

# Nedbank

## Guide to the Economy

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### CONTENTS

#### Feature

##### 1 | International background and outlook

Risk aversion soared in the third quarter as recession fears resurfaced. Growth in the developed world failed to bounce back as expected following the restoration of most of the supply chain hurt by the Japanese natural and nuclear disasters earlier in the year. Weak labour and housing markets and poor confidence as politicians argued over seemingly intractable government debt problems in the US and the Eurozone all contributed to the difficult environment. Many developing economies also saw some slowdown in growth as weaker export demand and tighter policies aimed at curbing rising inflation began to impact. The short-term outlook has deteriorated, but our central scenario is still one of continued albeit moderate growth.

##### 6 | Domestic review and prospects

Domestic economic growth slowed significantly in the second quarter of 2011 and early indications are that there was not much improvement in the third quarter. Weaker external demand, the strong rand, indebted consumers, rising energy prices and administered costs, infrastructure constraints and concerns over the policy environment have all weighed on growth. The outlook depends critically on the global environment. Provided international growth remains reasonable, growth of just above 3% this year and 3,5% next year is possible.

#### Facts and forecasts

11 | Annual

12 | Quarterly

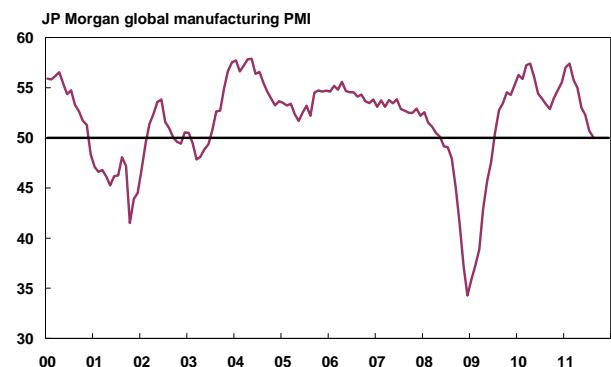
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#### International background and outlook

*Turbulent markets late in the third quarter reflected growing fears over the sustainability of the global economic recovery. Earlier hopes that the slowdown in the second quarter was due mostly to temporary supply disruptions were dashed as weakness in developed world economies extended into the third quarter. There was a growing realisation that many of these economies will continue to be hampered by deep-seated structural weaknesses for many years. The massive increases in household and public sector debt and the aftermath of the collapse in housing markets will complicate efforts to restore what was considered to be trend growth over the medium term. The markets were also rattled by the lack of necessary political will in the United States to find solutions to curb rising government debt and in Europe to address the sovereign debt crisis and to restore faith in the euro.*

*Developing world economies have remained relatively firm, by contrast, with China and India still expected to register strong growth. However, the overall picture is more mixed, with many countries also experiencing softer growth. Against this background commodity prices have mostly softened and currencies have fallen against the US dollar and its perceived safe-haven status.*

Graph 1: Global manufacturing activity has lost momentum



Source: Bloomberg



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The International Monetary Fund (IMF) downgraded its view of **global growth** in September (see table 1). In contrast to 2010, when forecasts were generally progressively upgraded, the current update is distinctly more sombre than those published in April and June. Even so, the forecasts still reflect modest growth in developed countries being more than offset by continued strong growth in developing countries. Our own view is that this could prove to be too optimistic, with structurally weaker growth in developed countries also hurting developing economies and keeping global growth below 4%. This would assume that the world escapes accumulating dangers in the short term, including, but not restricted to, unresolved fiscal problems and weak confidence. Economic solutions to the debt problems of the world's dominant economies – the United States and Europe – do exist, but there is a growing sense in the markets that the necessary political compromises will be a lot more difficult to achieve.

Table 1: IMF September 2011 forecasts

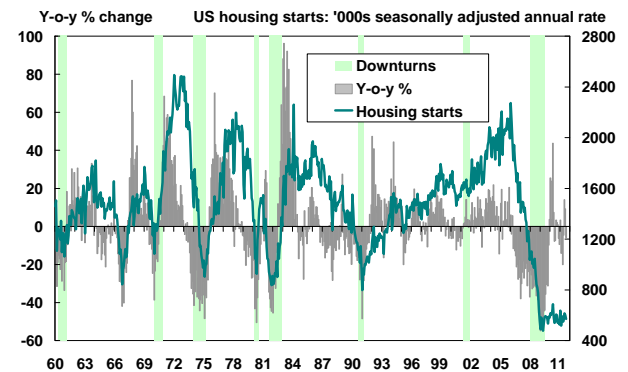
Countries and regions											Forecasts September 2011			Forecasts June 2011	
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2011	2012	2013	2011	2012	
World	4.6	5.3	5.4	2.8	-0.7	5.1	4.0	4.0	4.5	4.3	4.5	4.5	4.3	4.5	
Advanced economies	2.7	3.1	2.8	0.1	-3.7	3.1	1.6	1.9	2.4	2.2	2.6	2.6	2.2	2.6	
US	3.1	2.7	1.9	-0.3	-3.5	3.0	1.5	1.8	2.5	2.5	2.7	2.5	2.5	2.7	
Japan	1.9	2.0	2.4	-1.2	-6.3	4.0	-0.5	2.3	2.0	-0.7	2.9	2.0	-0.7	2.9	
Euro area	1.7	3.2	3.0	0.4	-4.3	1.8	1.6	1.1	1.5	2.0	1.7	1.5	2.0	1.7	
Germany	0.8	3.9	3.4	0.8	-5.1	3.6	2.7	1.3	1.5	3.2	2.0	1.5	3.2	2.0	
UK	2.2	2.8	2.7	-0.1	-4.9	1.4	1.1	1.6	2.4	1.5	2.3	1.6	2.4	1.5	
Emerging and developing	7.3	8.2	8.9	6.0	2.8	7.3	6.4	6.1	6.5	6.6	6.4	6.5	6.6	6.4	
Developing Asia	9.5	10.3	11.5	7.7	7.2	9.5	8.2	8.0	8.4	8.4	8.4	8.4	8.4	8.4	
China	11.3	12.7	14.2	9.6	9.2	10.3	9.5	9.0	9.5	9.6	9.5	9.5	9.6	9.5	
India	9.0	9.5	10.0	6.2	6.8	10.1	7.8	7.5	8.1	8.2	7.8	8.1	8.2	7.8	
Middle East and N Africa	5.4	6.0	6.7	4.6	2.6	4.4	4.0	3.6	4.3	4.2	4.4	4.3	4.2	4.4	
Sub-Saharan Africa	6.2	6.4	7.1	5.6	2.8	5.4	5.2	5.8	5.5	5.5	5.9	5.5	5.5	5.9	
South Africa	5.3	5.6	5.6	3.6	-1.7	2.8	3.4	3.6	4.0	n/a	n/a	n/a	n/a	n/a	
Angola	20.6	20.7	22.6	13.8	2.4	3.4	3.7	10.8	6.7	n/a	n/a	n/a	n/a	n/a	
Nigeria	5.4	6.2	7.0	6.0	7.0	8.7	6.9	6.6	6.3	n/a	n/a	n/a	n/a	n/a	
Zimbabwe	-2.2	-3.5	-3.7	-17.7	6.0	9.0	6.0	3.1	3.0	n/a	n/a	n/a	n/a	n/a	
Namibia	2.5	7.1	5.4	4.3	-0.7	4.8	3.6	4.2	4.3	n/a	n/a	n/a	n/a	n/a	
Latin America	4.6	5.6	5.8	4.3	-1.7	6.1	4.5	4.0	4.1	4.6	4.1	4.6	4.1	4.6	
Brazil	3.2	4.0	6.1	5.2	-0.6	7.5	3.8	3.6	4.2	4.1	3.6	4.2	4.1	3.6	
Mexico	3.2	5.2	3.2	1.2	-6.2	5.4	3.8	3.6	3.7	4.7	4.0	3.7	4.7	4.0	
Central & Eastern Europe	5.8	6.4	5.5	3.1	-3.6	4.5	4.3	2.7	3.5	5.3	3.2	3.5	5.3	3.2	
Russia	6.4	8.2	8.5	5.2	-7.8	4.0	4.3	4.1	4.1	4.8	4.5	4.1	4.8	4.5	

