower yield gap of 349 basis points on 23 June.

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

After declining from around the 6,0 per cent level to the 5,0 per cent level in November 2010, *break-even inflation rates* across short- and long-term maturities fluctuated higher in line with the increase in nominal yields, while real yields remained broadly on the same level. Break-even inflation within the two-year maturity range, however, increased less pronouncedly to the beginning of February after which it fluctuated lower to 23 June. The longer-term break-even inflation rate in the 12–15 year maturity range soared to the middle of March 2011, after which it also declined to 23 June, although remaining on higher levels when compared with the short-term break-even inflation rate.

The JPMorgan Emerging Markets Bond Index Plus (EMBI+)[6] spread narrowed from a recent high of 337 basis points in June 2010 to 245 basis points in October, before widening to 288 basis points in May 2011, as risk aversion towards emerging markets' assets increased. Similarly, the *sovereign risk premium* on the South African government US dollar-denominated bonds in the eleven-year maturity range trading in international markets narrowed from a high of 216 basis points in May 2010 to 147 basis points in October, before increasing to 169 basis points in March 2011. Subsequently, the sovereign risk premium reverted to 147 basis points in May.

6 EMBI+ measures total returns on US dollar-denominated debt instruments of emerging markets.

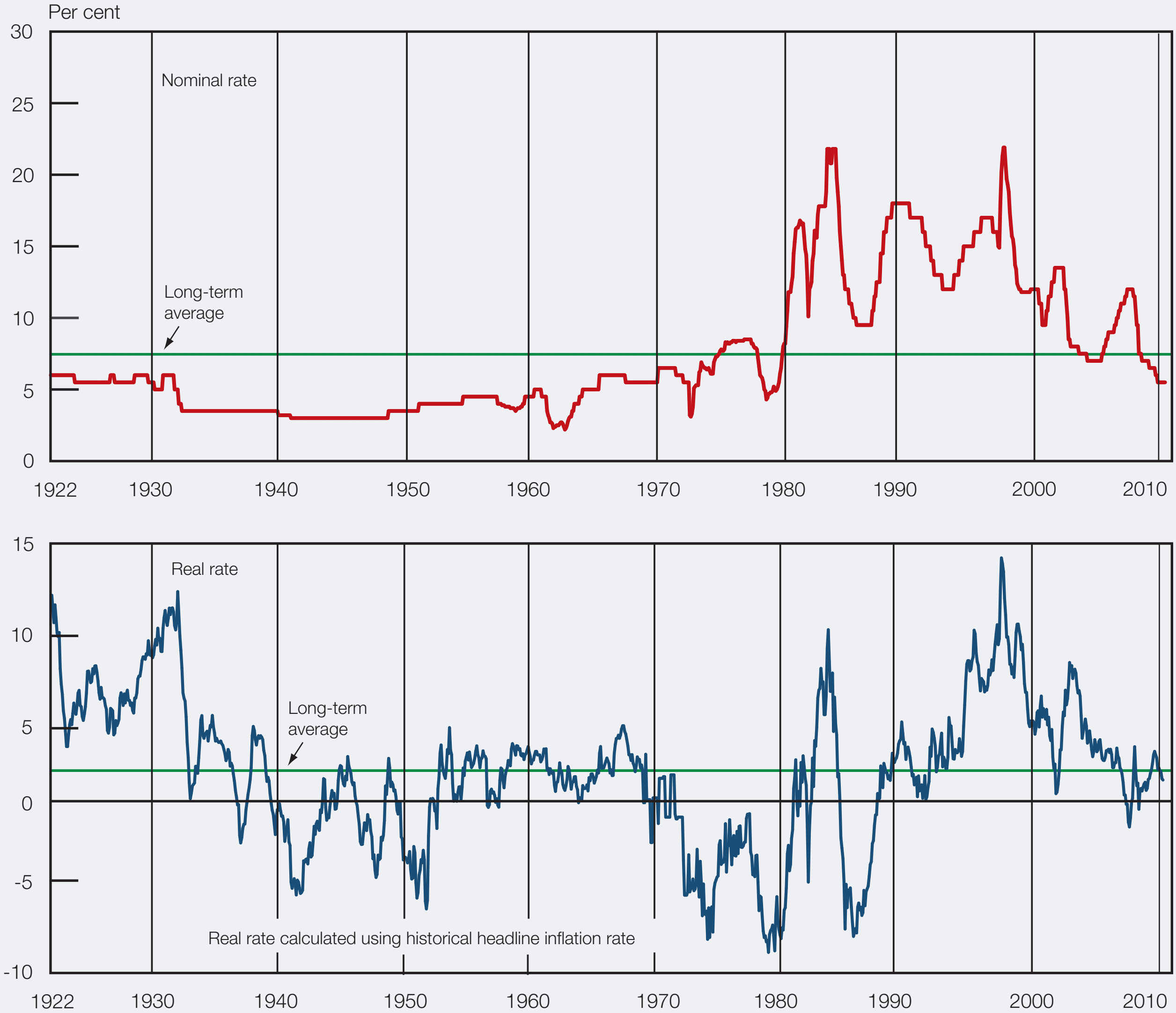
Box 7: The Bank's policy interest rate

During the first decade after the South African Reserve Bank opened for business, real interest rates were quite high on account of the deflation which was recorded at the time.

Policy-makers' degrees of freedom were more constrained and interest rates were generally less volatile and lower during the period before the collapse of the Bretton Woods system in 1971. The higher inflation of the 1970s and 1980s brought about higher and more volatile nominal interest rates. In 1998 money-market interest rates also reached exceptionally high levels in the wake of the Southeast Asian crisis.

Since 2000, when formal inflation targeting was introduced, interest rates have been less volatile and lower than in the preceding two decades.

South African Reserve Bank's key policy interest rate*



* Since 1998 the repurchase rate, previously Bank rate or discount rate used in extending accommodation to the banking system

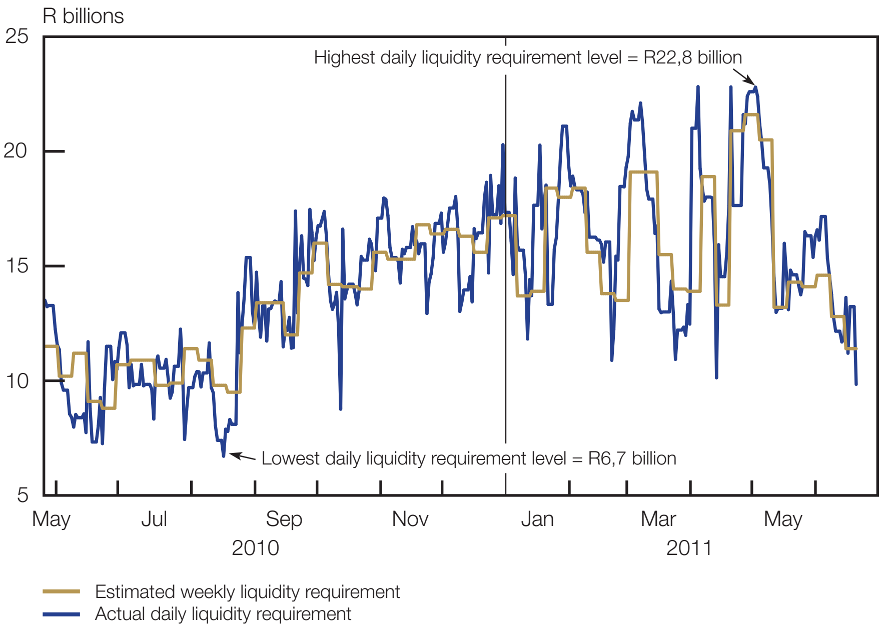
Money market

A number of changes to the monetary policy operational procedures of the Bank were implemented from the end of August 2010. These 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 discontinuation of announcing the estimated ranges of the weekly liquidity requirement; and the widening of the spread between the rates for standing facilities and the repurchase rate from 50 basis points to 100 basis points below and above the prevailing repurchase rate. The SAMOS penalty facility was also abolished from August 2010, in favour of an automated end-of-day square-off process at prevailing standing facility rates. Over and above these changes, the Bank also phased out the use of Category 2 assets[7] as eligible collateral in its refinancing operations with effect from 1 March 2011.

7 Category 2 assets include assets and financial instruments that form part of the All-Bond Index (Albi), and are issued and underwritten by parastatals or public corporations.

The money-market liquidity requirement, which had remained relatively low before the modification of the monetary policy operational procedures in August 2010, responded to the changes with fluctuations in the liquidity requirement of the private-sector banks spanning a broad range of R6,7 billion to R22,8 billion between July 2010 and May 2011. Narrower ranges of R2,6 billion to R12,6 billion, and R6,6 billion to R15,5 billion were registered for the 2009/10 and 2008/09 periods respectively, with the more modest oscillations having occurred in the latter period at the height of the recession. Liquidity provided by the Bank at the weekly main refinancing auctions varied between R9,6 billion and R22,8 billion between July 2010 and May 2011.

