

Economy 2012



we finds the answer when **me** cannot.



01 Foreword
Resilience, resolve and reason.
 (Page 5-6)



02 The Global Economy
Greek ruins.
 (Pages 7-16)



03 Emerging Markets
Between a rock and a soft landing.
 (Pages 17-28)



04 Sub-Saharan Africa
Africa's resilience?
 (Pages 29-46)



05 South Africa's Political Economy
Mangaung holds the key.
 (Pages 47-54)

contents

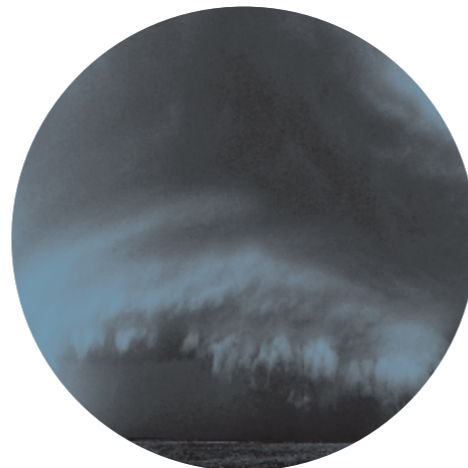
06 South African Economy
Jobs wanted.
 (Pages 55-72)



07 Forecasts
Through the looking glass.
 (Pages 73-76)



08 Conclusion
In Europe's clutch.
 (Pages 77-80)



09 Meet the team
We find the answer when Me cannot.
 (Pages 81-84)



10 Disclaimer
 (Pages 85-89)



Foreword

In 2012 we will remain captive to the fall-out from the Great Recession of 2009, itself borne of the numerous excesses throughout much of that decade.

Europe's sovereign debt-servicing difficulty, the centrepiece of current risks to global welfare, is another in a series of post-recession gusts that have shaken the world.

Essentially, recent years have been defined by insufficient global aggregate demand for goods and services that has unearthed the latent vulnerabilities and absence of stabilising buffers in many economies. Furthermore, the interconnectedness of countries, regions and continents has meant that, in an assortment of ways and in varying degrees, practically the entire world is being affected.

In 2012 the US and Japanese economies will be weak, while Europe will shrink. Therefore, about half the world's economy will contribute very little to increasing income. And, while emerging economies remain kernel to global expansion, their contribution will subside. The risk is therefore for even poorer outcomes.

Africa has maintained its dynamism through the crisis and has been the second-most resilient region after Asia. The combination of strengthening internal markets and more resilient external relationships should prove profitable this year. But, Africans cannot indulge the conceit that they are remote from the world's tripwires. To be sure, South Africa, the continent's largest and most externalised economy – when measured across trade and financial channels – will grow at about half its pre-crisis rate this year.

2012 will be another occasion that tests humankind's resilience, resolve, and reason. Recessions are costly, and beyond their impact on incomes and jobs, recessions also test our humanity. Related to this will be the search for a type of market economy that seeks to balance commercial and social objectives. The gap between what companies produce and what governments provide is glaring, as the "occupy" movements remind us. But capitalism has always been evolutionary, and its contours will, somewhat, soften this year.

This report addresses these and other material issues. Steven very elegantly casts light on Europe's institutional deficiencies which limit more effective rescue. Jeremy gives appropriate currency to emerging markets' slowing growth and the attendant risks to supply chains. Stephen is optimistic about Africa's cyclical prospects. Thabi suggests that the global crisis should not be lost on South Africa's policymakers, especially in areas such as microeconomic reforms and infrastructure expansion. We think that you will find the report valuable, and we welcome your views. The research team and I, wish you an agreeable 2012.

“
2012 will be another occasion that tests humankind's resilience, resolve, and reason.”
Goolam Ballim

The Global Economy

STOP
BUYING OUR
DEMOCRACY

OCCUPY
THE
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LIFE, LIBERTY AND THE PUR

The coming European recession will have profoundly negative and far-reaching consequences. This impact could even be more severe if the European Monetary Union collapses. Understanding how this crisis unfolds will be the key to 2012.

The Global Economy

2012 is going to be another difficult year for the global economy. The debt crisis in the Eurozone looks set to continue and could probably become materially worse in spite of government efforts to stabilise the situation. The contagion risks from this crisis are already being felt globally. Some countries, such as China, have ample room to ease monetary and fiscal policy to try and avoid economic stagnation. Others, such as the US, are pretty much tapped-out when it comes to policy easing and, as a result, are much more vulnerable. A recession in the US is possible; for the Eurozone it's a virtual certainty, while those with policy flexibility will have to use it deftly to avoid a similar fate.

Introduction

Forecasting is not easy at the best of times, and in the midst of a crisis, like the Eurozone debt crisis, it is especially difficult. In fact, this particular crisis makes prediction very hard because nobody knows how and when it will end. This might seem to be the same with all crises, but that's not necessarily the case. For instance, if a country starts to experience a currency crisis we can be sure that monetary policy will have to be tightened and, when it is sufficiently tight, the crisis will come to an end as the currency recovers. If the currency happens to be in a fixed-currency regime it is likely that devaluation will occur to end the crisis. We might not know "when" the crisis will end, but we have a decent idea "how" the crisis will end. But with the Eurozone debt crisis there are many potential "solutions", ranging from money printing by the ECB through to complete disintegration of the whole system. Of course there's also the scenario that the crisis won't be resolved at all; that 2012 will be another year of muddle through. This may, in fact, be the most likely outcome. But what are some of the more reasonable predictions that we can make about the global economy and financial markets in 2012? Here are just a few:

- The Eurozone will be in recession for most of 2012.
- The Eurozone recession should help contribute to a fall in euro/dollar to at least 1,20, with 1,0 not out of range.
- The ECB will have to ease monetary policy significantly, taking the key policy rate down to 0,5%, at least.
- Bond yields in the Eurozone will remain elevated.
- The UK will endure a recession as well, based partly on Eurozone contagion, but mainly as a result of severe fiscal tightening.
- Sterling too should gain at the euro's expense with 0,75 the likely destination for euro/sterling by year-end.
- Other European countries will be driven close to the edge of recession and some, such as Switzerland, are likely to fall over.
- The US economy may just avoid a recession in 2012 but any growth will be lacklustre and the Federal Reserve will have to ease further.
- The cycle of debt downgrades by rating agencies is likely to continue in the US and Europe.

- China will slow too, but the enormous scope for both monetary and fiscal activism should shelter the economy just as it did during the credit crunch.
- This sheltering of Chinese growth will come at a cost of some of the planned reforms to the economy and financial markets.
- Many emerging market countries will have to take much greater action to obviate the contagion risks flowing from the Eurozone.

All eyes on Europe

The Eurozone debt crisis dominated domestically and internationally through much of 2011. It is difficult to believe that 2012 will be any different. The difficulties of the region imply both an "economic" contagion risk, as Eurozone imports fall, and a "financial" contagion as the weakness of banks in the region keeps money market conditions tight across many countries. The last few months of 2011 might have seen many countries around the world adjust to the new – weaker – reality of the Eurozone, but it seems likely that more will have to be done in 2012. And if the debt crisis takes a material turn for the worse, these contagion risks would be greatly magnified.

Short and long-term solutions

Two things need to happen for policymakers in the Eurozone to put an end to the crisis. The first is a short-term fix that stops the market speculating against the Eurozone bond market. The second is a longer-term solution that addresses the fact that EMU is not a transfer union. Both are incredibly difficult to achieve. The former is tough because bond market crises are notably more difficult to contain than currency crises. A currency crisis creates an inflationary threat and, as such, central banks can credibly raise policy rates significantly. Higher rates bear down on inflation and, importantly, make the cost of short-currency positions prohibitively expensive. But a bond market crisis is deflationary, not inflationary. Hence the ECB is cutting rates, not raising rates and it cannot credibly hike rates even though this would have the effect of making short-bond positions more expensive to fund. Instead, policymakers are trying to limit speculation against Eurozone bonds, through creating a large buyer of the market. This is the European Financial Stability Facility (EFSF), which will be joined by the European Stability Mechanism (ESM) in the middle to 2012. But their resources are finite, presently standing at just over 5% of the size of the Eurozone bond market. A better solution would be to have infinite resources, but this can only come from the money-printing presses of the ECB. The ECB refuses to entertain such an idea but if the debt crisis deteriorates dramatically in 2012, it might be forced to change its tune.

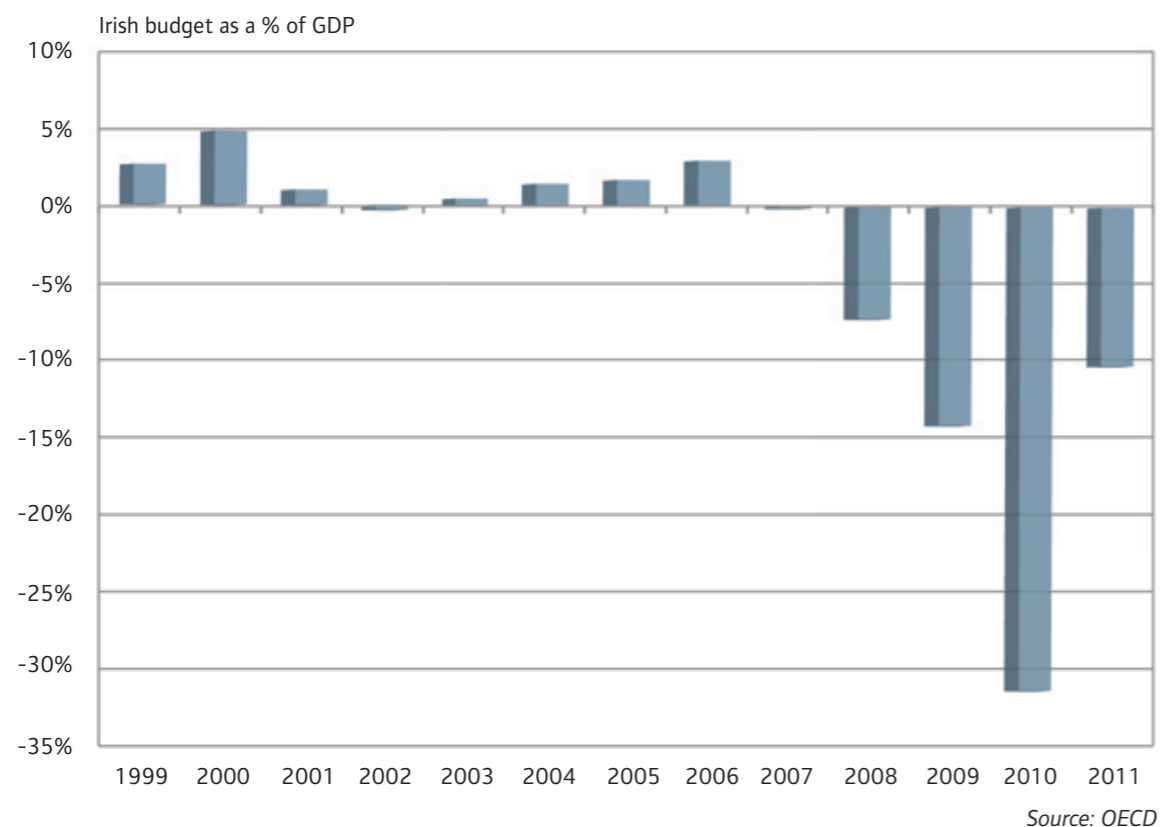
A single bond market for the Eurozone?

If finding a short-term solution to bond market weakness is tough; finding a longer-term solution to the transfer problem is even harder. It is particularly tough when policymakers not only rule out the creation of a proper transfer system but insist on seeing the crisis as one of poor fiscal discipline instead. In our view, this crisis is not one of poor fiscal discipline. Many countries around the world have large deficits and poor fiscal discipline: the US, UK and Japan to name but three. But they don't have debt crises. They don't have debt crises because they can do the things individual Eurozone countries cannot do, like print money and depreciate their exchange rates. In the absence of such options within the Eurozone, a proper transfer system is required that shifts resources from richer countries to poorer countries. Bailouts can work as a substitute for transfers but they are clearly not a permanent solution. Better budget discipline can help as well but it is not a solution. Ireland, for instance, ran budget surpluses right the way through to 2008 and was not seen as fiscally profligate, yet it still required a bailout.

We might not know when the crisis will end, but we have a decent idea how the crisis will end.

The last few months of 2011 might have seen many countries around the world adjust to the new – weaker – reality of the Eurozone.

Figure 1: No signs of trouble before 2008



Our belief is that a single bond market is likely to be developed.

In short, the Eurozone has a systemic problem, not a problem of poor budget discipline among its members. If we add this “systemic failure” to the ECB’s current refusal to entertain monetisation of debt, it looks as if 2012 will be a real slog in ending this crisis. Could it become so difficult that countries leave, or the EMU breaks up? It is certainly possible but it is not something that we currently expect. A break up would surely send the euro into a tailspin, but even in the absence of such a dramatic conclusion the euro should still fall. We target 1,20 against the dollar but fear this might prove too conservative. What’s more, we should not forget that if one solution to the crisis is to cajole the ECB into backstopping the bond market, the potential loss of monetary control would still be expected to undermine the euro. This tends to hint that the euro will fall whether the crisis is resolved or not. However, this ignores the fact that there are other options than the printing of money by the ECB. For instance, policymakers could move towards the creation of a single bond market. They would hope that just as the elimination of national currencies stopped disruptive speculation against the French franc, or the Italian lira, a single bond market would stop speculation against Italian or Spanish bonds. What’s more, just as the euro has developed into a pretty strong international currency, they might expect a single bond market to be stronger than the sum of the national bond markets that preceded it. But even though the single bond market idea has many attractions in our view, there is still a great deal of resistance, especially from Germany which is, after all, the Eurozone’s main cash machine when it comes to bailouts. Our belief is that, despite these reservations, a single bond market is likely to be developed. But this will take some years and market scepticism combined with a vigorous political debate in the Eurozone over the merits of such a solution, suggests that 2012 is still likely to be marked out as a year of strain for the Eurozone’s bond markets – and the euro.

Containing the contagion threat

The latter stages of 2011 saw more and more countries affected by contagion risks from the Eurozone debt crisis. Some central banks that had planned on raising interest rates were forced to postpone such plans and,

in some cases, started cutting rates. Through 2012, it looks as if policymakers around the world will continue to have to grapple with the threat posed by the Eurozone crisis. The “economic contagion”, created by the Eurozone recession and weaker import demand, is likely to make more central banks ease policy, while the “financial contagion” stemming from banking stress, is likely to mean that the same central banks will have to ensure that their own domestic banking systems are flush with liquidity.

The latter stages of 2011 saw more and more countries affected by contagion risks from the Eurozone debt crisis.

Limited policy flexibility in the big developed economies

Policymakers’ ability to respond to the looming Eurozone recession differs considerably. Many of the biggest developed countries, such as the US, UK and Japan, have very little room to respond. As a result, the UK seems to be a good bet to fall into recession again, as does Japan, while the US has no more than a 50:50 chance to avoid falling GDP. Central banks in all three countries are likely to try to resist weaker growth by purchasing more bonds. But while this is likely to be government bonds in the case of the Bank of England and the Bank of Japan, the Fed might initially aim its sights at the housing market by purchasing mortgage-backed securities. Would such efforts bear fruit? We are sceptical. Major nations are in a liquidity trap which compromises the effectiveness of monetary policy, but leaves fiscal policy more effective. This is because bond yields are less likely to rise significantly in the event of a fiscal stimulus and so “crowd out” the cut in taxes or the increase in government spending. The problem, of course, is that fiscal policy cannot be used pro-actively to spur growth. Japan and the US saw debt downgrades by rating agencies last year and are primarily embarked on restrictive fiscal policy. The same is true in the UK; the only difference being that so far, the UK has not had its AAA rating cut, which largely reflects the more zealous deficit-reduction programme undertaken by the government. But just as expansionary fiscal policy is likely to be more effective in a liquidity trap, fiscal restraint can harm the economy more significantly when interest rates are near-zero. This is because fiscal discipline is unlikely to create the sort of fall in interest rates that can help “crowd in” higher spending, particularly investment spending. Hence, with monetary policy largely tapped out and fiscal policy on a broadly restrictive course, the outlook for growth among the big developed countries is poor at best and recessionary at worst.

Major nations are in a liquidity trap.

Europe at risk

Stepping away from the world’s bigger countries allows us some hope that the global economy won’t fall into recession in 2012. Starting with the other significant developed nations, such as Canada, Australia, New Zealand and Scandinavia; we find that their banking systems are relatively unimpaired by the strains within the Eurozone banks. We also find that policymakers in these countries have room for more pro-active fiscal and monetary policy. Some have already started to use this “wobble room”, especially in monetary policy. We are likely to see more of this in the early stages of 2012. Could this policy flexibility be sufficient to avoid recession? Much here depends on the scope for easing and, of course, the depth of the downturn in the Eurozone economy. Broadly speaking, it seems likely that non-European developed nations would be able to avoid recession, but avoiding negative growth could be tougher for European countries like Norway, Sweden and Switzerland.

Policy flexibility in emerging economies

Contagion threats from the Eurozone debt crisis to developing markets are somewhat different to the contagion risk confronting developed markets. One reason for this is that banking risks differ for many developing markets while another is that exchange rate strains could complicate policymakers’ ability to respond. Concerning the first of these, an undoubted contagion threat stems from the fact that European banks are the world’s big international lenders. Hence, as banks in the Eurozone strive to recapitalise, it is possible that they leave something of a void if they retrench from overseas lending, especially in developing market countries. In Africa, for instance, some 76 cents of every dollar that is lent to African countries, by non-African banks, comes from a European bank.

Figure 2: Who's most vulnerable to a recession in the Eurozone?

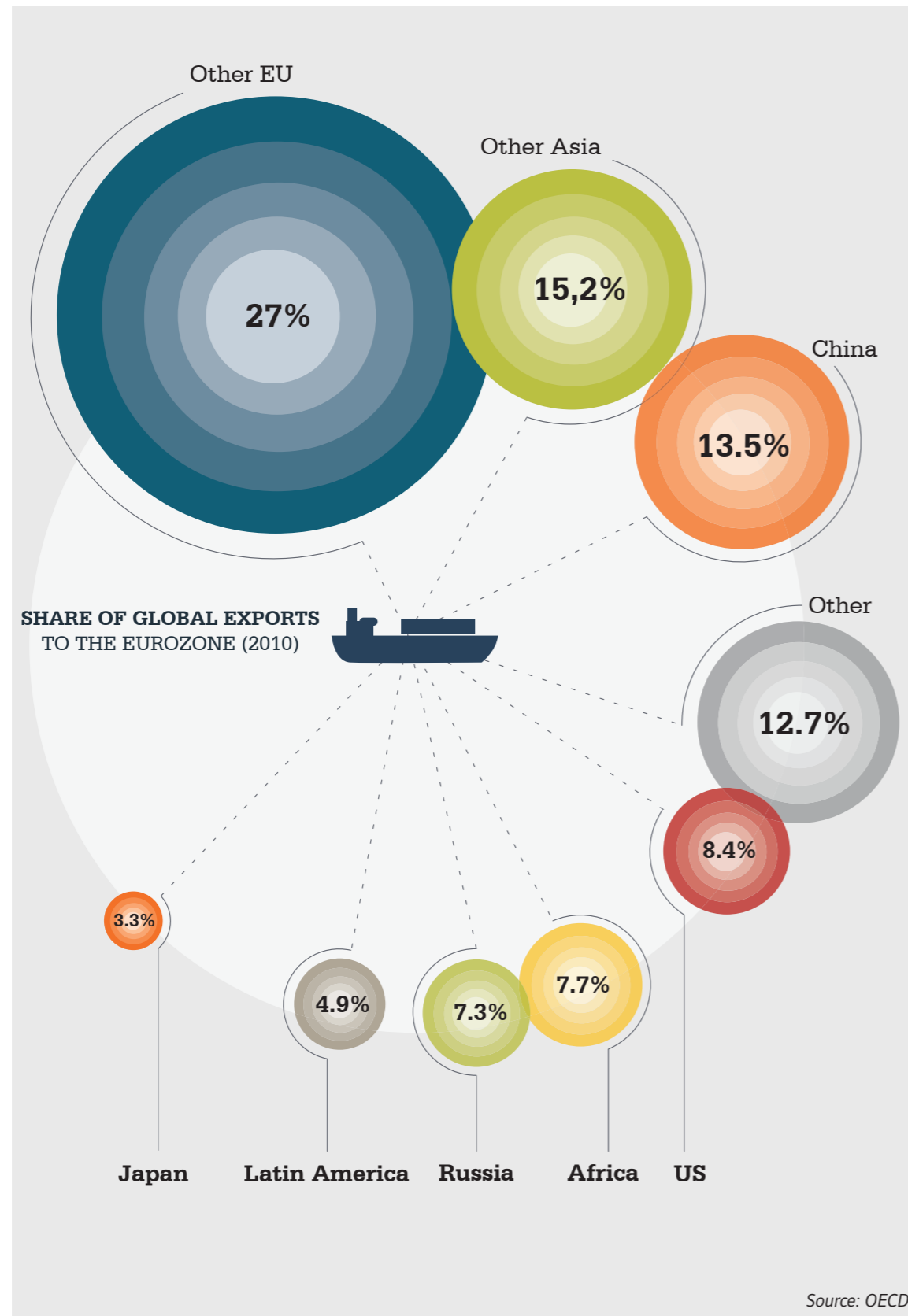
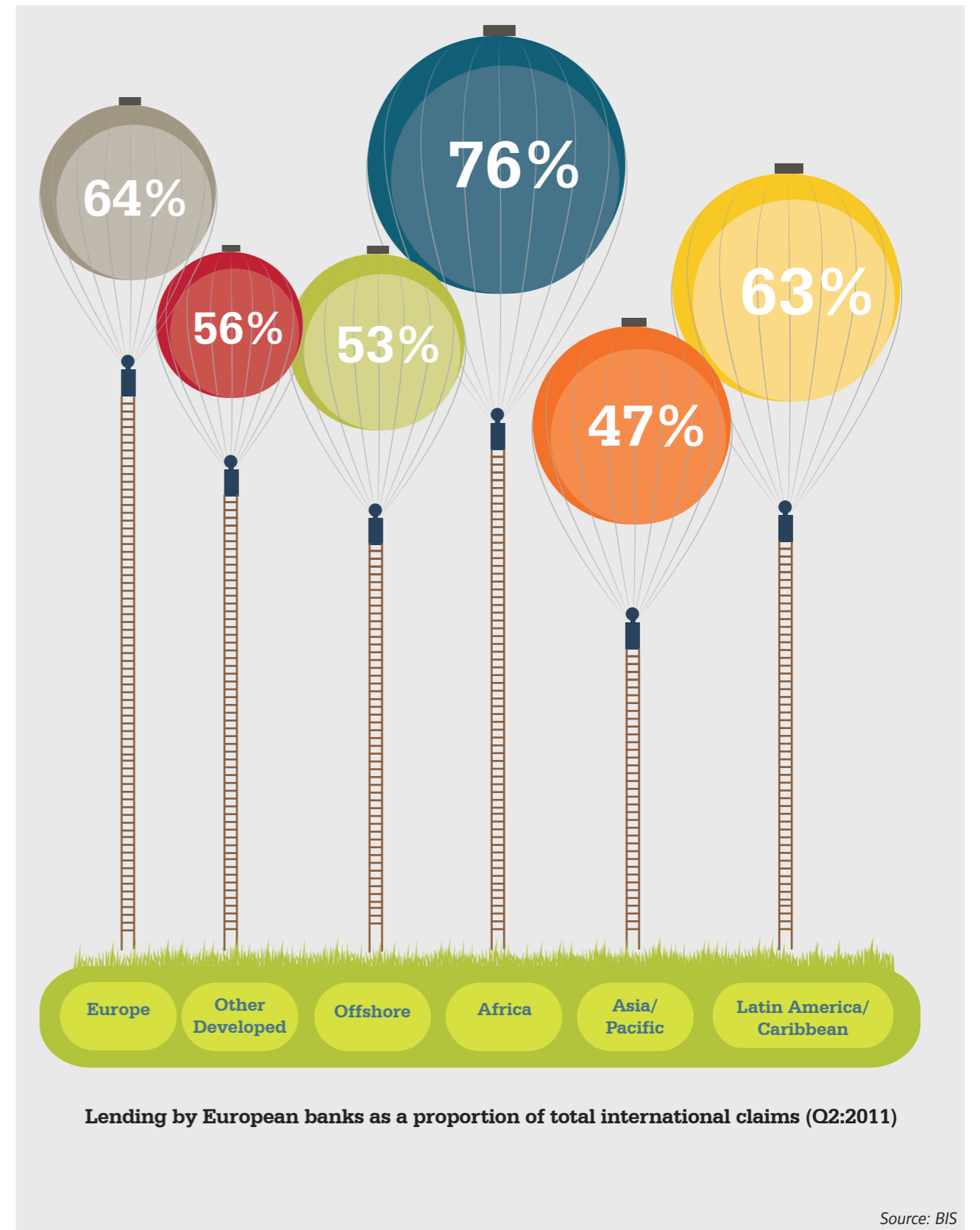


Figure 3: European banks dominant in international lending



This figure is lower when it comes to other developing regions, but it is still the case that European banks dominate other regions in terms of international lending around the globe. For developing nations the financial contagion risks from the Eurozone crisis are likely to be associated with asset withdrawals and lending reductions by Eurozone banks. This differs from developed markets where we assess the bigger contagion risk to come from strains in local money markets, primarily as Eurozone banks attempt to secure dollar funding, rather than lending withdrawal by Eurozone banks. These contagion risks to developing nations should be surmountable in many instances, not least because banks from other regions are likely to take up the slack should Eurozone banks retreat. This still leaves the “economic contagion” risk for emerging nations which results from the likely drop in Eurozone import demand plus the second-round effects, such as a fall in global commodity demand. These things could severely test the resilience of economies in the developing world. Another potential difficulty associated with contagion from the Eurozone, and which is less prevalent in developed markets, is the performance of exchange rates. For with euro/dollar expected to reach at least 1,20 there is a clear danger that the dollar rallies to such an extent against emerging market currencies that it impinges on central banks’ abilities to ease policy. In some cases, central banks could feel under pressure to hike rates, not cut rates, if currency weakness is substantial. This too, could hinder policymakers as they seek to ensure that the storm that’s raging in the Eurozone’s bond markets does not blow growth off course in their own countries.

