SOUTH AFRICA

The pace of recovery has slowed as a result of weak external demand, negative effects of the global slowdown on consumer and investor confidence and domestic labour unrest. As these factors ebb, growth should pick up somewhat in 2012, but remain below potential for a fifth consecutive year. As confidence returns, output growth should accelerate more decisively in 2013. Inflation is at the upper end of the central bank's target range, but in the absence of further rises in commodity prices and given the negative output gap should ease to the middle of the target range by 2013.

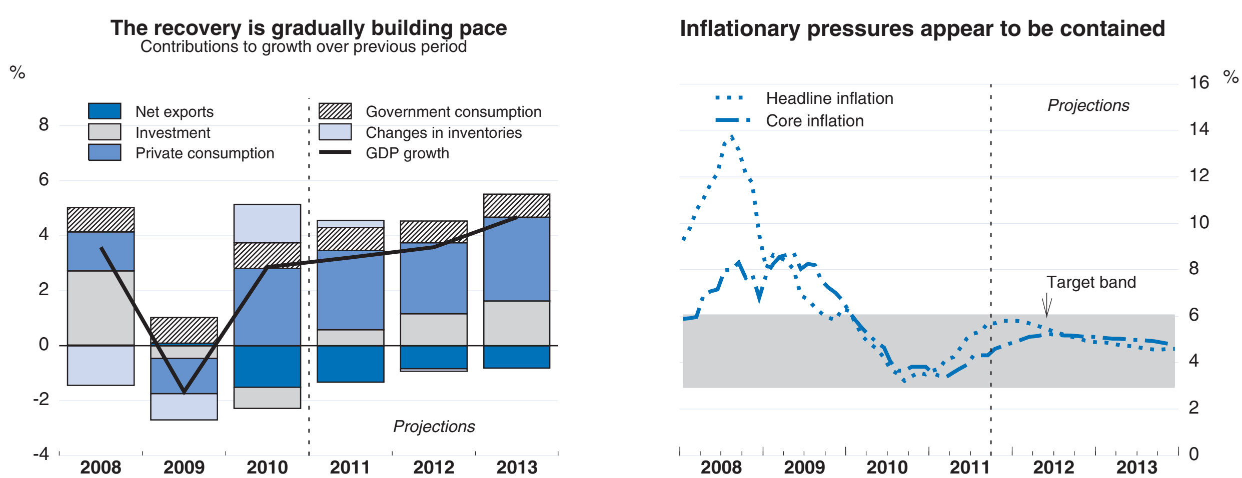
Less dynamic external demand and domestic labour unrest have restrained output growth

Private consumption and fixed investment have increased roughly in line with potential in recent quarters, but export growth has slowed while import volumes continue to expand faster than real GDP. Output has also been disrupted by strikes. Average annual ouput growth in 2011 is expected to be below potential for a fourth consecutive year, and unemployment has continued to edge up, averaging over 25% so far this year. With an expected gradual strengthening of confidence and a recovery in external demand growth after recent weakness, GDP growth should accelerate, with the output gap beginning to narrow in 2013.

Inflation should ease as recent food and energy price shocks fade

Strong improvements in the terms of trade helped to compress the current account deficit in 2009-10, but that effect has been partially reversed in 2011 and the deficit has begun to widen again. Over the past year headline inflation has moved up from near the bottom of the 3-6 per cent target band of the South Africa Reserve Bank (SARB) to near the top, but most of that increase came from higher food and fuel prices. Core inflation rose by only 0.7 percentage point in the year to September 2011, reaching 4.3%. Inflation expectations moved up with the rise in the headline rate, but remain consistent with the SARB's target

South Africa



1. *Note*: Break in inflation series in 2008. Numbers are not fully comparable.
Source: OECD Economic Outlook 90 database and South Africa Reserve Bank.

StatLink http://dx.doi.org/10.1787/888932541588

South Africa: **Macroeconomic indicators**

	2009	2010	2011	2012	2013
Real GDP growth	-1.7	2.8	3.2	3.6	4.7
Inflation	7.1	4.3	4.9	5.3	4.7
Fiscal balance (per cent of GDP)	-5.5	-6.0	-6.0	-5.6	-4.8
Current account balance ($ billion)	-11.2	-10.1	-15.0	-18.7	-21.2
Current account balance (per cent of GDP)	-4.1	-2.8	-3.7	-4.7	-4.8

Source: OECD Economic Outlook 90 database.

StatLink http://dx.doi.org/10.1787/888932543089

range. Inflation is expected to test the upper end of that range in late 2011 and early 2012 before falling back as base effects become more favourable.

The central bank should remain responsive to weakening activity

Faced with unexpected weakness in economic activity and notwithstanding the increase in headline inflation, the SARB has held its repurchase rate constant at 5.5% since November 2010. Given the large negative output gap and adequately anchored inflation expectations, this was well judged. Along with other emerging markets, South Africa has been hit by a wave of risk aversion in international capital markets since September, and the rand weakened sharply. There is likely to be some passthrough of that exchange rate move to consumer prices, but the SARB should continue to look through such temporary factors, and may need to ease further if demand growth continues to disappoint.

Fiscal consolidation should be accelerated

The recent Medium-Term Budget Policy Statement foresees only a modest narrowing of the budget deficit through fiscal year 2014-15, mainly due to subdued revenue growth. On the current projection, a more ambitious profile of fiscal consolidation would not only safeguard debt sustainability but also contribute to higher national saving, reduce upward pressure on the exchange rate and crowd in private investment.

Downside risks predominate

The main risk to the projection is a worsening of the sovereign debt crisis in OECD countries, which would undermine external demand and probably result in lower prices for South Africa's main exports.

Policy orientation should downside risks materialise

If such downside risks materialised, the OECD has identified, as part of its Strategic Response, key macroeconomic policies, as well as structural reforms which, while desirable in any case, would become essential to raise growth.

- The first line of defence if the economy is weaker than projected should be monetary policy, although on the fiscal side the automatic stabilisers should be allowed to function, which could mean that the overall deficit rises temporarily.
- Fiscal policy was too loose in the last cyclical upswing, and South Africa has had continuous underlying budget deficits, even though there were headline surpluses for a time before the 2008-09 crisis. The scope for

fiscal stimulus in the event of an economic slowdown is therefore less than it would have been if fiscal policy had been more countercyclical. The Treasury should continue to place increasing emphasis on the structural balance, for which it could eventually adopt medium-term targets. Such a rule could usefully be buttressed by an expenditure rule to restrain procyclical spending increases in good times.

- The main inflation risks would come from a sharp weakening of the rand or surges in international food and energy prices. Underlying inflation looks well anchored within the target range of the SARB, and the negative output gap suggests that, despite some continuing cost-push pressures, inflation will ease over the next two years. In the event of a weakening of the economy, there therefore appears to be scope for further reductions in the SARB's policy rate.
- Given the extremely high unemployment rate, especially for youth, structural measures should above all focus on encouraging employment. Over the longer term, higher labour force participation will be needed, and activation policies will be important. If the economy weakens, however, measures to boost labour demand, like wage subsidies, would be particularly useful.
- Liberalising product markets would strengthen competitive forces in the economy, and would thereby improve the functioning of labour markets by limiting the sharing of product market rents between firms and employed insiders.

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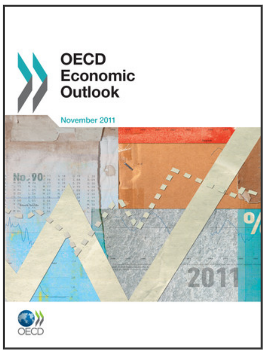

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