Actual versus expected liquidity requirement



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 –)

	2010		2011
	Jan–Jun	Jul–Dec	Jan–May
Notes and coin in circulation	4,1	-8,8	3,3
Required cash reserve deposits	-2,0	-1,5	-2,1
Money-market effect of SARB* foreign-exchange transactions	18,1	6,0	54,7
Government deposits with the SARB	-28,3	0,3	-27,1
Use of liquidity management instruments	-9,1	0,8	-6,7
Reverse repurchase transactions	3,6	-3,1	-0,9
SARB debentures	-12,7	3,9	-5,8
Other items net	13,6	-3,9	-18,4
Banks' liquidity requirement (decrease + increase –)	-3,6	-7,1	3,7

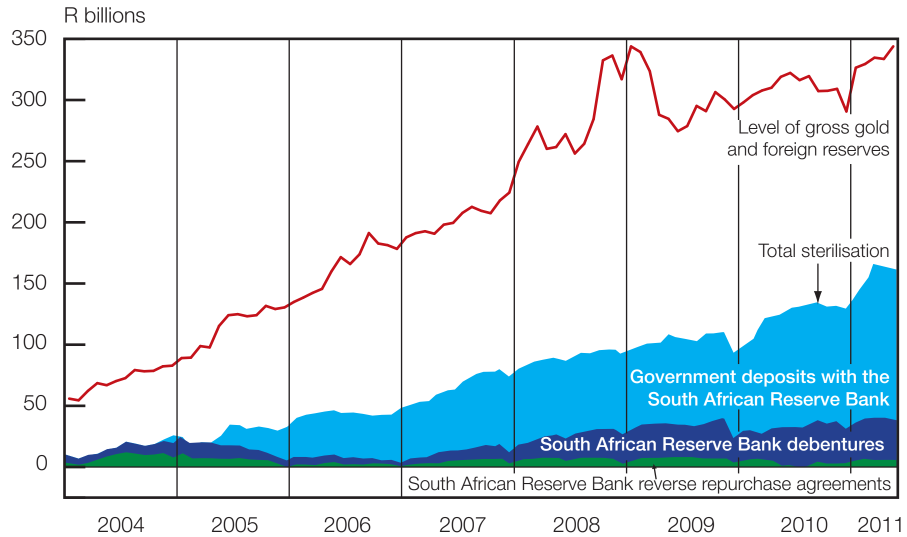
* SARB: South African Reserve Bank

In the eleven months to May 2011, notes and coin in circulation and required cash reserve deposits drained liquidity to the amount of R9,1 billion from the money market. This liquidity drainage was in conjunction with a R26,8 billion increase in government deposits with the Bank, and the use of liquidity management instruments to the value of R5,9 billion. These transactions were mainly neutralised by a sizeable injection of R60,7 billion worth of liquidity, resulting from the purchase of foreign currency by the Bank for reserve-accumulation purposes during periods when rand exchange rate developments favoured such action.

The Bank moderately stepped up its use of liquidity-draining operations from the fourth quarter of 2008, when high levels of liquidity were experienced in the money market. These operations were kept almost unchanged during the recessionary period before increasing from early 2010. Government deposits with the Bank, in particular, increased considerably from levels of around R70 billion at the end of 2009 to a high of R126 billion at the end of March 2011. These deposits largely moderated liquidity injected into the money market, emanating from foreign-exchange transactions by the Bank. The balance on government deposits with the Bank contracted somewhat to R125 billion at the end of May 2011.

The capital redemption and coupon interest payments on various government bonds amounted to R39,0 billion for the period January 2010 to May 2011, with only R0,6 billion of this amount having accrued to the Bank as income.

Level of gross reserves and sterilisation balances



Bond market

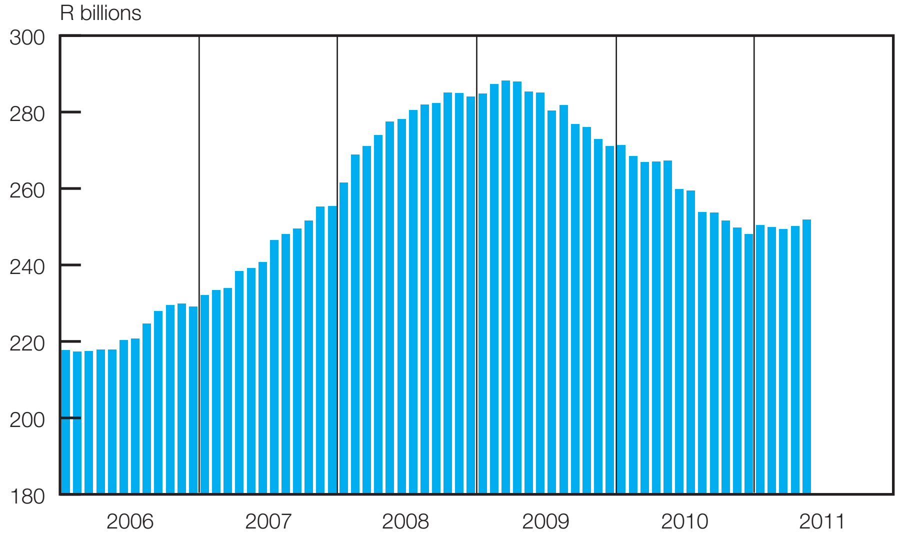
Net issues of fixed-interest securities in the *primary bond market* amounted to R189,7 billion in 2010 compared with R138,3 billion recorded in 2009, while in the first five months of 2011 net issues amounted to R84,8 billion. Of this amount, the public sector was responsible for the bulk of the net issuance at R67,5 billion in the five months to May 2011, dominated by national government issuance. A third municipality utilised the bond market for the first time in July 2010, contributing to total net issues by local governments of R1,8 billion in 2010 and R1,7 billion thus far in 2011. Funds raised by National Treasury in the retail bond market increased from R3,2 billion in 2009 to R4,9 billion in 2010 and amounted to R1,1 billion in the four months to April 2011.

After an absence of four years, public corporations raised R17,7 billion in *international bond markets* during 2011 to assist with the funding of spending on infrastructure. National Treasury continued with its yearly issuance of the past two years, raising R5,2 billion through the issuance of a US$750 million 30-year bond in March 2011.

Although securitisation issuance remained subdued, the improvement of financial market conditions was observed as net issues by the *private sector* nearly doubled from R14,9 billion in 2010 as a whole to R26,9 billion in the first five months of 2011. Even though funding activity was largely driven by banks, which registered net issues of R20,0 billion thus far in 2011, net issues by private companies also picked up. Activity in *commercial paper* remained subdued in 2011 with net redemptions of R9,6 billion in the five months to May, compared with net redemptions of R3,7 billion in 2010.

The outstanding balance of rand-denominated bonds issued in the *European and Japanese Uridashi bond markets* declined from a high of R288 billion in March 2009 to R248 billion in December 2010, before moving slightly higher to R252 billion in May 2011. This uptick followed as issuance activity in the European bond markets picked up in 2011 with net issues of R5,5 billion in the five months to May, compared with net redemptions of R0,2 billion in the corresponding period of 2010 and R14,4 billion in 2010 as a whole. However, rand-denominated bond issuance in the Japanese Uridashi bond market waned, possibly in part as a result of the downgrade of Japan's sovereign debt credit rating and revision of the outlook for the country by rating agencies in the aftermath of the natural disasters. Nominal issuance of R4,3 billion was registered in the first five months of 2011, compared with issues of R8,6 billion in the same period of 2010, contributing to net redemptions of R1,6 billion thus far in 2011.

Outstanding balance of rand-denominated bonds issued in the European and Uridashi bond markets



Amid volatile bond yields, trading activity in the *secondary bond market* continued strongly in 2011, after recording an increase of 25 per cent in 2010, when compared with 2009. Turnover of R8,9 trillion in the five months to May 2011 was some 40 per cent higher than the value traded in the same period of 2010, while the daily average turnover increased gradually from R63,0 billion per day in 2009 to R73,7 billion in 2010 and further to R87,6 billion thus far in 2011. This filtered through to the steady increase in bond market liquidity from a ratio of 14 in 2009 to 15 in 2010 and further to an annualised ratio of 16 in the first five months of 2011. As shown in the accompanying table, the R157 government bond is the most liquid government bond followed by the R206 bond, reflecting high liquidity in the shorter- to medium-term maturity range.

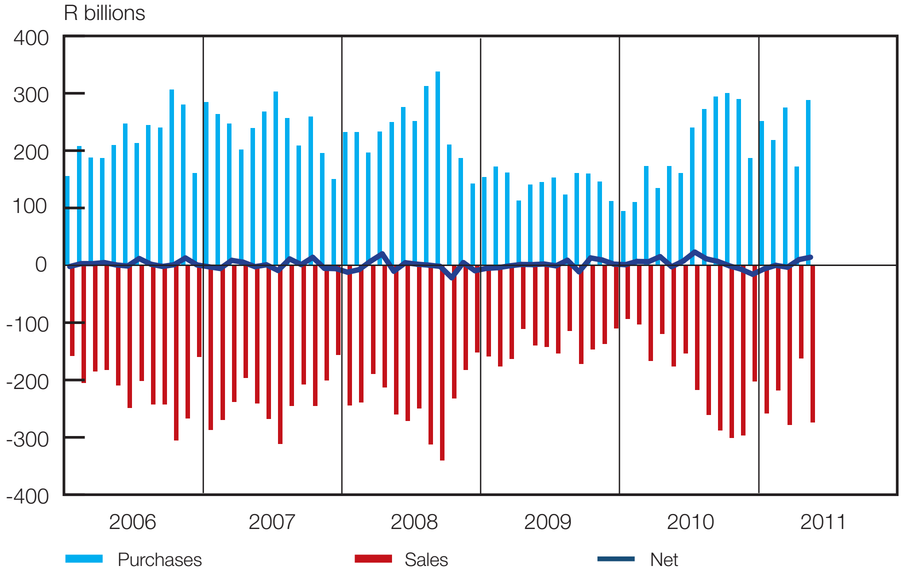
Liquidity ratios of listed nominal* government bonds

	2010	January–May 2011
R157 (2014/15/16)	74	90
R206 (2014)	54	50
R186 (2025/26/27)	30	26
R209 (2036)	27	30
R204 (2018)	20	22
R203 (2017)	20	22
R208 (2021)	20	27
R207 (2020)	17	18
R201 (2014)	16	17
R155 (2011)	15	1
R214 (2041)	12	24
R213 (2031)	10	19

* Inflation-linked government bonds are generally not very liquid
Data for January–May 2011 are annualised

Non-residents' net acquisition of domestic-listed debt securities amounted to an all-time high of R52,0 billion in 2010, as they sought to benefit from high local bond yields. After attracting strong net inflows until September 2010, the domestic bond market waned as non-residents' sales exceeded their purchases from October 2010. They registered net sales of bonds to the value of R32,9 billion during the six months to March 2011. Non-residents' sell-off of local debt securities followed a strong bout of profit-taking, at the same time that geopolitical unrest in the MENA region impacted on investor perceptions of emerging-market securities. This changed in April and May 2011 as non-residents returned to being net purchasers of locally listed bonds to the value of R24,0 billion. Non-residents' trading activity, measured as their purchases and sales as a percentage of the total purchases and sales of bonds on the JSE, averaged 13 per cent during the first five months of 2011 and 2010. In general, their gross purchases and sales dwarfed their net transactions, as may be expected.