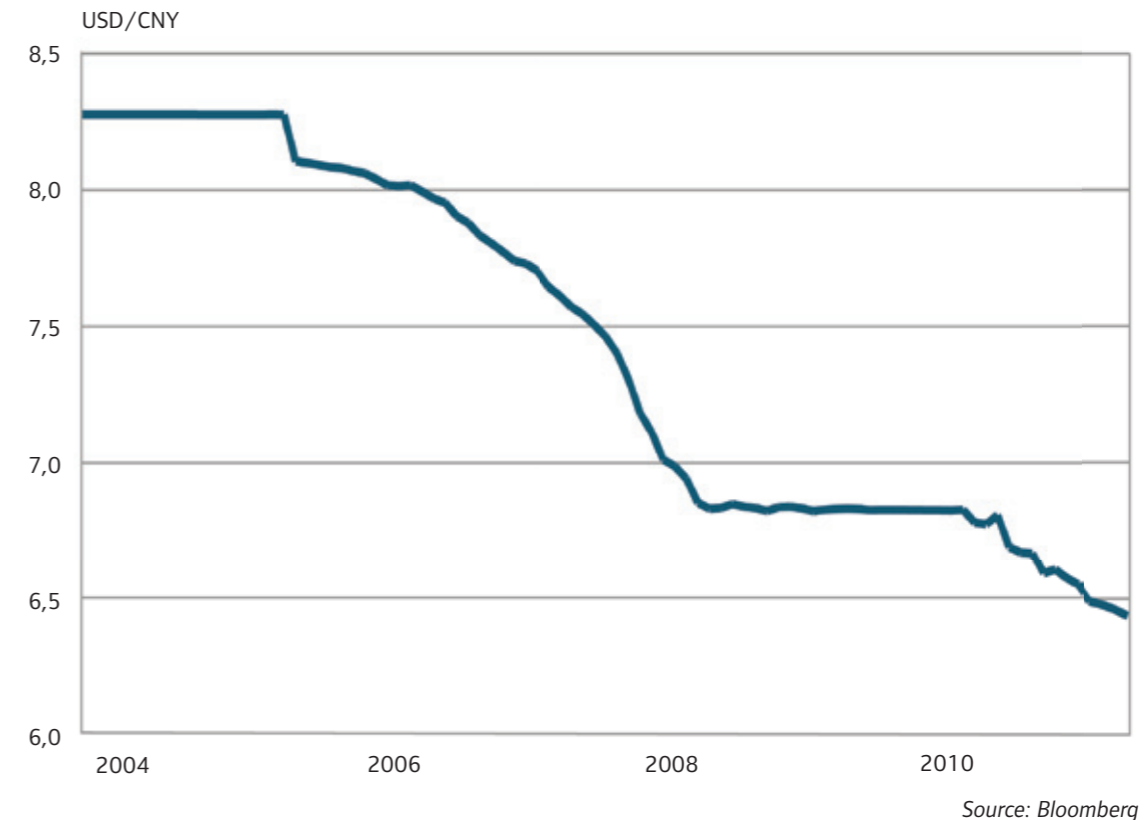
The risk of protectionism

With European demand and European banks weak, many developing nations will be reliant on other pockets of demand to maintain growth. In Asia, this primarily means China. Undoubtedly, growth will slow in China, probably to around 8% in 2012, but there’s substantial room for policy responses on both the fiscal and monetary front. The latter has already begun, in the form of lower reserve requirements for banks and there is likely to be more of this in 2012. It is also possible that China cushions itself against global risks by restricting appreciation of the renminbi, just as it did during the credit crunch, between the summer of 2008 and the summer of 2010.

Such action would probably not be well received in the US where November’s Presidential election could prove a lightning rod for protectionist pressure. Much depends on who leads the Republican fight against President Obama and whether the US economy falls into recession. A resolutely protectionist bias from the Republican candidate, in combination with a US recession, could clearly raise significant strains in Sino-US relations. In our view, Chinese policymakers won’t put the renminbi into lock-down and will, instead, allow the currency to rise to around 6,0 against the dollar by year-end. A corollary of this is that we are not anticipating a surge in protectionist sentiment in 2012 from the US. Needless to say, if we are wrong about this, the world could endure a depressionary phase, not just a recessionary risk.

With European demand and European banks weak, many developing nations will be reliant on other pockets of demand to maintain growth.

Figure 4: Will the renminbi be placed in lock-down again?



Steven Barrow



Emerging Markets

With every year that passes, fluctuations in China are mattering more and more to the global economy; it has never been more important to understand the trajectory of China's economy, its own evolution and the potential bumps along the way.

Introduction

The Mayans predicted that the world would end in 2012. To be sure, apocalypse is not upon us, but 2012 will be more difficult than 2011. Events in advanced nations will shape the trajectory of all emerging economies. Relative to advanced economies, emerging markets will benefit from negative real interest rates, low levels of indebtedness and structurally strong underlying domestic demand. However the impact will be varied. Some have ample room to extend policy support and avoid economic stagnation, including Brazil and China; others may suspend intentions for fiscal consolidation, like Mexico. Nevertheless, far more have less capacity for supportive measures this time around than during the past recession, including Chile, Malaysia, Pakistan, South Africa, Turkey and Venezuela; whilst worse still, a few are actually tapped-out. A severe external shock emanating from the Eurozone may matter most for Eastern Europe, but will also be felt for trade-dependent Asia and much of Africa and Latin America. Indeed, emerging markets will see growth moderate from 6% in 2011, to 5,6% this year, which is materially lower than its five-year pre-2008 average growth rate of 7,6% each year. At this point the slowdown is likely to be shallow and gradual, rather than deep and abrupt. However, a fracture of the Eurozone will push an already soft US into a recession and will make a hard landing in leading emerging markets, like China, unavoidable.

Slower growth but still a two-speed world

Perhaps now, more than ever before, the ability to balance short-term uncertainties against longer-term positives is necessary. The gap in economic growth between advanced economies and emerging markets has widened from virtually nil in the early 1990s to around four or five percentage points (pps) in 2010. Essentially, favourable demographics, productivity gains and significant catch-up potential have resulted in systematically higher growth rates in emerging economies. Emerging markets will continue to push the global economy forward, as they urbanise, modernise and industrialise. Consider that China and India will add more to global demand over the next two years than either the US or the Eurozone.

Over the next five years, the divergence will be broadly maintained. We expect emerging markets to expand by an average of 6% each year through 2015. Ten large emerging markets (EM-10¹) will see their combined output increase from USD17tr in 2010, to USD30tr within five years. Their growth has (and will increasingly) lead to a surge in new trade corridors between emerging markets, which reflects in an increase in the flows of goods, commodities, remittances, and portfolio and direct investment, amongst emerging markets. Simply put, the widening arc of globalised nations, including Latin America and Africa, are supporting the ongoing structural shift in economic momentum and political influence towards the South and East. Many, like much of Africa for instance, are reaping the rewards of reforms, better macroeconomic management, investments in infrastructure, more constructive trade partnerships and other pro-active initiatives, making them more resilient than ever before to external fragility.

Whilst the long-term trend seems quite clear, from a cyclical perspective, these same emerging market economies have undeniably experienced significant momentum loss. Indeed, emerging markets growth moderated to 6% in 2011, down from an average of 7,6% each year from 2002 to 2008. This year, emerging markets will see economic growth moderate further to 5,6%, but the extent of the slowdown will be varied. And, the global recovery profile includes potential headwinds, exemplified by movements in financial markets over the course of much of last year.

Throughout last year, financial markets have indicated that stress in emerging markets was materialising. At times, risk appetite simply dissolved as fear and insecurity overpowered other instincts. Outflows from emerging market equity markets reached an apex last seen at the height of the financial crisis in 2008. Conversely, money markets attracted record net inflows. Market moves were also violent as prices across asset classes moved in concert. The re-pricing of risk has manifest in emerging market currencies, equity markets and credit markets. Testament to this, CDS prices (in this case on 5-yr sovereign debt) have acted as the whistleblowers—widening by over 100 points on average in emerging markets last year, which has also reflected in equity prices (Figure 1).

Can emerging markets go it alone?

In the current climate, the question that springs to mind is whether or not emerging markets could go it alone? Are financial markets right to signal alarm? The short answer is yes. Granted, relative to advanced economies in a number of emerging market economies macroeconomic fundamentals are relatively good, policy options are available and confidence levels are high and resilient. Indeed, many emerging markets will benefit from negative real interest rates, low levels of indebtedness and structurally strong underlying domestic demand, but it is clear is that events in advanced nations will shape the trajectory of all emerging economies.

Indeed emerging markets have withstood over two years of economic sluggishness in advanced nations, quite famously. Consider that whilst G7 output in 2011 is roughly equivalent to 2007 levels, EM-10 has seen output surge by 68%, from USD10tr to USD17tr. However, as financial markets have been warning, it does seem that emerging market economic growth is unlikely to “decouple” again.

Quite simply, the last slowdown has taken its toll. Many previously global-minded firms originating from EM-10 have seen margin compression and cost rationalisation already. Throughout last year, emerging market exporters have reported that they are confronting falling orders—a trend which accelerated in the final half of 2011. Even the seemingly independent economic islands in Africa and elsewhere feel the pinch, as a global slowdown, reduces (1) terms of trade (in other words the price its exports fetch relative to imports), (2) volume of exports, and the (3) potential sources of and volume of capital, remittances and aid inflows.

Unsurprisingly momentum loss is underway in each of the EM-10, with industrial production expanding more slowly in H2:11 than H1:11 and PMI for manufacturing moving averages shifting lower in the final months of 2011. Hardest hit are more externalised economies, like China, Malaysia and Thailand, and especially those, like Mexico and Russia where exports to advanced economies play a proportionately larger role. In addition, China has played a critical role in linking numerous emerging markets – notably in Asia – into global supply chains, which are often ultimately reliant on demand in advanced nations. Unfortunately, to move from export-led to domestically driven economic growth requires better social safety nets to discourage high domestic savings, help for the small- and medium-sized firms that are key to job generation, and deepening and broadening of capital markets. Of course, these and other measures will take time to take effect.

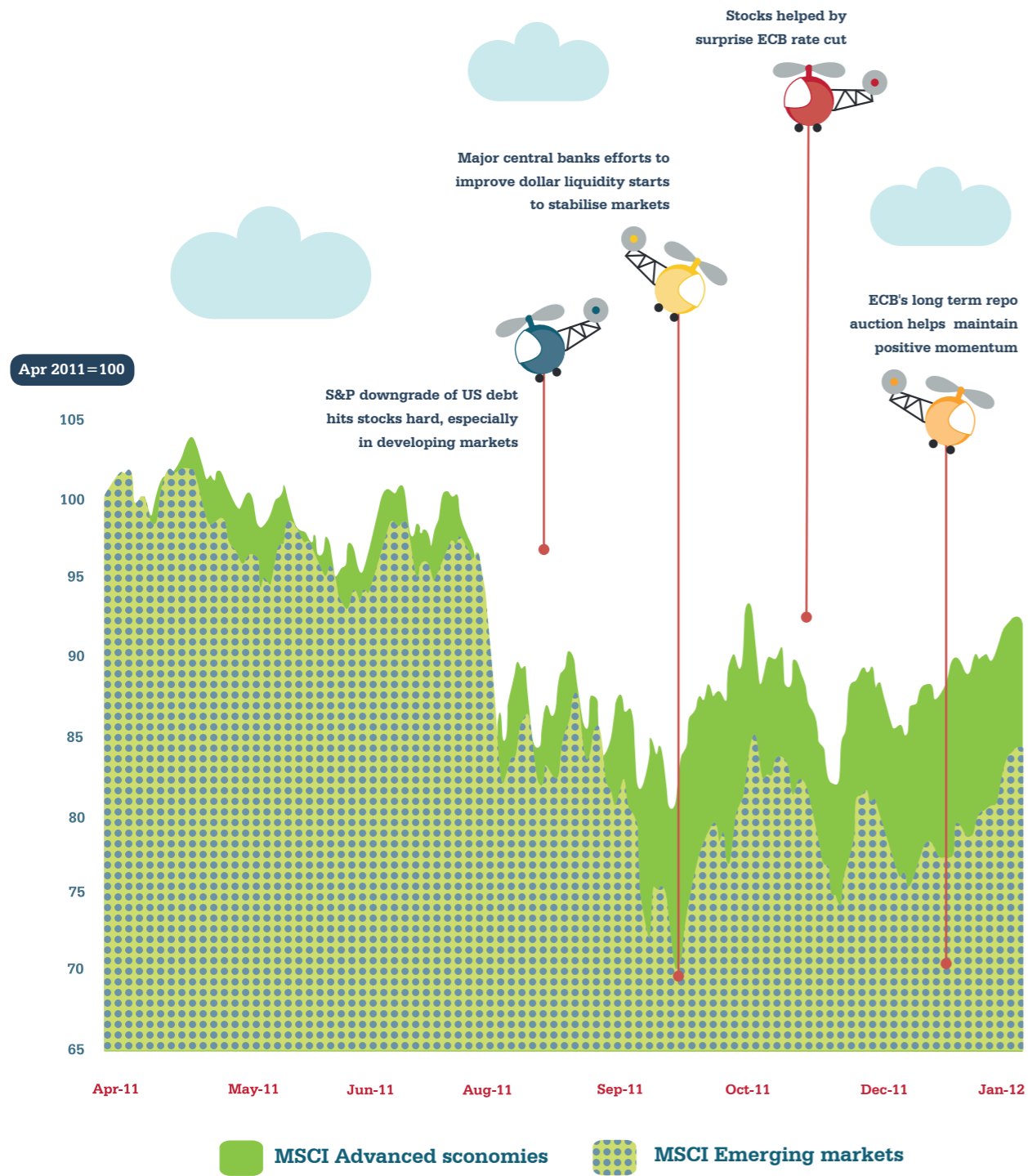
The structural essence of the growing role of emerging markets remains intact.

Volatility will persist this year because downside risks are omnipresent, the range of potential outcomes wide and there are even fewer safe havens to invest in.

EM-10 has seen output surge by 68%, from USD10tr in 2007 to USD17tr in 2011, but global fragility has taken its toll.

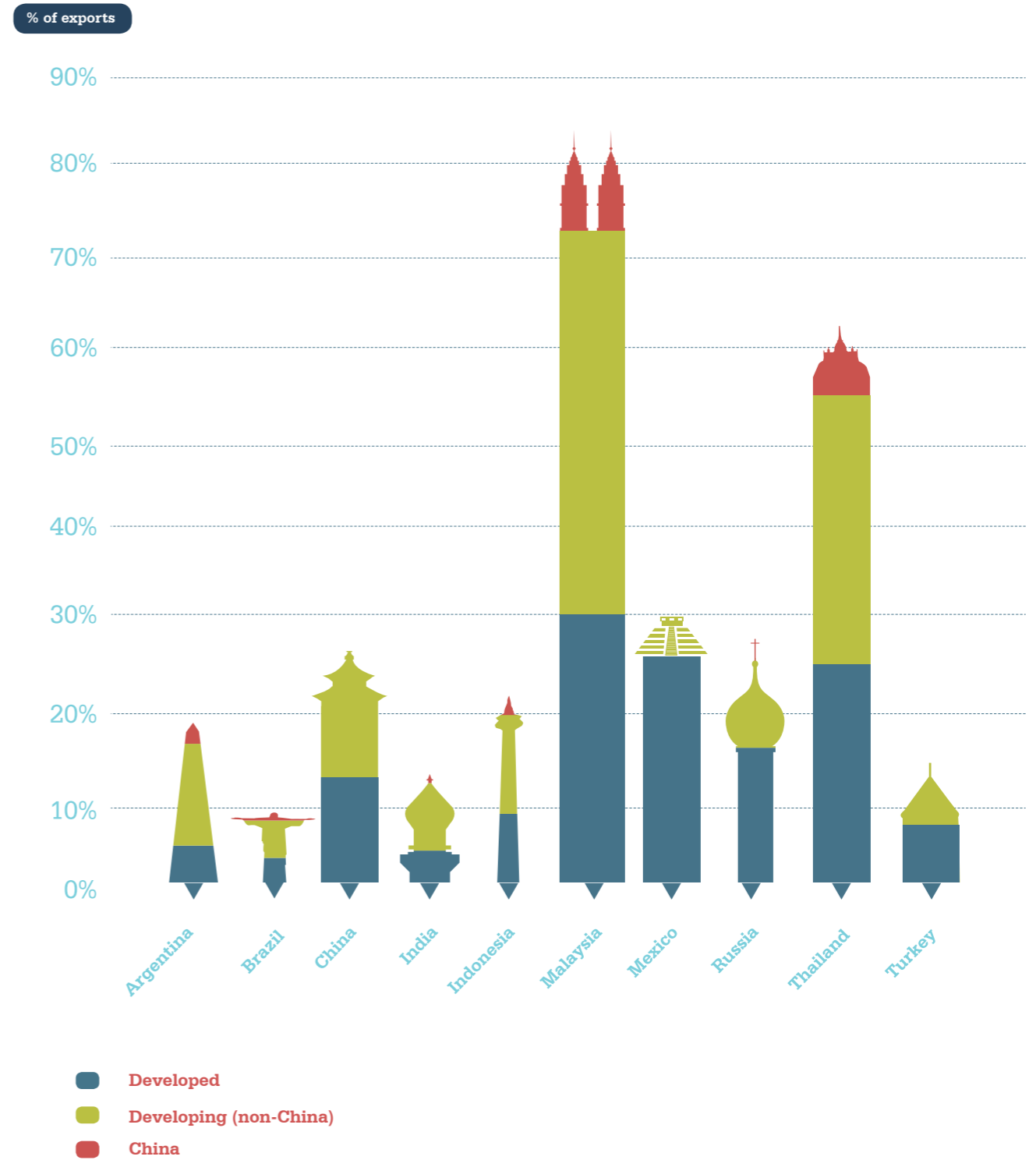
¹ Argentina, Brazil, China, India, Indonesia, Malaysia, Mexico, Russia, Thailand and Turkey

Figure 1: Equity markets downgrading emerging market growth expectations



Source: Bloomberg

Figure 2: Extent and nature of externalisation



Sources: Standard Bank Research; UNCTAD

Total net private capital flows to emerging markets neared 1.5tr last year and is expected to be equaled in 2012.

Indeed, emerging economies' demonstrated resilience during the financial crisis and its aftermath, which has manifested in a reallocation of capital towards emerging economies? Total net private capital flows to emerging markets neared 1.5tr last year and is expected to be equaled in 2012. After increasing materially during 2010, inflows into Asia and Latin America fell modestly last year and will fall again in 2012, but will still account for over half the inflows into emerging markets. Interestingly, last year private flows to Africa (USD55bn) actually came in below the 2010 level, but should recover this year. Again the effect of any tightening of capital flows will be felt unevenly with India, Mexico and Turkey the most vulnerable, exemplified by material current account deficits; in contrast, China, Malaysia and Russia have robust current account balances.

Many emerging markets may have to take much greater action to obviate the contagion risks flowing from advanced economies. Recall that during the recent recession, emerging market government took matters into its own hands. This time around, the willingness and ability of the state to intervene in Chile, Malaysia, Pakistan, South Africa, Turkey and Venezuela as aggressively is far less apparent. However, a broad easing of monetary policy for most is inevitable as almost all key emerging markets have space to ease, given falling inflation rates. Recall, inflation is expected to fall in each of the EM-10 (except for Thailand) during 2012. Already, in many emerging market economies, real rates have turned negative as policy rates have fallen dramatically.

Recognising the fragility in the global economy, the fiscal policy stance across emerging markets changed in Q4:11. Brazil, Turkey and Indonesia have already cut lending rates; Thailand, Malaysia, Mexico and Philippines are rolling out infrastructure spending programmes. Households will manage to ride out the storm as long as they remained employed. So far, unemployment in emerging markets hasn't headed higher, but a fairly rapid deterioration in labour markets would weigh on households' disposable incomes. Amidst deep uncertainty, consumption is proving an important stabiliser. Consider that on average, income per person has increased by over 15% p.a. each year since 2005 in Brazil, China, Indonesia, Russia, Thailand and many other large emerging markets. Hence, fiscal policy must continue to focus on employment.

Table 1: Economic growth forecast (Real GDP, % y/y)

	2009	2010	2011F	2012F	2013F	2014F
Argentina	9,16%	7,99%	4,62%	3,80%	3,98%	3,96%
Brazil	-0,20%	7,00%	4,20%	3,90%	3,80%	4,10%
China	9,10%	9,70%	9,10%	8,00%	8,10%	8,10%
India	6,70%	8,20%	8,00%	8,10%	8,50%	8,50%
Indonesia	6,11%	6,40%	6,30%	6,10%	7,00%	7,00%
Malaysia	7,19%	5,20%	5,10%	4,80%	5,10%	5,00%
Mexico	5,42%	3,79%	3,61%	3,55%	3,82%	3,39%
Russia	-7,80%	4,30%	4,40%	3,90%	4,10%	4,50%
Thailand	7,78%	3,54%	4,79%	4,20%	4,90%	5,08%
Turkey	8,95%	6,59%	2,24%	3,43%	3,76%	4,09%

Sources: Asian Development Bank, International Monetary Fund, Standard Bank Research

Central banks will try to mitigate a meltdown by pumping the system with liquidity, cutting interest rates and guaranteeing deposits. We expect policy rates to fall across the emerging market spectrum. Nevertheless, restoring the system will take a lot more than slashing interest rates. In the recent past, economic downturns

have been alleviated by reductions in interest rates to create more credit-induced spending, which allow the juggernaut of debt sweeping aside market signals. Worryingly, the overall debt burden in the emerging market economies is currently at record levels, raising concerns that a recession could set off a sharp downward spiral.

The softening in global commodity prices should help to contain the slowdown in growth and assist in reducing inflation. It is worth highlighting that virtually all commodity prices decline during a recession. We believe that this is likely to be the case once again, should we experience a recession. Therefore, should we enter a recession, amongst the commodities we analysed, we would look for only gold to rise (by 20%). All other commodities we expect to fall, with copper and thermal coal declining the least (by 15% each), followed by iron ore (-25%), platinum (-25%), aluminium (-30%) and Brent crude (-40%).

