

# Nedbank

## Guide to the Economy

7 October 2008 | ISSN 1023-7097

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Developed economies are at significant risk of entering a recession as the global financial system totters. Although the developing world has weathered the storm quite well so far, some cracks are appearing.

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The South African economy has performed relatively well in the face of a deteriorating global climate and a household sector under stress from rising inflation and interest rates. Strong growth in fixed capital formation and a recovery in the agricultural sector have helped shield the overall economy. However, a period of slower growth is likely until some relief on prices and interest rates starts filtering through in the second half of 2009. The approaching 2010 FIFA World Cup comes at a good time, adding further stimulus to activity and providing a confidence booster to consumers and businesses.

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#### Dear Reader

The format of the Nedbank Guide to the Economy changes in this edition. The publication will now consist of an international and a domestic economic review and outlook. It will be released around the end of each quarter.

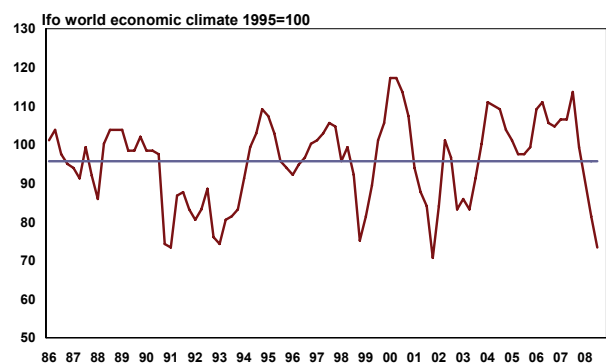
Feature articles will still be produced. For email subscribers these will be distributed as and when they are written. Recipients of the printed version of the Guide will receive individual articles, together with the main publication, once a quarter.

Dennis Dykes  
Chief Economist

#### International background and outlook

The global financial crisis worsened dramatically towards the end of the third quarter, culminating in massive nationalisations and bailout plan proposals on an unprecedented scale in recent history in the US. Interbank activity ground to a halt as the bank failures created panic and speculation over which institution might be next. Underlying the stress in financial markets was a further deterioration in the economic conditions in developed countries, with both Europe and the US either in recession or very close to it. A key question for South Africa is whether the robust growth experienced in Asia so far will continue or whether so-called decoupling is a myth that is about to be disproved.

Graph 1: World economic conditions deteriorate



Source: Ifo World Economic Survey, third quarter 2008

The **global economic and financial climate** deteriorated markedly in the third quarter. The dislocation caused by the subprime crisis intensified, prompting drastic action by governments and central banks to keep the banking system functional.

At the heart of the problem lies a decade or more of massive debt buildup in many developed economies, stimulated by rising global liquidity and low interest rates. While this was accompanied by increasing asset prices (principally house prices), there was little concern either for regulators or banks. The subprime mortgage debacle

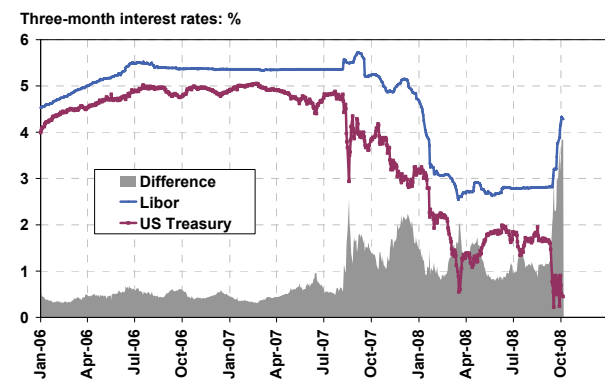


MAKE THINGS HAPPEN

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was the final, but fatal, step in a debt-inspired boom. The underlying rationale for lending to borrowers with a suspect credit history was that the collateral (houses) would always be worth more tomorrow than it was today and that therefore such lending was almost risk-free. This 'limited' risk was further reduced by packaging the mortgages and selling it on to investors in the form of securitised paper. Derivatives further geared up the bets being made. Once interest rates started rising and subprime adjustable-rate mortgages reset at much higher rates, defaults became inevitable and house prices started falling, not just in the lower categories.