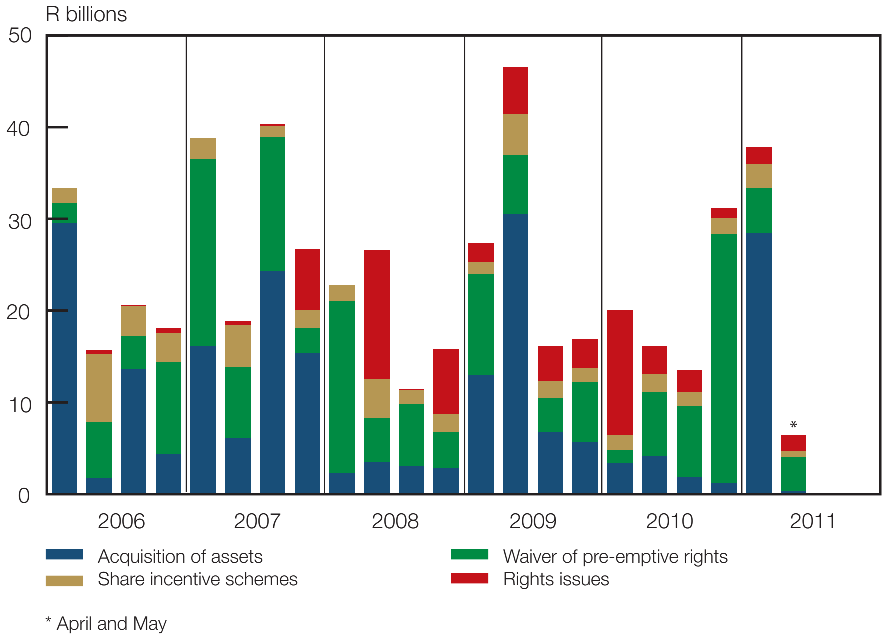
Non-resident transactions in the domestic secondary bond market



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 R80,9 billion in 2010, which was 24 per cent lower than the amount raised in 2009. Equity funding reached a recent high of R24,3 billion in December 2010 whereafter it decreased gradually in 2011, possibly on account of uncertainties regarding the global economic recovery, together with the recent political unrest in the MENA region. The R44,3 billion raised in the five months to May 2011 was, however, still 48 per cent higher than the equity funding in the matching period of 2010. Companies with primary listings on the JSE contributed 53 per cent of the total capital-raising activity in 2009. This contribution then increased to 72 per cent in 2010 and further to 76 per cent in the first five months of 2011. Over this period, capital was mainly raised through the acquisition of assets, accounting for 65 per cent of total equity funding, followed by capital raised through waiver of pre-emptive rights at 19 per cent.

Equity capital raised by method



The total *number of companies listed* on all boards of the JSE decreased from 410 in December 2009 to 407 in December 2010 and further to 406 in May 2011, as delistings exceeded new listings. The listings breakdown across the different boards is shown in the accompanying table.

Listings breakdown on the JSE Limited, January to May 2011

	Alt^X	Venture and Development Capital boards	Main board	Africa board	Total
New listings	1	0	3	0	4
Transfers (in)	2	0	0	0	2
Delistings	0	1	4	0	5
Transfers (out)	0	1	1	0	2
Total (May 2011)	71	7	326	2	406

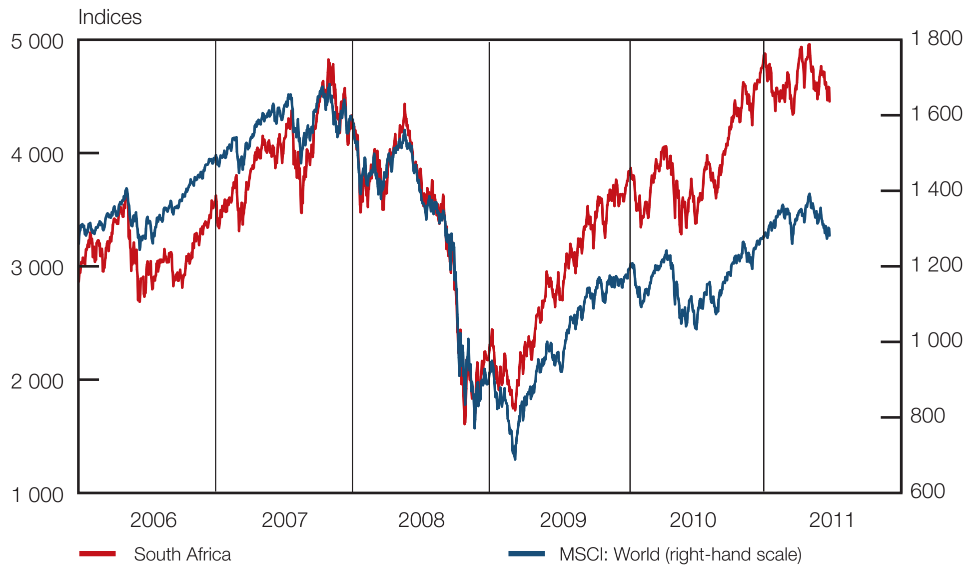
As expected, volatility in the share market subsided after the financial crisis, with higher share prices contributing to an increase of 7 per cent in total *turnover* on the JSE from R2,8 trillion in 2009 to R3,0 trillion in 2010. In the first five months of 2011 turnover amounted to R1,3 trillion or a monthly average of R262 billion, representing an increase of 5 per cent over the average turnover per month in 2010. The total market capitalisation of the JSE reached a high of R6,9 trillion in May 2011, amplified by elevated share prices. After recording high market liquidity[8] of 72 per cent in 2008, liquidity declined to an average level of 46 per cent from 2009 to May 2011.

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

After registering net purchases of R17,0 billion worth of domestic shares in the last half of 2010, *non-residents* reduced their holdings of local shares by R3,1 billion in the first quarter of 2011, as negative developments in the euro area and the MENA region continued to weigh on the domestic market. Purchases by non-residents of South African-listed shares were higher than sales in April 2011, with net purchases of R6,0 billion, before reverting to net sales of R0,6 billion in May. Non-residents' participation rate, measured as their purchases and sales as a percentage of the total value of shares traded on the JSE, averaged 16 per cent during 2010 and the first five months of 2011.

Since 3 March 2009, share prices have trended higher with the *FTSE/JSE All-Share Price Index* (Alsi) gaining 63 per cent to 15 April 2010, in line with higher commodity prices and improved global equity markets. Nervousness and volatility in share markets were evident in February 2010 and again from May to August 2010 as a result of the European sovereign debt problems, resulting in a decline of 12 per cent in the Alsi to 1 July. Renewed interest in shares took the Alsi higher by 27 per cent to 14 February 2011, before the upward momentum was again interrupted by the negative influence of political unrest in the MENA region and the natural disasters that struck Japan, causing instability in financial markets. The Alsi declined by 8 per cent to an index value of 30 327 on 23 June, as commodity prices also impacted on share prices. In US dollar terms, the Alsi increased by 32 per cent from 1 July 2010 to 23 June 2011, outperforming the Morgan Stanley Capital International (MSCI) World Index, which rose by 24 per cent over the same period.

Share prices in US dollar



The higher level of share prices contributed to the decrease in the *dividend yield* on all classes of shares from an average level of 3,3 per cent in 2009 to 2,2 per cent in 2010. Thereafter, the yield increased to 2,4 per cent in the first five months of 2011, as the increase in dividends declared surpassed the increase in share prices. Similarly, the average *earnings yield* declined from 8,4 per cent to 5,6 per cent, before edging higher to 6,1 per cent over the same period. The *price-earnings ratio*, as an inverse of the earnings yield, increased from an average of 12,8 in 2009 to 18,1 in 2010, before declining to 16,5 in May 2011.

Market for exchange-traded derivatives

The South African economy continued to show signs of recovery in the aftermath of the global financial crisis and recession, along with improvements in the domestic equity market. Consequently, *turnover on the Equity Derivatives Division* of the JSE increased in 2010, aligned with a decline in the South African Volatility Index, which implied optimism among investors regarding the performance in the underlying equity market. However, to some extent, gains in the equity market in 2011 were held back by the geopolitical tension in the MENA region and the continued effects of the debt crisis in the euro area. Although the total number of equity derivatives trades decreased by 10 per cent in the five months to May 2011, when compared with the same period of 2010, turnover was boosted by the upward bias in the underlying share market. Turnover in equity index futures and options contracts accounted for 94 per cent of total turnover in the first five months of 2011.

Domestic agricultural commodity prices followed Brent crude oil prices and international commodity prices higher in 2010, aggravated by global projections of lower supply and higher demand for commodities. Together with a 12 per cent increase in *trading activity in commodities* on the Commodities Derivatives Division of the JSE, turnover displayed an upward trend in 2010. The upward bias continued in the five months to May 2011, as the number of commodity derivatives contracts traded increased by 17 per cent compared with the corresponding period of 2010. Trade in maize contracts contributed to the bulk of activity, accounting for 56 per cent of the total number of contracts traded in the first five months of 2011.