But, currency depreciation would add haze to the outlook. The Eurozone recession should help contribute to a fall in euro/dollar to at least 1,20, with 1,0 not out of range. After a torrid 2010, the US dollar showed remarkable strength for the most part of 2011, appreciating markedly against most currencies. Evidently, in a re-run of 2008, as the rest of the world realised the associated implications of continued financial fragility, financial markets whipsawed, commodity prices receded and the dollar benefited. Basically the widespread repatriation of funds during H2:11 led to a broad-based dollar strengthening, which has superseded other forces at play in global markets. As long as the Eurozone is fragile emerging market currencies are certainly vulnerable.

At a minimum, continued softness will prohibit emerging markets from consolidating any recent macroeconomic successes, and at worst, pressure already stretched economies further. Of course, a fracture of the Eurozone will push an already soft US into a recession and will make a hard landing in leading emerging markets, like China, unavoidable. Quite suddenly, the global economy would be flung into a vicious downward spiral. Consider for example that European banks have the most global reach, providing more dollar-denominated loans to emerging markets than US banks do. Simply put, the Eurozone plays a lead role in global funding markets meaning that an aggressive retrenchment there and the links between real and financial markets will become even more clear. In Asia, for instance, Europe's banks account for 40% and 76% of Asia and Africa's external funding market, respectively. Therefore, a contraction in European funding will at minimum raise the cost of capital in the region, and at worst lead to a painful re-enactment of 2008.

Conclusion

Momentum loss in emerging markets will continue in H1:12. Disentangling the harmful implications of Eurozone troubles will prove problematic – especially as visibility regarding the trajectory of the path back to "normal" is unclear. Adding mist to the hazy horizon are elevated fears that a "hard" landing in key emerging markets is plausible. Policy response will be critical. Already, in many emerging market economies real rates have turned negative as policy rates have fallen dramatically. Monetary and fiscal policy will step into the breach. Economic growth in emerging markets will likely outshine the rest of the world in 2012, given the weak growth prospects beleaguered developed nations currently are facing. In anticipation of weaker demand and slower growth from developed markets, central banks in emerging market economies have begun to loosen monetary policy. We expect this trend to continue into the first half of 2012, as the global macro environment remains unclear.

Jeremy Stevens



Commodity prices will fall, giving space for monetary policy support.

Text box 1: China's internal adjustment and implications for Africa

Economic growth has slowed from 9,1% y/y in Q3:11, to around 8,2% y/y in Q4:11. Industrial production growth decelerated to its slowest pace since the first half of 2009, and electricity production is growing at single digits for the first time this year. For the first time since Q4:08, manufacturing and non-manufacturing PMI simultaneously slipped into contraction in November. Recall the last time that occurred, GDP growth slowed to 6,2% y/y in the next quarter.

We are expecting growth to come in below 7,5% y/y in Q1:12 – the first sub-8% print since mid-2009. The likelihood of double-digit growth has dissolved in China, and the risk of a sub-7% growth rate in one of the quarters in 2012 (like we saw in Q4:08 and Q1:09) has increased meaningfully. And if economic activity in China is going to slip materially in the near term, Q1:12 is likely to be the cyclical bottom.

Apart from the growing likelihood of an external shock, if investment falls, China is in serious trouble because the rest of the economy would need to grow twice as fast to compensate and that isn't a viable alternative in 2012. Worryingly, around a quarter of the recent investment surge has been siphoned to real estate. Since 2004, fixed asset investment in real estate has increased by over 20% p.a., leading to house prices doubling in 35 cities. Then, quite dramatically, investment in property peaked in 2010 – growing at 38% y/y in 2010.

The Chinese government has put in place a plethora of policy initiatives to engineer a deceleration of price growth and siphon speculative forces from the sector. As a result, 15 (out of 37) cities saw m/m price declines in November. Looking ahead, prices will fall further as developers try to boost sales. China Vanke Co., the largest property developer in China, suffered a 36% y/y fall in sales during November – the fourth consecutive and largest fall so far this year.

SMEs have faced the brunt of credit tightening. Typically, small firms in the Mainland use retained earnings or private sources of capital to fund themselves. So, when cash flows were strained this year – in large part due to falling export orders and rising input costs – and credit conditions tightened, absent of established adequate credit lines, small firms were pushed to unsustainable sources of credit in the shadow banking sector. Private funding is estimated to be worth the equivalent of at least 20% of lending during the past two years. The surge of defaults in Wenzhou is just a start. Worse is to come as private lenders traditionally call their outstanding loans before Chinese New Year.

The State Council has already announced a few measures which will direct funding to SMEs. The result was swift: in November new CNY loan data beat expectations, increasing from CNY470bn in September, to CNY587bn in October and most expect another CNY550-CNY600bn each month in November and December.

The PBoC has already acted to support activity, cutting the RRR. Inflation has fallen from a cyclical peak of 6,5% y/y in July, to 4,4% y/y in November. In response, the PBoC announced a "pre-emptive" reduction to the RRR – by 50 basis points to 21%. The reduction is the first one in exactly three years, freeing CNY380bn of bank capital. Next year, headline inflation will average just below 4%, providing space for more reductions. The RRR will fall to 18,5% by the end of Q1:12. We don't expect interest rate cuts next year.

Yuan appreciation will continue. The CNY/USD is on course to appreciate from 6,36% to 6% by the end of next year. We had anticipated a swifter advance to 5,5, but the Chinese government will hesitate as weak exports hit home. Movement will be especially trepid in Q1:12. However, the internationalisation of the renminbi is more necessary than ever because it means more buyers and sellers doing business in that currency (meaning less reliance on dollar funding).

Despite a seemingly widespread acceptance that China's trend growth is falling, it coincides with the generational transfer of power, and the new leaders will be reluctant to see growth diverge from trend too rapidly. The government has a broad policy toolkit at hand. An important advantage for China, which will come in handy next year, is that once decisions are made, implementation can be swift and effective.

Fiscal support will address internal contradictions. Over the next five years, China has also earmarked USD1,7tr for "strategic sectors", including alternative energy, biotechnology, advanced equipment manufacturing, and water resources. That is twice the size of the recent stimulus package of 2009/10. The government will provide more financial support for exporters. Tax reductions and subsidies for exporters are inevitable – especially SMEs and products with high-added value. Fiscal support for consumption (both rural and urban) through supporting employment and income growth, providing rebates for purchases, direct income transfers, investments in agriculture. Affordable housing will be front-loaded and water projects will be accelerated. Additional reforms and investments in social security, health care and education will occur, freeing up some discretionary income.

The situation strongly suggests that growth quality will deteriorate. Efforts to incubate China imply that the pursuit of better quality economic growth and reducing the proportionate role of investment and exports could be placed on the back-burner. This would exacerbate credit misallocations (already ubiquitous across this economy, testing policymakers' agility throughout 2011).

Luckily, time and time again, we have seen that China-Africa is a structural story, rather impervious to cyclical forces. Trade between China and Africa will surpass USD155bn in 2012, well on its way to our forecast of USD300bn by 2015. And trade draws investment; so it's no surprise that in the past three years China has financed more projects in Africa than any other country. According to MOFCOMs official numbers, South Africa has attracted the seventh-most Chinese FDI stock in the world, and Africa is a fraction behind Europe.

Indeed, the Chinese economy is down-trending in structural and cyclical terms, but the Chinese economy will reach USD7,7tr next year. Over the past two years, twice as much domestic demand has been created in China (USD2,4tr) than in the Eurozone (USD1,2tr). Clearly, size matters. So, even though growth is slowing, China will still consume the most coal, copper, nickel, steel and tin in the world and second-most oil and lead. Add growing food demand in China from the growing middle class, and Africa's role is clear. Sure, Africa is a long way from being a world bread basket, but in areas like coffee, teas, tobacco, cocoa, soybeans, fruit and so on, Africa will become increasingly important.

We also expect China's interest in investing in Africa to continue – especially in minerals and energy – as the current environment gives more bargaining power to China. Moreover, Africa's markets are mattering more and more too – especially as advanced economies remain depressed. Over the past decade, better internal management has complimented and re-enforced better external ties across Africa. Africa has grown faster, which has raised purchasing power. Looking ahead, Africa is a growing market for Chinese-owned production for export, which is looking for alternative markets.

A few other features suggest ties will be affected, but will again be resilient. First, high-level political relations are now being matched by the development of robust bilateral and multilateral institutions which want to work with business to support bilateral ties. Second, many Chinese SOEs were encouraged to “go out”, but have subsequently been successful in Africa, growing revenue streams through African operations and diversifying, to become independent engines. Third, there are around 2 000 Chinese companies with operations in the 17 African nations in which Standard Bank is present; there are one million Chinese people in Africa. Each has risked resources—both labour and capital—to set up operations in Africa and they are there for the long haul. Fourth, future cash flows from projects in Africa are favourable, made better by more stable internal political and improving economic environments. Fifth, Africa is open to Chinese investment and can serve as a pressure release for China’s excess capacity. Africa offers China real assets as an alternative to dollar-denominated fixed income products, which suits China’s desire to passively diversify its consistently accumulating FX reserves and Africa supports RMB internationalisation.



We achieves what **me** can't.
We makes **me** smarter.
We finds a way when **me** gives up.
We succeeds when **me** fails.

We does the impossible. **We** triumphs. **We** is team spirit.





Sub-Saharan Africa

The resilience of Africa's economic performance will be tested, again. As in the 2009 global downturn, natural resource endowment and nimble policy-making will determine which countries fare better.

Introduction

In its Sep 11 World Economic Outlook, the IMF revised down its expectations for sub-Saharan African growth to 5,2% in 2011 (from a previous 5,6%) and 5,4% for 2010.

At the beginning of 2011, we were reasonably confident that Africa's economies would continue to flourish over the following 12 months, with growth accelerating, compared to 2010. We had to temper our 2011 expectations fairly early on as a variety of exogenous and endogenous punches started to land around the continent. In its September 11 World Economic Outlook, the IMF revised down its expectations for sub-Saharan African growth to 5,2% in 2011 (from a previous 5,6%) and 5,4% for 2010. It has growth rising to 5,8% in 2012. We suspect that the 2011 estimate will have to be revised lower still, to around 5,1%, and that there will be a further deceleration to nearer 4,8% in 2012 as the economies recover from previous blows and attempt to parry some additional jobs.

African growth: calculation issues

Whenever dealing with aggregate figures across a continent of some 54 countries, a major caveat regarding extreme diversity is needed. According to the IMF, Swaziland is set to be the worst-performing SSA economy in 2012, with a growth rate of 0,6%. The best performer is expected to be Sierra Leone at over 50,0%.

Apart from disparity, there is also an ongoing issue of data credibility. In late 2010, Ghana revised up its nominal GDP data by around 70%. The process of re-calibrating the weights of the different economic sectors has also been undertaken in Nigeria where a large upward revision is set to take place, which will also make its contribution to the continent's overall GDP number greater. With Nigeria's official GDP data showing limited dispersion from the 6%-8,0% growth range, then such a rebasing will pull up the overall growth rate for the continent and SSA.

The other key issue is to look at the performance South Africa, which remains the largest economy on the continent. The IMF has South Africa growing at 3,6% in 2012 (up from 3,4% in 2011), but we expect both of these numbers to be lower than expected, pulling down the SSA aggregate. Interestingly, excluding South Africa and Nigeria, the IMF sees SSA growth of 6,8% y/y in 2012, from 5,4% y/y in 2011. Once again we are more cautious, seeing a figure of 6,0% as more likely. It is also worth noting that we are broadly in accord with the IMF in seeing not one economy actually slipping into recession in SSA during 2012.

Global growth: still slowing

Following the 2008 financial crisis, we were generally more constructive than the market on the likely strength of the economic rebound. As such, we generally found our global growth outlook on the bullish side of the market throughout 2009 and 2010. It was a position that proved appropriate. We switched our stance in Q2:11 and have since found ourselves on the bearish side of consensus. This still appears to be the case. The IMF in its last WEO (September 2011) was looking for global growth of 4,0% in 2012, the same as in 2011. Once again, we suspect both will have to be revised down, with global growth probably nearer 3,0% in 2012.

Eurozone problems hold the key

Central to our more bearish global growth view has been our concern over the ability of EZ policymakers to deliver a solution to the region's structural troubles. We are still of the view that the credibility in EZ policymakers gets worse before it gets better. We are now of the view that recession is likely across EZ

as a whole, with the UK also getting sucked in. While the US may avoid negative growth, it will continue to struggle to keep economic activity growing, and the Fed is likely to further ease monetary policy in an attempt to do so. The last WEO has advanced economies growing at 1,9% in 2012; we suspect this will be nearer 1,2%.

China slowdown has further to go

With its clear export links to growth in the DM economies, we have been fairly negative on China growth outlook since Q2:11. Not only is there a drag from the net export component of GDP, but China's business/investment cycle also appears to be rolling over. While China is not fiscally constrained to the extent that most DM economies are, we are still looking for China to grow around 7,2% y/y in 2012, compared to the WEO estimate of 9,0%.

Global growth re-balancing

Growth in the EM economies is likely to be nearer 5,6% in 2012, compared to the 6,4% projected in the WEO. Importantly, while EM economic growth will clearly be dragged back by the problems facing the DM economies, the increasing broadening of intra-EM trade and financial flows means that the influence is increasingly muted. EM economies are likely to provide the bulk of the contribution to global growth for years to come. EM economies presently produce around a third of global output. The IMF assumes they would produce more than half by 2028. We suspect that they will contribute more than half of global output faster than that. We continue to believe that the 2008 global financial crisis marked a significant turning point in the organisation of the international economic system. An extended period of de-leveraging in the DM means slower growth and a sustained reversal of financial flows, which will foster a sharp outperformance by EM economies for years to come.

Search for yield

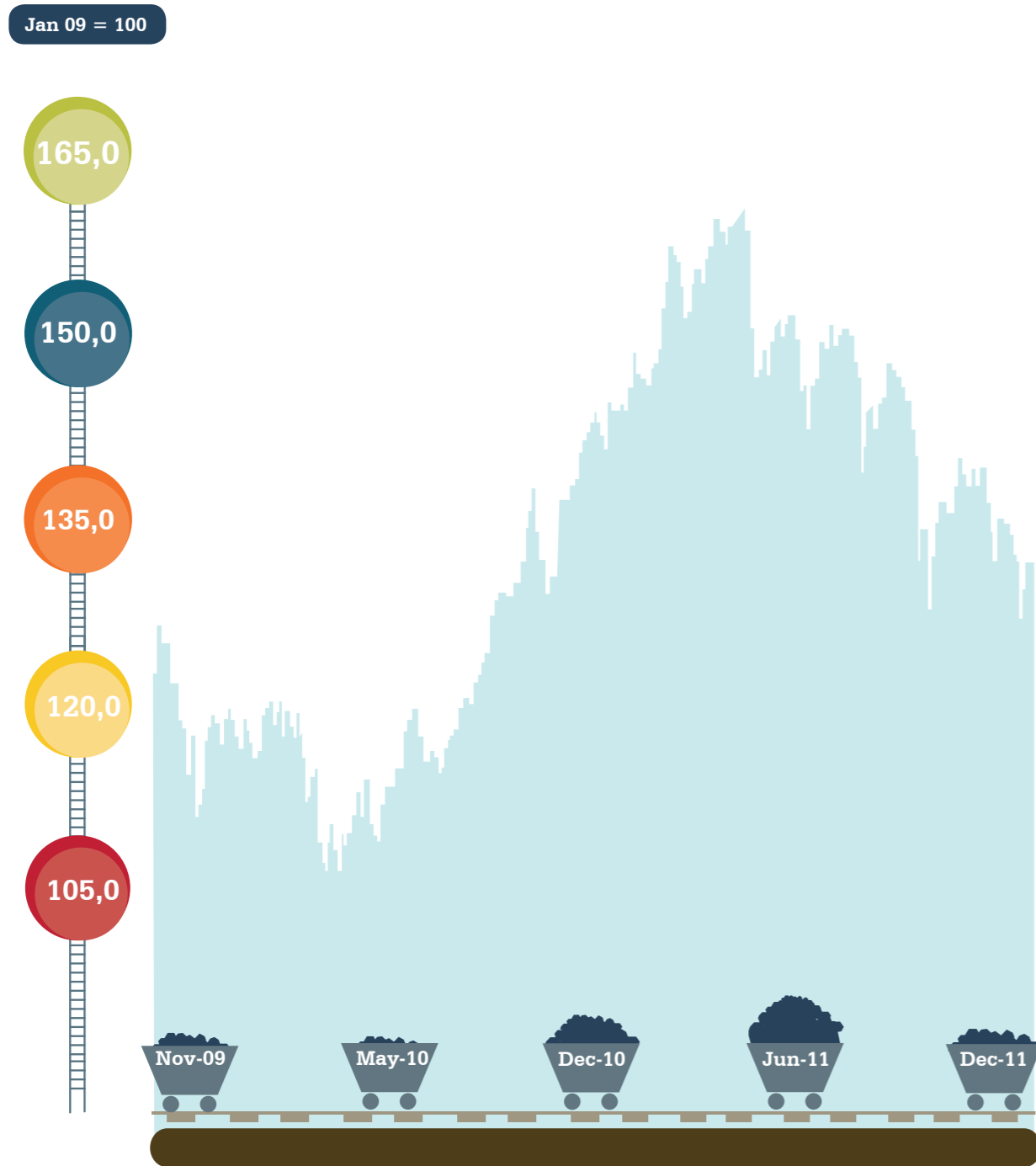
A key feature of EM economic outperformance will be the continued search for yield from DM investors and actually EM investors that had previously been invested in "safer" DM assets. In particular, the cyclical policy of degrading DM currencies via quantitative easing will foster greater demand for scarcer EM assets, while the loose monetary policy persists. Interesting, while foreign direct investment into EM and frontier markets has been reasonably solid post 2008 crisis, frontier markets (FM), including Africa, have underperformed wider EM in terms of portfolio flows. We see this as a cyclical opportunity as part of a wider multi-year structural shift.

Commodity prices on the back foot

In many ways, the key transmission mechanism between global growth (expectations) and African economic growth prospects is via commodity prices. But clearly the influence is hugely diverse across countries, with the key differentiator probably being between net importers and exporters of oil. The upward trajectory in average commodity prices that prevailed between late 2008 and early May 2011 has now given way to a downward trajectory. We see this continuing during 2012. Interestingly, the switch in the average commodity cycle as measured by the widely-traded Commodity Research Bureau (CRB) index took place at the same time as the switch in EUR/USD took place. Clearly, the CRB as with most commodities is priced in USD. So, not only will commodity prices continue to be undermined by negative growth sentiment, it will also be undermined by the expected strength of the USD, especially against the EUR.

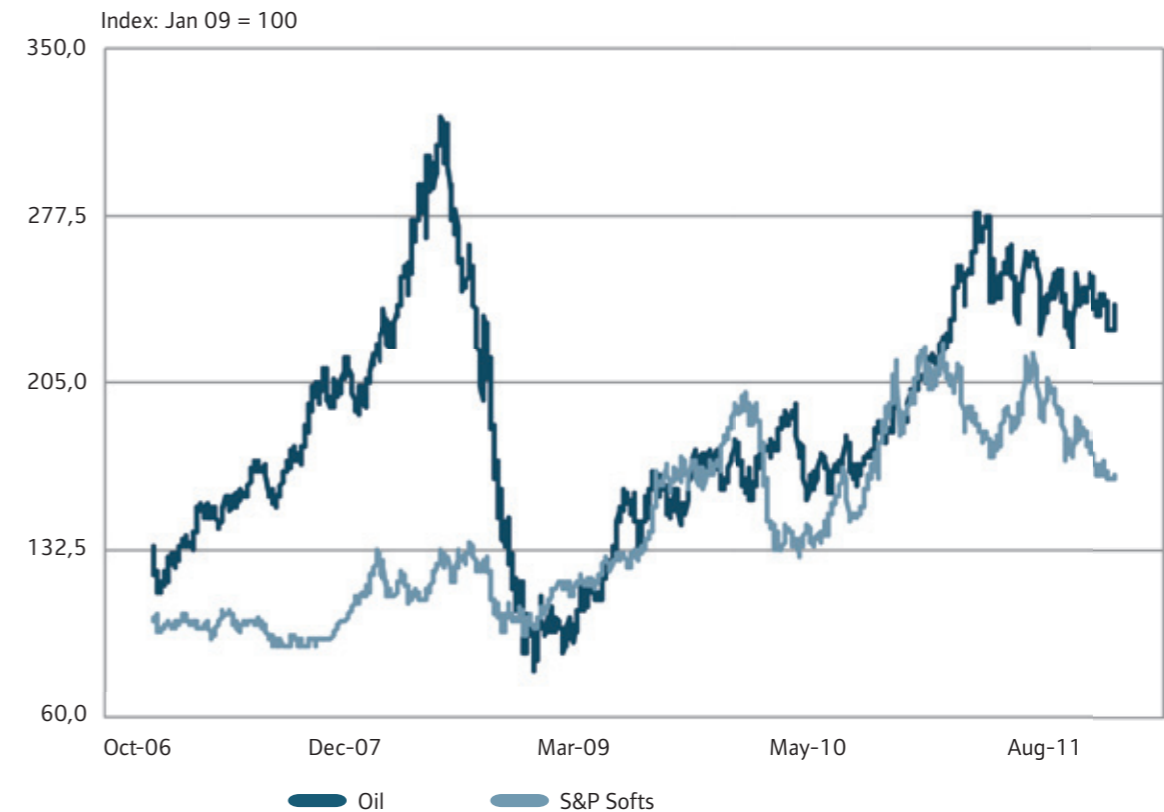
The key transmission mechanism between global growth (expectations) and African economic growth prospects is via commodity prices.

Figure 1: Commodities Research Bureau Index



Sources: Bloomberg, Standard Bank Research

Figure 2: Oil and soft commodity prices



Sources: Bloomberg, Standard Bank Research

Oil and food prices

In line with broader commodity prices, we are relatively sanguine on oil and food prices with a core scenario of a fairly gradual grind lower in line with price trends in recent months. That said, recent price action on growing concerns over oil supply from Iran appear to have added further support for oil prices during 2012. Having been looking for benchmark Brent front-month to move down to the mid-USD90/bbl before rebounding somewhat and averaging around USD100/bbl, our core scenario is now for an average price of USD105/bbl and USD100/bbl probably holding.

Africa's election schedule remains heavy

Africa's growth in 2011 was heavily influenced by the continent's shifting political sands. There was the usual risk going into elections generated by policy uncertainty. Yet from early 2011, political risk was additional augmented by the clamouring for democratic change across the Arab world. The risk of a popular uprising to overthrow less democratic leaders added to the risk around elections. Political risk perceptions across the continent were also increased by the slide into civil war in Côte d'Ivoire due to the incumbent's unwillingness to relinquish power.

There is no shortage of election risks across Africa in 2012, with elections (or referendum) taking place in possibly 20 out of the 54 countries across the continent. The most closely followed will be the outcome of the ongoing electoral process in Egypt, presidential election in Senegal on 26 February 2012, parliamentary and presidential elections in Kenya on 14 August 2012 and parliamentary and presidential elections in Ghana in December 2012.