Graph 2: Financial stress deepens



Source: INET

The sting in the tail was that banks had to bring many of these assets back onto their balance sheet and also incurred losses through holding other banks' paper. According to Bloombergs, these writedowns exceeded \$590 billion by the end of September, a massive hit to banks' capital that has only partially been offset by some capital-raising activity, mainly in the early stages of the crisis. For banks in developed countries this has meant that the ability to lend has been severely restricted, removing one of the key drivers for economic growth over the past decade. It has also resulted in a lack of trust between major institutions, with money flying out of bank paper and into US Treasuries (see graph 2). In short, the banking system has seized up.

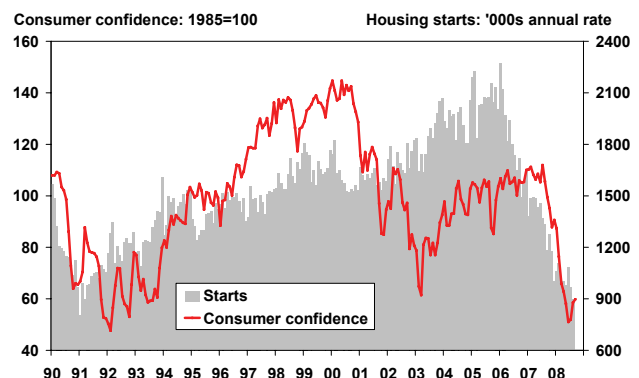
There are no easy solutions to the current crisis. Although the \$700 billion bailout plan has now been passed after initial rejection by the US Congress, it still will not address all the underlying problems. The proposed approach is for the government to purchase so-called 'troubled' residential and commercial property assets (and perhaps even other assets) – either the actual loans themselves or mortgage-backed securities – where the price is established through market mechanisms such as reverse auctions (where sellers bid to sell rather than buyers to buy). The assets would then be managed by appointed private sector managers and either sold on once market conditions improved or held to maturity. The government will also hold warrants (options to buy shares) in affected banks so that taxpayers will participate in any upside.

The aim of the proposal is to restore badly needed confidence in the banking system so that banks can start raising capital and start functioning more normally, with lending resuming, albeit more modestly. Despite potential unintended and unwanted consequences (such as some who helped to create the crisis in the first place benefiting), the alternative of doing nothing or even delaying could have been a deep recession that resulted in considerably higher costs in ad hoc bailouts and increased public spending, as well as in lost taxation revenue. Some comfort can also be drawn from the success of a historical precedent, the Resolution Trust Corporation (RTC) that was formed in the late 1980s in response to the savings and loan crisis.

Less encouraging however is that, despite the success of the RTC's activities in helping to stabilise the financial system, these were insufficient to help stave off a US recession in the early 1990s. The present crisis is more significant, both in terms of its potential damage to the US economy as well as in its reach into the global arena. It is now difficult to imagine how key economies are going to emerge from the current downturn as quickly as the consensus has been suggesting – at least until recently.

Most analysts are predicting some weakness in developed economies over the next two to three quarters and then a recovery in the second half of 2009, followed by 'normal' growth in 2010. Emerging and developing economies are expected to suffer mildly slower growth before resuming the path established over the past few years. In other words, there is still a strong view that the global economy will have a relatively soft landing. This assumes that banks will somehow resume lending, that business and consumer confidence will return quickly and that China and India maintain their strong growth paths, supported by healthy internal demand and regional trade. In short, a lot has to go right in an environment where new fault lines are being exposed daily. Our best guess is that most major developed economies will slip into recession and that the growth of emerging and developing economies will slow over the next two years.