Trading activity on the JSE's *Yield-X* market remained buoyant in 2010, marginally lower than the level recorded in 2009, contributing to record-high annual turnover in 2010. Currency futures and options contracts continued to perform well and accounted for 90 per cent of the total number of contracts traded in the first five months of 2011, tracking developments in the foreign-exchange market.

Alongside the downward trend exhibited by the number of *warrants* listed on the warrants market in 2010 and early 2011, demand for instruments in this market was subdued, despite the bullish underlying equities market over the same period. Trading activity was 40 per cent lower in the first five months of 2011, compared with the corresponding period of 2010. The number of warrants traded over constituents in the resources sector dominated trade at 74 per cent of the total number of warrants traded in the five months to May 2011. Turnover in all derivatives traded on the JSE during 2010 and the first five months of 2011 are indicated in the accompanying table.

Turnover in exchange-traded derivatives

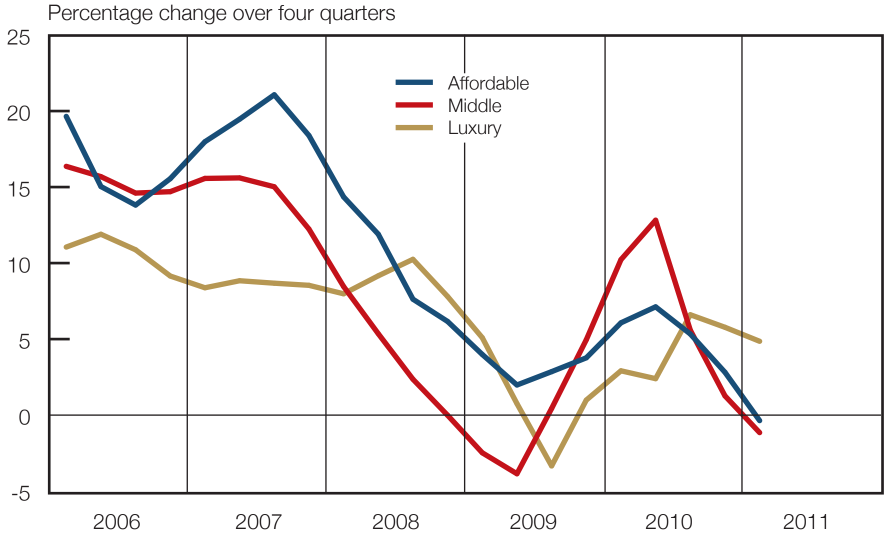
	Value		Change over one year	
	2010 (R billions)	Jan–May 2011 (R billions)	2010 (Per cent)	Jan–May 2011 (Per cent)
Equity futures and options on futures	3 645	1 501	15	9
Equity index	3 360	1 407	16	11
Single stock	285	94	12	-14
Dividend	1	0,3	63	14
Warrants	2	0,4	-47	-45
Commodity futures and options	228	122	-2	57
Maize	138	66	-11	39
Wheat	54	26	15	35
Interest rate derivatives	298	130	84	60
Currency	49	33	-22	98
Interest rate	68	47	33	59
Index	182	50	276	43

Real-estate market

Consistent with poor employment conditions and levels of consumer debt that remained high despite the low interest rate environment, the lacklustre performance of the domestic residential property market continued into the early months of 2011. Residential property demand remained subdued relative to supply, and some forced sales of property continued as cash-strapped households and property developers ran out of alternative options. More recently, the local residential property market experienced an element of support arising from first-time home buyers as job creation was resumed. This slowed, and in some areas reversed, the downward bias in house prices.

An analysis by price category indicates that the year-on-year rate of change in residential property prices in the luxury market segment, as measured by Absa, switched from a decline of 3,3 per cent in the third quarter of 2009 to an increase of 6,6 per cent in the third quarter of 2010, before slowing to 4,9 per cent in the first quarter of 2011. By contrast, the year-on-year rate of change in property prices in the middle segment rebounded from a negative 3,9 per cent in the second quarter of 2009 to a positive 12,8 per cent in the second quarter of 2010, before slowing again to a negative 1,2 per cent in the first quarter of 2011. The corresponding rate of change for house prices in the affordable segment displayed trends that were similar to those in the middle segment, though less pronouncedly. Steep increases in municipal rates and taxes impacted on the full cost of homeownership, acting as a brake on house prices.

House prices for different segments of the market



Source: Absa

Other measures of house prices, however, recently gave somewhat less subdued readings. After a steady downward trend, slowing from 10,8 per cent in May 2010 to 1,2 per cent in February 2011, the year-on-year rate of increase of the First National Bank average house price firmed to 2,1 per cent in May. Standard Bank's median house price improved from a year-on-year rate of change of 1,5 per cent in February 2011 to 3,3 per cent in May.

Non-bank financial intermediaries

Characterised by a continual rise in the prices of financial assets and a steady growth in cash inflows[9], the balance sheets of non-bank financial institutions[10] expanded by 14 per cent from December 2009 to R4,3 trillion in December 2010. The total asset holdings of these intermediaries stood at R4,4 trillion in the first quarter of 2011.

The growth in assets was more pronounced in the holdings of ordinary shares, which increased from 47 per cent of total assets in 2009 to 50 per cent in 2010. Increases in this asset class reflect improved investor sentiment and revaluation effects. Ordinary share holdings remained almost the same in the first quarter of 2011 at 49 per cent of total assets.

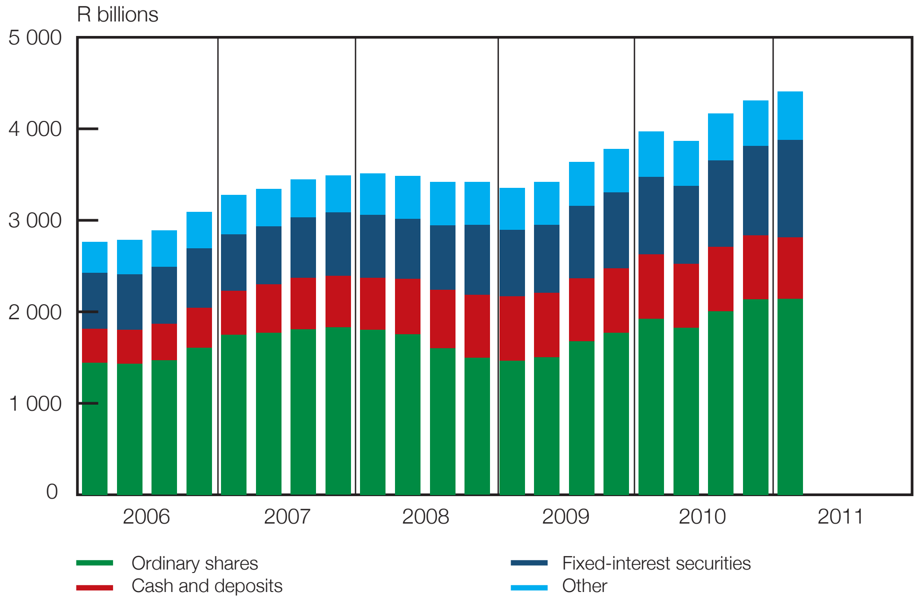
Holdings of fixed-interest securities by non-bank financial intermediaries rose at a subdued pace. The proportion of funds allocated to this asset class increased from 22 per cent in 2009 to 23 per cent of total assets in 2010, and further to 24 per cent in the first quarter of 2011. These institutions have recently increased their exposure to securities issued by public corporations, alongside increases in the liquidity of such instruments and state guarantees offered on some of them. Holdings of bonds issued by state-owned enterprises increased slightly in 2010, while government bond holdings fell back over the same period.

9 Measured as the sum of domestic current income surplus of insurers and pension and provident funds, and net sales of units by unit trusts. The domestic current income surplus is calculated as investment income plus the net current receipts and expenditure.

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

Investment in cash and cash equivalents as a percentage of total assets has been on a declining trend since the second quarter of 2009, consistent with a rebound in investor risk appetite due to favourable equity market conditions. Exposure to this asset class fell from 19 per cent of the balance sheet in the final quarter of 2009 to 15 per cent in the first quarter of 2011.

Total assets of selected non-bank financial institutions



Public finance

Fiscal policy

Following in the wake of the global financial crisis and mindful of the subdued economic activity and elevated levels of unemployment in South Africa, each of the three national budgets from 2009/10 has been expansionary. In 2009/10 and 2010/11 this fitted in very well with the need for strong capital spending in preparation for the 2010 FIFA World Cup™ tournament.

The Minister of Finance tabled the Budget for 2011/12 before Parliament on 23 February 2011. The Budget sought to step up government activities that made a difference to the lives and prospects of all South Africans, and allocate funds required for implementing the New Growth Path. The Budget was also aimed at maintaining macroeconomic stability, and at supporting enterprise and job creation.

It was noted that there were encouraging signs of a stronger recovery in the global economy at the beginning of 2011. On the domestic front, it was projected that improved household consumption and accelerating investment spending would support increased economic growth over the medium term. Growth in real gross domestic product was projected to reach 3,4 per cent in 2011, 4,1 per cent in 2012 and 4,4 per cent in 2013, hence a recovery in investment would be an important determinant of future growth.

Fiscal and monetary policy would continue to work in partnership, with the latter focusing on controlling inflation, whereas fiscal policy would continue to be countercyclical within a sustainable long-term framework. Government would continue to assist the Bank in the accumulation of foreign-exchange reserves when market conditions were favourable and engage in foreign currency swaps to moderate the effect of capital flows on the exchange rate. The Minister announced steps to enhance the regulatory framework and improve financial services, including a shift to a twin peak system of financial regulation which would culminate in the formation of an inter-agency financial stability oversight committee and a Council of Financial Regulators.