The risk of a popular uprising to overthrow less democratic leaders added to the risk

Table 1: Africa's election calendar for 2012

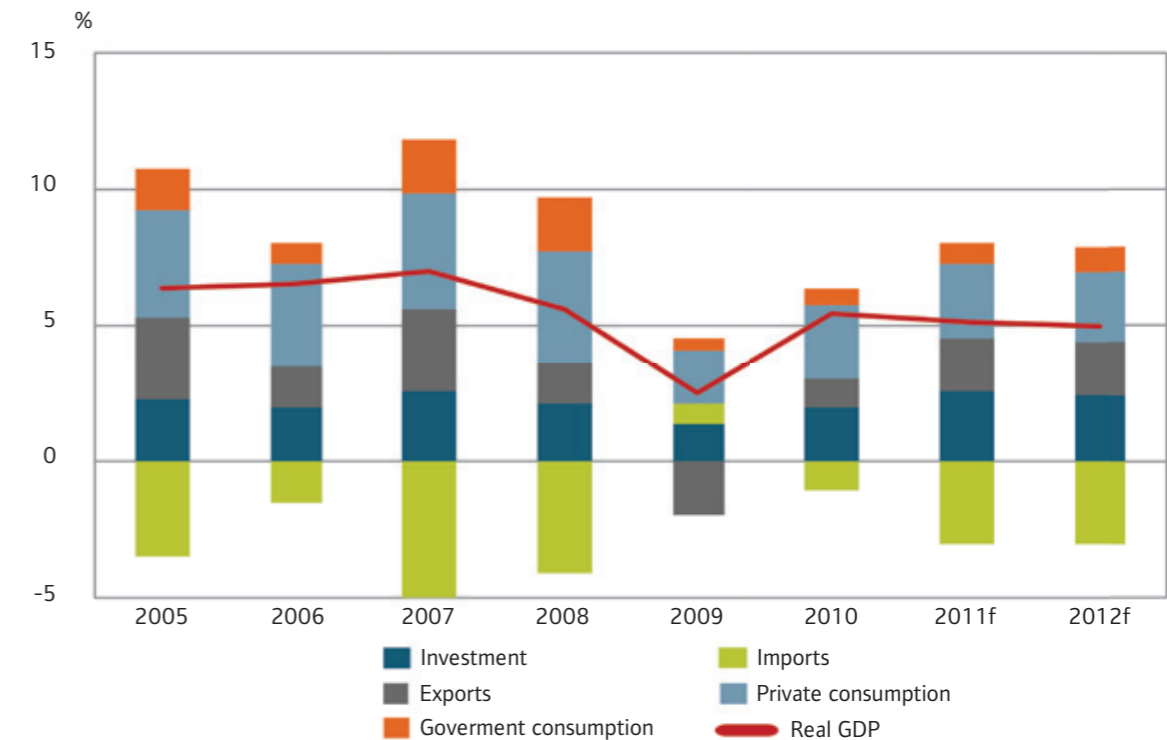
Country	Election type	Date
Egypt	Parliamentary (Stage 3)	3 January 2012
Egypt	Legislative (1st round)	3 January 2012
Senegal	Presidential	26 February 2012
Gambia, The	Legislative	24 March 2012
Egypt	Presidential	March 2012
Madagascar	Presidential (Tentative)	March 2012
Madagascar	Parliamentary (Tentative)	March 2012
Mali	Presidential (1st round)	29 April 2012
Mali	Presidential (2nd round)	13 May 2012
Burkina Faso	Parliamentary	May 2012
Mali	Parliamentary (1st round)	1 July 2012
Mali	Parliamentary (2nd round)	22 July 2012
Cameroon	Legislative	July 2012
Kenya	Presidential (1st round)	14 August 2012
Kenya	Parliamentary	14 August 2012
Sierra Leone	Legislative	August 2012
Angola	Parliamentary	September 2012
Sierra Leone	Presidential	17 November 2012
Ghana	Presidential	December 2012
Ghana	Legislative	December 2012
Senegal	Parliamentary	2012
Lesotho	Parliamentary	2012
Togo	Parliamentary	2012
Zimbabwe	Parliamentary (Tentative)	2012
Equatorial Guinea	Parliamentary	2012
Congo (Brazzaville)	Legislative	2012
Algeria	Legislative	2012
Guinea	Legislative	2012
Sudan	Referendum	2012
Zimbabwe	Referendum (Tentative)	2012
Zambia	Referendum	2012

Sources: Bloomberg, Standard Bank Research

African economic growth: cyclical undermining structural

In its September 2011 World Economic Outlook (WEO), the IMF revised down its expectations for sub-Saharan African growth to 5,2% in 2011 (from a previous 5.6%) and 5,4% for 2010. It has growth rising to 5,8% in 2012. We suspect that the 2011 estimate will have to be revised lower, to around 5,1%, and that there will be a further deceleration to nearer 4,8% in 2012.

Figure 3: Sub-Saharan Africa GDP by demand contribution



Sources: IMF (WEO), Standard Bank Research

The structural drivers of Africa's GDP growth are well rehearsed, and remain a strong backdrop going forward.

Accepting the caveat regarding the diversity across countries and the quality of the data, we remain constructive on Africa's GDP growth on a structural basis in coming years, even though there will be some cyclical headwinds in 2012. The structural drivers of Africa's GDP growth are well rehearsed, and remain a strong backdrop going forward.

On the endogenous side, the structural drivers include:

- High population growth, an improving working/dependent population structure and rapid urbanisation as the middle class grows.
- Technological leapfrogging delivering swifter productivity gains.
- The take of a virtuous cycle whereby high growth attracts back human and financial capital flight, and of course, foreign investment.
- Very low levels of indebtedness following significant debt restructuring.

On the exogenous side, the structural drivers include:

- The debasing of G4 currencies is arguable a structural trend in so far as it is likely to be with us for a multi-year period while de-leveraging takes place, and it will make EM currencies look more attractive.
- The global search for yield will make EM assets more attractive as DM hold rates low in an attempt to cushion the de-leveraging process.
- The swift urbanisation across EM is creating significant demand and structural support for commodity prices.

The cyclical (or more easily reversed) factors driving Africa's growth outlook are less supportive presently.

The endogenous cyclical drivers include:

- Poor macroeconomic management that allowed economies to overheat. The combination of expansionary fiscal and monetary policy fostered or threatened depreciation/inflation spirals.
- The resulting higher rates will almost certainly undermine credit extension to both the private and public sides of the economy slowing growth.
- The previous lack of investment in infrastructure means that supply side constraints threaten overheating fairly early in the economic cycle.
- The ongoing (and arguable post-crisis increase in) dollarisation makes it more difficult for central banks to control monetary growth because of domestic USD borrowing.

The exogenous cyclical drivers include:

- Investment (risk) confidence is being undermined by perception of the EZ's structural problems, potential financial dislocation and of course lower global growth.
- Lower commodity prices which will help lower inflation and interest rates.
- Strong USD which will tend to slow financial inflows and place depreciation pressures on African currencies as inelastic import bills rise.
- Slower global growth will undermine African export growth, although the commodity price influence is probably more important than any decline in volume.
- Slower global growth will reduce tourist arrivals and transfers, both official and private sector.

Fiscal policy: less expansionary

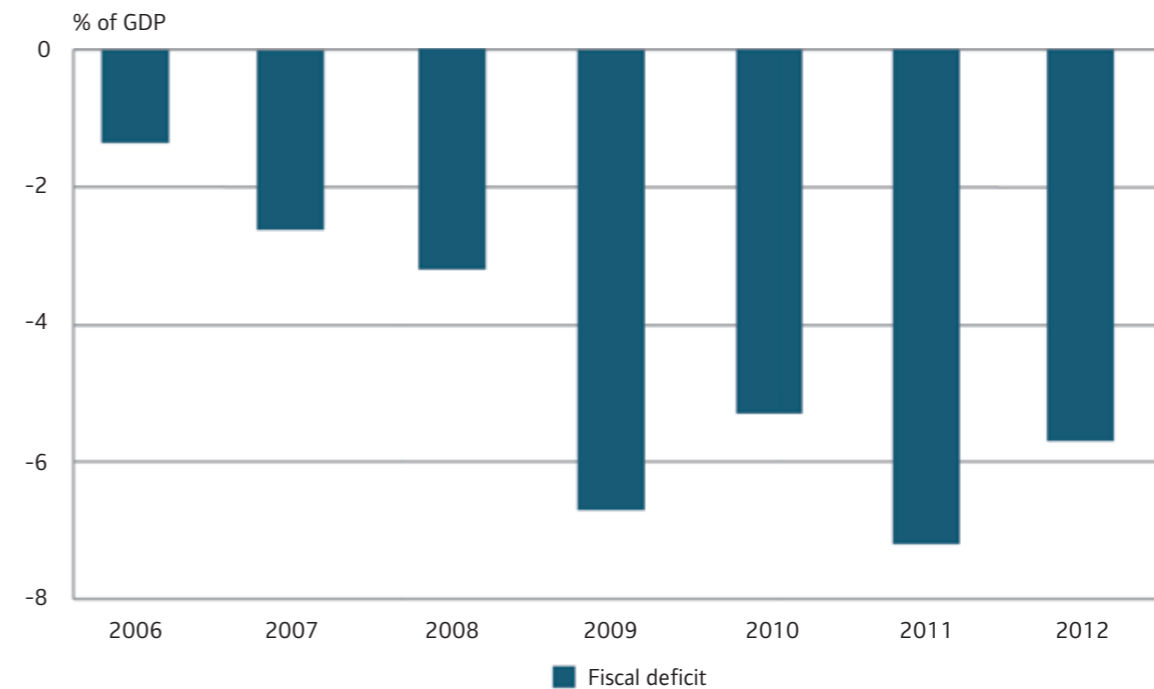
The increase in Africa's fiscal deficits after the 2008 crisis was to be broadly welcomed in so far as it fostered counter-cyclical stimulus. Back in early 2011, it became clear that a number of economies were threatening to overheat and required greater fiscal and monetary constraint. This was not particularly well delivered.

According to the IMF (September 2011 WEO estimates) the median fiscal balance (excluding grants) was 7,1% of GDP in 2011, from 7,8% in 2010 and 7,7% in 2009. They are looking for a slight moderation, to 6,0% of GDP in 2012 and 6,6% in 2011. Median government expenditure is expected to have reached 28,3% of GDP in 2011, compared to 22,6% of GDP in 2006. The growth in government spending relative to the size of the economies is probably not healthy, although much depends on the breakdown of spending between recurrent and capital. The need for accelerated infrastructure spending is clear. In fact, in many ways the lack of infrastructure continues to mean economies start to overheat far too swiftly. The other important point to note is that with the exception of Nigeria, Africa's other significant oil producers are building reserves and running reasonable fiscal surpluses, which clearly distorts any Africa-wide aggregate figures.

Meanwhile, according to the IMF (September 2011 WEO), levels of government debt remained relatively benign, at around 31,4% of GDP in 2010, compared to 54,6% of GDP back in 2004. Our figures for the 19 economies that we closely cover in the African Markets Revealed (AMR) publication suggest a slightly different picture. Based on a simple average (rather than weighted) domestic debt was around 20,6% of GDP in 2011, with an additional 18,7% of GDP from external debt. We see both numbers increasing in 2012.

The growth in government spending relative to the size of the economies is probably not healthy, although much depends on the break down.

Figure 4: Fiscal deficit: habit-forming



Sources: Standard Bank Research, based on median of AMR 19

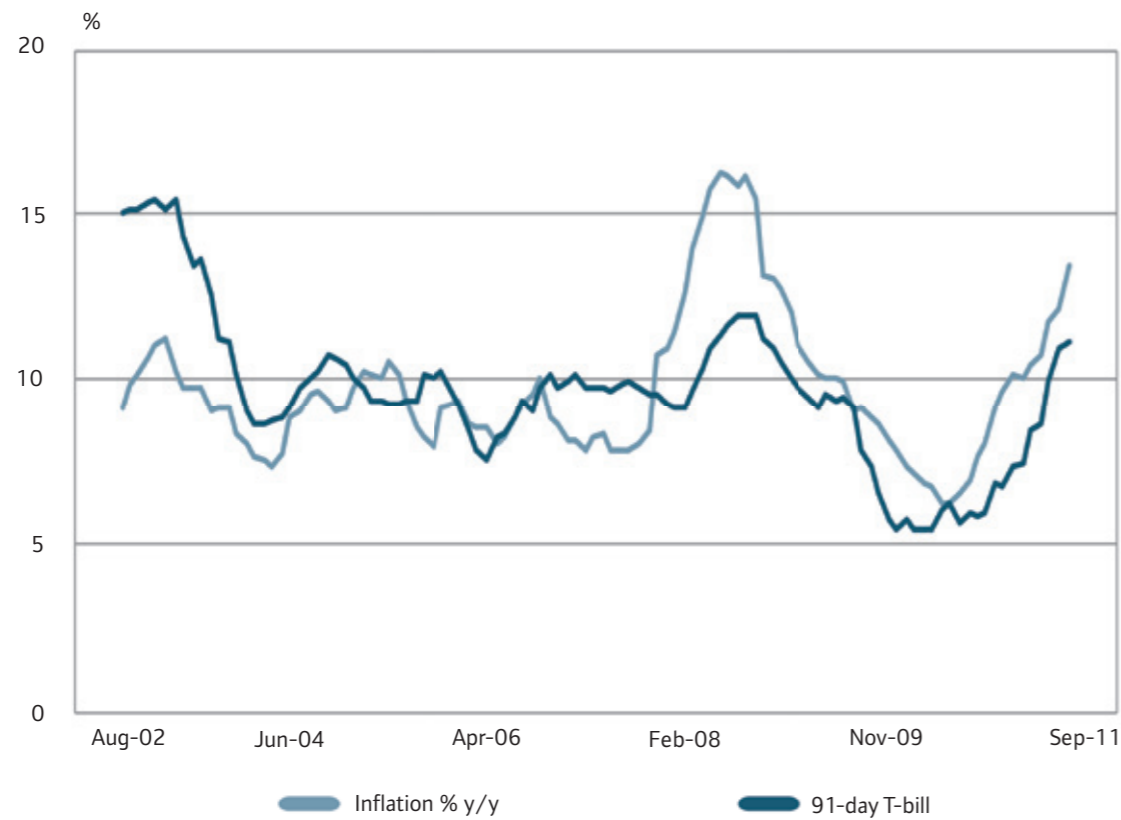


Monetary policy: real interest rates matter

If 2011 taught us anything, it is that real interest rates matter in Africa. The deliberate policy of extremely loose monetary conditions both through the exchange rate and interest rates channels created a significant loss of currency confidence in many countries across Africa in 2011. The ensuing currency weakness fostered inflation and has necessitated significantly higher interest rates.

Unfortunately, restoring confidence in these currencies (especially in an environment of weak global risk appetite) will be expensive in terms of interest rates having to be higher for longer than would otherwise have had to be the case. That said, inflation appears to be near to its peak, and is likely to decelerate for most of 2012. In particular, there are some significant base influences from Q2:12 onwards from lower international food and oil prices. High nominal interest rates, slower domestic demand and stronger currencies will broadly assist policymakers in bringing inflation back under control.

Figure 5: Real interest rates continue to be negative

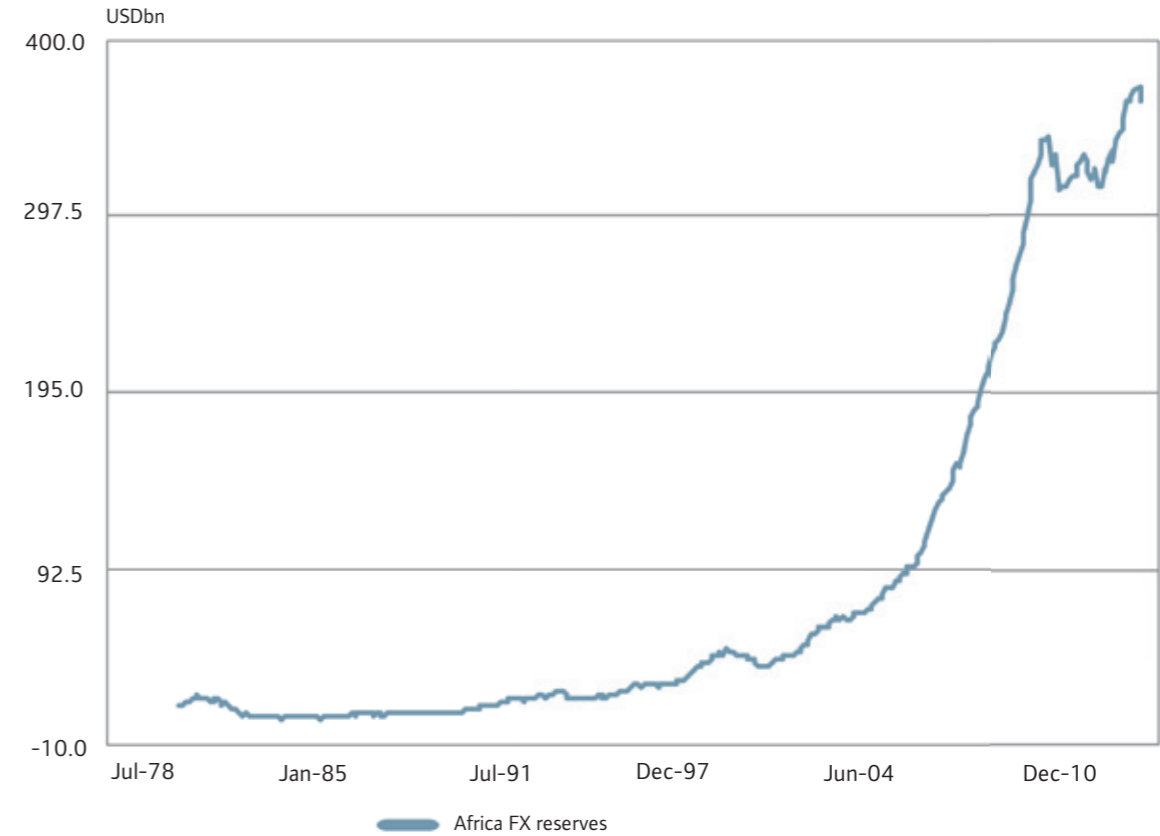


Sources: Standard Bank Research (based on AF10 African markets)
 Note: AF10 is Botswana, Egypt, Ghana, Kenya, Mauritius, Nigeria, South Africa, Tanzania, Uganda and Zambia

Balance of payments: set to improve in 2012

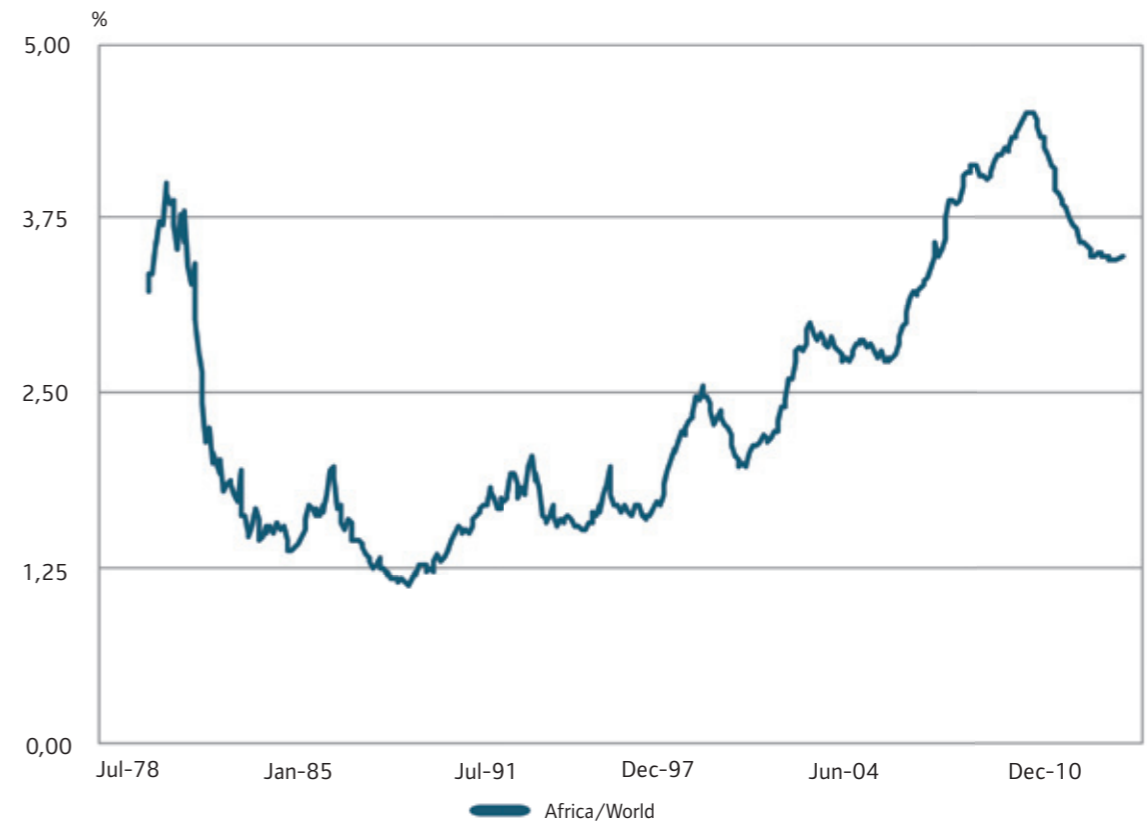
Although Africa's FX reserves crept up modestly in 2011 (see Figure 6) in absolute USD terms, as a percentage of World FX reserves they continued to decline (see Figure 7). The decline reflects the relatively weak current account and financial flow position in a number of the continent's key economies. It also reflects the ongoing surplus of USD liquidity in the global system, which is clearly not finding its way to Africa. We expect more of the global liquidity to reach, and be maintained, in Africa during 2012.

Figure 6: Africa's FX reserves resumed growth in 2011



Sources: IMF (WEO), Standard Bank Research

Figure 7: Africa's FX reserves as a portion of World FX reserves have fallen back since 2008



Sources: IMF (WEO), Standard Bank Research

Africa's current account deterioration in 2009 was a product of adverse moves in the terms of trade as commodity prices fell during 2008.

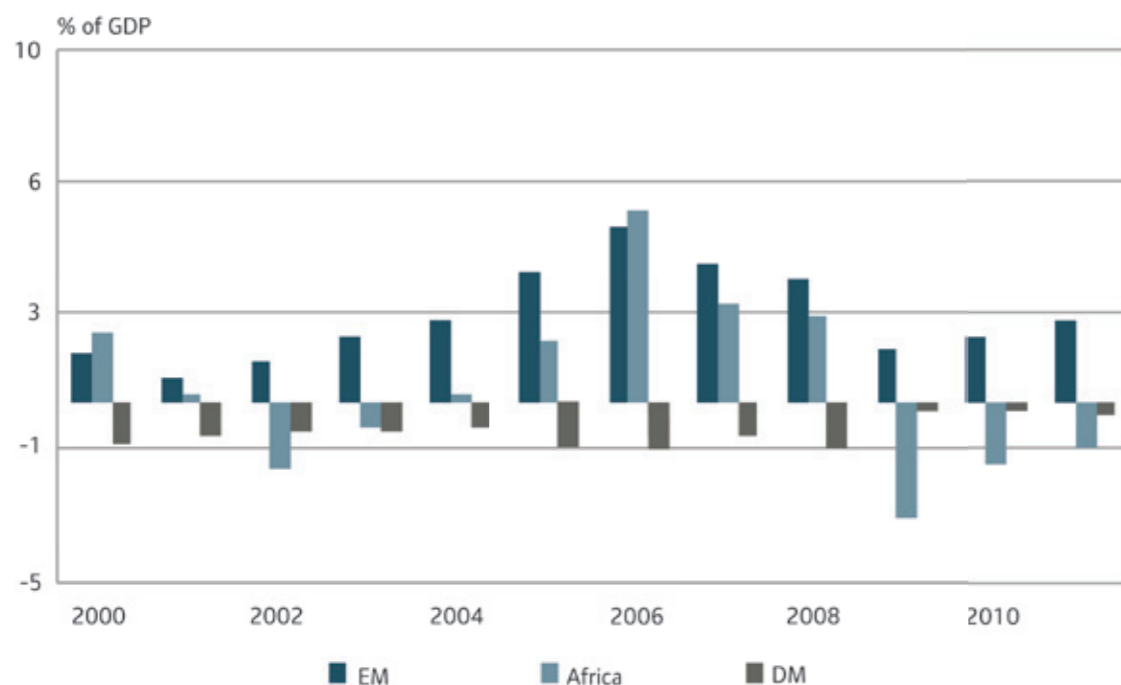
Current account: moderate deterioration

Africa's current account deterioration in 2009 was a product of adverse moves in the terms of trade as commodity prices fell during 2008. The improvement in 2010 and 2011 was associated with a rebound in commodity prices. That said, 2011 was a game of two halves for commodity prices, with the gradual slide lower starting in May 2011. Hopefully, 2012 will prove another game of two halves, with the gradual down-trend giving way to a rebound later in the year, but it is difficult to predict such timing as it is highly dependent on a solution to the EZ problems.