Source: International Monetary Fund

The **US** economy has again lost momentum. After growing by just 1% in the second quarter, recent indicators suggest little improvement in the third quarter. Consumer and business confidence is weak, the firmer employment growth seen in the early part of the year has disappeared and the housing market remains in the doldrums, with existing home sales still 29% below their pre-crisis peak. The usual mechanisms that lift an economy out of a downturn – low interest rates and falling prices – are no longer working to stimulate housing demand and finance. This is partly because of the overhang of problems created by the previous boom and the subsequent bust. These include a stock overhang and a host of legal problems that will take years to sort out. A weak housing and labour market, combined with modest income growth and a sharp decline in equity prices, has contributed towards a steep fall in consumer confidence. Combined with continued deleveraging, this implies continued weak consumer spending in the months ahead.

Growth in the manufacturing sector has also lost momentum, with the ISM manufacturing index close to the breakeven level of 50 over the past two months. The recent pullback in the dollar could hurt exports, the one area that has shown good improvement.

Graph 2: US housing starts



Source: US Federal Reserve

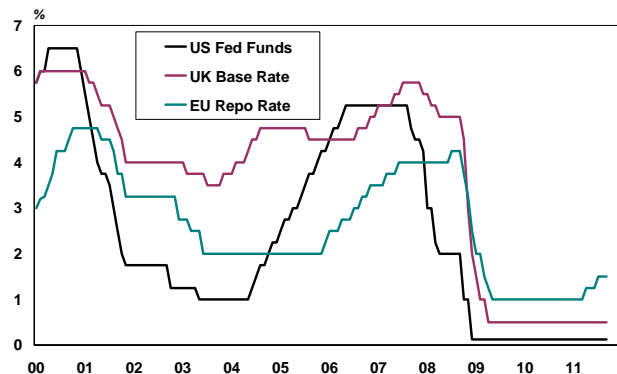
The concern is that, while the extensive policy measures introduced so far were successful in stabilising the economy in the wake of the global financial crisis, they have not led to sustainable growth and there is limited room for further policy measures. Near-zero interest rates and two rounds of quantitative easing suggest that there is little more that can be done on the monetary front. Further quantitative easing is possible, but the previous bond-purchasing programme had the unintended consequence of pushing commodity prices higher, which in turn hurts consumers. The recent announcement of the Federal Open Market Committee (FOMC) of long-term bond purchases in exchange for shorter-dated stock may help to stimulate some investment activity and reduce household debt service costs, but the problem is more that final demand is failing to respond to policy efforts.

Further potential for fiscal stimulus is also limited, both by already high debt, but also by the political impasse created by the combination of a Democrat presidency and a Republican-controlled House. President Obama's proposed \$450 billion package has little chance of being adopted in full, but even if it were, it would add limited stimulus because earlier measures will expire in 2012. The political tensions were also partly responsible for Standard and Poor's controversial decision to downgrade the US sovereign rating from AAA to AA+. However, in the current environment it has mattered little, with US treasury yields even subsequently falling.

**Eurozone** economic growth also moderated in the second quarter, dragged down by an intensifying sovereign debt crisis, fiscal austerity measures and weakening global demand. Conditions deteriorated further in the third quarter, with measures of business confidence and manufacturing activity falling steadily. Growth in countries like Germany and France, which led the recovery, has

stagnated as consumer spending contracted and manufacturing activity slowed sharply, raising doubts that these countries can offset declines in other Eurozone countries that are struggling with punitive fiscal austerity measures. Rising borrowing costs for banks as well as the prospect of large write-offs if Greece defaults will curb lending even further, curtailing domestic demand. The European Central Bank (ECB) has shifted its rhetoric from a tightening bias to language that now opens the door for further easing this year, if the crisis intensifies.

Graph 3: ECB could cut later this year



Source: Various central banks

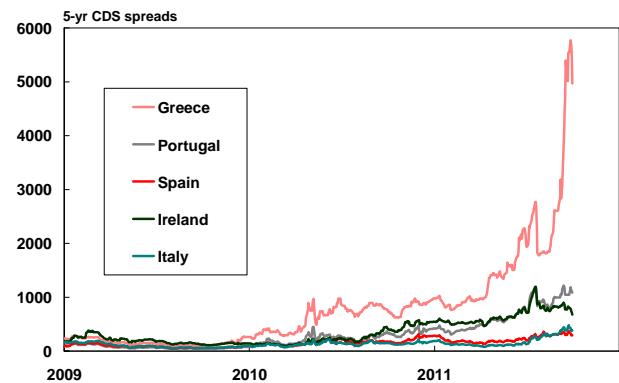
Over the past two years Europe's sovereign debt crisis has largely been contained to the periphery, with larger economies remaining unaffected. However, following the July package agreed for Greece, the markets focused their attention on Italy, which has the second largest debt burden relative to GDP in Europe, putting upward pressure on bond yields and prompting the ECB to purchase government bonds. In response Italian policymakers announced a new set of austerity measures. Even France did not escape investors' attention, with its financial sector highly exposed to Greek banks and government debt forecast to rise sharply. Another round of austerity announcements failed to allay the markets' fears for long. Greece's failure to meet its fiscal commitments to the IMF, as well as the decision by the German constitutional court to make it more difficult for the government to bail out other Eurozone members, has prompted bond yields to rise further.