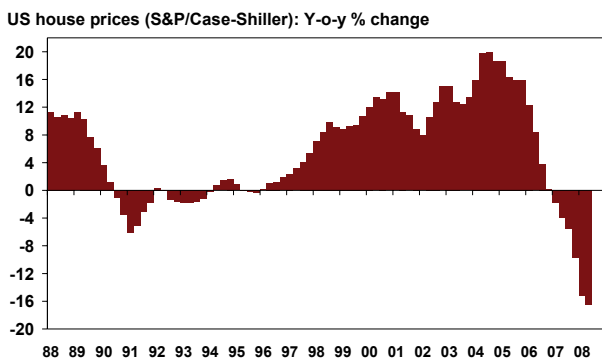
Graph 3: US consumer confidence is weak



Source: The Conference Board and US Census Bureau

Unsurprisingly, recent news from the **US** has not been encouraging. The economy has so far avoided recession (by the popular definition of two consecutive quarters of decline in gdp), but this has been due to falling imports and rising exports, a trick that may be difficult to repeat as other major economies slow more rapidly. In contrast, domestic spending has been flat or declining over the past three quarters, held back by falling capital formation (with residential construction in a deep recession) and only slow growth in consumer spending. The consumer has held up relatively well under the circumstances – declining asset prices, poor confidence and falling employment over the past eight months. This may be because household wealth remains high and unemployment – although at a five-year high – is still relatively low compared with previous slowdowns. Recently, lower energy prices have also helped to restore some of the lost purchasing power. However, the longer the financial crisis persists, the more the pain will spread, making a recession more likely.

Graph 4: US house prices weaken further



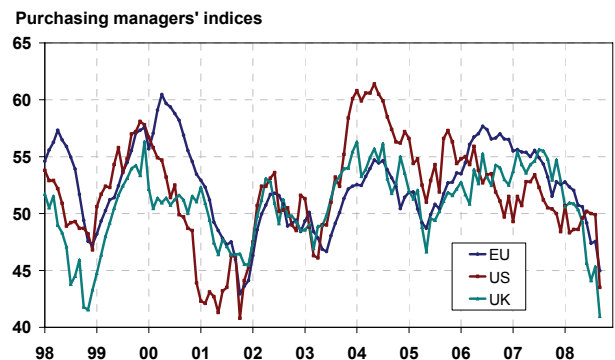
Source: Standard & Poor's

The sudden slowdown in the **Eurozone** over the past few months has made the region look relatively vulnerable, a key factor in the dollar's bounce back from mid-July. European banks have also been caught up in the turmoil, with several large failures underlining the interdependence of the global financial system. The area saw a mild contraction in gdp in the second quarter and indicators such as the purchasing managers index (PMI) and business confidence index suggest that this could be followed by another contraction in the third quarter. However, the experience in individual countries has been very different, with housing booms and busts in economies such as Ireland and Spain precipitating recessions, but Germany holding up reasonably well due to strong capital goods exports and a more conservative housing market. The European Central Bank has taken a harsher view on higher inflation, in contrast to the Federal Reserve, keeping interest rates relatively high, but also supplying significant liquidity to the banks.

The **UK** economy is also teetering on the edge of recession. House prices have fallen by around 15% and

are forecast to decline by another 20% before stabilising in 2010. Gdp was flat in the second quarter of 2008, the first time no growth has been recorded since 1992. In line with the US, net exports kept the economy from contracting, with declines in both fixed investment and consumer spending depressing domestic demand. Weak confidence and ongoing problems in the financial sector make a contraction over the next few quarters likely.

Graph 5: Purchasing managers' indices well below key 50 level



Source: INET

**Japan's economy** contracted in the second quarter, bringing to an end Japan's longest period of expansion since the 1980s. A protracted recession in the US will amplify the Japanese economy's current troubles, as the US is Japan's major export destination. With demand for exports expected to subside and the higher cost of capital, businesses have become more reluctant to invest in expanding capacity. Exports and business investment have been the main drivers of growth during the upswing. Wages are likely to remain suppressed, as tight corporate profit margins will make companies even more reluctant to increase wages. This, in conjunction with rising economic uncertainty, falling equity prices and inflation, will not entice Japanese consumers to spend. With inflation likely to peak soon, the Bank of Japan may opt to cut rates before the end of the year. However, they have little room to manoeuvre, given that they are already low.