As ever, when looking at Africa's current account position, it's important to differentiate between the hydro-carbon importers and exporters. Our core scenario for 2012 is for the hydro-carbon importers to benefit from lower prices, while the hydro-carbon exporters will see reduced earnings. That said, we are not looking for a dramatic slide in oil prices.

Service balances will continue to be undermined by the slide in G4 tourism receipts. G4 fiscal problems will continue to undermine aid flows (despite clear political claims to the contrary), with concessionary finance increasingly tied to products and services offered by the donor country. Private remittances from G4 are also likely to be hit, although the cyclical switch to higher interest rates at more attractive currency levels means that the investment component of these flows will improve.

Figure 8: Current account deficit moderating



Sources: IMF (WEO), Standard Bank Research

Financial balance: looking extremely positive

The IMF does not have estimates for Africa's financial flows yet for 2011. Given a very modest current account deficit and a gradual re-build of Africa's FX reserves, we know that the overall financial balance in 2011 was slightly positive. Importantly, while financial flows into South Africa were significant, flows into the other two large economies were heavily negative. Nigeria is clearly running a current account surplus (although the size is open to debate) but FX reserves have been stable, suggesting large financial outflows. Similarly, Egypt's current account is very modest, while their FX reserves have lost some USD25bn since October 2010, suggesting significant financial outflows.

While financial flows into SA were significant, flows into the other two large economies were heavily negative.

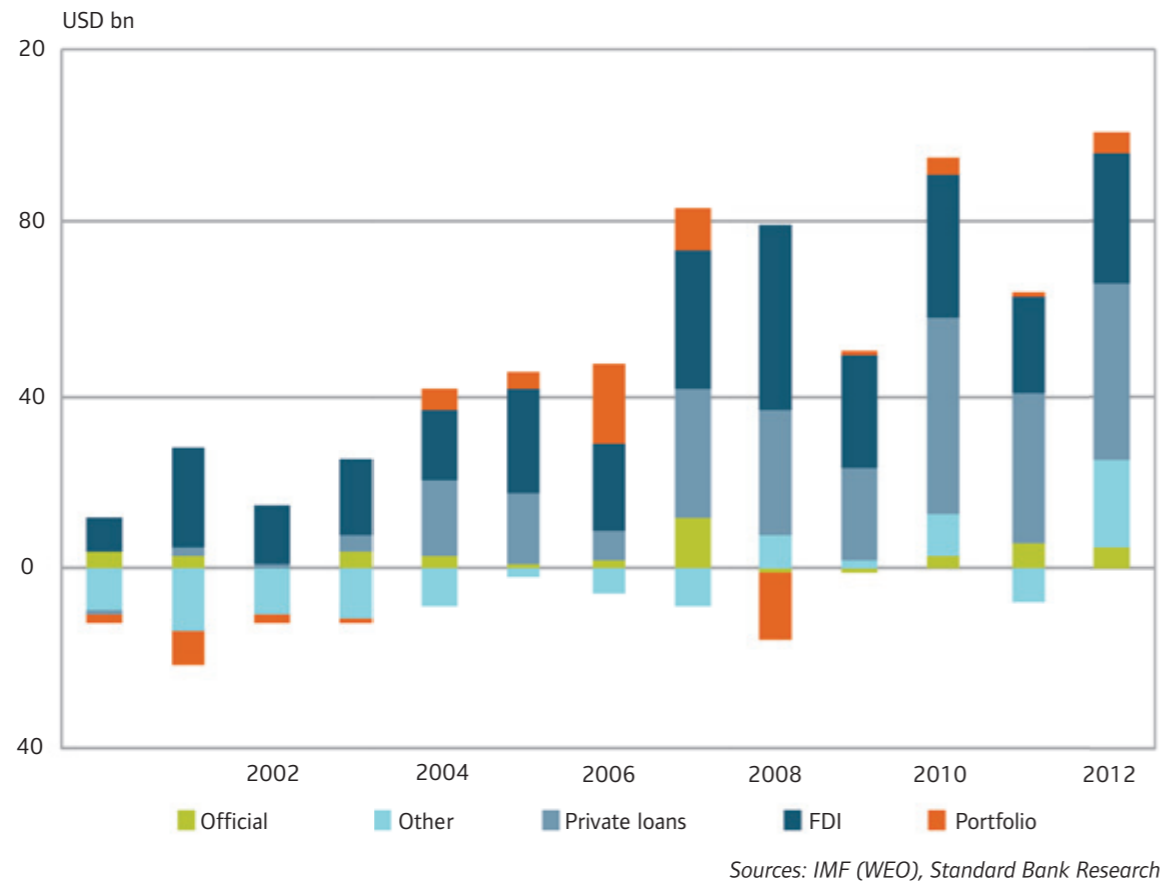
We are mildly constructive on financial flows in 2012. Official financial flows in terms of grants and loans will be maintained. We are also constructive on foreign direct investment generally, with the bulk of this coming from the re-investment of profit from ongoing operations. The ongoing issuance of Eurobonds and syndicated loans are also expected to continue to be reasonably solid. Importantly, we do not see the problems being experienced by the European banks significantly undermining the trade-finance and loans market in Africa, as there are plenty of well capitalized non-European banks willing to take up the slack at present.

Our constructive expectation for portfolio flows for 2011 proved a little optimistic. While our expectations prove appropriate for South Africa, which sits in the EM bucket, few other African countries received distinct net inflows. In particular, the large markets in both Nigeria and Egypt actually saw large outflows.

Our expectation for portfolio flows in 2012 is moderately constructive as a number of local assets are looking extremely attractive and ready for something of a rebound. However, we probably need to see a better risk climate globally for these flows to materialize in size. We are more constructive for H2:12, but even that is a low-conviction call.

Interestingly, the other category (which is dominated by deposit holdings) has performed badly in 2011, but we see this turning around in a number of economies in 2012. These flows tend to follow exchange rate expectations. The broader weakness across African currencies between early 2009 and mid-2011 increased USD holdings by locals and reduced local currency holdings of foreigners. The sharp hike in interest rates and the need to bring inflation back under control suggests that being positioned short USD and long local currency will be the dominate positioning by both locals and foreigner during 2012.

Figure 9: Africa's financial inflows look reasonably assured



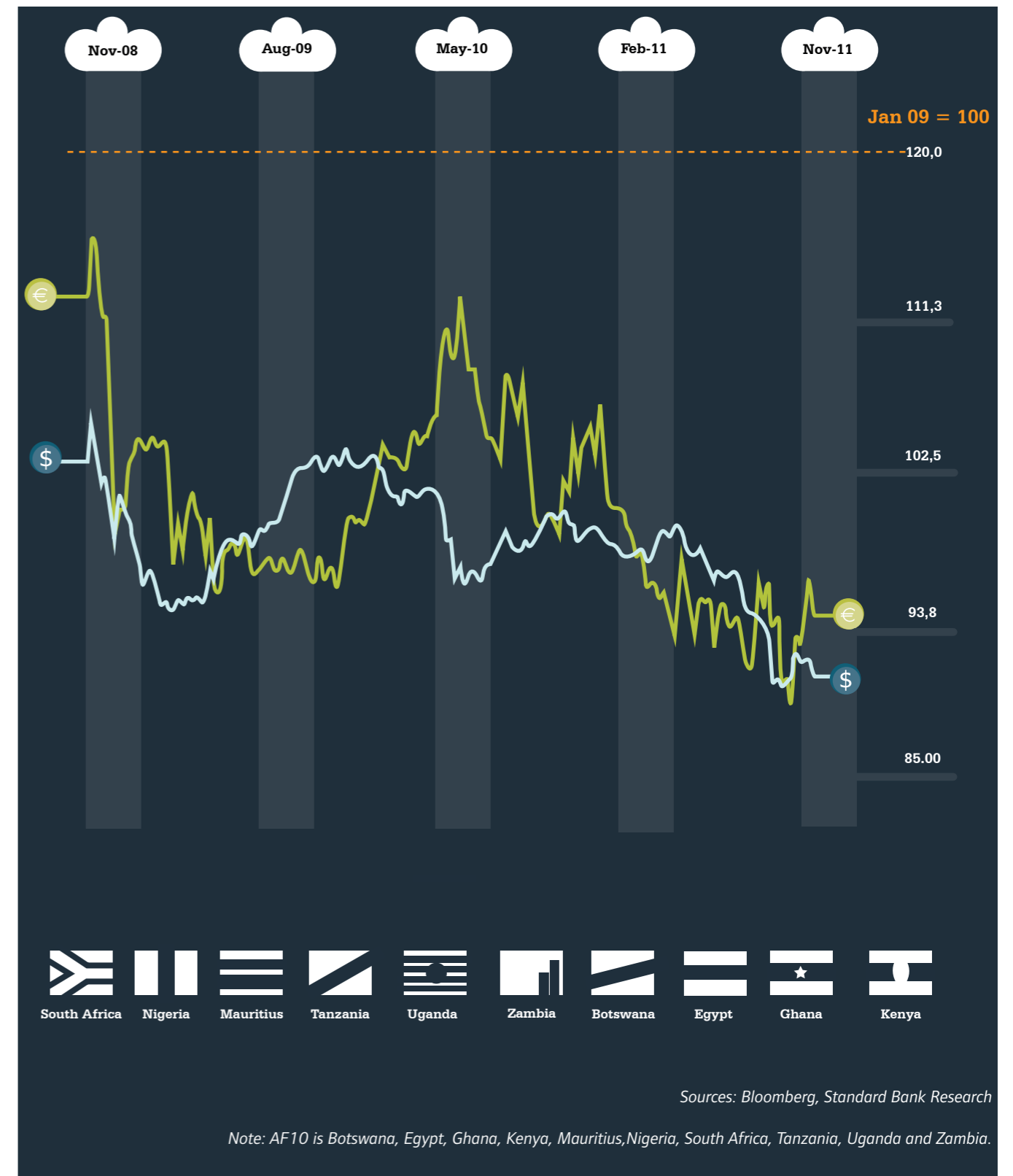
African currencies: rebound, at last

We have created a very simple evenly weighted index of the ten most widely traded (and flexible) African currencies: the AF10. Against the USD, the AF10 fell 7,1% in 2011, while against the EUR, the AF10 fell 5,0%. However, the picture appears to have changed materially since early October 2011. Against the USD, the AF10 was up 2,6%, while against the EUR, it was up 8,7%.

The turning point in early October 2011 mainly reflected the shift in East Africa after a sharp tightening of monetary policy finally started to shift negative sentiment on the region's currencies. With most African currencies still heavily policy determined, the shift towards authorities attempting to stabilise or strengthen their currencies via tighter monetary policy is for us probably the most important driver of currency direction in 2012. Interest rates (both real and nominal) in Nigeria and Egypt have also been raised to multi-year highs in order to restore/maintain currency confidence. Even in Ghana, where inflation has been extremely muted in 2011, the Bank of Ghana has started a process of monetary tightening in order to prevent a destabilising loss of confidence in the currency, a possibility which is heightened by the elections due on December 2012.

With most African currencies still heavily policy determined, the shift towards authorities attempting to stabilise or strengthen their currencies via tighter monetary policy is for us probably the most important driver of currency direction in 2012.

Figure 10: Africa's currencies are set for a period of stability/strength



Of course, the willingness of the central banks to preserve currency stability/strength is only part of the story. They also need the ability to deliver their favoured policy. This often requires buy-in from the government in terms of fiscal policy which pulls in the same direction as monetary policy. Such coordinated policy still remains a huge challenge in a number of countries, and increases further in an election year, as is being faced by Kenya and Ghana.

Then there is vulnerability to exogenous shocks. More often than not, this is manifest via a sharp change in commodity prices, but particularly food and fuel prices. It is important to note that of our AF10 index it is only really Nigeria, and a lesser extent Egypt, which is vulnerable to a sharp decline in oil prices. All the other currencies would arguably benefit from a slide in fuel prices.

In addition, Africa's currencies will be influenced by broader global risk appetite. One highly supportive factor for most African currencies (with exception of the ZAR and the GHS) is the very light foreign holdings of portfolio assets. So the vulnerability from a sharp deterioration in risk sentiment is fairly small via the portfolio flow channel. However, calling a concerted rebound in these inflows probably requires greater confidence over a solution to the EZ worries, and it's difficult to see that in H1:12.

Stephen Bailey-Smith

Africa's currencies will be influenced by broader global risk appetite.



we achieves what **me** can't.
we makes **me** smarter.
we finds a way when **me** gives up.
we succeeds when **me** fails.

we does the impossible. **we** triumphs. **we** is team spirit.



South Africa's Political Economy

ANC endurance hinges on the essentials, filling many empty bellies and nurturing eager minds. Patience is wearing.

Political economy

Politics during the year will be dominated by the run-up to the ANC's end of year conference in Mangaung, where a new leadership will be elected.

Prepare for a political year in 2012 which will be full of sound and fury – but which may turn out to signify far less than most of the commentary will claim.

Politics during the year will be dominated by the run-up to the ANC's end of year conference in Mangaung, where a new leadership will be elected. Since politicians will spend much of the year trying to advance their interests by trying to get us to believe that things are happening which probably are not, and since journalists will spend much of the year believing them, it will be important for people in business, and their analysts and strategists, to distinguish carefully between the illusions which some in politics may want to create, and reality. A careful reading of policy statements and conference resolutions will be essential, for there is likely to be a gap between what they say, and what media reports say they say.

One source of confusion will be working out what relates to the presidential succession and what does not. Another will be the many contradictory messages about the ANC elections themselves. Third, and most important for business planning and strategy, the year is likely to see immense confusion about the policy positions adopted at the governing party's mid-year policy conference and at Mangaung itself.

All roads lead to Mangaung?

One sign of the likely environment in 2012 has already become apparent – a frequent tendency to assume that everything the government does is somehow related to the ANC presidential succession. This obscures the fact that South Africa is a complex country and that the governing party, although important, is not the only political game in town.

Two examples of what to expect illustrate the point. In October, President Zuma's decision to sack two members of his Cabinet who had been accused of irregularities by the Public Protector, and to appoint a commission of inquiry into the controversial arms deal concluded before he became President was reported as an attempt to shore up his position ahead of the ANC election¹. This did not explain why his action would have any impact on the succession race at all.

The only group within the ANC alliance which had demanded action was the Congress of SA Trade Unions, which seems likely to support the president whether or not he pays attention to their public positions.

Neither of the ministers removed were rivals of the President, nor were they linked to the faction within the ANC which is interested in challenging him. The only group within the ANC alliance which had demanded action was the Congress of SA Trade Unions, which seems likely to support the president whether or not he pays attention to their public positions. Nor is there any indication that dismissing senior politicians accused of irregularities helps to win ANC elections. The ANC's history of having been a beleaguered movement surrounded by a hostile state has tended to encourage its members to band together when they are accused of corruption – it was former president Mbeki's decision to fire Zuma from the deputy presidency when he was accused of corruption which is said by some analysts to have cost him the support of ANC delegates². Firing people accused of irregularities is at least as likely to lose ANC elections, as to win them.

Given all this, it was surely clear that the President acted to deflect pressure from the media and various interest groups, not to strengthen his position in the ANC. The analysis which linked his action to the succession was misleading because it ignored two important political trends – the growing effectiveness of

the Public Protector in holding the government to account and the role of public pressure in supporting her. What should have been seen as an important sign of the improved health of democracy was reduced to a new sign of in-fighting in the ANC.

An even more clear-cut example was coverage of the Donen commission report which investigated South Africans' role in allegedly circumventing UN sanctions on Iraq. Because both deputy president Kgalema Motlanthe and Human Settlements minister Tokyo Sexwale were mentioned in the report, and both are said to be challengers for the Presidency, it was reported that the President was releasing the report to weaken his two rivals³. When the report was released, it turned out to contain no adverse findings on Motlanthe or Sexwale. It also became clear that the President had released it because he faced a legal action asking a court to order him to publish the report. So again, an incident which showed that democracy is working to force government to release documents it would prefer not to make public was passed off as an attempt to influence the Presidential race.

The fact that this analysis was shown to be ridiculous by the Donen report itself is unlikely to prevent media attributing much that happens in government in 2012 to the ANC election race. In many cases, the actions will have as little to do with the election as the examples mentioned here.

During 2012 it will, therefore, be important to distinguish between that which is related to the succession and that which is not. Society will not cease to exist in an ANC election year; private interest groups and their interaction with the government will continue to make an impact. The way in which government responds will tell us whether democracy continues to make progress – as it did in 2011 when government responded to citizens and held government ministers responsible for their actions.

During 2012 it will be important to distinguish between that which is related to the succession and that which is not.

A damp squib?

While there will be much jockeying between political factions in 2012, the presidential election itself may prove far less important than much of the reporting and commentary would suggest. To understand why this is so, we need to place the election race in context.

Reports have suggested that it is highly likely that President Zuma will face a contest, and that his likeliest challenge will come from deputy president Motlanthe, supported by the ANC Youth League⁴. None of these statements are likely to be borne out by events.

The battle which may affect Zuma's presidency is not one between him and the Youth League. The League is not an independent force in ANC politics. While for the past twenty years it has been active in contests over who should lead the ANC, it never decides itself who will seek the top job. It has always acted on behalf of senior politicians who make the decisions and then recruit the League to campaign for their favoured candidate. Nothing has changed and so the decision on whether Zuma is to be challenged will be taken not by the League but by the senior politicians whose bidding it does.

The battle which may affect Zuma's presidency is not one between him and the Youth League.

The reason why some senior politicians currently find the League so useful is that, ever since former President Mbeki was recalled in 2008, competing factions have been contending to take over the ANC. One faction is often described as the "nationalists" or "populists". They were discussed in last year's report – they are close to business and they use racial language to support demands for a greater share of the economic pie. And, for many in this group, politics is a route to personal wealth which can then be used to buy more political support.

¹ Sibongakonke Shoba 'President's move wins praise from across the board' Business Day 25 October 2011.

² Thokozani Mtshali 'Zuma supporters hail ANC bid to settle row' Sunday Tribune September 12 2005.

³ Sibongakonke Shoba and Sam Mkokeli 'Secret SA oil report "may deal blow to Zuma rivals"' Business Day 19 October 2012.

⁴ 'Tokyo talks but quiet Motlanthe the one to watch' The Citizen 14 November 2011

<http://www.citizen.co.za/citizen/content/en/citizen/opinion-leaders?oid=239589&sn=Detail&pid=334&>

The risks of taking on a sitting president and losing are very high – the challenge is certain to be seen as a hostile act and defeat is likely to mean being frozen out of senior positions.

They are opposed by a very loose alliance of opponents who are united simply by their opposition to this style of politics: they range from the left to champions of the market. At some point, the battle between these factions is likely to lead to a contest between them for control of the ANC. But the battle is unlikely to be fought in 2012.

The reason is that neither faction can be sure of winning at Mangaung. The risks of taking on a sitting president and losing are very high – the challenge is certain to be seen as a hostile act and defeat is likely to mean being frozen out of senior positions.

The anti-nationalist faction has clearly decided already that it is foolhardy to challenge Zuma (they are also hampered by the fact that they don't have an obvious candidate for president). And so they already seem to have decided to support a second term.

Their opponents, the nationalists, would like to support Sexwale for ANC president – his style of politics is different from that of the nationalists but he has allied himself with them, consistently seeking to protect Youth League president Julius Malema⁵ and appointing a prominent nationalist, Winnie Madikizela-Mandela, to examine the availability of toilet facilities to the poor⁶ (a significant issue because it attracted substantial attention during the 2011 local government elections.) But they too seem resigned to the likelihood that they would lose.

This faction's Plan B is to support Motlanthe for president – he is not clearly in either of the main factions and so might be able to win support from both. Their plan is to get Sexwale elected as his deputy, smoothing his way to the Presidency. But this scheme has a seemingly insoluble problem: Motlanthe is unlikely to run against Zuma. They have tried to solve this problem by telling the media that Motlanthe is both very popular and willing to oppose Zuma⁷. The first claim may be accurate, the second clearly is not. What is equally clear is why this is being leaked to the media: the purpose is to scare Zuma off and so persuade him not to run for another term. This is almost certain to fail too – Zuma is clearly not fooled, and is planning to run again.

Since the "nationalists" are not eager to challenge him outright, and Motlanthe seems likely to refuse to run against him, the likeliest outcome is that Zuma will not be challenged at all.

This postpones the battle for control of the ANC to the 2017 conference. It seems likely that the factions will want to use this year's gathering to test their strength. This will help them to refine their strategies for the next five years. Since they cannot challenge Zuma, the battle is likely to be waged through a contest for other positions. The most obvious is the secretary generalship, currently occupied by Gwede Mantashe, SA Communist Party chair and a strong opponent of the nationalists. He may face a contest with former Youth League president, Sports minister Fikile Mbalula⁸. The factions may also contest the national chair's post.

So, while the president's job security is unlikely to be threatened, there will probably be some contests between the factions in Mangaung and this gives them a strong incentive to continue politicking right through 2012. The pattern described here – in which media reports usually tell us more about what some politicians want us to believe than what is really happening – seems likely to persist through the year.

Because the ANC has still not reconciled itself to open contest for positions, the battle is likely to be fought from the shadows, and this means that the factions will rely heavily on persuading the media to see things their way, but in ensuring that what is said in public about the contest cannot be traced back to them.

This back-room politics may become even more evident in 2012 because this is the ANC's centenary year, and there are strong pressures to maintain a public impression of unity, at least in the first part of the year. Again, the incentive is to operate in the shadows, through media leaks.

All this means that it will be very difficult during the year to tell "spin" from reality. But it will be far easier to understand events if we know that the central reality in the ANC is the battle between the factions discussed here and the analyses of unfolding events through that lens. This is particularly important since policy debates are likely to be used through the year to gain political advantage.

The "n" word and other fantasies

The conventional way of examining factional battles – one much loved by many public commentators, is to insist that the two sides are battling because they want to make ANC policy. What this fails to recognise, is that often, policy making is a way of fighting factional battles.

This makes it particularly important to examine policy documents very seriously to see what, if anything, is being changed rather than relying on reports and commentaries.

An obvious example of an issue on which confusion is likely to reign is nationalisation. As last year's report pointed out, the debate is already distorted by the fact that the Youth League's "nationalisation proposal" does not actually call for nationalisation – it is rather about using a state-owned mining company to bail out owners of non-performing mining assets and enhancing the leverage of politically connected business people by forcing companies who want licenses to offer them a greater share of the mining action.⁹

This is one example of a way in which a term such as "nationalisation" can be used to disguise something different. This pattern may become more pronounced next year with the emergence of another key voice in the debate – Cosatu.

Until its 2011 central executive committee meeting, Cosatu joined the SACP in dismissing the "nationalisation" demand as a ploy to advance the business interests of politically connected people. At the meeting, it became apparent that some in Cosatu, led by the metalworkers and their general secretary, Irvin Jim, were concerned that Malema and the "nationalists" whose bidding he does, were stealing Cosatu's policy positions. They pointed out that it was the union federation and its left allies who had traditionally demanded nationalisation. Now, they were being pushed into supporting private enterprise and opposing a demand for state ownership. They argued that Cosatu needed to propose a nationalisation plan of its own.

They seem to have won the day – Cosatu appointed a task team to develop a nationalisation proposal and it was quoted as saying that nationalisation was now a "given" – all that remained was to work out the details.¹⁰

But, as with the Youth League, reality is more complicated. Cosatu is divided over nationalisation¹¹ and one of its opponents is the National Union of Mineworkers, whose view on the mining industry obviously carries weight. On the one hand, it therefore seems unlikely that it will come up with a demand for unqualified nationalisation. And on the other hand, it does need to be seen as endorsing nationalisation to satisfy those unions who are concerned about being accused of being outflanked on the left. The likeliest outcome, then, is that it will produce something which it will call a nationalisation proposal but will ensure that the fine print leaves plenty of room for continued private ownership.

This is one example of a way in which a term such as "nationalisation" can be used to disguise something different.

