ECONOMIC AND BUSINESS OUTLOOK FOR SOUTH AFRICA IN 2012

Introduction

Since the release of BUSA's economic and business outlook of 2012, in December, the global economic conditions have taken a turn for the worst. The principal factor set to dominate the South African economic environment in 2012 is the impact of the deteriorating global economy, in particular the ongoing European debt crisis. The year looks to be challenging, and growth in the South African economy threatens to hold back, following on the timid pace set in the second half of 2011. Given the assumptions on the global environment, BUSA offers an assessment of economic and business trends- the possible outlook for this year and policy recommendations to equip the economy on "weathering the storm". What BUSA wishes to do in this document is to broadly unpack current economic trends, outline what certain trajectories of the South African economy might be in the immediate future. And lastly, offer a response to the global crisis from a business perspective. This is based on an evaluation of existing economic data, recent discussions at BUSA's Economic Policy Committee and input from members of BUSA.

The assessment will therefore broadly revolve around:

- The global economic outlook, the key drivers and challenges
- SA domestic macroeconomic dynamics and business environment
- SA Global competitiveness
- Expectations of the 2012 National Budget

Global Economic Outlook- Key Drivers and Challenges

The global economy has entered a dangerous new phase. Global economic activity has weakened further and become more uneven, confidence has dropped and downside risks are increasing. While further bailout arrangements have been proposed for Greece and Italy, the two year Eurozone sovereign debt crisis remains largely unresolved and fears of a "double dip" recession have risen sharply. Both the World Bank and the IMF have recently lowered their global growth forecasts, projecting a slight recession for the Eurozone in 2012.

Weakening global trade and commodity prices are expected to keep global growth contained, while the rebound of activity in Japan and solid growth in developing nations will support growth. According to the World Bank's Global Economic Prospects (GEP) 2012, global output is now projected at 2.5 and 3.1 percent for 2012 and 2013, respectively. GDP estimates for developed nations have been downwardly revised to 1.4% in 2012 (previously 2.7%), with the Eurozone set for a mild contraction in 2012 at minus 0.3%. This is notably down from the Bank's June estimate of a 1.8% Eurozone expansion for the year.

The IMF has lowered its global growth projections to 3.3 and 3.9 percent in 2012 and 2013, respectively; these projections are down 0.7 and 0.6 percentage points from the September 2011 assumptions. Growth estimates for advances economies have fallen to 1.2% (previously 1.4%) and 1.9% (previously 2.4%) in 2012 and 2013, respectively. The IMF sees the Eurozone contracting by 0.5% (previously +1.1%) in 2012, while the 2012 growth forecasts for the US remain unchanged at 1.8%(assuming that US policymakers are able to introduce fiscal reform). Furthermore, recent data suggests a slightly more positive outlook for the US economy.

Prospects for emerging market economies have also become more uncertain, although some economies can counter the effect on output of weaker foreign demand with less policy tightening. Despite the downward revisions (on the back of the downturn in developed economies), emerging nations are still expected to achieve rapid growth in 2012, of 5.4% according to both the IMF and the World Bank. Growth in the Sub-Saharan region is expected to remain lively in 2012 on the back of "increased investment flows, rising consumer spending and the coming on stream of new mineral exports in a number of countries" within the region. The Sub-Saharan region is projected to growth by 5.3% in 2012 and 5.6% in 2013 according to the World Bank. This is relatively in line with the assumptions made by the IMF, of the region expanding by 5.5% and 5.3% in 2012 and 2013, respectively. South Africa (which accounts for an estimated ¾ of the region's growth) is set to expand at a slower pace according to the IMF, at 2.5 and 3.4 percent, in 2012 and 2013, respectively.

Following the benefits derived from the rapid surge in crude oil prices in first half of 2011, growth in the Middle East and North Africa region is expected to moderate in 2012, to 2.3% (World Bank) and 3.2% (IMF).

A bird's eye view of the global economy therefore suggests that this remains a delicate moment for it, and the crisis is not over until the key economies are creating enough jobs. There remains the concern that if the downside risks reinforce each other, the cumulative impact could possibly trigger stagflation in some advanced economies. The risk of the Eurozone 'disintegrating' is also now higher, attributable to financial panic, a rapidly weakening economic outlook and political brinkmanship.