There were hopes that the September IMF meetings would bring new international resolve to address the crisis, but these were largely dashed, with strong disagreements between US and European policymakers as well as public and private creditors. At the core of the debate is whether to address the insolvency issues head on and then help recapitalise affected banks or whether to keep on addressing liquidity in the hope that a mixture of growth and luck will help solve the insolvency issues in the longer term and also give banks time to adjust their balance sheets. The focus will now turn to the G20 finance ministers meeting in October, but in the meantime the

situation in Europe remains extremely fluid and the risk of contagion and default has increased significantly.

Second quarter growth in the **United Kingdom** disappointed, although extenuating circumstances, including an extra public holiday and Japan's natural disaster, were thought to have shaved as much as 0,5 percentage points off GDP. It was therefore hoped that there would be a bounce back in third quarter growth, but recent events suggest that this is unlikely to be the case. The manufacturing sector is faltering. The PMI has declined for seven consecutive months, falling below the 50 mark, which divides a contraction from an expansion. The decline has been led by falling export orders and a deteriorating labour market. The consumer is also faltering, with the recent drop in consumer confidence suggesting spending will contract this year. Households have seen real incomes decline steadily, with increased austerity measures and below-inflation salary increases. Companies and the government continue to shed jobs and new hiring is muted at best. Household wealth is also under pressure, with house and equity prices again looking soft. A recent study by the Institute of Fiscal Studies shows that living standards are expected to fall further over the next three years. Although inflation is still set to rise above 5% by the end of the year, driven by food and fuel, core inflation is expected to moderate further. This, combined with the poor state of the economy, will prompt the Bank of England to keep rates on hold.

Graph 4: European risk premiums have risen further



Source: Datastream

**Japan's** short-lived recovery following March's earthquake and tsunami already appears to be losing momentum. Consumer confidence stalled in August, as conditions in the labour market worsened and uncertain economic prospects made households less willing to make big-ticket purchases. Forward-looking indicators of activity in the service and manufacturing sector point to weakness ahead. There are a number of factors that will contain growth. Power shortages will continue, as many nuclear power plants remain shut, although energy saving measures have been effective so far. The continued strength of the yen and waning global growth will also weigh on the manufacturing sector. More generally, the

boost provided by reconstruction spending will in time be offset by tax increases as well as cuts in other areas. Recent revisions to inflation data suggest that deflation is more firmly entrenched than previously thought, making further action by the Bank of Japan more likely, particularly if growth slows sharply in the remaining months of the year. Despite concerns about the sustainability of Japan's public debt burden – the highest in the world – re-emerging following Moody's decision to downgrade the country, there seems to be little danger of – mainly Japanese – investors losing confidence, with yields on government bonds below those of Germany's, which are still AAA-rated.

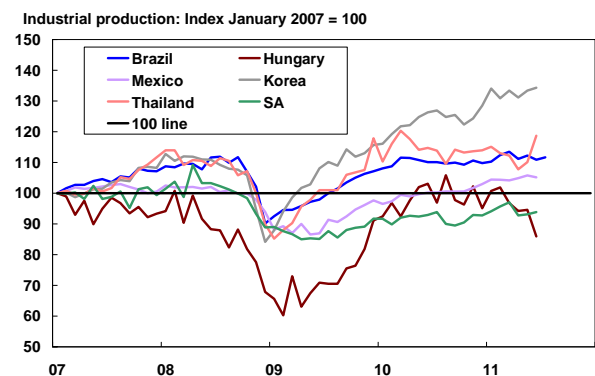
Growth across **Asia** in the second quarter was relatively weak, particularly among export-orientated economies. Singapore, Hong Kong and Thailand saw contractions and Taiwan recorded only modest growth. While some have attributed this to the impact of weaker growth in the United States, temporary supply-chain problems from Japan's earthquake and tsunami in March are all also to blame. More broadly, growth has also slowed in response to tighter monetary and fiscal policies. Despite this, growth is still forecast to average 6% this year.

Asia remains better placed than other regions to withstand global turmoil. Debt levels remain low and the banking sector remains sound, with limited exposure to Europe's troubled banks. China is also increasingly becoming an important source of final demand within Asia. Besides China, India is also an important engine of growth within the region. Although industrial production has slowed this year and external sector risks have increased, domestic demand looks resilient, due to healthy wage rises and continued credit growth. Business confidence remains strong, which should support solid investment growth. Overheating and therefore inflation in certain countries remain major policy concerns. Vietnam has the highest inflation in emerging Asia at over 22%. A strong rebound following the global recession, which has quickly eroded the output gap, and rising wage demands, due to strong employment growth, have contributed to inflationary pressures. This has prompted a number of central banks to hike interest rates, despite concerns about a possible recession in the United States and a European crisis.

**Latin American** growth will slow slightly in 2011, following robust growth in 2010. Medium-term growth will continue to be supported by high commodity prices, growing investor interest in the region and rising domestic incomes. However, in the short term, a number of problems remain, including inflation, currency appreciation as well as weaker export competitiveness. A recession in the United States, as well as a full-blown debt crisis in Europe, also poses a risk to the region. Commodity exporters such as Brazil, Chile and Argentina would see lower prices and falling demand. Brazil is well placed to mitigate any shock, due to a large cushion of international

reserves and a well-capitalised banking system. Fiscal and monetary policies remain loose in Argentina, putting upward pressure on prices and wages, which is eroding competitiveness. A fall in commodity prices – a major source of government revenue – will erode the fiscus, possibly prompting the government to make further policy mistakes. Good macroeconomic fundamentals as well as a stable political environment will help cushion Chile from exogenous shocks. Central America, with its close trade and investment ties, would be worst affected by a recession in the United States.