⁵ ANC's NDC slams Sexwale's Malema testimony' Times Live <http://www.timeslive.co.za/local/2011/11/14/anc-s-ndc-slams-sexwale-s-malema-testimony>.
⁶ Kingdom Mabuza 'Young Reds livid over Winnie's probing of sanitation problems' Sowetan November 18, 2011.
⁷ Phillip de Wet 'SA streets want Kgalema Motlanthe' Daily Maverick September 29, 2011 <http://dailymaverick.co.za/article/2011-09-29-sa-streets-want-kgalema-motlanthe>.
⁸ Matuma Letsaalo and Mandy Rossouw 'Mantashe vs Mbalula' Mail and Guardian September 4 2009 <http://mg.co.za/article/2009-09-04-mantashe-vs-mbalula>.

⁹ ANC Youth League 'Towards the transfer of Mineral wealth to the ownership of the people as a whole: A Perspective on Nationalisation of Mines August 2010' <http://www.ancyl.org.za/show.php?id=5502>.
¹⁰ 'Nationalisation a certainty: Cosatu' Times Live 5 August, 2011 <http://www.timeslive.co.za/politics/2011/08/05/nationalisation-a-certainty-cosatu>
¹¹ 'Cosatu "divided" over nationalisation' New Age July 4, 2011.

The nationalist faction which uses the Youth League may not be serious about nationalisation.

This example has been discussed in some detail not only because it dominates business concerns but because it is likely to provide an accurate illustration of how policy debates will proceed in 2012. Policy positions will, to a considerable degree, be hostage to political jockeying and so politicians are likely to be more concerned with being seen to endorse certain positions than with actually supporting them.

The nationalist faction which uses the Youth League may not be serious about nationalisation. But, because they have chosen to use the word to pursue their agenda, they have created an environment in which many in the ANC fear being seen to have been outflanked on the left. This gives them an incentive to insist that they and the ANC are moving left even if it is not. Some will find it politic to insist that the ANC supports nationalisation even if it does not. They will not want much attention focused on the small print which shows that the proposal is not nearly as dramatic as it seems.

Another example of how this process works is National Health Insurance (NHI). This is ANC policy, adopted by conference resolution. It is a popular project among ANC activists. The health ministry must, therefore, be seen to be pursuing an NHI. However, the minister, Aaron Motsoaledi, recognises the need to tread very carefully because the public health system cannot yet cope with NHI. The political demands of his position force him to show that he is fully committed to the project¹² – the practicalities force him to adopt a cautious approach in which each stage is piloted and in which changes are negotiated.¹³ Business strategists and analysts who read only the expressions of commitment will conclude, wrongly, that the NHI will be implemented rapidly, and in a manner which is certain to weaken the private health sector significantly. Those who read all the minister's statements, and the documentation on NHI, will discover that the plan is to phase it in over 14 years and that there is a great deal of leeway left to negotiate the details and to ensure that health care does not suffer.

This example illustrates a further important point. Even if dramatic policy shifts are adopted at the two ANC conferences – which still seems unlikely – that does not mean that whatever is agreed upon is going to happen. The process between the adoption of resolutions and their translation into government actions is often slow and complicated and filled with negotiations that change the details of what is agreed. A policy resolution is the beginning of a process, not its end. Even if the fine print does indicate a significant shift, a process has to occur before that becomes a reality.

Listening through the noise

All of this means that 2012 is certain to be a year in which listening carefully to what is really happening, through the noise of politicians and journalists seeking to convince us that something else is on the go, will be particularly important.

One sign of democratic health – at least among those who are able to take part in the national debate – is that political battles here are often fought through the media. This means that we know more about in-fighting in the governing party than we might in a less open society. But the price to be paid is that, because open competition is still discouraged in the ANC, and the battle is therefore often fought through leaks and hints rather than public statements, it is often difficult to cut through the “spin” and work out what is happening.



¹² Katharine Child 'Motsoaledi unveils "radical" NHI plan' Mail and Guardian August 11, 2011.

¹³ Sipokazi Fokazi 'We're open-minded on NHI, says Motsoaledi' Cape Argus September 23, 2011.

This will be a particular problem during 2012 because there will be a community of interest between some politicians and journalists to portray both the ANC election and the policy debates as far more dramatic than what they really are. The journalists clearly want the story to be as exciting as possible. The politicians are assuming that the context in the ANC during this election year requires them to over-estimate both the extent of the threat to the President and the degree to which policies are shifting.

When the year is over, we are certain to find that the centre of gravity of our politics has not shifted nearly as much as we were told.

There is no majority within the ANC which will support a radical shift in policy to the left: five years ago Zwelinzima Vavi complained that the ANC would not move left because there were too many people in its ranks with links to business and the middle class. Nothing has happened since then to change this and so any policy shifts which do occur will be limited and subject to both qualification and negotiation with key interests, including business.

Nor is it likely that attempts to persuade President Zuma to stand down will succeed. This means that those who wish to unseat him will have to rely on deputy president Motlanthe's willingness to oppose him, and this remains unlikely. And so, shifts in the ANC leadership may prove as limited as the policy changes.

Amidst the noise that this will create, an ability to ignore the distraction and focus on the details which they are meant to distract us from, will be essential.

There is no majority within the ANC which will support a radical shift in policy to the left.



South African Economy

Usurped by Europe, South Africa's road to recovery has now become blurred and the gains made in 2011 have been eroded. Moreover South Africa will not escape Europe's cold grip in 2012.

South African Economy

In Europe's cold grip

2011 was certainly the year for new beginnings, the year where the new norm became accepted and the year in which we grappled with this new paradigm. We ushered the year in with a bit of relief that the threat of a double dip in the US was dissipating. But, it became clear that the sovereign debt vulnerabilities across Europe would lead to further debt restructuring that could potentially destabilise the global economy. Additionally, emerging markets (Brazil, India and China in particular) – the last bastion of economic growth, started to slow somewhat as they embarked on tightening cycles to avoid overheating. Political turmoil and conflict in the Middle East and North Africa disrupted economic activity, causing upward pressure on international crude oil prices.

In early 2011, we lauded and applauded ...

South Africa started the year strongly, with first quarter growth of 4,6% q/q (saar), well on its way to reaching the consensus growth. Growth had exceeded expectations with unanticipated buoyancy in the finance, real estate and business services as well as stellar growth in the manufacturing industry. While there were still pockets of weakness, there was an evidently strong counterbalance. A continued rise in real consumer expenditure by households boosted final demand, facilitating further increases in real disposable income. Households' indebtedness ratio declined, helped by the 36-year low prime lending rate and an increase in disposable income. Final consumption by government also picked up somewhat, mainly as a result of the purchases of a number of military aircraft. The most prominent output gains were recorded in the manufacturing sector, where expansion occurred in all sub sectors, however, aggregate production in the manufacturing sector remained below its pre-crisis level and capacity utilisation only made mild gains. Growth in the tertiary sector accelerated slightly, not least on account of rising sales volume in the commerce sector, but momentum was lost in the primary sector following field crop production as a result of flooding which suppressed agricultural production. Furthermore, mining activity slowed as lower production volumes of gold and coal contributed to the slowing of output by the primary sector. The rate of real fixed capital formation picked up following increases in outlays by both public corporations and the private sector. High levels of domestic expenditure brought vigour into import volumes, but export volumes remained lacklustre, not least due to relatively subdued growth in South Africa's traditional export destinations. A deterioration in the terms of trade contributed further to the widening of the deficit on the current account of the balance of payments; however, the healthy inflow of capital flows was able to fully finance the deficit. In all, in the first quarter, the South African economy was characterised by rising levels of activity and expenditure with sluggish export volumes, but a favourable terms of trade and a manageable current account. South Africa was technically out of recession for 18 months, with annual GDP growth expected to range between 4,5% – 5,5% and growth in employment forthcoming, in the absence of exogenous shocks. But there was always the fear that debt levels in advanced countries could throw a shadow over our growth forecasts. Indeed, when the world economy stumbles, the South African economy follows, and the long-term costs do seem particularly dear. Sadly, Europe did stumble, taking South Africa's economy in its downwards spiral. Furthermore, the barrage of negative supply shocks that hit the world economy in early 2011 had their most pronounced effect on growth in Q2:11.

Growth had exceeded expectations with unanticipated buoyancy in the finance, real estate and business services as well as stellar growth in the manufacturing industry.

... but got tripped up.

Global risks escalated, particularly in the second half of the year, justifying a cautious outlook. The looming uncertainty in Europe took a turn for the worst, with political squabbling grabbing headlines. The sixth tranche of Greece's aid package was held hostage due to division amongst European leaders as to whether Greece was doing enough to restore its fiscal credibility. Across the Atlantic, after placing the US on review for a possible downgrade on 13 July, due to the small but rising probability of a default on the government's debt obligations because of failure to increase the debt limit, S&P ratings agency downgraded the US to AA+, one notch below the top grade of AAA. In addition, there was a series of domestic industrial actions in Q2:11 and parts of Q3:11, which debilitated output, particularly the manufacturing and mining sectors. Both sectors, which account for just over 20% of overall GDP continued to struggle through much of the year. Mining output, for instance, slumped by 5,4% in September, from a year ago, contracting for the third consecutive month. Agricultural output also declined as crops, while large, did not match the bumper crops harvested in the previous year. Besides being compromised by the industrial action, the manufacturing sector took a knock due to a slowdown in global demand as well as strong international competition. These events tripped up South Africa's growth acceleration. After lauding the recovery in Q1:11, GDP growth in Q2:11 eased more than expected, to 1,3% q/q (saar) and 1,4% q/q in Q3:11. High-frequency data, with the exception of retail sales, remains weak. The outlook for growth in 2012 looks daunting, particularly when there is little thrust to revive the economy. With consumers supporting growth to a degree, can we really rely on consumption to buffer the economy from a further downfall or even a recession?

Figure 1: GDP contributions



Source: SARB

Can consumers drive the economy in 2012?

The ripple effect of the financial meltdown in Europe and the uncertainty in the global economy has certainly had a pronounced effect on the South African economy, including consumers. Final consumption expenditure by households accounts for around 60% of GDP, and with growth slowing, household expenditure eased more than expected in Q2:11 to 3,8% q/q (saar) from a robust growth of 5,2% q/q (saar) in Q1:11 as consumer finances came under increasing strain. However, as a contribution to GDP, households continued to raise their real final consumption expenditure, allowing the ratio of debt-to-disposable income to inch lower. Growth in household expenditure on durable goods was particularly strong in Q3:11, increasing by 17,8% q/q, after cutting back by 14,1% q/q in Q2:11. While consumer outlays on durable goods remained strong, expenditure on services slowed considerably. The number of headwinds households faced in Q2:11, which include subdued income growth, poor employment prospects and rising inflation, saw consumer confidence slide further in Q3:11.

Indeed, households have become pessimistic about their financial positions as well as the state of the domestic economy. However, rising disposable income as well as higher wage settlements must have given consumers some solace. The question remains: To what extent is rising consumer expenditure a reflection of improved financial health? This question is not easily answerable as it depends largely on where we are in the business cycle and whether households have deleveraged sufficiently, particularly after recession periods. The declining confidence and softer growth in household consumption expenditure is corroborated by the declining trend in the uptake of credit extension. While credit extended steadily (but not convincingly) throughout the year, the bulk of momentum emanated from corporate credit demand. In line with global trends, corporate earnings have indeed improved and, as they consolidate their balance sheets, have begun to reflect healthier positions. The bulk of credit extended to households has come from mortgage advances. Since the financial crisis started impacting on the South African consumer, the South African Reserve Bank (SARB) cut the lending rate to encourage spending. The SARB cut the repo rate from 12% in 2008 to 5,5% in November 2010 and has kept rates at a 36-year low since.

The credit crunch that began in 2008 has restricted liquidity, therefore making it difficult for loan applications especially from those who are not financially healthy. One would expect households to therefore be in a healthier position, considering that debt servicing costs have declined substantially, however this is not entirely the case. Households are still highly indebted and the subdued pace of deleveraging year-to-date, as well as low savings, is concerning. Indeed, South Africa's savings rate is lower than that of its peers, primarily because of very low household savings. The gross national savings rate has averaged about 15,5% of GDP since 1994, compared to 24% for emerging countries. If China is excluded, from the emerging markets average, whose high savings rate distorts the average upwards, the median rate for emerging markets would still be a high 19%. Households' savings have been volatile, but have hovered just above zero since 2000. Savings rates are held down by the low income levels of large sections of the population. Other structural factors that may reduce incentives to save and may therefore have held down national savings rates include somewhat elevated inflation rates, an accessible and widely applied social welfare system, the availability of reasonable pension systems for the organised labour market and a young population.

The debt and duration of the deleveraging cycle, as well as the time it takes to recover to "normal" debt levels, is alarming. Comparing past recessions and the corrections in the household debt-to-disposable income ratio, it is likely to take a while before households are fully able to consolidate their balance sheets. Over the past fifteen quarters, the household debt-to-income ratio has only fallen 7 index points, far better than the stark downturns of 1978 and 1984 where the declines of 15 index points were recorded. If we consider the characteristics of the 1998 downturn, the current consolidation cycle seems to follow a similar

path. If the deleveraging cycle follows this trend, we are likely to see meaningful consolidation after about seven years. The current deleveraging cycle is considerably softer, however, if the SARB hikes rates, we could see households' deleveraging plans take longer to materialise.

Business confidence among retailers is trending down, reflecting concerns about employment, slower wage and income growth and declining levels of consumer confidence. Other factors expected to constrain consumer expenditure include high levels of household debt, constrained access to credit and consistently above-average increases in a range of administered prices which reduce the amount available for household discretionary expenditure. Consumption expenditure by households has been the main driver of growth in 2011; however, it has been moderating. Furthermore, consumption patterns have been distorted somewhat by the high base effects arising from the 2010 FIFA World Cup tournament. Should the crisis in Europe escalate leading to further global slowdown, a consumer-led growth is unlikely to occur in 2012.

Public finances take a step back

The crisis in Europe has brought to the fore concerns about fiscal sustainability globally. While the rest of the world, particularly the developed world, is adhering to tightening fiscal positions, the South African budget deficit is now expected to widen further.

The February Budget review was presented amidst a rather promising economic outlook, following 2010 GDP growth of 2,8% y/y and the assumption that economic growth would expand further in 2011. The main drivers of growth were strong commodity prices, lower interest rates and better-than-expected global growth. The primary focus of the February Budget was job creation, supported by numerous welfare programmes and expansive spending as outlined by the New Growth Path. In February, the budget for the 2012-2013 fiscal year was raised from 3,9% to 4,8% on expected GDP growth of 3,4% y/y in 2011 and 4,1%y/y in 2012. As developments in Europe took a turn for the worse and domestic growth moved directionally in tandem with Europe's, growth was revised.

The Medium Term Budget Policy Statement (MTBPS), which sets the budget framework for the next three years, revised GDP growth downwards to 3,1% y/y, from 3,4%y/y in 2011, projected in the February Budget Review. However, the overall outlook erred more on the cautionary than negative side. Government is expected to continue to implement a counter-cyclical measure on finances. National government collected R326bn from taxes and non-tax receipts in the first six months of the fiscal year (2011/12), reflecting a 7,1% y/y increase compared with the same period in 2010. However, halfway through the fiscal year, only 44,6% of the total revenue stated in February 2011 was collected by government. Given the current subdued economic conditions, the weakness could continue in the second half of the fiscal year, making it difficult for government to reach the originally budgeted target. The National Treasury downwardly revised its tax revenue forecast to R729bn in 2011/12 from R742bn initially estimated, mainly due to an underestimation of VAT refunds in 2011 but also reflecting weakness in household spending. As a ratio of GDP, national government revenue amounted to 22,0% in the first two quarters of fiscal 2011/12, compared with 22,6% in the first two quarters of fiscal 2010/11. Tax revenue has become more sensitive to changes in the economic cycle since the tax base was restructured in the early 1990s. As a result, tax revenue tends to accelerate when the economy is doing well, and to slow sharply when the economy is underperforming. If revenue does not cover expenditure, borrowing is a short-term solution, but higher government expenditure as a share of GDP ultimately requires a growing tax base or higher tax rates. At the height of the recession, revenue underperformed expectations by R60.6bn.

Households are still highly indebted and the subdued pace of deleveraging year-to-date, as well as low savings, is concerning.

Government is expected to continue to implement a counter-cyclical measure on finances.

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Tax collections have slowed and revenue has declined as a percentage of GDP, reflecting the weaker domestic economic conditions. Tax revenue was expected to recover, but with economic growth projected to remain sluggish in 2012, the South African government is likely to remain under pressure to find ways to increase revenue in order to reduce the budget deficit. Given the decline in national government revenue collections and the counter-cyclical expenditure policy, the budget deficit for the current fiscal year is projected to reach 5,7% of GDP. The cash-book deficit was originally budgeted to amount to R159.1bn in the 2011/12 fiscal year; however, the MTBPS 2011 revised it upwards to a total of R169.5bn.

While the February Budget Review focused more on job creation, the MTBPS outlined the shifting of resources in favour of growth and job creation. The government aims to shift the composition of public expenditure towards investment and economic developments, while strengthening measures to promote industrial development, expand trade opportunities and extend funding for housing and infrastructure. The MTBPS also aims to switch the focus of government expenditure initiatives away from consumption-based spending to investment activity, including a R25bn initiative to promote industry over the next six years. During the recession, government borrowing increased, resulting in higher debt burden. As debt costs consume a rising share of expenditure over the next 5 years, the challenge for government is to maintain expenditure on social and economic priorities. Nearly 15 million people depend on some form of government grant and for many households, social security payments are the only regular source of income.

In cyclically adjusted terms, the overall deficit of consolidated government swung from a surplus in fiscal year 2007/08 to a deficit. A shortfall in revenue in 2011, due to weaknesses in economic activity, prompted the government to revise its estimates for the 2011/12 consolidated fiscal deficit to 5,5% of GDP from 5,3%. The projected deficits over the next couple of years have also been increased. For 2012/13, the budget deficit is now projected at -5,2% (was -4,8%). According to estimates of potential output, the structural deficit will likely be around 3,5% of GDP in 2013/14, five years after the trough of the recession. The 2011 budget envisages that gross national government debt is likely to peak at around 43% of GDP in 2013/14. The government is expected to avoid contractionary impulse in 2012 when output is expected to remain below potential. Furthermore, by adhering to real spending growth to 2% and ensuring that tax revenues gradually recover to pre-crisis peaks, fiscal policy would become more counter-cyclical than currently envisaged. On the spending side, government would have to maintain the nominal spending levels over three years, as indicated in the 2011 budget review, and increase real spending by 2-3% annually thereafter. The growth in government expenditure, which has experienced double-digit growth for a number of years, is projected to average a much reduced 8,4% a year for the next 3 years, with salary increases budgeted to rise by only 5% a year. With inflation on an upward trend, this is will be very difficult to achieve. On the revenue side, the government should ensure that the revenue-to-GDP ratio increases by a ¼ percentage point on average each year, so it can approach the pre-crisis peak of around 29% of GDP in five years' time. This would deliver a cyclically adjusted fiscal deficit that is close to balance. It would also contain debt at around 35% of GDP, helping the country rebuild some of the buffers that protected it from the global crisis.

Key to containing growth in expenditure, and reducing it as a percent of GDP is keeping the public sector wage bill under control. In recent years, compensation of employees has been one of the main drivers of spending growth and in the current fiscal year, it is estimated that it will account for 11,5% of GDP in 2010/11. At its current level, the public sector wage bill is well above the average for other emerging markets in the G-20. An additional R4.4bn had to be found for public sector wages, as the public sector wage bill increased from 35% three years ago to nearly 40% of non-interest expenditure. Additionally, the impact of higher wages will be perpetuated into fiscal years. Public sector wage increases should be kept to levels that can be justified by productivity improvements.

The government borrowing requirements remain large, however, the issuance of rand-denominated bonds and bills at low interest rates against the backdrop of large capital flows, can help narrow the deficit. Domestic borrowing is expected to remain the primary source of funding for national government over the medium term; however, borrowing in the international capital markets would continue to finance government's foreign currency commitments.

South Africa's fiscal position remains extremely favourable by global standards; however, the fiscal position could deteriorate more than projected if government is unable to curtail its current growth in consumption expenditure. It has become extremely important for the government to broaden its tax base through job creation. Tough policy choices will have to be made in order to create employment. Improved investment activities as well as government's service delivery are equally imperative.

Government deficit spending is a contentious issue in economics. Keynesian economics' position is that deficit spending is desirable and necessary as part of counter-cyclical fiscal policy, but there should be a balance. In an economic slump, government should run deficits to compensate for the shortfall in aggregate demand. Conversely, governments should run corresponding surpluses in boom times so that there is no net deficit over an economic cycle.

Investment gains traction ... but more is needed

In addition, South Africa is dependent on foreign capital inflows to augment its domestic savings and investment efforts to allow higher levels of capital formation to take place. The government is set to reform the prudential and investment regulatory framework with the aim to promote investment into South Africa and as a gateway into Africa, and to reduce the cost of doing business. Main components of the proposed reform are to enhance domestic capital markets and to modernise the foreign direct investment framework, to improve access and competition in cross-border money remittances, and reducing red tape on cross-border transactions.

Gross fixed capital formation since 1994 peaked in 2008 at 23% of GDP and has declined to below 20% of GDP in 2010. It is expected that capital formation will be around 19% of GDP in 2011. After dipping to 18,8% of GDP in Q1:11, it appears that capital formation has turned the corner with a slight recovery to 18,9% of GDP reported in both Q2:11 and Q3:11.

Real gross fixed capital formation increased by 6% q/q in Q1:11, 5% q/q in Q2:11 and 5,6% q/q in Q3:11. In 2011, fixed capital formation seems to have turned the corner, growing steadily despite weak GDP growth. What is pleasing is that capital formation by the private business enterprises has continued to gain traction. Improved business confidence lifted private fixed capital formation a notch, as it also recorded positive but modest growth. Recovery is still partial, with its current levels remaining below pre-crisis. The agricultural, mining, transportation and communications sectors, contributed positively to the acceleration in growth. The agricultural sector, in particular, benefited from an increase in maize prices, a positive outlook for the wheat crop, the competitive pricing of agriculture equipment and more affordable finances in the form of low interest rates. Similarly, the transport sector benefited from the increase in global demand for base and precious metals. Capital formation in the communications sector was supported by ongoing capital outlays in the network capacity. Residential construction remains in the doldrums with a slower pace of activity recorded and no improvement in sight yet. The weaker construction sector also led to a weakening of capital formation by the financial sector. Despite the increase in capital formation, the overall performance of capital formation is not yet where it should be, given that during the recession, relatively little capital formation took place.

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A faster pace of increase in capital formation by public corporations (which grew by 6,3% from 5,4% in Q2:11) also supported overall capital formation in Q3:11. Higher capital outlays took place in the electricity and transport sectors, boosted by ongoing investment by Eskom in electricity generation. Substantial capital spending was also reported by Transnet, in particular spending on the new multi-products pipeline, which resulted in increased expenditure on machinery, equipment and construction works. The rate of increase in capital formation by general government improved significantly after recording negative growth for nine consecutive quarters before posting positive growth in Q2:11. Capital spending by provincial and local government in the form of housing and construction works and water projects were stepped up in the quarter; however, investment by local authorities was hampered by a shortage of bitumen in the quarter. The level of real inventory accumulation (which in terms of the national accounts is classified as capital formation) increased in Q3:11 when inventories amounting to R5bn from R4.2bn in Q1:11 was reported. Inventory accumulation in the first nine months of 2011 came to R8bn, against a rundown of inventories in the same period in 2010.

The strong possibility of a recession in the Eurozone is likely to weigh on local economic prospects, including the investment outlook.

The outlook for capital formation in 2012 is clouded by the uncertain developments in the global economy and in particular in the Eurozone – South Africa’s major trading partner. The grim economic outlook for these and other developed countries is likely to hold many emerging countries hostage in 2012. The strong possibility of a recession in the Eurozone is likely to weigh on local economic prospects, including the investment outlook. The cooling off in growth in China is likely to add to the woes of other emerging countries and could impact severely on the demand for commodities. This will not leave South Africa – and in particular the mining sector – unscathed. Locally, the expected tepid growth in the economy over the medium term is not conducive to creating a climate where investment will flourish. Nonetheless, the steady improvement in capital formation over the last five quarters point to an improvement in investor sentiment and provides some hope for higher investment levels in 2012 and beyond. Many companies in the economy are cash-flush, interest rates are at the lowest level in 37 years and the prospects for a tightening in monetary policy in the near future seem remote. In addition, the long lead times involved in major capital projects may prompt some investors to consider investing so as not to miss an opportunity when the economies recover. Clearly though, under current conditions, an improvement in global and local confidence is needed to provide the spark to set capital formation alight.