Domestic Economic Outlook

In its last MPC address, the South African Reserve Bank downwardly revised its growth forecasts to 2.8% for 2012 (down from 3% previously), while growth expectations for 2013 fell to 3.8% (down from 4.2% previously). This goes to show that the economic prospects for South Africa may be not as strong as the pre-recession prospects and unemployment will continue to be high. Growth is the South African economy has been sluggish in the previous year(2011) with GDP coming out at a disappointing 1.4% in the third quarter of 2011 on a seasonally adjusted and annualised basis. Most analysts in the country have downwardly revised their GDP forecasts i.e. "The December Reuters Econometer showed analysts had cut their gross domestic product (GDP) forecasts, with the economy expected to grow by a median 2.8% in 2012, compared with 3.0% in the previous poll"(source fin24). BUSA, not being oblivious to the global and domestic trajectory, has also downgraded its GDP forecasts. We now expect the domestic economy to grow by 2.7% in 2012 (down from 3%) and 3.3% (down from 3.8%).

One of the main drivers for this gloomy outlook is the dampening of global growth/demand(from SA's key trading partners) in particular the Eurozone, which accounts for about a third of our trade and is a major partner in trade agreements.

The CPI is currently at 6.1% which is just outside of the SARB target range of 3%-6%. The CPI has been on an upward trend for most part of 2011, the main drivers being of a cost-push nature, such as food prices and administered prices(mostly electricity). This poses a dilemma for the SARB of having to combat inflation while trying to support a fragile economy. The MPC decided to leave the interest rate unchanged at 5.5%(all time low) at its first meeting of the year. Interest rates have remained flat for the whole of 2011(the SARB has dropped rates by 650 basis points since 2010). BUSA feels that the Bank could have been lowered rates by at least 0.5 basis points bringing the repo rate to 5.0% in an effort to induce stronger growth, especially given that inflation is not demand driven. Core inflation remains within the Bank's target. The CPI is expected to remain outside of the target range for most part of 2012 with inflation expectations remaining outside the target range, this may perhaps be an incentive for the SARB to raise interest rates within the 1st qrt of 2013. The PPI is expected to slow due to moderating commodity prices.

Manufacturing came out stronger in November at 2.6 y-o-y, this however is a slight improvement given that it has been under pressure for most part of the year in 2011. The Primary sector was also in the woods for most part of 2011, this is an indication that the production side of the economy was under pressure for most part of 2011. Manufacturing may have shown an improvement but it is not out of the woods yet given that exports will be under pressure for most of 2012 due to global demand. Furthermore, the sticky high unemployment rate could hinder consumer demand for domestically manufactured goods. The Kagiso PMI showed a further drop below the 50 mark in December. Perhaps the SEZ (Special Economic Zones) bill being introduced by Trade Minister Rob Davies which aims to support industrial development in certain regions might help mitigate some of the risks faced by the manufacturing sector.

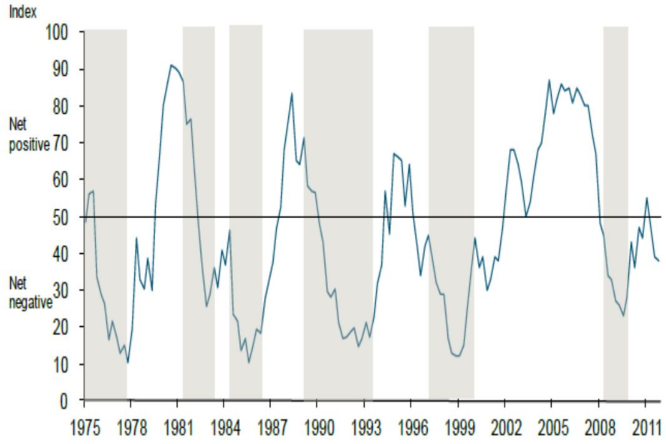
Retail sales continue to be the better performing indicator amidst gloomy prospects with total sales growing by 6.8% y-o-y in November. This goes to show that consumer spending, although moderate, has been a supporting factor in keeping economic growth positive. Retail sales and consumer spending are expected to have been high in December due to the December holidays and the benefits of the relatively low interest rates, but this peak is expected to dampen in 2012 because of inflation prospects/expectations.