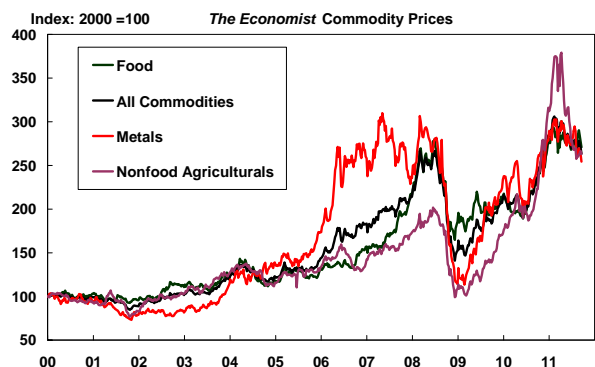
Graph 5: Production momentum has slowed



Source: Datastream

Growth is expected to average more than 5% in **sub-Saharan Africa**. Medium-term growth prospects remain promising due to continuing economic reform, combined with expected commodity price outperformance and foreign investor interest. East Africa is forecast to be the best performing region, led by Kenya and Tanzania. Growth in Kenya will benefit from infrastructure spending and a recovery in the agricultural sector following last year's drought. Mining, construction and services will boost the Tanzanian economy. In contrast, growth in central and west Africa will slow modestly, with some exceptions such as Ghana, where a major oil find will boost growth. Growth in southern Africa will be more modest in comparison, due to the large weight of the South African economy in the region. Angola will be one of the best performing countries, growing by more than 6% on the back of investment in the oil sector.

Graph 6: Commodity prices are off recent peaks, but still high

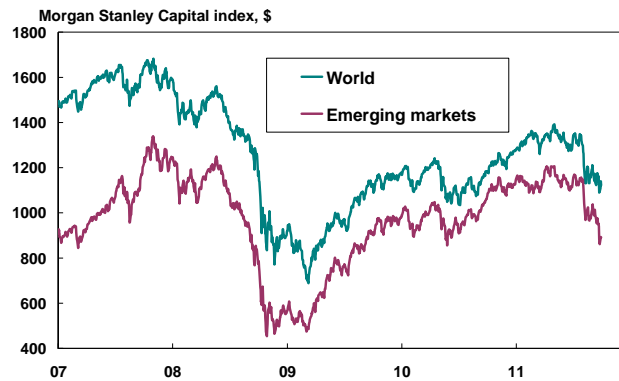


Source: I-Net Bridge

Risks to the region have increased significantly, however. A relapse in both Europe and the United States would dent Africa's performance, hurting commodity prices and export volumes. Together, these two regions take 50% of Africa's exports.

**Commodity prices**, including agricultural prices, remain off the highs reached earlier this year, as global growth continued to slow and liquidity slowed with the end of QE2. Price movements have been very volatile in recent months, falling sharply in early August as concerns about a possible double-dip recession gripped the market. The overall trend is likely to be weaker, due to slower economic growth in much of the developed world as well as in China. An exception could be agricultural prices as stocks remain at low levels following this year's severe weather-related supply disruptions. A repeat of unfavourable weather patterns next year would push prices higher. The price of gold scaled new highs, reaching \$1 900 an ounce in early September as risk aversion intensified. However, there was a major reversal later in the month as investors grappled with the deflationary implications of the crisis. Speculation that the United States might enter a recession in early August pushed oil prices down to just above \$100 a barrel. A slight recovery in sentiment has helped push oil prices higher in recent weeks.

Graph 7: Equity markets have corrected

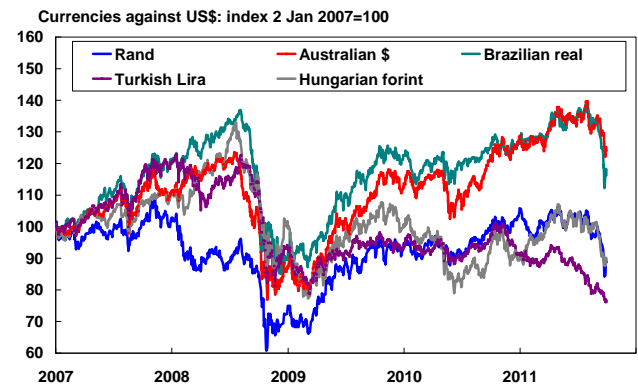


Source: MSCI Barra

In **currency markets** the dollar traded in a narrow band against major currencies for much of the past three months, strengthening slightly in early August as Europe's fiscal troubles re-entered the spotlight. The decision by Standard and Poor's to downgrade the United States sovereign credit rating did not have a lasting negative impact on the currency. By September the dollar's fortunes appeared to have turned more decisively as Europe's debt crisis intensified. With a third quantitative easing package still unlikely in the United States and the crisis in the Eurozone far from over, the dollar could strengthen further in the months ahead. Emerging market currencies performed well for much of this year, but the

recent resurgence of risk aversion has sent investors back into safer markets such as the United States.

Graph 8: Emerging market currencies fall on risk aversion



Source: Reuters

Carmen Altenkirch

## Domestic review and prospects

Economic growth lost momentum in the second quarter, dragged down by sharp drops in manufacturing, mining and agricultural production. Prolonged strike action, the tsunami in Japan and a softer global economy were mainly to blame. However, conditions in the third quarter have been equally tough and growth will probably be moderate for much of the remainder of the year. Consequently, softer gdp growth of 3,1% for 2011 as a whole now seems more likely. The troubled global economy will continue to weigh on the manufacturing and mining industries. Consumer spending will be supported by continued low interest rates and firm wage growth, but hampered by high debt levels, rising living costs and worries about job security. The recovery in fixed investment spending will continue, but remain moderate due to sufficient existing capacity in the private sector and delivery issues in the public sector.

Table 2: Gdp sector breakdown

Industries	Q-o-q % change (seasonally adjusted and annualised rates)										Size % total 2010
	2008	2009	Q1'10	Q2'10	Q3'10	Q4'10	2010	Q1'11	Q2'11		
Agriculture	16.1	-3.0	4.9	13.6	16.3	12.5	0.9	-3.7	-7.8	2.5	
Mining	-5.6	-4.2	18.7	-24.5	33.7	17.1	5.8	-4.0	-4.2	9.6	
Manufacturing	2.6	-10.4	8.3	5.7	-4.9	4.1	5.0	14.5	-7.0	14.6	
Power & Water	-3.1	-1.6	4.9	-1.7	-2.2	5.6	2.0	3.3	0.9	2.8	
Construction	9.5	7.4	1.3	1.0	0.8	0.2	1.5	0.0	0.5	3.8	
Trade	0.8	-2.5	3.1	6.0	3.3	3.5	2.2	4.4	4.1	13.9	
Transport & comm	3.4	0.6	2.4	4.5	3.0	4.2	2.9	3.6	4.1	9.1	
Finance	7.3	0.9	3.2	4.0	1.4	1.7	1.9	4.8	2.9	21.2	
General government	4.5	4.1	1.2	4.6	0.5	5.7	3.0	1.8	5.7	16.1	
Personal services	3.9	-0.3	3.5	3.6	3.1	3.3	0.6	2.7	2.8	6.3	
Value Added	3.7	-1.5	4.6	2.7	2.6	4.5	2.8	4.6	1.0	100.0	
GDP	3.6	-1.7	4.8	2.8	2.7	4.5	2.8	4.5	1.3		