Export-orientated **Asian economies** will battle to maintain their current growth momentum as the global slowdown gains traction. Rising wages and resilient consumer confidence will continue to shore up consumer spending, but this will be insufficient to compensate for weakness in the export sector. Inflation still poses some threat, posing a dilemma for policymakers who will increasingly want to consider some easing in interest rates. Recent **Chinese** economic data as well the government's decision to cut interest rates and talk of a stimulatory fiscal package suggest that authorities are concerned about the prospects of an economic slowdown. However, the economy is still expected to expand by more than 8% next year, albeit slower than the double-digit growth seen over the past six years. Export performance has remained remarkably resilient, but this trend is likely to be reversed.

China's prospects will depend on how protracted and deep a US and European recession turns out to be. The government's focus on infrastructure as well as low domestic interest rates will support investment spending, which has been a major driver of growth in the past. However, overinvestment poses a risk. Domestic spending is likely to remain weak, as a 60% drop in equity markets, slower growth in house prices and increased uncertainty weigh on consumers.

An improvement in **Latin America's** economic fundamentals will help it weather the US downturn better than in previous episodes. However, close trade and financial ties to the US will not allow Latin America to escape unscathed. Lax monetary and fiscal policy has aggravated commodity-price-fuelled inflation and, with wage demands set to rise sharply, inflationary pressures are unlikely to abate. Despite this, central bankers will remain reluctant to hike interest rates significantly as the US slips into a recession. Falling commodity prices may prove to be a mixed blessing for commodity exporters. While lower commodity prices will put downward pressure on consumer prices, they may adversely affect exchange rates, muting the effect of declining commodity prices. Growing discontent with leftist governments in Venezuela and Bolivia as well as deteriorating economic conditions will add to political uncertainty in the region.

**Sub-Saharan Africa's** growth is expected to ease next year as the commodity-inspired boom, which has fuelled growth across the region, loses momentum. The inflow of foreign capital into commodity-rich countries is expected to slow as certain investors become more risk averse. However, much of the capital has been of a long-term nature and better projects will go ahead. Inflation remains a major policy concern. This year's poor harvests in some countries will keep food prices high, adding to inflation and increasing the chance of more civil unrest. Ongoing conflict in certain regions as well as the failure quickly to resolve issues in the two-headed government in Zimbabwe also detract from Africa's investment potential.

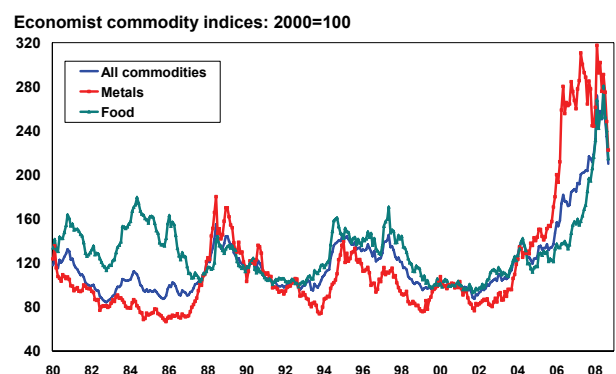
Growth in **Eastern Europe** is expected to slow further as the EU enters a recession. Much of the expansion of the previous few years has been financed by cheap credit from abroad. High external debt burdens and overextended banking systems have made many of these economies, particularly that of Hungary, Romania and Kazakhstan, vulnerable to the ongoing banking and liquidity crisis. Tight credit conditions will make it extremely difficult to refinance loans and will further constrain economic activity.

**Global equity markets** continued to tumble, interspersed with brief rallies as investors bet that an end to the turmoil was in sight. Financial stocks were hardest hit, as the year-long credit crisis claimed some high-profile banking victims. The realisation that the crisis was no longer

confined to the banking sector and would impact the real economy added to bearish sentiment, while news that the US, the UK, Europe and Japan were heading for a recession compounded the gloom. Markets will remain extremely volatile until there is greater certainty that the US bailout plan will relieve the stress in the financial system.