Public sector capital formation also plays an important role in a country’s capital formation, especially in the form of infrastructure investment. The government’s Medium Term Budget Policy Statement released in October set out in broad terms government’s spending plans for the next three fiscal years. According to the Statement, government aims to shift the composition of government spending towards investment in long-term assets that can build the economy. Public sector infrastructure spending over this period is projected to reach R802bn and to average 7,3% of GDP per year over the period. This is on par with infrastructure investment as a percentage of GDP over the last two years. In growth terms, infrastructure investment is projected to tail off with growth of 6,1%, 4,8% and 1,7% respectively expected over the next three fiscal years. Major investment programmes include continued investment in the road network, expanding investment in bulk freight rail to support mining production, investment in commuter rail infrastructure, completion of Transnet’s Durban-to-Johannesburg multi-product pipeline by 2014/15, Eskom’s capital expenditure to increase its electricity generation capacity, the second phase of the Lesotho Highlands water project and investment in partnership with the private sector fibre optic infrastructure in the large urban areas and the building of networks in underserved areas.

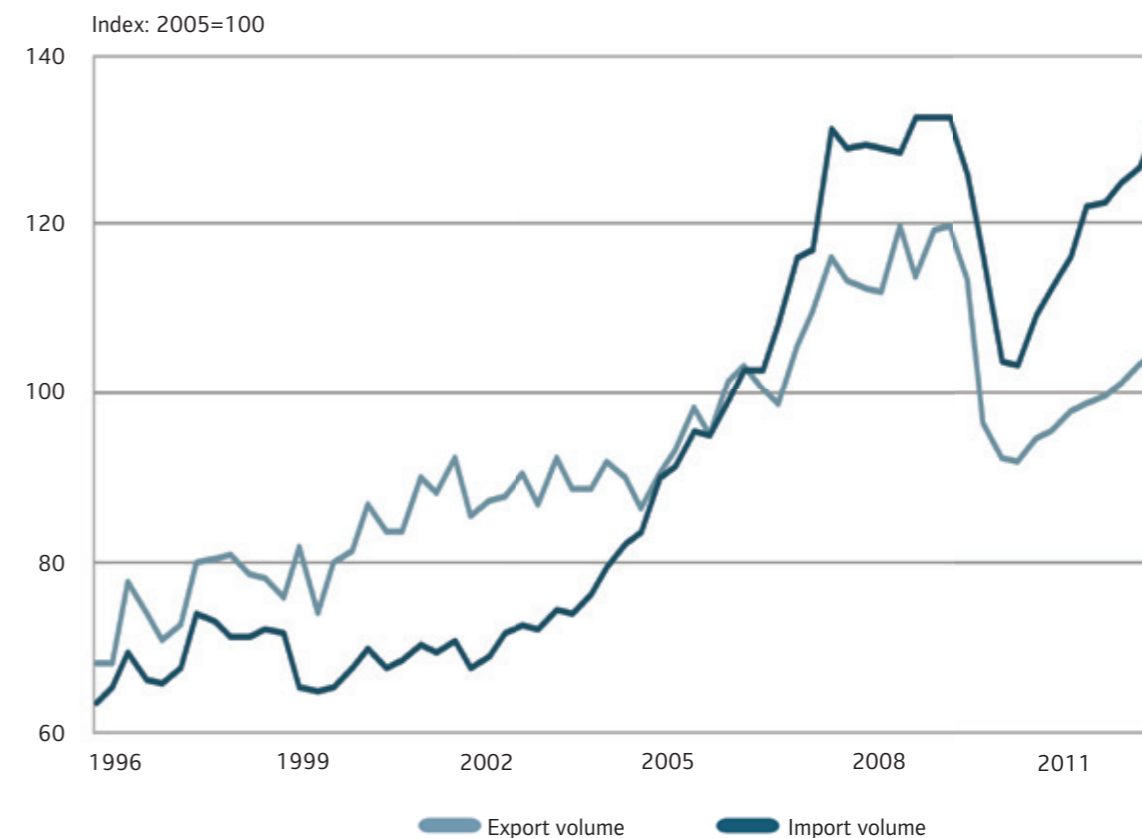
Notwithstanding the relatively gloomy global and local outlook, we expect gross fixed capital formation to show a steady but slow recovery in 2012. Growth in real terms is expected to be slightly above 4%, from growth of 2,5% in 2011.

That shrinking feeling

South Africa’s trade surplus shrank consistently in 2011. Merchandise export volumes fell a seasonally adjusted 3,6% in Q1:11, reflecting weaker international demand for transport equipment, coal and diamonds. This was offset by an increase in the price of metals and minerals, leaving export earnings (excluding gold) broadly unchanged in dollar terms. Import volumes increased by 3,1%, as well as higher import prices, particularly the cost of crude oil, resulting in an 8.8% increase in the import bill. The net result was a smaller trade surplus in Q1:11 than in Q4:10. The deficit on services, income and transfers widened slightly in the beginning of the year, to an annualised R110.6bn from R103bn in Q4:10. The deterioration in net income was due to an approximate 20% increase in dividend payments to non-residents. This reflected both the rise in profitability of domestic companies as well as increased foreign ownership as a result of FDI and net purchases of shares by non-residents in 2010. There was slight improvement in monthly data for the first six months in the external position. Exports were 29,1% higher than in the same period last year, while imports were up 27,9%. This may reflect the rise in commodity prices rather than any significant improvement in demand. On the export side, mineral products, precious stones and precious metals, and base metals accounted for around 65% of total exports in the first half of the year.

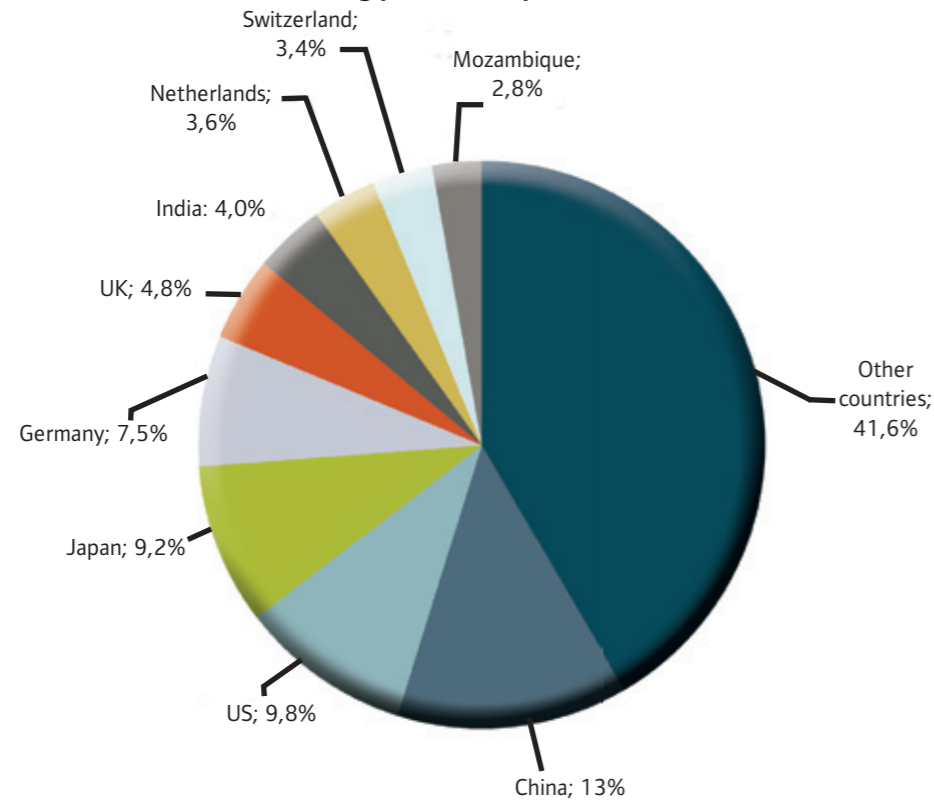
South Africa’s trade surplus shrank consistently in 2011.

Figure 2: Imports growing much faster than exports



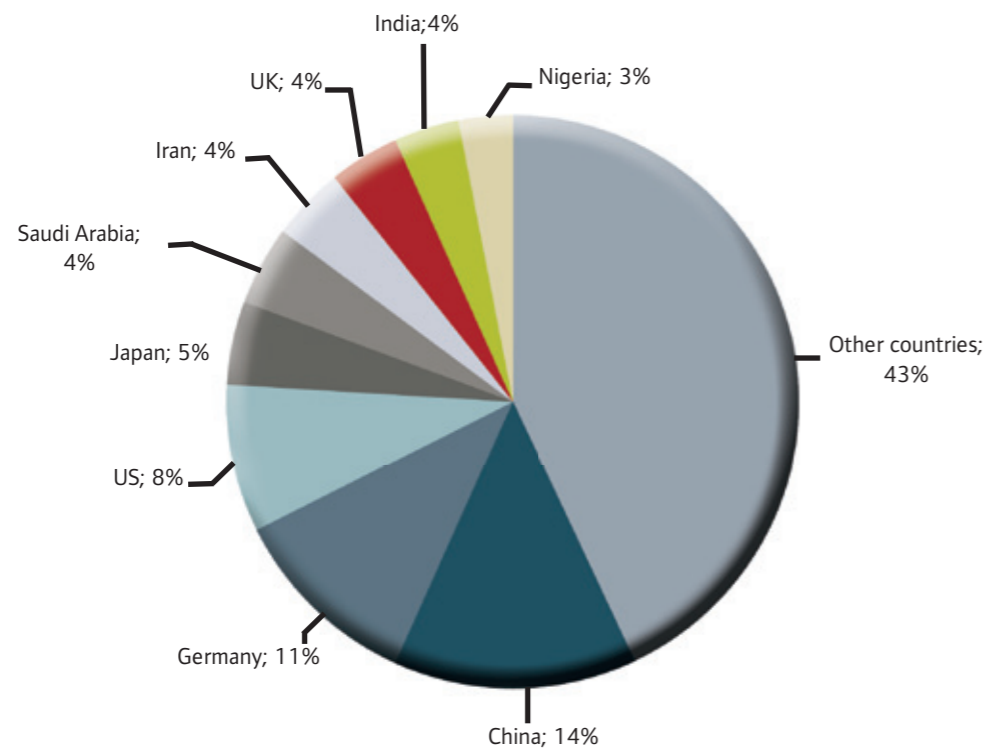
Source: SARB

Figure 3: South Africa's main trading partners: exports



Source: Department of Trade and Industry

Figure 4: South Africa's main trading partners: imports



Source: Department of Trade and Industry

Sluggish export growth, reflecting fragile recoveries in the developed economies and competition challenges caused the surplus on the trade account to narrow from R26.8bn in Q2:11 to R18.1bn in Q3:11. Export volumes moderated somewhat in 2011, due to an increase in domestic demand for imported capital, intermediate and consumer goods. Furthermore, a moderation in economic activity in the Eurozone, which is South Africa's largest trading partner, adversely affected many export-driven economies. Notwithstanding these developments, demand from Asia and the Africa increased, albeit at a slower pace.

When looking at the breakdown of merchandise exports by continent of destination, the value of manufactured goods exported to Asia and Africa increased unabatedly, while export growth to Europe and America remained fairly lacklustre. The depreciation of the rand during the month of September 2011 more than neutralised the marginal decline in international prices of non-gold mining exports, raising the rand price of merchandise exports by 2,2% in Q3:11. While some international commodity prices declined in Q3:11, the gold price continued to benefit from increased demand amid heightened uncertainty and volatility in global financial markets related to the impact of the sovereign debt crisis in Europe. Consistent with the steady domestic demand, import volumes into South Africa increased at a firm pace of 4,6% in Q3:11 – far more rapidly than the previous quarter and surpassing the growth of exports substantially. The higher import volume was primarily buoyed by firm consumer demand and increased spending on capital equipment.

In rand terms, import prices rose by 1,5% in Q3:11, driven by increases in local currency prices in South Africa's main trading partner countries and a decline in the external value of the rand since September 2011. The value of imported goods in the first three quarters of 2011 increased by roughly 17% compared with the same period in 2010, highlighting the rand's relative strength.

South Africa's share of global exports has stagnated since 2005, falling sharply during the 2008/9 crisis, but recovering somewhat in 2010. During 2005 – 2010, comparable emerging markets have, by contrast, expanded their global market shares by 16% on average. Moreover, the export performance appears even more disappointing once the composition of South Africa's exports is controlled; for while commodity producers have done well, there have been declines in the market share of manufactured exports. The weakness of non-commodity exports could reflect structural factors, such as weak skills, poor infrastructure or even a weak take-up of technology. 2011 has been a testing year for exports as global demand continues to be benign. The rand is expected to remain weak in 2012, particularly in the first two quarters of 2012. This should provide a boost to exports; however, the weaker currency may not be enough to counter the effect of slower growth in many of South Africa's key trading partners. With growth in Europe, US and China expected to slow, this does not inspire confidence in South Africa's trade outlook.

Labour market – stall-speed in 2012

South Africa continues to suffer from persistently high unemployment levels, leading to a depressed absorption rate of below 45% and almost the lowest among large emerging market economies. The 2008/9 recession made the situation worse, with almost 1 million jobs eliminated. Proportionately, this is as many jobs as countries in the epicenter of the global financial crisis lost. The New Growth Path (NGP) set an ambitious target of creating 5 million more jobs in the next decade, however, against the current backdrop of a slowing global economy, how possible is this? When global growth was accelerating, between 2000 and 2009, the annual employment growth rate was about 1 percentage point below the emerging markets median. The ratio of employment to the working-age population has declined from around 45% in 2008 to 40% in early 2011, implying that employment remains some 0.9 million (or 6,5%) below the pre-crisis level. The low employment opportunities also reflect a worrisome reduction in the participation rate.

The higher import volume was primarily buoyed by firm consumer demand and increased spending on capital equipment.

Figure 5: Unemployment likely to increase in 2012

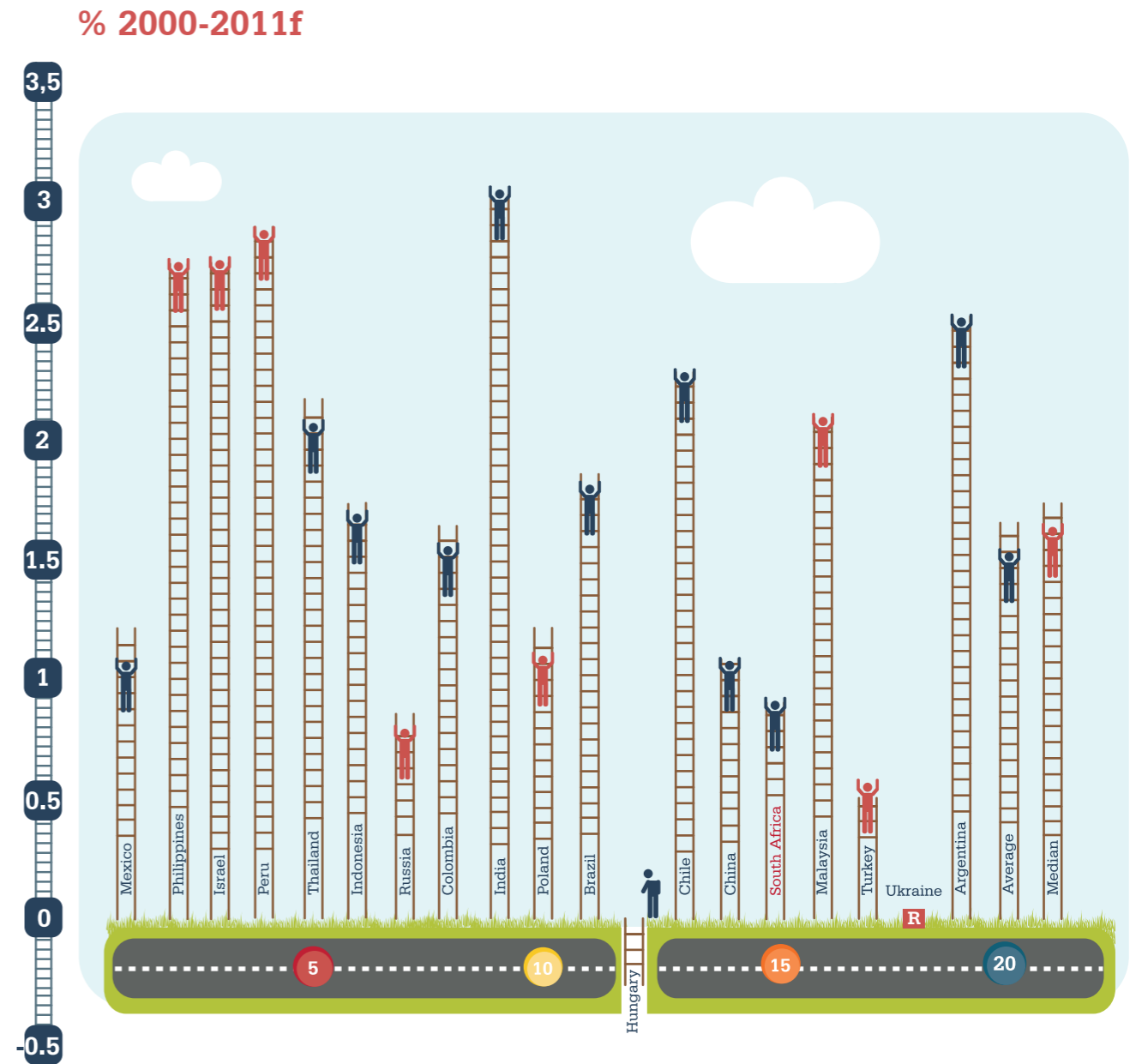


Source: Stats SA

In a study conducted by the IMF, fast job creators saw more favourable macroeconomic outcomes, with slightly high growth and substantially lower inflation.

Job creation is intrinsically linked to output growth; however this relationship varies substantially among countries. All sample countries saw productivity growth in the last decade (that is, a decline in the employment-to-output ratio), South Africa has a slightly more negative value relative to the median for this group of countries, implying that employment growth on average lagged output by close to 3 percentage points each year. Therefore, South Africa requires 3% of output growth each year to maintain the current employment level. In a study conducted by the IMF, fast job creators saw more favourable macroeconomic outcomes, with slightly high growth and substantially lower inflation. According to the IMF study, fast job creators are more likely to see the real effective exchange rate (REER) depreciate or less appreciation and these countries export more of their output and have a better current account balance. Fast job creating countries tend to have lower government revenue-to-GDP ratio. Relative to other countries, two things stand out for South Africa. Firstly, South Africa's growth fell short of even the median of slow job creators, but its average inflation exceeded the median of slow job creators. Secondly, South Africa saw its REER depreciate more than most other countries, but still has a much weaker current account balance and a lower export-to-GDP ratio. Qualitative indicators point to significant differences between fast and slow job creators in the areas of union density, wage levels, hour flexibility and the share of public sector employment. South Africa's union density and hourly pay in the manufacturing sectors are higher than the median for slow job creators by 25 and 12 percent respectively. South Africa is also much less flexible in terms of work hours and the share of public sector employment is significantly higher compared with other countries in the sample.

Figure 6: South Africa amongst the lowest job creators



Source: IMF

When comparing South Africa with its peers, it is rather evident that the country may have missed the glory days.

Reaching the job creation goals set out by the NGP will be a close to impossible task for the government. Even with the right policies and a large working-age population, the sluggish global growth in 2012 will have a detrimental effect on the South African labour market. When comparing South Africa with its peers, it is rather evident that the country may have missed the glory days. The past ten or so years were a good time to embark on 5 to 10 year plans targeting growth. Brazil in one such country that managed to halve its unemployment rate after initiating programmes that encouraged take-off growth and reduced unemployment. In a period where inflation is set to be at elevated levels for most of 2012, the expected high inflation pressures are unfavourable to long-term job creation. High average wage levels – in particular, a higher minimum wage in terms of output and higher minimum wage for youth workers – are likely to be linked to slow employment creation. In this regard, the levels of the average wage and minimum wage seem on the high side.

With growth rates of around 3%, (GDP is expected to be around 3% in the next few years) reforming both product and labour markets would be key to raising potential growth and increasing labour intensity of growth. Should bargaining outcomes which prioritise wage growth over job growth continue in 2012, we are likely to see real wage growth outpace productivity gains.

No room for impulsive policy moves

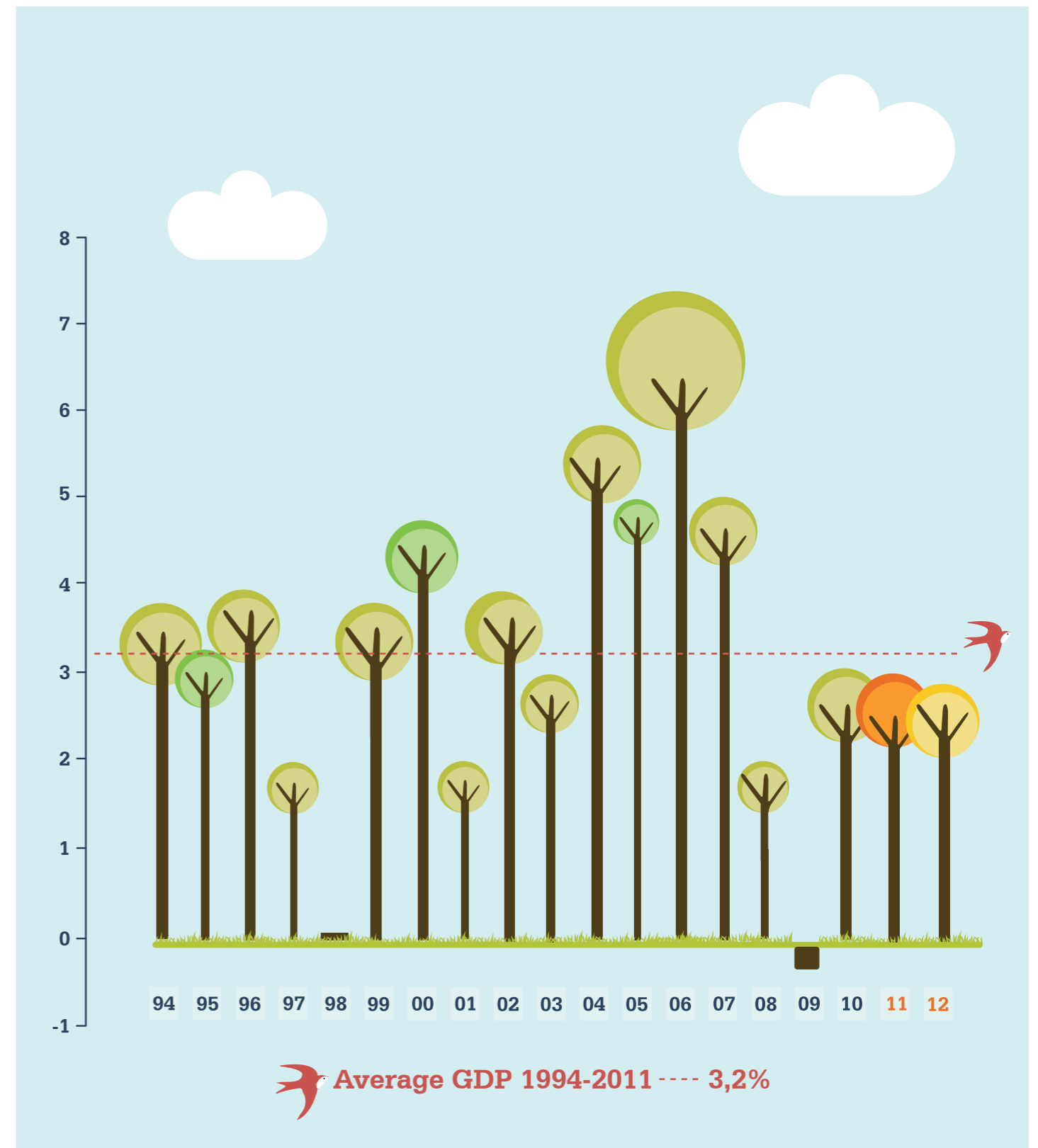
Heightened uncertainty regarding the sovereign debt crisis, particularly in the second half of the year has left monetary policy with no option but to wait and see. Domestically, a slowing economy together with increasing prices could lead to a stagflationary environment. When an economy slows, rates are cut to revive the economy. However, when inflation rises, rates are hiked to cool down inflation. So the current environment of sluggish growth and high inflation is a conundrum for policy making.