In line with the subdued global and domestic economic sentiment, investor confidence remained timid during the fourth quarter of 2011 (Q4 2011). The FNB/BER business confidence index moderated further (albeit marginally) to 38 index points during Q4 2011 (Graph 1). The principal driver for the hesitant sentiment within the business environment is the decline in confidence of new vehicle dealers to 44 index points in Q4, down from 58 in the preceding quarter. Business sentiment remained muted amongst the manufacturing and building industries, with both indices falling by one index point during the quarter, down to 35 and 19 respectively.

Confidence in the domestic manufacturing sector is likely to deteriorate during the course of 2012, as global trade slows. South Africa's largest trade region (Eurozone) is set to experience a mild recession in 2012. Building activity will also remain sluggish on the back of the projected slower pace of domestic activity.

In contrast, sentiment within amongst retailers and wholesalers improved duringQ4 2011, limiting the extent of the fall in overall business confidence. Retail confidence recovered by 8 index points, to 56, while wholesale confidence quickened to 38, up from 31 in Q3 2011. However, an improvement within the trade sector is expected during Q4, given the benefits derived from the festive season.

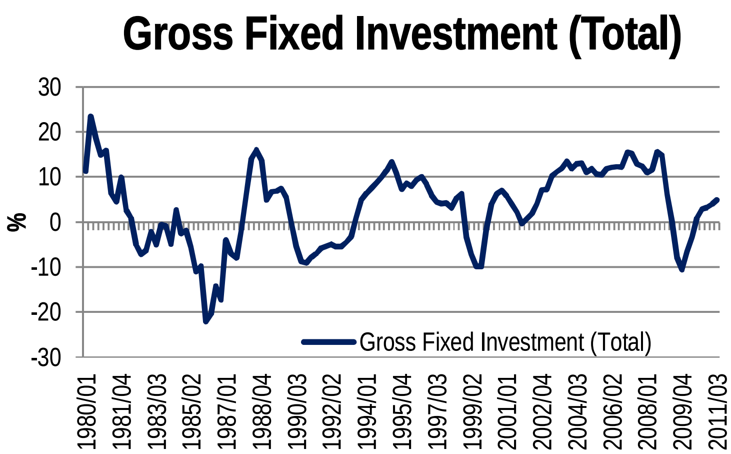
Graph 1: FNB/BER Business Confidence Index



Source: BER, SARB (Shaded areas represent economic downswings)

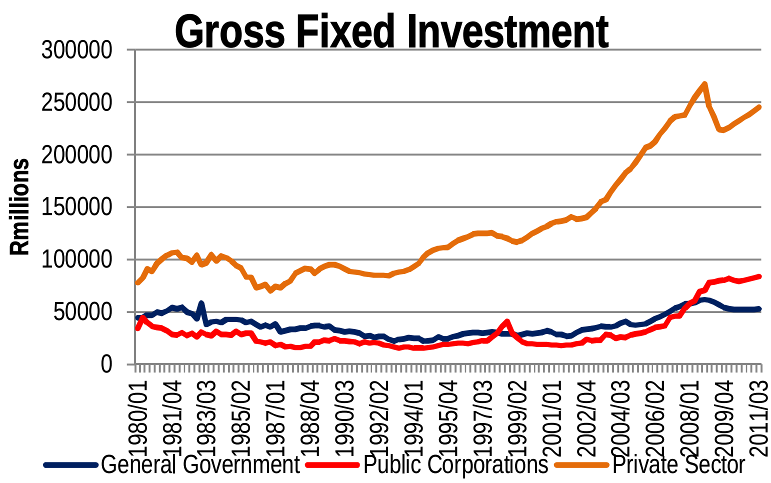
Turning to investment expenditure, gross fixed capital formation rose by a seasonally adjusted and annualized 5.6% in Q3 2011, up from 5% in the preceding quarter (Graph 2). This is attributable to increased capital outlays by the agriculture and 'transport, storage and communications" industries.

Graph 2: Fixed Investment



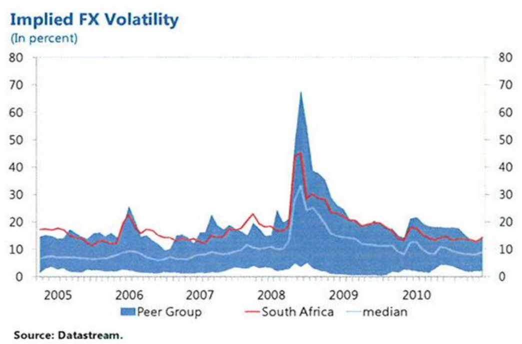
Prior to the devastations of the 2008/2009 recession, the private sector was the biggest driver of domestic investment, as shown in graph 3. What was most concerning about this was that the lack of investment by the public sector (improved rail, road and overall infrastructure) was not supportive of maximum business expansion which is critical in job creation (Graph 3). However, following the energy crisis, government via its public corporations increased capital outlays. Increased investment expenditure, in particular Eskom and Transnet supported investment growth during the turbulent economic environment.