**Commodity prices** have fallen strongly from the highs seen during July. The price of Brent crude oil remains extremely volatile, but has fallen back below \$100 dollars a barrel. Previously bullish sentiment towards oil appears to have turned recently as concerns about the effect that a global slowdown will have on demand predominate. The dollar's recent strength has also weighed on oil prices. Gold has lost some of its lustre, but has not fallen by as much as either platinum or oil. The precious metal has been supported by safe-haven buying, as investors seek an alternative to mounting losses in equity markets and uncertainty over the safety of even bank deposits. The price of platinum has halved since July, falling to just below \$1 000 an ounce. Declining vehicle sales in some developed markets are expected to put further downward pressure on demand for platinum, which is used in auto catalysts. Base metals have followed precious metals lower, as emerging economies such as China are likely to lose momentum. Prices of agricultural goods have stabilised, but remain at relatively high levels. Food prices are unlikely to fall as significantly in the short term, as demand from both the biofuels industry as well as emerging economies is now structurally higher. Commodity prices are expected to correct further as the global slowdown intensifies, but will probably remain above peaks seen in earlier upswings.

Graph 6: Commodity prices correcting

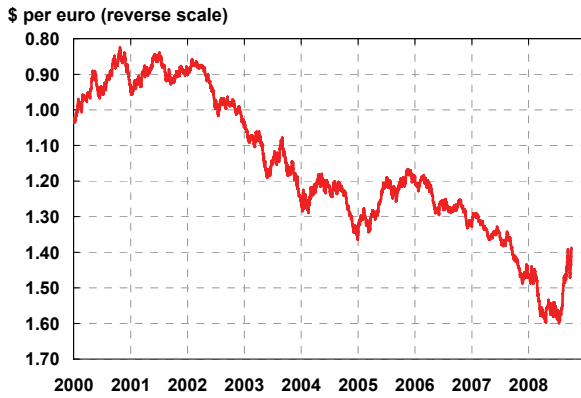


Source: The Economist

On **exchange rate markets** the dollar rallied strongly, reversing some of its six-year losing streak. The US unit was favoured, as negative attention turned from the US to other key economies where recessionary conditions started emerging. This was particularly the case in the Eurozone and the UK, where losses and uncertainty connected to the subprime crisis and tighter monetary policies made the US's short-term growth prospects look

relatively favourable. In the short term the US unit will be supported by safe-haven buying as the crisis continues to unfold and with the prospect of lower interest rates in the UK and EU. However, medium- to longer-term prospects remain poor.

Graph 7: Dollar rebounds against euro



Source: Reuters

## Domestic review and prospects

South African economic growth has so far held up reasonably well in the face of the global slowdown. However, the full effect of some moderation in the terms of trade and more uncertain capital inflows is still to be felt. The household sector remains stressed by relatively high debt and the significant rise in interest rates over the past two years. A recovery in agriculture and strong fixed capital formation spending will continue to help the economy avoid recession, but slower growth until the second half of 2009 looks inevitable. Thereafter the expected boost provided by the 2010 FIFA World Cup and some recovery in consumer spending as interest rates moderate should lift growth closer to longer-term potential.