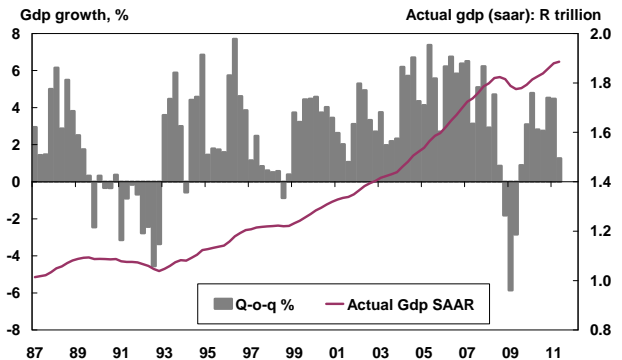
Source: Statistics South Africa

The economy stalled in the second quarter. **Real gdp** grew at a seasonally adjusted annual rate of only 1,3% over the quarter, much slower than the pace set in the previous two quarters. The sudden loss of momentum was mainly due to sharp falls in manufacturing, mining and agricultural production. The manufacturing sector was hard hit by a protracted strike in the automotive industry and global supply constraints caused by the natural disaster in Japan. Softer export sales due to a weaker global economy and fading export competitiveness also contributed. In the mining sector, safety concerns and technical problems disrupted production at some mines. Agricultural output was dragged down by drops in field crop and livestock production.

Producers relied more on inventories to meet demand. The rate of inventory accumulation slowed in the second quarter. Despite the tough environment, there were some positive developments. The private sector upped the pace of capital expenditure, with outlays rising by an annualised 4% off a low base. The agriculture, mining and telecommunications industries were mainly responsible for this acceleration. Commercial farmers were encouraged by higher global food prices and took advantage of the strong rand to modernise equipment. Within the mining industry expectations of continued strong demand for

commodities from emerging Asia convinced some firms to expand capacity, especially in gold, coal and platinum. Expansion activities in telecommunications were dominated by additional fibre-optic and cellular network capacity to meet rising demand and alleviate broadband constraints.

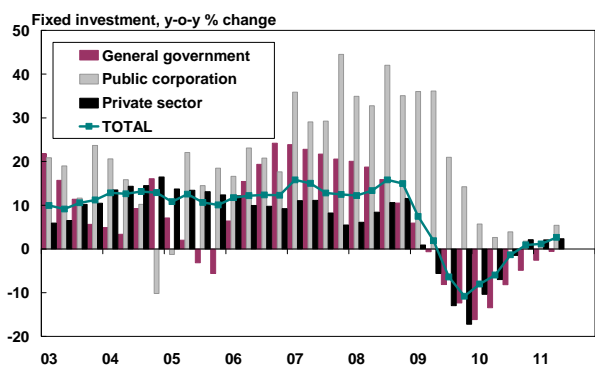
Graph 9: The economic recovery is stalling



Source: Statistics South Africa

Capital expenditure by public corporations also increased, but at a slower pace. Eskom and Transnet dominated activity as work on the new power stations and the multiproduct pipeline continued. However, the Reserve Bank noted that much of the spending was on machinery and equipment, with only marginal increases on construction works. Encouragingly, capital expenditure by general government picked up after nine consecutive quarters of decline. Provincial government and local authorities stepped up expenditure on housing and other general infrastructure. This helped the struggling construction industry, where real value added edged up slightly by 0,5% in the second quarter.

Graph 10: Capital formation is expanding, but at a slow rate

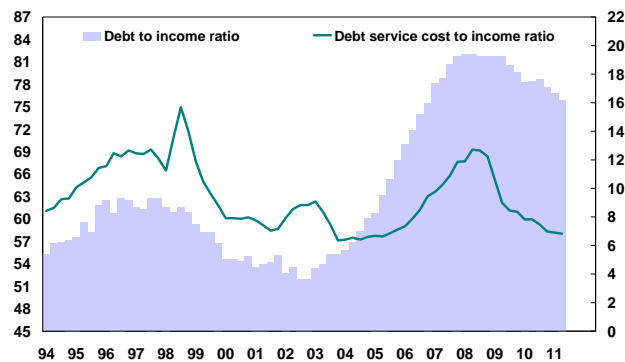


Source: South African Reserve Bank

The services industries fared relatively well, but growth rates moderated noticeably. Consumers were more cautious. Household spending rose at an annual rate of 3,8% over the quarter, still reasonable but considerably slower than the 5,2% pace set in the first quarter. The slew of bad economic news, both locally and abroad, clearly weighed on households, undermining confidence.

Disposable income still grew at a reasonable but slower pace of 4,1% over the quarter. However, higher prices of essentials, especially on food and fuel, eroded purchasing power. Asset prices also provided little incentive for spending. House prices faltered, while equity prices tumbled off earlier highs. Households also remained very reluctant to borrow despite interest rates hovering near 36-year lows. As a result, the ratio of household debt to disposable income dropped to 75,9% in the second quarter from 76,8% in the first quarter. Similarly, the ratio of debt servicing costs to disposable income eased to 6,8% from 6,9% previously.

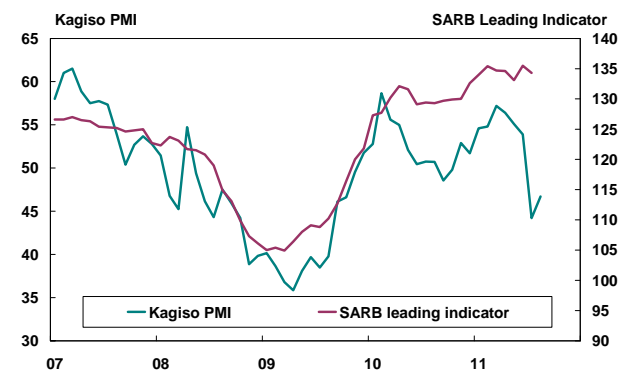
Graph 11: Trends in household debt



Source: South African Reserve Bank

The outlook for the rest of the year is subdued. More of the same mixture is expected. Consumer spending is likely to buoy the economy, while production and exports remain under pressure. Mining and manufacturing production fell sharply in July. The weakness probably continued for much of the third quarter, dragged down by waves of strikes and structural failure at some key steel producing plants. Exports will also remain sluggish as the world economy slows and commodity prices moderate.