Graph 3: Fixed Investment by Economic Activity

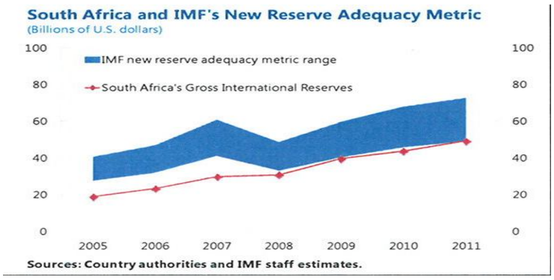


Turning to the rand, the local currency was instrumental in keeping inflation contained for the greater part 2011, counteracting the negative impact of the rapid surge in commodity prices, seen in the first half of the year. However, the strength and volatility (the rand is highly volatile compared with its emerging market peers (Graph 4)) hampered export oriented sectors, such as manufacturing, prompting the call for the Reserve Bank to intervene more in the currency market.. According to the IMF, South Africa's Reserves remain below the Adequacy Range, allowing for more room for reserve accumulation (Graph 5). With South Africa's relatively high interest rates, compared with that of the US and Euro, there was an influx of foreign capital which kept the currency strong. There has been a reversal in the rand trajectory since sharp fall in August 2011. Even though this was a welcomed change, the industrial sector has not reaped the full benefits given the embedded structural constraints curtailing industrial competitiveness. Moreover, the currency depreciation was not immune to South Africa, but across emerging markets, which are more efficient export oriented sectors, thus further strengthening their competitiveness against South Africa.

Graph 4: Rand Volatility

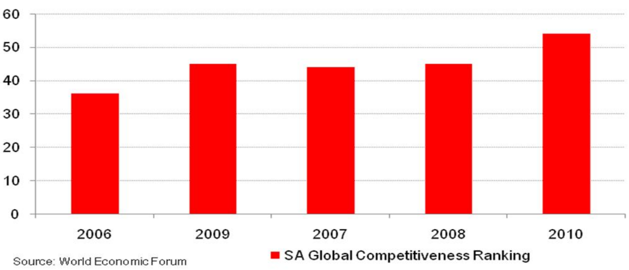


Graph 5: SA Reserve Accumulation and the IMF Range

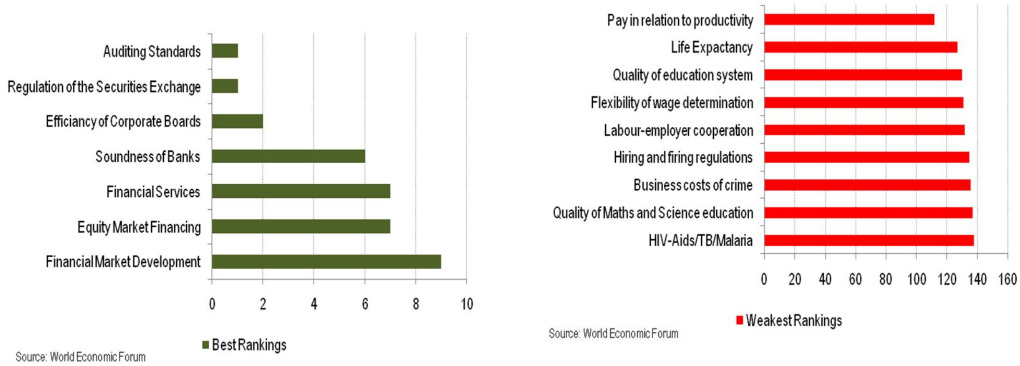


South Africa is falling in terms of its relative competitiveness, with the biggest shortfalls stemming from increasing structural constrains.