Table 1: Components of economic growth

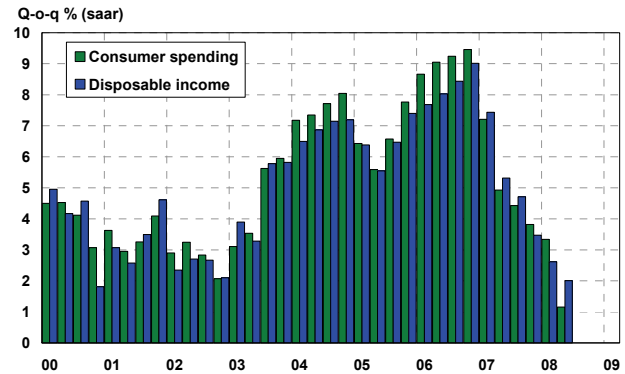
Industries	Gdp growth (q-o-q % change saar)							
	2006	Q2'07	Q3'07	Q4'07	2007	Q1'08	Q2'08	% in '07
Agriculture	-7,9	8,3	4,4	11,2	0,3	17,2	19,6	3,2
Mining	-0,1	-9,1	0,9	-5,8	-0,6	-25,1	15,6	7,7
Manufacturing	5,2	-0,1	-2,5	8,2	3,9	-1,0	14,5	18,2
Power & Water	3,0	2,8	3,0	-1,8	3,2	-6,2	-1,3	2,5
Construction	14,7	11,8	14,7	14,2	18,1	14,9	10,6	2,9
Trade	7,0	4,7	4,5	2,1	5,0	3,6	-2,2	13,9
Transport & comm	5,0	6,1	4,4	3,6	5,2	3,5	4,1	9,0
Finance	8,6	10,2	12,3	8,5	8,3	4,9	2,3	22,2
General government	3,1	1,2	3,3	4,4	3,4	4,6	1,1	14,5
Personal services	4,5	4,3	5,1	4,3	4,1	3,9	3,9	5,9
Value Added	5,3	4,0	4,9	5,2	5,2	1,9	5,1	100,0
GDP	5,4	4,0	4,6	5,1	5,1	2,1	4,9	

Source: Statistics South Africa

The economy's performance was patchy in the second quarter and has worsened in the third quarter. The statistics were mixed and often conflicting, but the overall tone was negative. **Real gdp growth** bounced back in the second quarter, up to an annualised 4,9% q-o-q from a sluggish 2,1% in the first quarter. Much of this strength was deceptive, mainly brought about by a return to more normal output levels in the mining and manufacturing sectors after severe power outages disrupted production in the first quarter. Although these distortions overstated the economy's performance, there were some pockets of strength. Agricultural production rose sharply, construction powered on and activity levels in the transport and communications industries picked up. In contrast there was further evidence of weak consumer demand as value added by wholesale, retail, hotels and accommodation industries fell for the first time in over six years, while value added by the finance and real estate industries still grew but at a much slower pace.

A truer reflection of the underlying conditions in the economy came from the expenditure numbers, where most components of final demand lost significant momentum. Domestic expenditure contracted by over 4% in the second quarter as both inventories and government spending dropped sharply off a high base, while growth in consumer spending continued to falter. Only fixed investment activity remained robust.

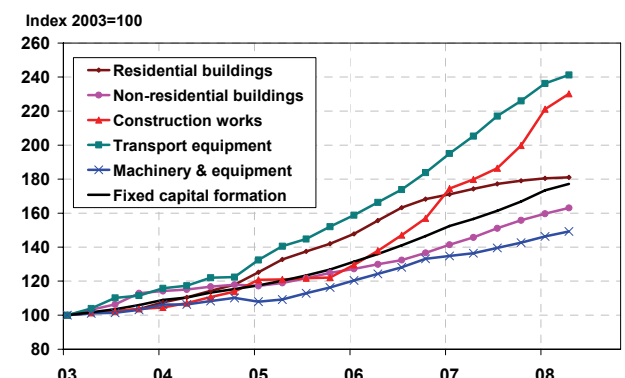
Graph 8: Income and spending slow



Source: South African Reserve Bank

Conditions for **households** have become tougher. Growth in real disposable income slowed to a crawl, largely eroded by surging inflation. There was little or no support from asset prices. Average house price growth largely evaporated, while equity prices were down just over 20% since the start of the year. Households generally avoided taking on more debt. Consequently, the ratio of household debt to disposable income dropped to 76,7%, down from a record high of 78,2% in the first quarter. However, interest rates increased further, pushing debt service costs higher. As a result the ratio of debt service costs to disposable income rose to a high of 11,9% from an already punishing 11,3% in the first quarter. Under mounting financial pressure, household confidence faded and spending slowed markedly. Spending on durable goods plunged, but households also cut back aggressively on purchases of semi-durable and non-durable goods. Spending on services accelerated, mainly bolstered by continued demand for transport and communication services.