The countercyclical fiscal surpluses registered in the two years before the global financial crisis meant that the economy entered the recession with a healthy fiscal position and comparatively low debt level, which allowed government spending to be maintained despite a sharp decline in revenue. Slower growth in revenue and additional expenditures would result in a higher deficit for fiscal 2011/12 than had been projected in October 2010. However, over the medium term the consolidated government deficit would trend downwards and reach 3,8 per cent of estimated gross domestic product in 2013/14, consistent with stabilising growth in debt and the conduct of a countercyclical fiscal policy. To reinforce long-term sustainability of the public finances, the Minister proposed a set of fiscal guidelines informed by three principles, namely a counter-cyclical fiscal stance, long-term debt sustainability and inter-generational equity.

National government expenditure

The provisional expenditure outcomes for the fiscal year 2010/11 indicated that government stayed within its budgeted expenditure envelope, but it remained a concern that under-spending continued to impair some programmes.

Expenditure by *national government* totalled R785 billion in fiscal 2010/11, some R13 billion less than the original budgetary provision of R797 billion anticipated in the *Budget Review 2010*. Higher spending on wages and other unanticipated priorities required an additional R6 billion to be added to the Adjustments Budget in October 2010. Despite this, the contingency reserve amount, combined with savings and cut-backs in non-priority areas, meant that government departments were able to make adjustments without increasing the total expenditure bill.

In nominal terms, this resulted in a year-on-year rate of increase of 10,0 per cent in national government spending, considerably more than the headline consumer price inflation, which averaged 3,8 per cent in 2010/11. During fiscal 2010/11, national government expenditure increased by 6,2 per cent in real terms, which was lower than the growth rate recorded in fiscal 2009/10. At the height of the recent recession in 2009/10, the year-on-year rate of increase in real terms amounted to 7,5 per cent, reflecting the decidedly expansionary fiscal policy that government had implemented to bolster economic activity in the face of dire circumstances.

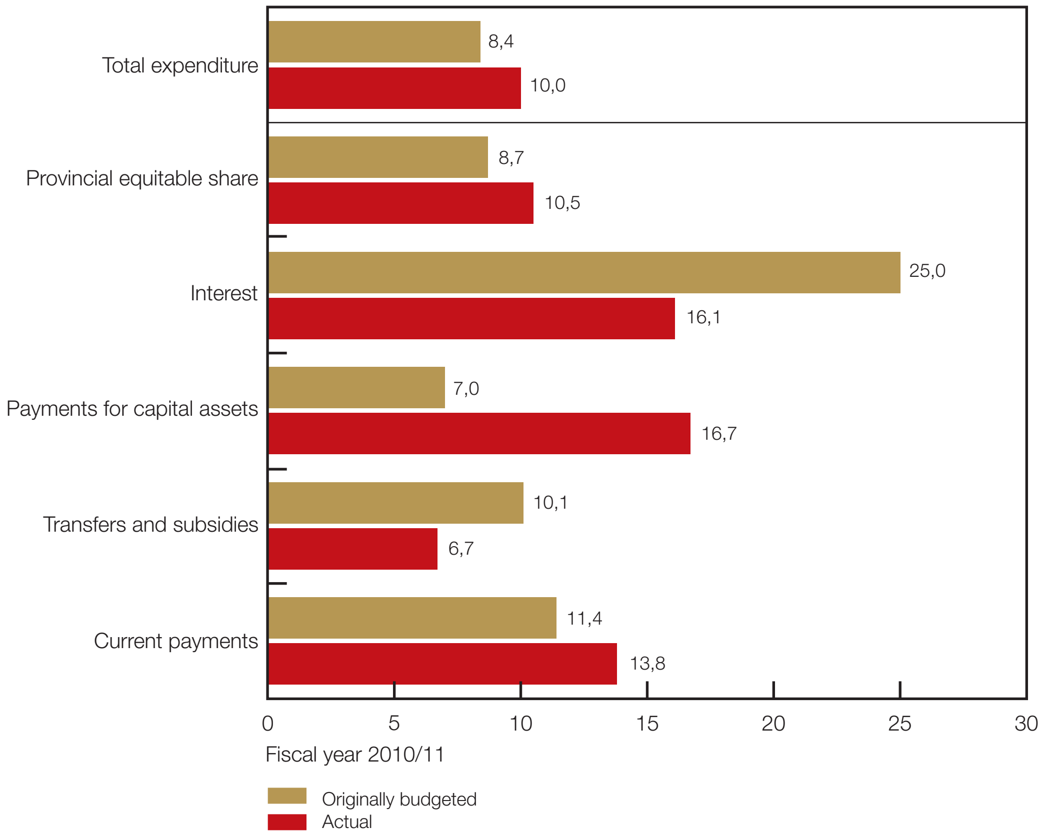
National government expenditure relative to gross domestic product amounted to 28,6 per cent in fiscal 2010/11, compared with 29,2 per cent in the previous fiscal year.

Strong growth in national government spending stemmed from higher current payments, together with transfers and subsidies, which underpinned the increase in voted expenditure. In fiscal 2010/11 the third and final tranche of R20,0 billion[11] was paid over to Eskom as financial support for its capital investment programme. The *Budget Review 2011* indicated that expenditure on energy would be markedly lower over the Medium Term Expenditure Framework (MTEF) period in comparison with the preceding years as financial assistance to Eskom came to an end in 2010/11. Current payments by the Justice and Protection Services cluster also grew strongly during fiscal 2010/11, mainly in the form of compensation of employees. This was implemented through what was termed the 'occupation-specific dispensation', the aim of which was to improve conditions of service and the extension of justice services to the country.

11 These amounts were not included in total expenditure in the Government Finance Statistics analysis of the Bank as they were deemed to constitute a capital injection.

National government expenditure

Percentage change over one year



Further contributions to the higher spending were from the Social Services cluster, driven by the Departments of Health and of Social Development. Transfers and subsidies by the Department of Health increased by 18,6 per cent year on year, due to the grants paid to provincial governments and municipalities for health professions training and development; national tertiary services; hospital revitalisation; and comprehensive HIV/AIDS grants. A significant part of the spending by the Department of Social Development comprised transfers, mainly to households, which increased by 10,4 per cent in fiscal 2010/11. This was predominantly allocated to income support for the elderly, disabled and caregivers of children, with the old-age grant comprising the largest portion, followed closely by the child support grant and the disability grant. The increase was to cushion the purchasing power of the grants against inflation. In addition, the department concluded the gradual implementation of the age equalisation process in 2010, resulting in both men and women being eligible to receive social grants from the age of 60. As a ratio of gross domestic product, social grants transferred mainly to households amounted to 3,4 per cent in fiscal 2010/11, slightly lower than the previous fiscal year.

Interest paid on national government debt increased by 16,1 per cent to amount to R66,2 billion in fiscal 2010/11. The high year-on-year rate of increase in interest payments could be attributed to higher issuances of domestic government bonds to finance the deficit. Interest payments were originally budgeted to amount to R71,3 billion in fiscal 2010/11, but were revised downwards to R67,5 billion in the *MTBPS 2010*, as a result of lower interest rates and net redemptions of foreign debt. Lower debt-service costs for 2010/11 created more space for funds to be channelled to other priority areas. As a ratio of gross domestic product, interest payments edged higher from 2,3 per cent to 2,4 per cent between fiscal 2009/10 and 2010/11.

Payment for capital assets amounted to R10,1 billion in fiscal 2010/11, which was 16,7 per cent higher when compared with the previous fiscal year. The bulk of infrastructure spending continues to take place at provincial and local government levels and through public corporations.

National government revenue

Albeit from a low base, government revenue registered a firm increase in 2010/11 as the economic recovery progressed.

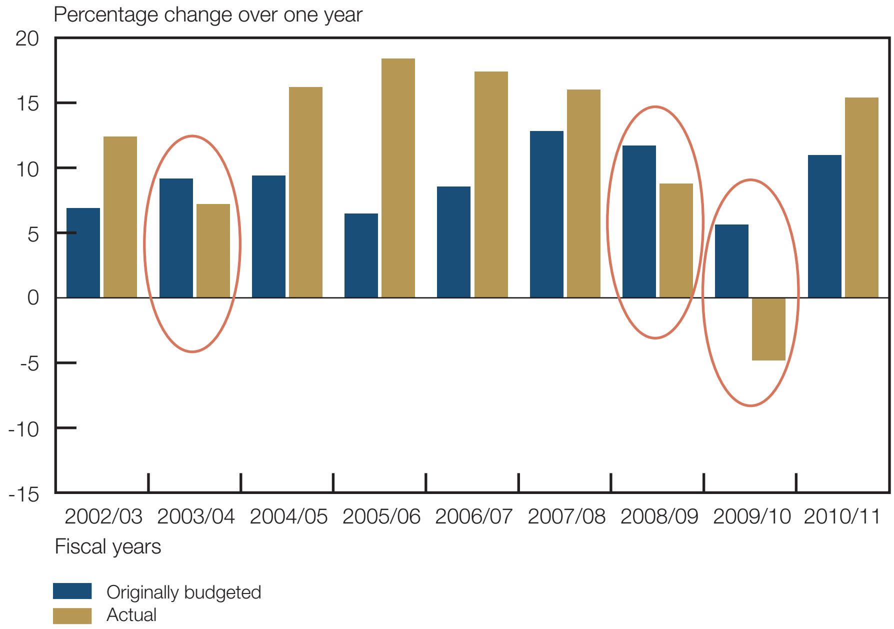
As shown in the accompanying graph, national government receipts outperformed the originally budgeted projections each year from 2004/05 to 2007/08, propelled by strong economic growth. Higher personal income tax collections were largely a result of an expanded tax register reflecting employment growth and improved compliance. Corporate income tax collections emanated from all economic sectors, with the mining sector in particular driven by high commodity prices. Taxes on property also contributed to the increased revenue, resulting from the buoyant activity in the real-estate and financial markets.