Graph 12: Softer trend will stay in the short term

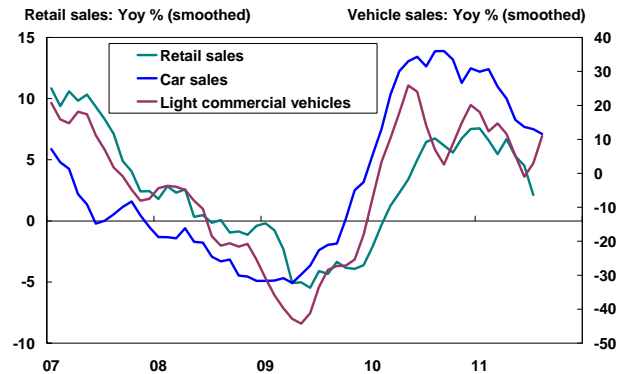


Source: South African Reserve Bank and BER/Kagiso Securities

The tougher environment will make firms cautious, discouraging rapid inventory accumulation while containing capital expenditure. Fixed investment by private firms will therefore continue to increase at only a moderate pace. The focus is more likely to be on

modernising existing facilities than aggressively adding to production capacity. But public corporations are expected to step up capital expenditure, especially as construction work at Medupi, Kusile and Ingula power plants returns to normal after labour-related disruptions earlier this year. Infrastructure spending by government should also improve further off a very low base. The recovery in capital expenditure, however modest, will provide some relief to the beleaguered construction industry.

Graph 13: Growth in consumer spending is also slowing



Source: NAAMSA and Statistics South Africa

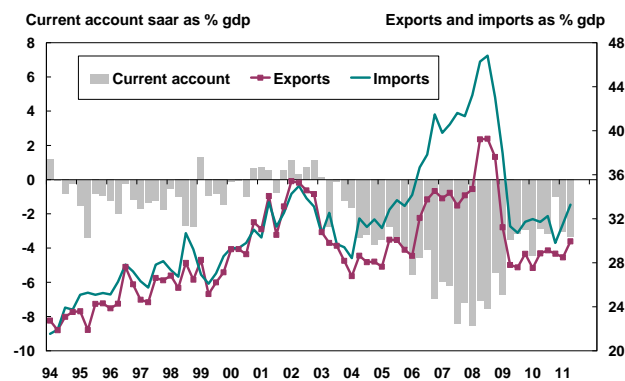
Rising disposable income and low interest rates will support household spending, but consumers will probably become more careful as prices rise, the economy stalls, worries about job security resurface and debt levels remain quite high. Wholesalers and retailers will benefit the most, but bankers and realtors will continue to toil under the drag of consumers' reduced appetite for credit and tighter regulatory requirements. Growth in government consumption expenditure is still expected to slow as budget constraints force some restraint. Overall, real gdp is forecast to grow by only 3,2% in 2011 as a whole and 3,5% in 2012. Much, however, will depend on the global economic climate, which has the potential to alter the outlook dramatically.

Underlying conditions related to the **balance of payments** remained relatively steady. The current account deficit widened to 3,3% of gdp in the second quarter from 3,1% in the first quarter. The slight deterioration was mainly due to a combination of a smaller trade surplus and a wider services deficit. On the trade account, import volumes outpaced those of exports and the terms of trade deteriorated further. However, capital inflows comfortably covered the shortfall on the current account. Net portfolio inflows swelled on strong foreign demand for local government bonds. In contrast, foreign appetites for local equities waned on risk perceptions and valuation concerns. Encouragingly, net direct investment increased, mainly reflecting the impact of the Walmart/Massmart deal.

The trade balance is expected to deteriorate further during the remainder of this year. Softer global demand will

contain growth in export volumes, while continued consumer spending and demand for capital goods will prop up import volumes. However, the country's terms of trade (the ratio of export to import prices) should improve slightly as gold and platinum prices hold relative to oil and food prices. The services deficit will widen as dividend payments to foreigners continue to rise on improved corporate earnings. Overall, the deficit on the current account of the balance of payments is forecast to widen to around 4% of gdp in 2011 from 2,8% in 2010. Capital inflows should remain more than sufficient to offset the shortfall on the current account deficit, but net portfolio inflows will remain volatile given heightened uncertainty about global growth prospects and lingering concerns about valuations of emerging market assets.

Graph 14: Current account deficit little changed

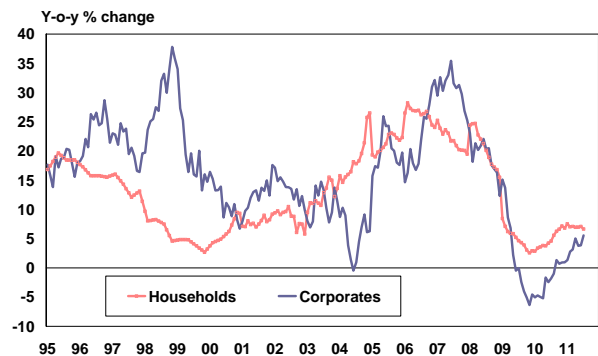


Source: South African Reserve Bank

**Credit demand** remained subdued in the first seven months of this year. Growth in private sector credit extension eased to 5,7% y-o-y in July, after crawling up to 6,2% in April from 5,5% at the end of last year. Household demand continued to drive the slow recovery in bank loans, mainly due to strong demand for unsecured personal loans and the continued recovery in instalment sales and leasing finance. In contrast, mortgage finance remained weak. Corporate demand for credit also remained muted due to poor business confidence and a generally erratic and unfavourable investment environment.

Credit growth is expected to rise modestly off a low base during the remainder of this year, supported by still low interest rates and reasonable income growth. However, high existing debt levels, tighter lending standards, rising cost pressures and worries about job security due to a faltering economy will contain the pace of the recovery. Corporate demand for credit will remain relatively subdued as businesses stay hesitant to expand operations too aggressively, given lingering uncertainties over the strength of the local and global recoveries, significant power and transport infrastructure constraints, ample spare capacity in some sectors and an uncertain regulatory and policy environment.