Graph 6: SA Global Competitiveness Ranking

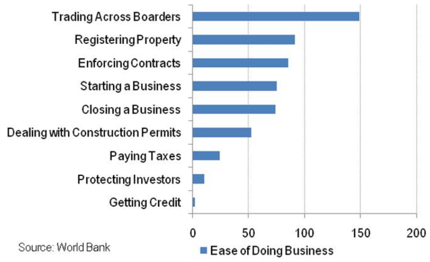


Graph 6: Best and Worst Rankings



The country's ranking in terms of the "Ease of doing business" has also fallen; the biggest contributors to the downgrade include the difficulties associated with trading across borders, registering property, enforcing contracts and starting a business. This coincides with the recent survey published by Grant Thornton, which highlights "overregulation and red tape" as the biggest constraints to business expansion in South Africa.

Graph 7: Ease of Doing Business Ranking



2012 NATIONAL BUDGET PREVIEW

The assumptions underlying the 2012 budget are volatile and uncertain, presenting a challenge for fiscal policy in trying to contain the budget deficit in the face of falling revenue collection and the need to support the fragile economy.

In the October 2011 MTBPS, the Minister managed to deliver a solid, balanced speech in the midst of a waning domestic economy and uncertain global economic environment. The speech built on the themes of prioritizing job creation, poverty reduction, infrastructural development and economic growth. The deteriorating economic environment prompted government to focus on key areas that will boost economic growth.

BUSA looks for the 2012 Budget Speech to follow on the themes laid out in the 2011 October MTBPS with no real shocks and a speecg that will boost business confidence.

The key issues and recommendation towards the 2012 National Budget, include:

- How is the government planning to address the budget deficit?
- What strategy does the Treasury have to control the wage bill (especially in light of the rising inflation expectations)?
- Avoiding tax shocks
- More focus on provincial budget management following the recent evident of highlighting the poor state of provincial public finances.
- BUSA welcomes policies such as the New Growth Path and efforts to boost job creations but would like to see more effort directed towards implementation.
- BUSA would like to see a balance between increased welfare spend and the burden on the tax payers. Furthermore, even though social security has played a pivotal role in poverty reduction and expanding the economically active population of the country, the government needs to be mindful of encouraging state dependency, as social expenditure makes up a huge portion of total government expenditure (table 1) . The opportunity costs of which is increasing expenditure of job is creating categories such as economic services.

Table 1: October 2011 MTBPS Expenditure Estimates

Consolidated Government Expenditure by Function (R bn)	2011/12	2012/13	2013/14	2014/15	Average annual growth,
	Revised estimate	Medium-term estimates			2011/12-2014/15
General public services	53.0	54.7	58.7	64.9	7.0
Defence	38.3	41.8	44.4	47.0	7.1
Public order and safety	90.6	98.8	105.9	112.1	7.4
Economic infrastructure	77.4	85.5	91.9	101.5	9.5
Environmental protection	52.4	56.3	60.2	62.6	6.1
Housing and community amenities	121.5	128.4	140.5	146.2	6.4
Health	113.2	121.5	130.6	140.1	7.4
Recreation and culture	9.6	9.6	9.2	9.7	0.2
Education	190.8	202.6	218.2	231.7	6.7
Social protection	147.8	159.8	172.6	182.3	7.2
Allocated Expenditure	901.9	967.2	1041.3	1107.9	7.1
State debt costs	76.9	89.1	104.1	115.1	14.4
Contingency reserve	-	6.0	12.0	24.0	
Consolidated expenditure	**978.8**	**1062.3**	**1157.4**	**1247.0**	**8.4**

* Consisting of national, provincial, social security funds and selected public entities.

Source: National Treasury, Medium Term Budget Poilcy Statement 2011

Table 2: Macroeconomic Projections

Calender Year	2008	2009	2010	2011	2012	2013
Annual Growth %	Actuals			Forecasts		
PCE	2.2	-2.0	4.4	4.0	3.3	4.5
GFCF	14.1	-2.2	-3.7	2.3	3.2	4.2
Exports	1.8	-19.5	4.5	4.3	3.9	4.7
Imports	1.5	-17.4	9.6	8.3	8.0	9.1
Real GDP	**3.6**	**-1.7**	**2.8**	**3.0**	**2.7**	**3.3**
CPI	11.3	7.1	4.3	5.0	6.0	5.6
Prime rate	15.0	10.5	9.0	9.0	9.5	10.0
C/A as % GDP	-7.1	-4.1	-2.8	-3.3	-4.0	-5.1

Source: IMF WEO, BER and BUSA