During the fiscal years 2008/09 and 2009/10, national government receipts underperformed originally budgeted projections as economic activity receded. Revenue in the major tax categories such as personal income tax, VAT and customs duties declined substantially, alongside the weak performance of the economy. The decrease in personal income taxes originated largely from job losses and lower bonuses paid out in 2008/09. Taxes on property also declined considerably on account of a contraction in real-estate market activity. In fiscal 2009/10, the decline in revenue was most pronounced in corporate income taxes and signalled a steep decrease in the profitability of companies.

The *Statement of National Revenue, Expenditure and Borrowing* indicated that unaudited national government revenue amounted to R669 billion in fiscal 2010/11 – some 15,4 per cent more than in the previous fiscal year and substantially more than the original February 2010 budgeted increase of 11,0 per cent. In the February *2011 Budget Review*, the increase in national government revenue was revised upwards to 15,0 per cent. However, the eventual outcome for fiscal 2010/11 was R2,4 billion more than the revised estimate in the *Budget Review 2011* due to better tax revenue collections in the final quarter of fiscal 2010/11.

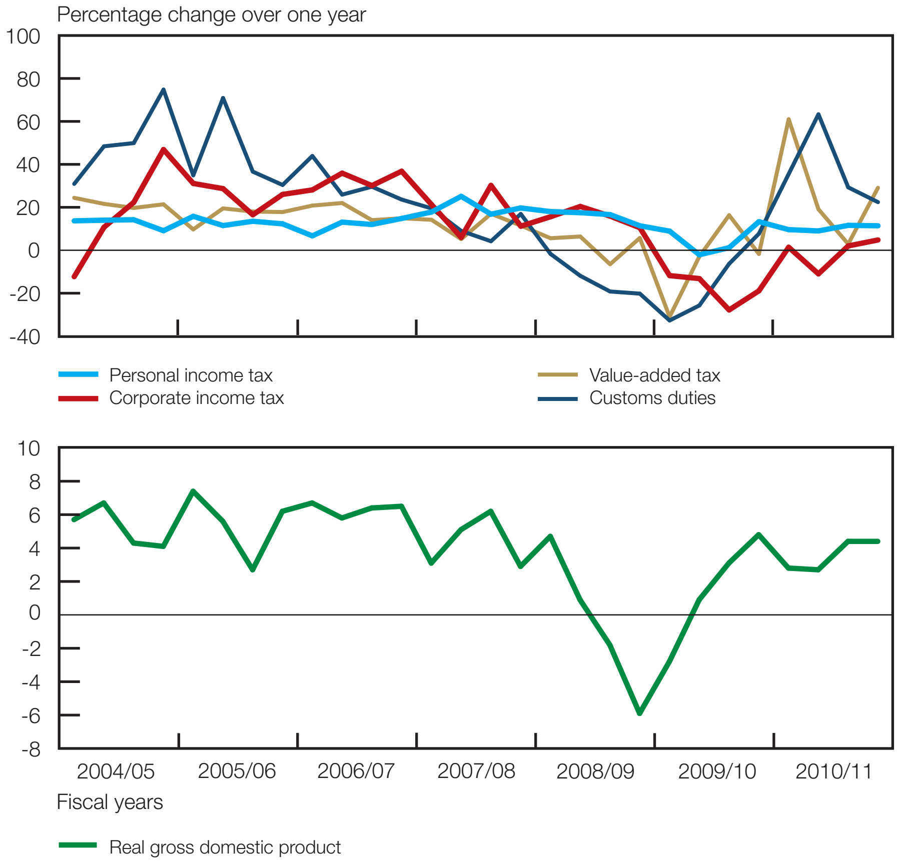
Relative to gross domestic product, national government revenue reached 24,3 per cent in fiscal 2010/11, slightly higher than the ratio of 23,7 per cent recorded in the previous fiscal year. The lowest ratio of 22,9 per cent was recorded in fiscal 2003/04. In 2007/08, the fiscal year before the recession, national government revenue amounted to 26,9 per cent of gross domestic product.

Revenue of national government



National government revenue in fiscal 2010/11 reflected the recovery in domestic economic conditions after the recession. The growth in taxes on income, profits and capital gains was influenced by personal income tax which, in turn, was driven by wage settlements in excess of inflation in the finance, public administration and agencies sectors. The average wage settlement in 2010 was estimated at 8,2 per cent, following 9,3 per cent in 2009. The numerous jobs lost in the previous two years showed a limited impact on the trajectory of personal income tax, but for a decline in 2009.

National government revenue and real gross domestic product



Corporate income tax recorded negative growth in fiscal 2010/11. Lower assessment and provisional tax payments, alongside significantly higher refunds, resulted in collections from this category decreasing by 0,5 per cent from the previous fiscal year. Corporate income tax collections tend to lag economic activity, and in 2010/11 sectors still lagging the recovery included mining and construction. However, some sectors proved to be more resilient and performed better as far as tax collections are concerned, including telecommunications, transport, wholesale and retail trade, and medical services. Going forward, the recovery in demand and high commodity prices are likely to underpin improvements in business profitability and tax revenue.

Collections from taxes on goods and services amounted to R249 billion in fiscal 2010/11. VAT collections showed a significant improvement compared to collections in the previous year. Domestic VAT collections recovered moderately, which reflected the extent of improvements in domestic demand and the brisk recovery in vehicle sales. Import VAT collections recovered the most, mainly due to increased imports of vehicles, automotive parts and machinery. Lower VAT refunds stemmed mainly from the finance, agriculture, forestry and fishing, vehicle manufacturing and mining sectors, and from municipalities. As turnover in these sectors improved, vendors moved to being net VAT payers. The lower refunds also stemmed from reduced capital expenditure and the conclusion of 2010 FIFA World Cup™ infrastructure spending.

Robust growth in customs duties resulted from strong growth in imports of footwear and clothing, electrical equipment and vehicles on account of an upswing in household consumption expenditure. Customs duties also received a boost from vehicle imports ahead of the implementation of a carbon emissions tax, which came into effect in September 2010.

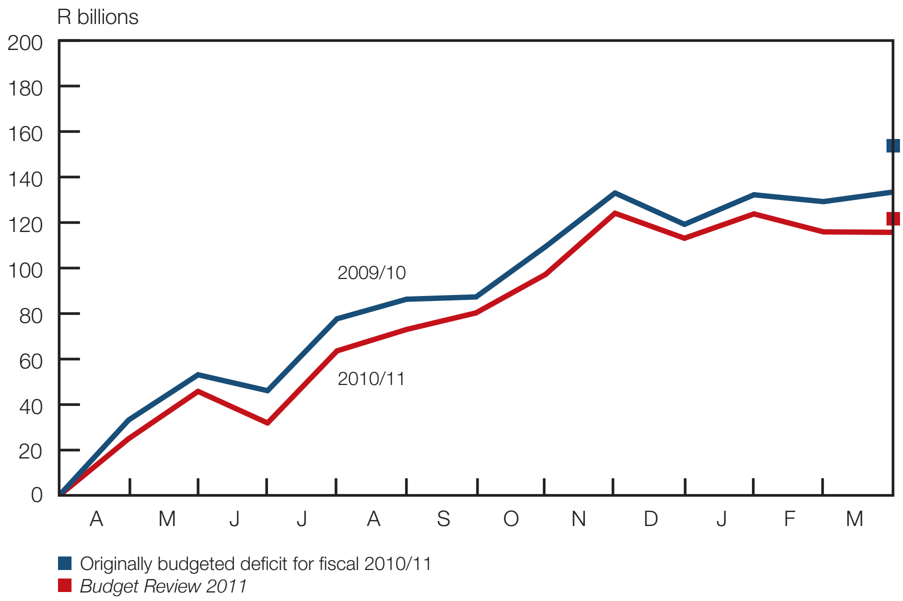
During fiscal 2010/11, Southern African Customs Union (SACU) payments amounted to R17,9 billion, representing a year-on-year rate of decrease of 35,9 per cent. Included in this amount was an additional payment of R2,9 billion transferred to Botswana, Lesotho, Namibia and Swaziland pertaining to adjustments made in respect of fiscal 2006/07 and 2007/08.

National government deficit

12 The deficit differs from that of National Treasury as the loan to Eskom was excluded from expenditure.

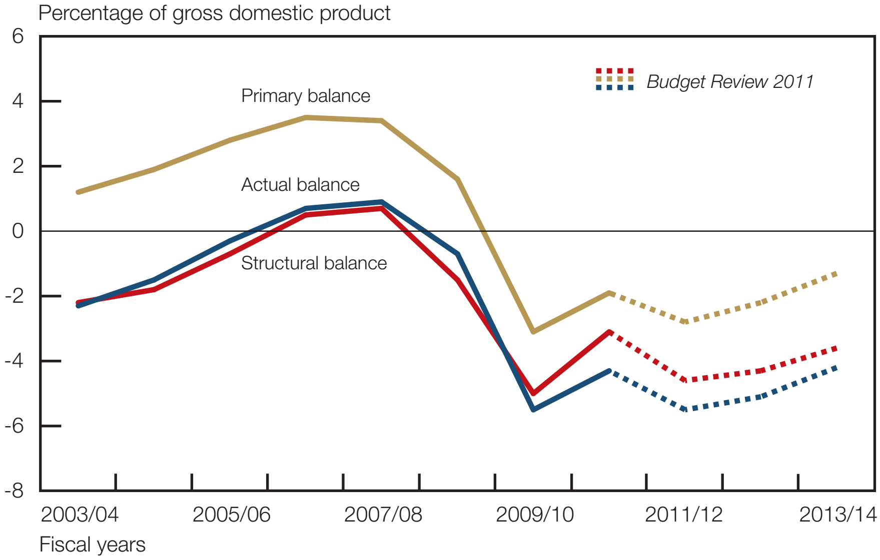
Cyclical forces played a key role in the development of the deficit over the past few years. The improvement in the economy and accompanying recovery in tax revenue, and some savings on debt-service costs, yielded a cash-book deficit of R116 billion in fiscal 2010/11[12] – some R18 billion lower than the record cash-book deficit registered in fiscal 2009/10. As a ratio of gross domestic product, the deficit amounted to 4,2 per cent in fiscal 2010/11, compared with a deficit ratio of 5,5 per cent recorded in the preceding fiscal year.