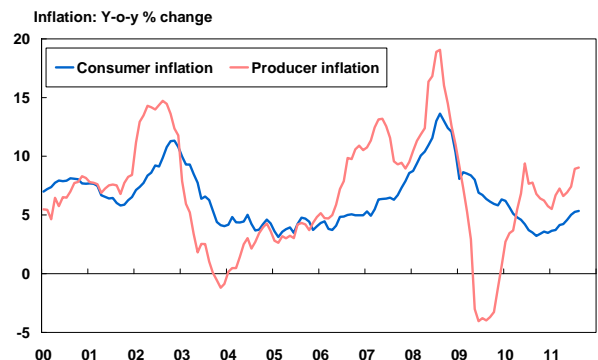
Graph 15: Credit growth still modest



Source: South African Reserve Bank

**Inflation** rose steadily since the start of the year. The low base established in 2010, rising food and fuel prices and surging electricity tariffs were behind the rise. Consumer inflation reached 5,3% in August from 5% in June and 3,5% at the end of last year. Inflation is forecast to move higher off the low base during the remainder of the year as the earlier surge in global food and fuel prices slowly filters through and the rand depreciates. Inflation is expected to rise towards 6% by the end 2011, before breaching the upper limit of the Reserve Bank's target band in early 2012. The upside risks to the forecast will mainly come from above-inflation wage increases, a sharper-than-expected depreciation of the rand or renewed upward pressure on global food and oil prices.

Graph 16: Consumer inflation still low, but rising

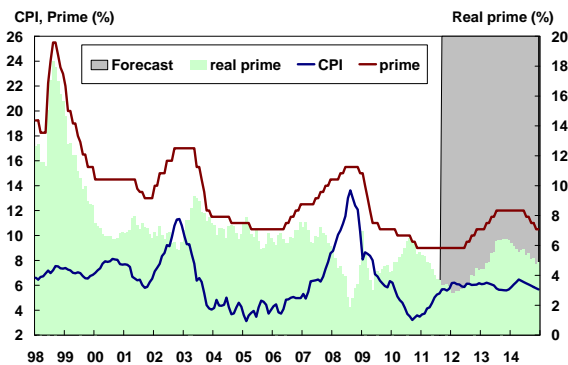


Source: Statistics South Africa

The Reserve Bank's Monetary Policy Committee (MPC) maintained its accommodative stance in the September meeting, leaving the repo rate unchanged at 5,5%, which kept the prime rate at 9% – its lowest level since May 1974. The Reserve Bank still expects consumer inflation to breach the upper 6% limit of the target range by the end of 2011, peaking at 6,2% in the first quarter of 2012, before easing back into the target range by the second quarter of next year and ending 2013 around 5,5%. Although inflation is expected to breach the target band, the Committee felt that the downside risks to economic growth continued to outweigh the upside risks to inflation. Concerns over the potential impact of slower growth in the

United States and Europe on an already fragile local recovery dominated. In contrast, the sources of inflation remained contained, driven mainly by administered prices and external factors. The Committee therefore felt that there was little evidence of more generalised inflationary pressure, with retailers still lacking pricing power and credit demand still very weak, suggesting that the breach was likely to be temporary. In the months ahead, the economy will probably remain under pressure, with local producers taking considerable strain and the world economy looking increasingly vulnerable. Consequently, the MPC will probably maintain its neutral stance for longer, leaving **interest rates** unchanged until the second half of 2012. In the short term the risk remains to the downside, especially if the current lull in both the global and local economies were to continue or worsen.

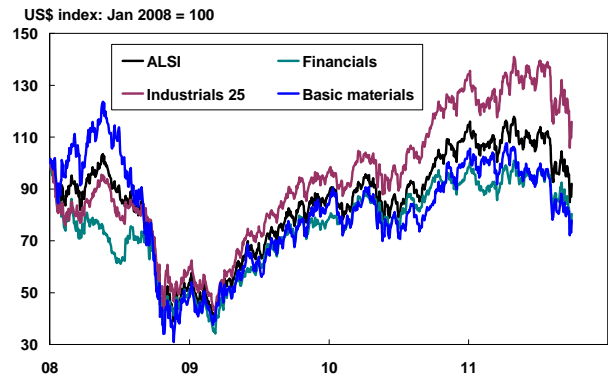
Graph 17: Inflation and interest rate forecasts



Sources: Statistics South Africa, Nedbank calculations

**Financial markets** weakened sharply in the six months to September. Volatile and weak global markets dragged local **equity prices** down. International investors were spooked by signs of a faltering global recovery, led by weak confidence, employment, production and consumption statistics from the United States and Europe. Softer industrial activity in China and other large emerging markets, mainly in response to surging cost pressures and tighter monetary policy, heightened fears of a possible global double-dip recession. However, the risk of sovereign default by Greece and contagion to other European countries continued to dominate the headlines, pushing yields on Spanish, Italian and even French bonds sharply higher. Investors were also unsettled by the prolonged US impasse over the lifting of the debt ceiling and the unexpected ratings downgrade of US and Japanese long-term debt. In late September rand weakness led to renewed interest in local resource counters, which helped to contain the fall in the FTSE/JSE all-share index to only 2,5% for the year to date. Resources shed 8% of its value since the start of the year, while industrials and financials fell by 10,3% and 1,6% respectively over the same period. Local equities are expected to remain volatile throughout 2011, given elevated levels of risk aversion globally and valuations concerns locally.

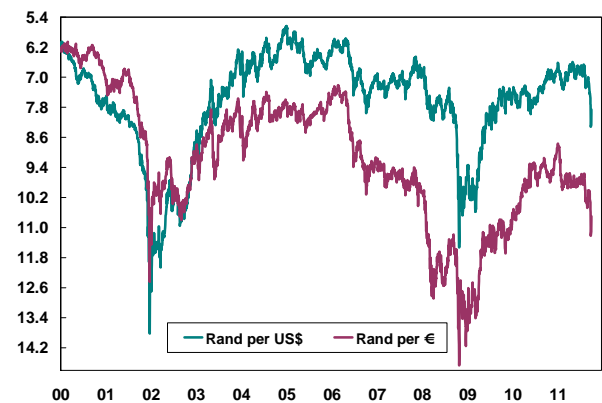
Graph 18: Equity prices still reflecting uncertainty



Source: I-Net Bridge

**Bond yields** edged up slightly in September after strengthening in August on a renewed surge of foreign buying as sovereign debt worries in Europe intensified. The yields on the R157 2015 and the R186 2025 rose to 6,94% and 8,31% respectively by mid-September, after easing to 6,52% and 8,11% at the end of August from 7,50% and 8,59% at the end of June. The local bond market is likely to remain relatively firm in the months ahead as foreign investors look for a combination of respectable returns and sound credit ratings. However, with the risk to local inflation edging up, some reversal is likely towards the end of 2011 and into 2012.