Year-on-year percentage change in headline consumer price index increased from 4,2% in April to 5,7% in September. The 1,5 percentage points increase in the inflation rate since April 2011 was driven by high food and non-alcoholic beverages (NAB) and transport categories. Year-on-year inflation rate measured in terms of the producer price index for domestic output increased by 10,1% in November, from 6,6% recorded in April. Price inflation maintained its rising trajectory in 2011, primarily driven higher by imported commodities, especially mining and quarrying.

The consumer price index breached the inflation target of 3% - 6% in December, posting a 6,1% increase. Core inflation, however, remains contained, implying that inflation is being driven by cost-push factors. Food and non-alcoholic beverages, transport and housing and utilities were the main drivers of higher prices. Consumers will continue to experience increasing erosion of their purchasing power, as higher fuel costs are likely to keep year-on-year increases high. Exogenous factors increasingly undermine the inflation outlook. The search for yield in an environment of abnormally low interest rates attracted capital flows and created appreciation pressures in early 2011. However, as a response to risk aversion in H2:11, the currency depreciated.

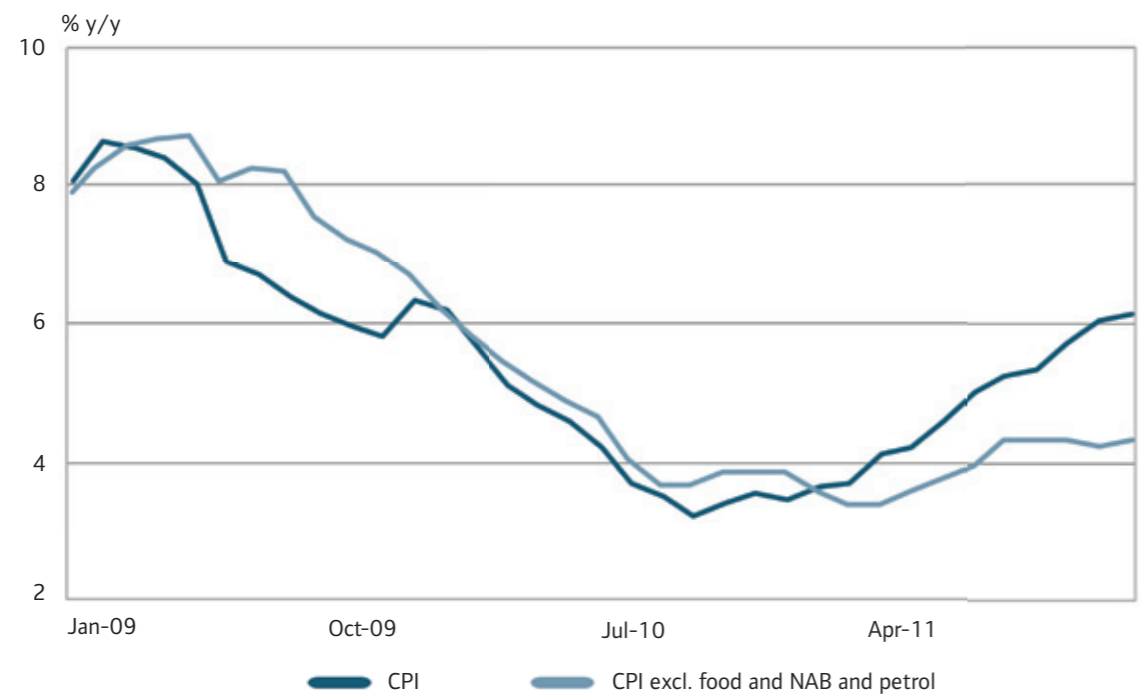
Exogenous factors increasingly undermine the inflation outlook.

Figure 7: GDP averaging 3%



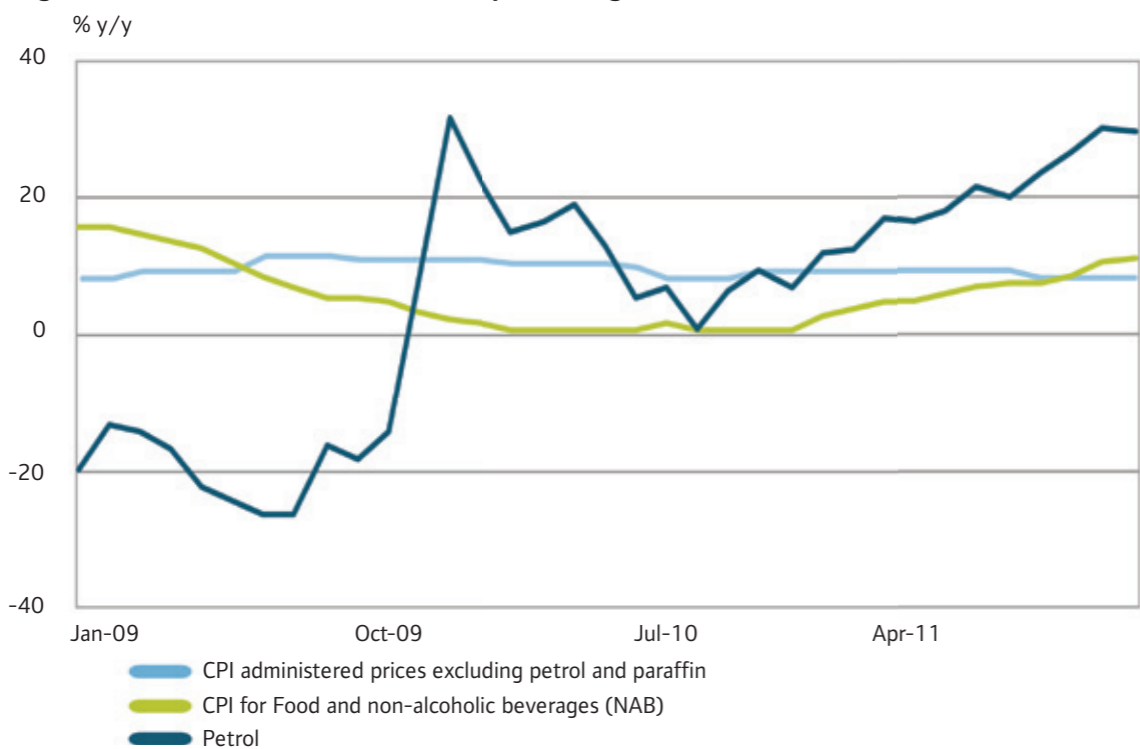
Source: Bloomberg

Figure 8: CPI breaching, likely to remain above target in 2012



Source: Stats SA

Figure 9: Fuel and food are the main culprits to higher CPI



Source: Stats SA

The main risk to the inflation outlook is exchange rate moves. Since July 2011, the rand has depreciated by about 20% against the US dollar, and has traded in a range of between R6,65 and R8,50. Inflation responds to the speed, duration and extent of exchange rate depreciation. If depreciation is expected to be of limited duration, its impact on inflation should be minimal. However, if depreciation is continuous, this is likely to have a severe impact on inflation.

CPI is driven by cost-push factors, as illustrated by the benign core inflation outcomes. Inflation is expected to remain outside the target ceiling for much of 2012. Inflation is expected to return within the target band in the last quarter of 2012, largely due to base effects and commodity prices tapering off. During the next 12 months, the output gap is set to close. With inflation accelerating, an unchanged policy rate implies declining real interest rates. Early monetary reaction may help to stabilise expectations. Conversely, the increase in headline inflation largely reflects international food and fuel prices and, therefore, should fall back sooner than when monetary policy would be able to influence it.

Risks in 2012 and beyond

The possibility of a much more pronounced global slowdown would be problematic for South Africa, given its links with the global economy. An escalation of the Eurozone sovereign debt crisis would severely affect the ongoing recovery in Europe, South Africa’s largest trading partner and the main destination for manufacturing exports. Even a limited default by some European countries could increase risk aversion in the global markets, raising the cost of capital and possibly reversing capital flows to developing countries. South Africa, like other large emerging market economies, attracted “hot money” capital flows. The lurking risk is a sudden stop in the inherently volatile portfolio flows. Since much of the flows went to South Africa’s bonds, that would raise the borrowing cost for both the corporate and the public sectors.

With China’s strong demand for commodities, a cooling of the Chinese economy beyond baseline projections, would dampen commodity prices and reduce exports from South Africa and investments in its mineral sector. The possibility of higher oil prices would pose another risk for South Africa. The rand continues to be volatile and is likely to remain this way. The risk to rand weakness is that this could add to inflationary pressure, triggering higher interest rates and dampening domestic consumption.

Domestically, business confidence remains low; therefore investment decisions by the private sector have been muted despite low interest rates. The labour market is still under pressure, with hiring decisions still lagging. Wage demands by the trade unions, as seen in 2011 may add to the complexities. Household indebtedness also presents downside risk to the recovery, particularly by subduing household consumption which has been a key driver of domestic absorption.

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.

Thabi Leoka

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Forecasts

Forecasts

Global economy					
	2012f	2013f	2014f	2015f	2016f
Gross domestic product (%)					
US	1,7	2,0	3,0	2,5	2,0
Eurozone	0,2	0,5	1,0	2,0	1,7
Japan	1,8	1,0	1,0	1,5	2,0
China	8,0	8,5	9,0	9,0	9,5
Consumer price inflation (%)					
US	2,0	1,5	2,0	2,5	3,0
Eurozone	1,5	1,0	1,0	1,5	2,0
Japan	0,0	0,0	0,2	0,5	1,0
China	4,0	5,0	5,5	6,0	7,0

Commodities										
	2006	2007	2008	2009	2010	2011f	2012f	2013f	2014f	2015f
Gold (\$/oz)	605	697	872	974	1227	1620	1895	1850	1825	1800
Platinum (\$/oz)	1142	1306	1574	1210	1613	1722	1525	1650	1850	2025
Palladium (\$/oz)	321	355	350	266	529	734	688	750	875	950
WTI (\$/bbl)	66	72	100	62	80	92	105	108	110	105
Brent (\$/bbl)	66	73	99	63	80	108	110	110	110	105

Sub-Saharan Africa				
	2011e	2012f	2013f	2014f
Inflation, average consumer prices (% y/y)	8,4	8,3	6,34	6,1
Inflation, end of period consumer prices (% y/y)	9,4	6,7	6,2	5,9
Gross domestic product, constant prices (% y/y)	5,2	5,8	5,5	5,4
General government gross debt (% of GDP)	31,9	31,8	31,8	31,2
Investment (% of GDP)	21,4	21,8	22,0	22,4
Current account balance (% of GDP)	0,6	-0,6	-1,1	-1,4

South African Economy

	2006	2007	2008	2009	2010	2011f	2012f	2013f	2014f	2015f
Growth data										
GDP (% y/y)	5,6	5,6	3,6	-1,7	2,8	3,1	2,8	2,9	3,5	4,1
Final consumption expenditure by households – FCEH (% y/y)	8,3	5,5	2,2	-2,0	4,4	4,9	3,5	4,3	3,6	3,9
Gross fixed capital formation – GFCF (% y/y)	12,1	14,0	14,1	-2,2	-3,7	4,2	4,0	4,4	6,4	7,5
Government expenditure (% y/y)	4,9	4,1	4,7	4,8	4,6	4,3	3,8	3,9	3,8	4,0
Exports (% y/y)	7,5	6,6	1,8	-19,5	4,7	6,0	3,9	5,3	4,5	2,7
Imports (% y/y)	18,3	9,0	1,5	-17,4	9,6	9,5	7,1	9,1	6,3	4,9
Current account balance (% of GDP)	-5,3	-7,0	-7,1	-4,1	-2,8	-3,5	-3,8	-4,0	-4,3	-4,3
Inflation data										
Headline CPI (% y/y) annual average	4,6	7,1	11,5	7,1	4,1	5,0	6,2	5,8	5,2	5,5
PPI (% y/y) annual average	7,6	10,9	14,2	0,2	6,0	8,4	10,0	10,1	9,5	9,8
Interest rates data										
Prime (year end)	12,50	14,50	15,00	10,50	9,00	9,00	9,00	10,50	11,00	11,00
Prime (annual average)	11,20	13,08	15,13	11,81	9,90	9,00	9,00	9,43	10,97	11,00
Exchange rates										
USD/ZAR (average)	6,77	7,05	8,27	8,40	7,32	7,26	8,01	7,79	8,09	8,29
EUR/ZAR (average)	8,52	9,66	12,08	11,66	9,70	10,09	9,63	9,99	11,53	11,19
GBP/ZAR (average)	12,51	14,11	15,15	13,09	11,30	11,63	12,55	13,26	13,54	12,85
JPY/ZAR (average)	17,30	16,72	12,75	11,26	12,00	11,05	9,08	9,79	9,49	10,25
EUR/USD (average)	1,26	1,37	1,47	1,39	1,32	1,39	1,20	1,28	1,43	1,35
GBP/USD (average)	1,84	2,00	1,85	1,57	1,55	1,60	1,57	1,70	1,68	1,55
USD/JPY (average)	116,35	117,79	103,37	93,6	87,73	79,71	72,75	76,25	76,75	85,00

f = forecast
e = estimate

Conclusion

Economists miscalculated the scale of global connectivity and so failed to foresee the grave impact the US housing market collapse in 2007 has had on economies everywhere. Now, Europe holds the world in its clutch. We must not, again, miscalculate.

Conclusion

2012 is going to be another difficult year for the global economy. The debt crisis in the Eurozone looks set to continue and could probably become materially worse in spite of government efforts to stabilise the situation. The contagion risks from this crisis are already being felt globally. In fact, this particular crisis makes prediction very hard because nobody knows how and when it will end. The Eurozone debt crisis dominated domestically and internationally through much of 2011. The difficulties of the region imply both an “economic” contagion risk, as Eurozone imports fall, and a “financial” contagion as the weakness of banks in the region keeps money market conditions tight across many countries. The “economic contagion”, created by the Eurozone recession and weaker import demand, is likely to make more central banks ease policy, while the “financial contagion” stemming from banking stress, is likely to mean that the same central banks will have to ensure that their own domestic banking systems are flush with liquidity. With European demand and European banks weak, many developing nations will be reliant on other pockets of demand to maintain growth.

Events in advanced nations will shape the trajectory of all emerging economies. Relative to advanced economies, emerging markets will benefit from negative real interest rates, low levels of indebtedness and structurally strong underlying domestic demand. Some have ample room to extend policy support and avoid economic stagnation, including Brazil and China; others may suspend intentions for fiscal consolidation, like Mexico. Far more have less capacity for supportive measures this time round than during the past recession, including Chile, Malaysia, Pakistan, Turkey, Venezuela and South Africa. A fracture of the Eurozone will push an already soft US into a recession and will make a hard landing in leading emerging markets, like China, unavoidable. The gap in economic growth between advanced economies and emerging markets has widened from virtually nil in the early 1990s to around four or five percentage points in 2010. While momentum loss in emerging markets will continue in H1:12, we expect emerging markets to expand by an average of 6% each year through 2015.

In Africa, following the 2008 financial crisis, we were generally more constructive than the market on the likely strength of the economic rebound. As such, we generally found our global growth outlook on the bullish side of the market throughout 2009 and 2010. It was a position that proved appropriate. We switched our stance in Q2:11 and have since found ourselves on the bearish side of consensus. This still appears to be the case. We remain constructive on Africa’s GDP growth on a structural basis in coming years, even though there will be cyclical headwinds in 2012. The structural drivers of Africa’s GDP growth are well rehearsed, and remain a strong backdrop going forward.

The ripple effect of the financial meltdown in Europe and the uncertainty in the global economy has certainly had a pronounced effect on the South African economy, including consumers. With growth rates of around 3% over the next few years reforming both product and labour markets would be key to raising potential growth and increasing labour intensity of growth. Should bargaining outcomes which prioritise wage growth over job growth continue in 2012, we are likely to see real wage growth outpace productivity gains. The possibility of a

much more pronounced global slowdown would be problematic for South Africa, given its links with the global economy. An escalation of the Eurozone sovereign debt crisis would severely affect the ongoing recovery in Europe, South Africa’s largest trading partner and the main destination for manufacturing exports. Even a limited default by some European countries could increase risk aversion in the global markets, raising the cost of capital and possibly reversing capital flows to developing countries. The pace of the domestic 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.



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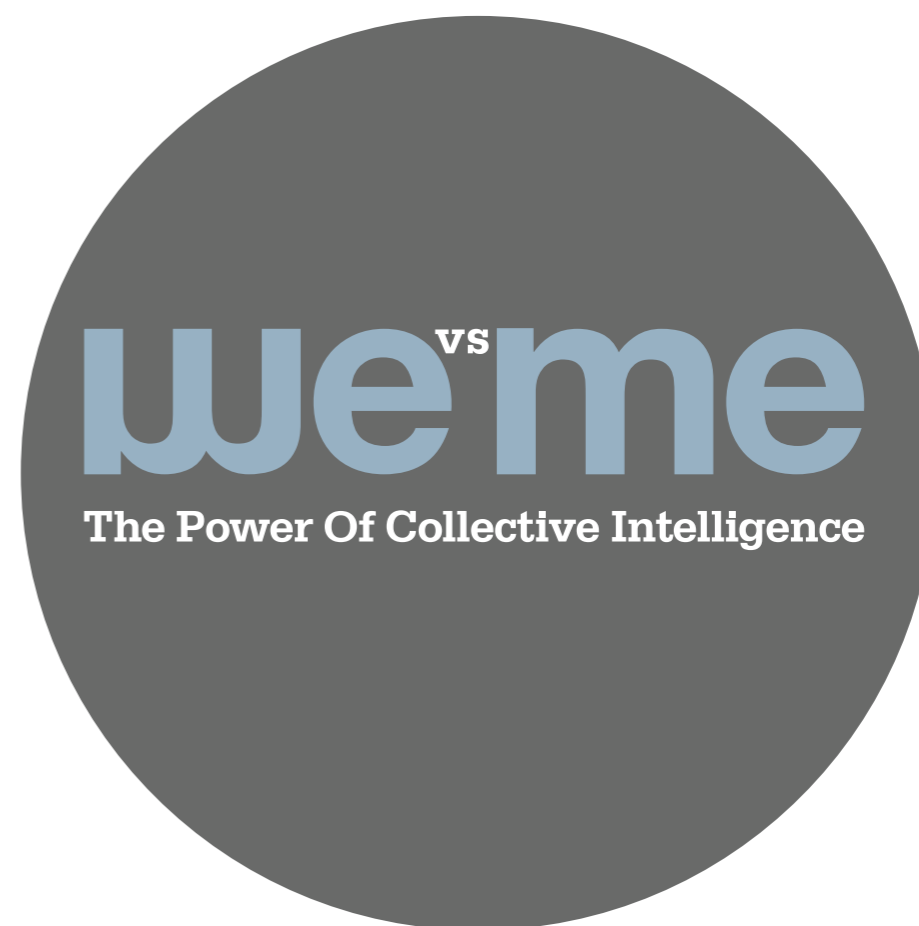
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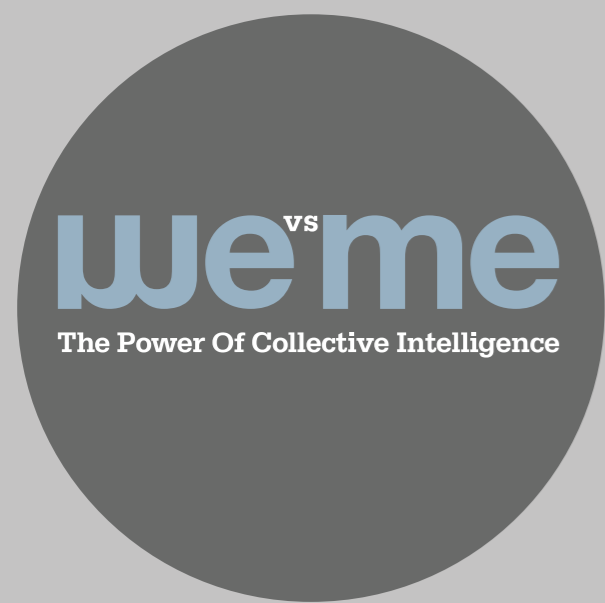
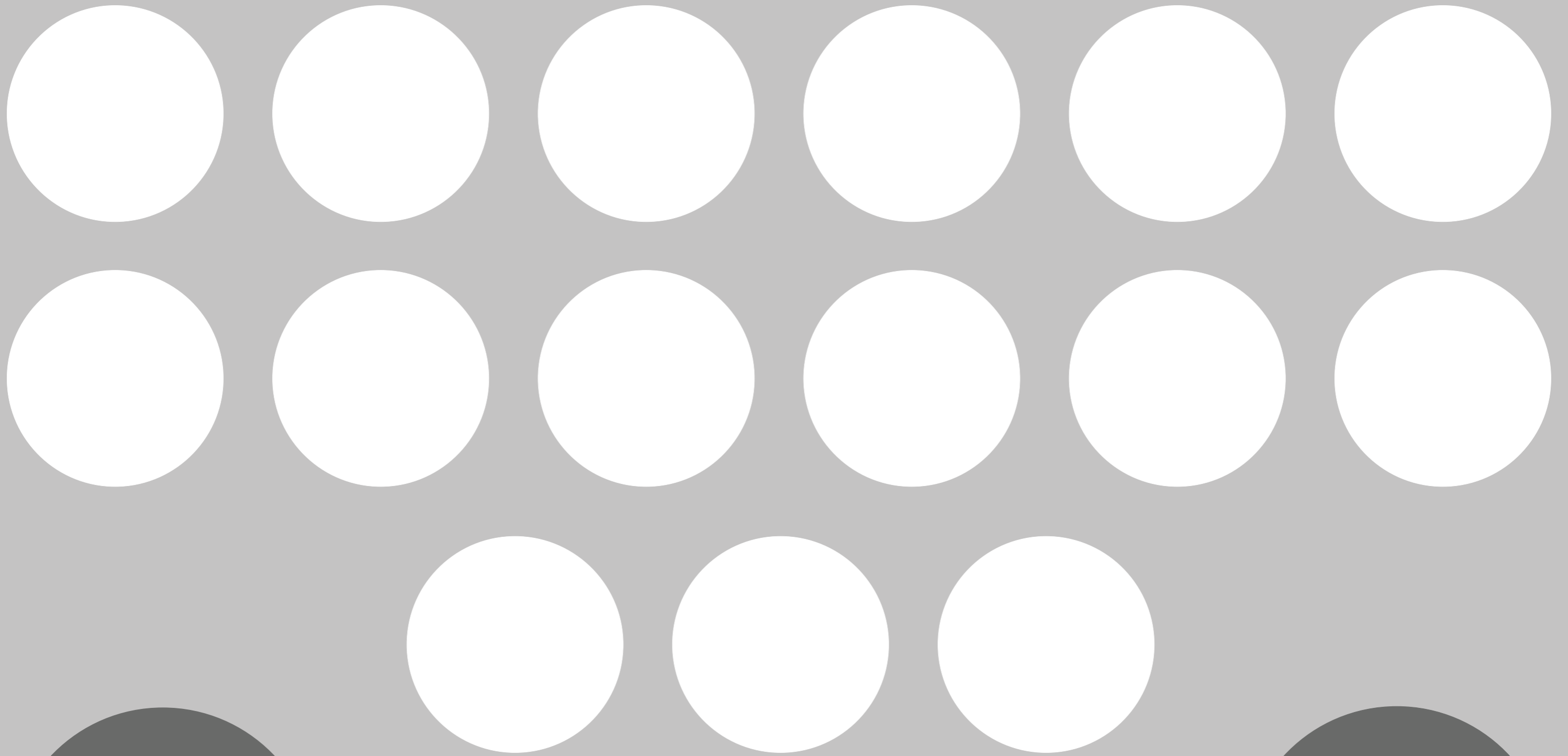
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