Cumulative deficit of national government



With encouraging signs of stronger recovery in the global economy at the beginning of 2011, government's fiscal policy would continue to be countercyclical within a sustainable long-term framework. The earlier fiscal prudence and the countercyclical fiscal surpluses recorded in the two years before the global financial crisis meant that the economy entered the recession with a healthy fiscal position, which allowed for a considerable increase in the budget deficit without exerting undue pressure on the fiscus. It was expected that the deficit would average 4,9 per cent of gross domestic product over the medium term to fiscal 2013/14.

National government fiscal balances



A key indicator of fiscal sustainability is the primary balance, which adjusts the actual balance by excluding the cost of servicing public debt from expenditure. The outcome[13] for fiscal 2010/11 was a primary *deficit* of R49,5 billion, or 1,8 per cent of gross domestic product, in stark contrast to the *surplus* ratio of 1,6 per cent in fiscal 2008/09. As a percentage of gross domestic product, the primary deficit was expected to widen slightly in 2011/12, thereby supporting economic activity levels, but to narrow over the medium term in the interest of fiscal sustainability.

13 Excludes the subordinated loan to Eskom.

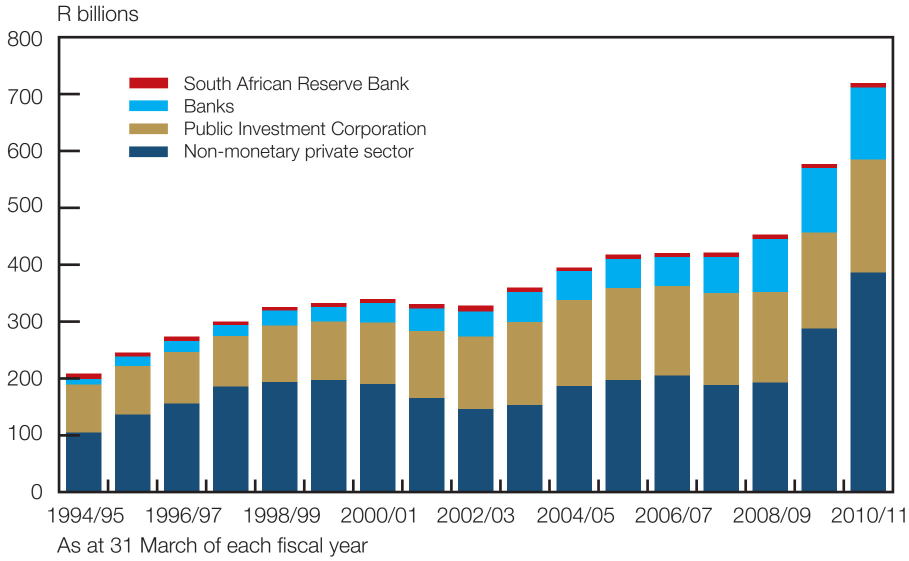
National government financing and debt

South Africa's sound management of cyclical economic policies, deep and liquid capital markets, and the availability of international funding enabled government to finance the 2010/11 budget deficit at a lower cost than initially anticipated. The primary source of funding remained domestic borrowing, through a combination of Treasury bills, fixed-income and inflation-linked bonds.

The net outcome of national government's cash-flow revenue and expenditure was a cash-flow deficit of R127 billion in fiscal 2010/11 – some R17 billion lower than the cash-flow deficit recorded a year earlier. Extraordinary receipts included the transfer from the Equalisation Fund account, special dividends from Telkom and the liquidation of the SASRIA investment. Extraordinary payments consisted of losses on the conversion of foreign currency transactions, losses on the Gold and Foreign Exchange Contingency Reserve Account (GFECRA) and a premium on debt portfolio restructuring.

After accounting for extraordinary transactions and the cost on revaluation of maturing foreign debt, the net borrowing requirement equalled the cash-flow deficit in fiscal 2010/11. This was significantly lower than the net borrowing requirement of R141 billion recorded in the preceding fiscal year. During the period under review, government's funding strategy was concentrated in the domestic long-term bond market: in fiscal 2010/11 national government raised R131 billion from long-term domestic government bonds and retail bonds, and R35 billion from Treasury bills and short-term loans. Most of the domestic government bonds were held by the non-monetary sector. Net issues of RSA Government Retail Savings Bonds amounted to R5 billion, bringing the total balance outstanding to R10 billion at the end of March 2011.

Ownership distribution of domestic marketable bonds of national government



Although there has been a measured decline in the borrowing requirement, government maintained the *2010 Budget Review* funding levels, using the surplus cash to support the Bank in accumulating foreign currency reserves. Government continued to manage refinancing risk actively through the domestic switch programme, which has already reduced the redemption value of the *R189* bond by almost R20 billion and is set to continue over the medium term. Government's funding strategy takes into account risk benchmarks of 70/30 for fixed-rate versus non-fixed-rate domestic debt, and a 20 per cent maximum exposure to foreign debt as a percentage of total national government gross debt.

With strong international investor interest in emerging-market securities, national government managed to increase its foreign debt liabilities by raising R5,2 billion from the issuance of a US$750 *million* global bond in March 2011. This bond carried a coupon rate of 6,25 per cent and matures in March 2041. Funding activities increased national government's available cash balances by R41,8 billion in fiscal 2010/11.

National government's total gross loan debt as a ratio of gross domestic product increased from 32,6 per cent to 35,5 per cent between March 2010 and March 2011. Apart from revaluations related to the impact of the exchange value of the rand on foreign debt, the higher issuance of domestic debt instruments played a significant role in explaining the increase. Domestic debt of national government, as a proportion of total gross loan debt, increased from 87,5 per cent to 90,0 per cent between the respective dates, with foreign debt accounting for the remainder.

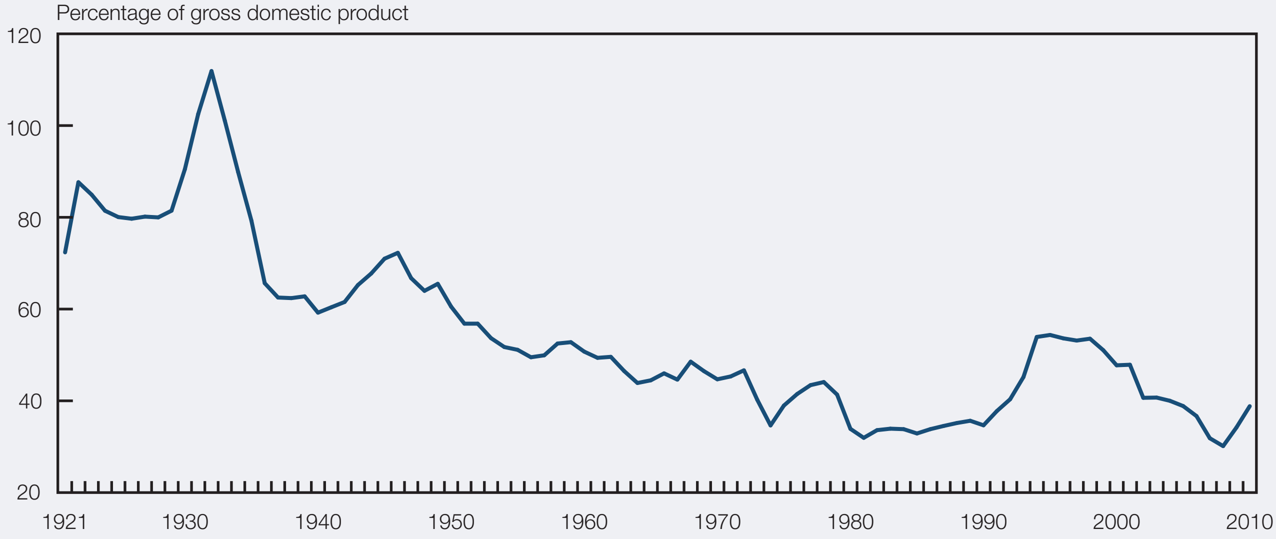
Box 8: Government debt

Government loan debt was relatively high in the early 1920s as the authorities had incurred debt in order to build up the country's infrastructure. Furthermore, with the nominal value of the outstanding government debt fixed, the falling prices and contracting nominal income which characterised the post-World War I recession caused the ratio of loan debt to nominal gross domestic product to rise. The same mechanism was in operation from 1929 to 1932, with a falling general price level.

From 1933 onwards, gross domestic product rose strongly, mainly on account of higher volumes of production but also due to rising prices. This brought about a notable decline in the government debt ratio. Around the World War II years, government borrowing again increased significantly. Thereafter, despite generally rising nominal levels of government debt, the debt ratio trended lower until the late 1980s. This was brought about by rising levels of nominal gross domestic product, which reflected generally strong real growth up to the early 1970s, followed by high rates of inflation up to the late 1980s. The high inflation, while helpful to reduce the government's debt ratio, simultaneously eroded the purchasing power of savers' holdings of government bonds.

Lower inflation was achieved from the early 1990s. The large government deficits recorded in the early 1990s were reflected in a rapidly rising government debt ratio. Realising the need to ensure fiscal sustainability, government reduced the Budget deficit from the mid-1990s onwards. The fiscal discipline brought the debt ratio down to less than 30 per cent of gross domestic product by 2007. The fiscal space created in this way turned out to the advantage of the country: when the global financial crisis intensified in 2008 and 2009, government could adopt a strongly countercyclical fiscal stance, running large deficits and incurring debt to support the economy.