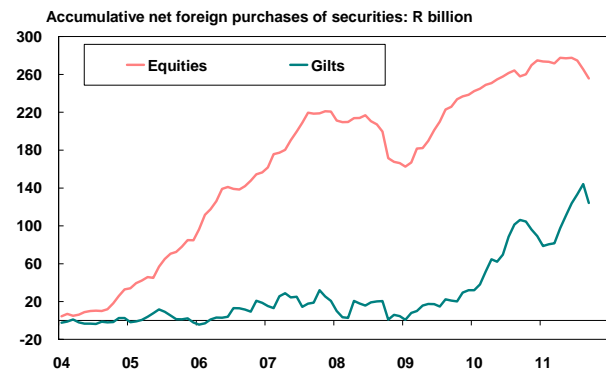
Graph 19: The rand has weakened



Source: Reuters

The **rand** came under pressure in late August and much of September as global risk aversion rose sharply on the same worries that haunted world equity markets over this period. On a trade-weighted basis the rand weakened by 6,6% in August and September, taking the depreciation for the year to date to 13,4%. The rand lost the most ground against the Japanese yen, which together with the Swiss franc rose sharply on their safe-haven credentials. The local unit also depreciated against the beleaguered euro and the troubled US dollar. Fears of a possible double-dip recession resulted in some retreat from emerging markets into gold and other safe havens.

Graph 20: Portfolio outflows on increased global risk aversion



Sources: Reuters, Nedbank calculations

The rand is likely to remain volatile in the months ahead. The local unit will probably weaken further, dragged down by weak investor sentiment and waves of risk aversion. Investors will remain nervous as European policymakers seem unlikely to contain the fallout from Greece's sovereign debt crisis and that of other peripheral countries, with only moderate global growth and pressure on commodity prices.

**Nicky Weimar**

## FACTS AND FORECASTS OF KEY ECONOMIC VARIABLES

30 September 2011

	2007	2008	2009	2010	2011	2012	2013
<b>Growth (real, % change)</b>							
GDP	5,6	3,6	-1,7	2,8	3,1	3,5	4,1
GDE	6,3	3,4	-1,7	4,2	4,3	4,5	4,8
PCE	5,5	2,2	-2,0	4,4	4,5	4,2	4,6
GDFI	14,0	14,1	-2,2	-3,7	2,5	4,5	5,8
Exports	6,6	1,8	-19,5	4,5	4,1	5,0	8,0
Imports	9,0	1,5	-17,4	9,6	8,3	8,5	9,5
<b>Balance of payments (Rbn)</b>							
Exports	537,5	704,3	556,4	625,4	739,6	935,2	1 182,5
Imports	573,9	739,9	554,2	598,2	704,0	892,7	1 100,7
Trade balance	-36,3	-35,6	2,3	27,2	35,5	42,5	81,7
Net services	-104,2	-126,3	-99,3	-102,2	-123,5	-160,1	-195,3
Current account	-140,6	-161,9	-97,1	-75,0	-88,0	-117,6	-113,5
Capital account	188,4	187,9	114,1	106,3	120,0	165,0	190,0
Change net reserves	47,8	26,1	17,0	31,3	32,0	47,4	76,5
Gross reserves (eop)	224,3	317,3	293,0	290,7	354,1	428,8	529,3
Current account as a % of GDP	-7,0	-7,1	-4,1	-2,8	-3,7	-4,5	-3,8
<b>Gold price (average per ounce)</b>							
Dollar	696,5	872,2	973,1	1 226,8	1 563,1	1 802,9	1 829,3
Rand	4919	7208	8217	8996	11294	14105	15129
<b>Exchange rates</b>							
Dollar-rand	7,06	8,26	8,44	7,33	7,23	7,82	8,27
Euro-dollar	1,37	1,46	1,39	1,33	1,40	1,34	1,31
Dollar-yen	117,7	103,4	93,5	87,8	79,5	79,3	79,6
British pound-dollar	2,00	1,83	1,56	1,54	1,60	1,63	1,74
Euro-rand	9,67	12,10	11,75	9,76	10,11	10,46	10,81
Rand-yen	16,7	12,5	11,1	12,0	11,0	10,1	9,6
GBP-rand	14,13	15,16	13,17	11,33	11,57	12,75	14,36
<b>Interest rates (end of period)</b>							
Three-month JIBAR	11,25	11,43	7,23	5,55	5,58	7,28	8,53
Prime	14,50	15,00	10,50	9,00	9,00	10,50	12,00
Long bond	8,35	7,33	9,08	8,15	7,86	8,42	8,28
<b>Inflation (average)</b>							
CPI new			7,1	4,3	4,9	6,1	6,0
CPIX (metro and other urban)	6,5	11,3					

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## FACTS AND FORECASTS OF KEY ECONOMIC VARIABLES

30 September 2011

	2010				2011				2012			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
<b>GDP (q-o-q annual %)</b>	4,8	2,8	2,7	4,5	4,8	0,9	1,5	2,5	4,4	4,5	4,3	4,2
<b>Interest rates</b>												
Three-month JIBAR	6,67	6,62	6,03	5,55	5,58	5,58	5,58	5,58	5,63	5,78	6,78	7,28
Prime	10,00	10,00	9,50	9,00	9,00	9,00	9,00	9,00	9,00	9,00	10,00	10,50
Long bond (10 yr)	8,62	8,86	7,90	8,15	8,76	8,39	7,64	7,86	7,93	8,05	8,39	8,42
<b>Inflation</b>												
CPI new	5,1	4,2	3,2	3,5	4,1	5,0	5,7	5,7	6,1	5,9	6,0	6,2
CPIX												
<b>Exchange rates</b>												
Dollar-rand	7,36	7,65	6,98	6,62	6,78	6,76	8,02	7,78	7,62	7,77	7,93	8,09
Euro-dollar	1,36	1,22	1,36	1,34	1,42	1,45	1,37	1,38	1,35	1,34	1,32	1,31
Dollar-yen	93,2	88,6	83,4	81,6	82,8	80,5	76,7	77,1	78,6	79,8	80,2	80,6
British pound-dollar	1,51	1,51	1,59	1,55	1,59	1,61	1,56	1,58	1,60	1,63	1,66	1,68
Euro-rand	9,99	9,36	9,48	8,84	9,62	9,81	10,97	10,70	10,28	10,38	10,48	10,59
Rand-yen	12,66	11,58	11,95	12,32	12,20	11,90	9,56	9,91	10,31	10,26	10,11	9,96
GBP-rand	11,09	11,52	11,06	10,29	10,77	10,89	12,47	12,29	12,23	12,67	13,13	13,61
<b>Gold price per ounce</b>												
\$	1109	1243	1310	1426	1432	1510	1624	1722	1790	1844	1826	1807
Rand	8161	9513	9136	9442	9713	10210	13021	13388	13645	14336	14476	14618

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