Government loan debt



General government finance

Growth in spending by general government in 2010/11 focused on education and skills development, improved health outcomes, integrated and sustainable human settlements, and rural development. Furthermore, social and economic infrastructure investments would be scaled up.

In fiscal 2010/11 *consolidated general government* recorded a cash deficit of R125 billion, or R18,7 billion less than the cash deficit recorded in the preceding fiscal year. National government accounted for the greater share of this cash deficit, which was well below the originally budgeted projection and revised estimate stated in the *Budget Review 2011*. The fiscal framework supports a reduction of debt over time, which would reduce interest payments and create fiscal space. Government borrowing to fund capital expenditure – such as the Gautrain – would increase the overall capital stock of the economy. Conversely, borrowing to finance consumption creates debt obligations that must be paid off long after the funds have been spent without a corresponding asset being acquired. The current position – the result of higher borrowing during the recession – would not be sustainable over the long term. A moderation in the growth of expenditure, combined with a recovery in revenue, would consolidate the fiscus over the medium term.

For fiscal 2010/11, the general government cash deficit as a ratio of gross domestic product amounted to 4,5 per cent, moderately below the revised estimate of 4,8 per cent stated in the *Budget Review 2011*.[14]

14 Balance adjusted to exclude the Eskom loan.

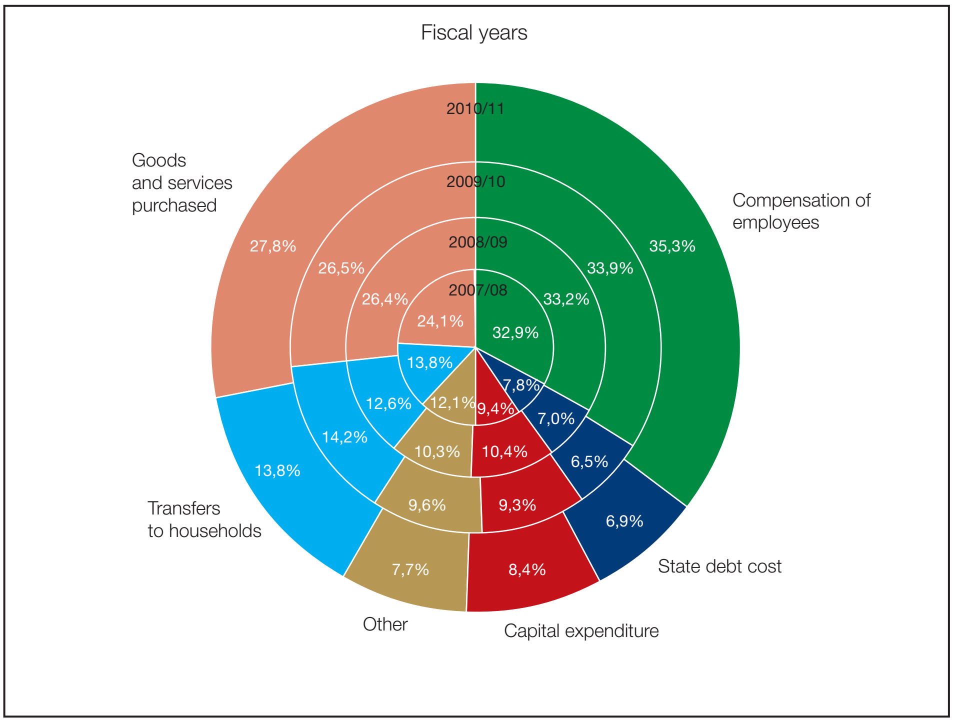
The improved cash deficit recorded by national government could be ascribed to slower growth in expenditure, alongside higher-than-expected revenue collections. An increase in spending was underpinned by transfers and subsidies earmarked for social spending and infrastructure development. Sustained real growth in transfers to households over the past years also contributed to wealth redistribution and poverty alleviation. Over the three years to 2010/11, non-interest government expenditure grew by an annual average of 13,4 per cent, compared with annual average increase of 13,1 per cent between fiscal 2005/06 and 2007/08.

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 and by 10,5 per cent in fiscal 2010/11. The increase in equitable share transfers was aimed at extending and improving service delivery outcomes in the health and education sectors, and at putting provinces in a better position to help local governments implement the Municipal Finance Management Act. Provincial governments recorded a cash *surplus* of R4,4 billion in the period under review, which was a turnaround from the cash *deficit* of R8,3 billion recorded in the previous fiscal year. Local governments received a total of R7,5 billion from national government as part of the general fuel levy-sharing agreement with metropolitan municipalities following the abolition of Regional Services Council levies. Total expenditure by municipalities remained robust in response to the demand for the provision of basic services and other infrastructure-related spending.

The transfers to provincial and local governments included earmarked grants for the delivery of housing, electricity, water and sanitation services to households. Provinces are also at the forefront of delivery of education, health care, social welfare and human settlements, alongside support for rural development and agriculture.

In fiscal 2010/11 the consolidated general government operating expense increased by 10,0 per cent to R948 billion. The growth rate was lower than in the previous fiscal year. Net investment in non-financial assets by consolidated general government receded and amounted to R86 billion, following the near-completion of the 2010 FIFA World Cup™-related infrastructure spending. Infrastructure-related spending by local governments 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 2010/11, consolidated general government expenditure relative to gross domestic product amounted to 37,6 per cent compared with 38,9 per cent recorded in the preceding fiscal year.

Consolidated general government expenditure: Economic classification



As a proportion of total operating expense, compensation of employees accounted for 38,5 per cent during the period under review. Personnel costs, including salary adjustments and the implementation of occupation-specific dispensations, were the major cost driver of the public order and safety cluster. Significant amounts were also spent on construction projects and information technology systems.

In 2010/11 real growth in compensation of employees amounted to 9,5 per cent – higher than the 9,0 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 salary increases to improve the conditions of service for public servants, and increased government employment. Relative to gross domestic product, compensation of government employees remained broadly unchanged between fiscal 2009/10 and 2010/11.

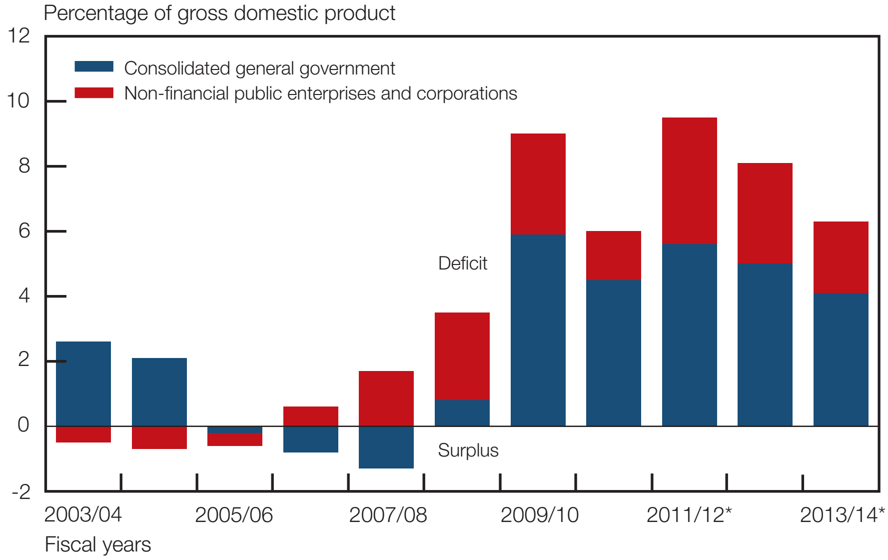
Government reduced its dissaving – an excess of current expenditure, including depreciation of fixed capital, over current income – between 2003/04 and 2007/08, and was able to effectively mobilise the savings accumulated during the growth period to fund revenue-generating capital projects. However, government again became more reliant on other institutional sectors' savings to finance the current balance and capital investment programme as its own savings began to dwindle.

Non-financial public-sector borrowing requirement

The activities of the *non-financial public sector* resulted in a considerable narrowing of the borrowing requirement from R218 billion in fiscal 2009/10 to R167 billion in fiscal 2010/11. This was R94 billion lower than the revised estimate as envisaged in the *Budget Review 2011*.[15] The lower borrowing requirement reflected the financial shortfall of both national government and the non-financial state-owned entities, partly to finance their infrastructure-related spending.

15 Balance adjusted to exclude the Eskom loan.

Non-financial public-sector borrowing requirement



* *Budget Review 2011*

As a ratio of gross domestic product, the non-financial public-sector borrowing requirement amounted to 6,1 per cent in fiscal 2010/11, lower than the ratio of 9,8 per cent estimated in the *Budget Review 2011*. During fiscal 2007/08, when the economy was in a boom phase, the borrowing requirement amounted to 0,4 per cent of gross domestic product and increased to 8,9 per cent in fiscal 2009/10, following the global financial crisis when fiscal policy remained countercyclical.

The largest contributors to government's capital infrastructure programme are Eskom and Transnet. Borrowing by these enterprises was expected to continue in support of their capital expenditure programmes. Improvement of co-ordination, oversight and governance of these state-owned entities, as well as enhanced monitoring of their financial performance and development impact, remained a policy priority. In the *Budget Review 2011*, the borrowing requirement of non-financial public entities was expected to decrease from R134 billion in fiscal 2010/11 to R79 billion in fiscal 2013/14.

The total public-sector infrastructure expenditure was projected to amount to R809 billion over the medium term. As a proportion of gross domestic product this spending was estimated to reach 9,8 per cent for fiscal 2010/11 as a whole and average 8,4 per cent over the medium-term period. Government and state-owned enterprises would continue to make large investments in power plant construction, expansion and upgrading of the transport network, and the provision of new sanitation and water infrastructure. This investment in infrastructure would enhance the long-term growth potential of the country and provide better services to all South Africans.