Graph 9: Capital formation uneven over asset classes



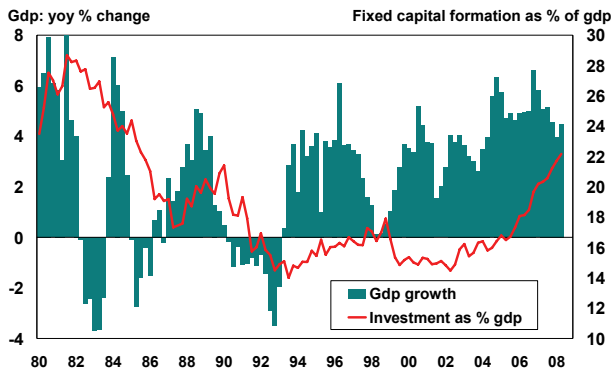
Source: South African Reserve Bank

**Fixed investment** remained strong, accounting for 22,2% of gdp in the second quarter. However, the rate of growth slowed somewhat as capital investment by the private sector, general government and public corporations moderated off very high bases. According to the Reserve

Bank, capital outlays by the private sector were mainly driven by increased spending in the booming agriculture and construction sectors, while investment spending by public corporations was still exclusively driven by Transnet and Eskom. Progress was made with some of the big power generation projects, while the refurbishment of rail coaches also gained momentum. The focus of capital spending by general government was on addressing provincial infrastructure backlogs.

A much weaker performance is expected in the second half of this year and the first half of next year. Overall the economy is forecast to grow by a modest 3,5% and 2,6% in 2008 and 2009 respectively. Household finances will remain under pressure from slowing income growth, high inflation, punishing interest rates and heavy debt burdens. Recent statistics are not encouraging, with real retail sales falling by almost 5% y-o-y in July and sales of new cars dropping by about 19% y-o-y in July and over 30% y-o-y in August. Household demand, which accounts for over 60% of gdp, is therefore expected to weaken further. As a result, very sluggish growth is forecast for the next three quarters, with some recovery expected from around the second quarter of 2009 as inflationary pressures begin to ease, interest rates start to come down and confidence gets a boost from the buildup to the 2010 FIFA World Cup.

Graph 10: Fixed investment rising as a proportion of gdp



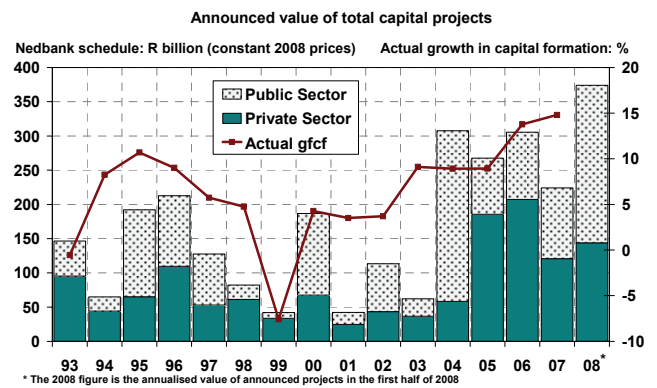
Source: South African Reserve Bank

It is commonly argued that the impact of slower household demand will partly be offset by the continued investment boom, with some support from more aggressive government spending. While this largely holds true, there are worrying signs of fading momentum in some sectors. Part of the problem is that the cyclical downturn is becoming more broad-based, with tougher trading conditions spreading to an increasing number of industries. Mining production dropped sharply in June and July, falling 6,3% y-o-y and 12,6% y-o-y respectively. Manufacturing production, which has held up relatively well until recently, slowed to 3,3% y-o-y in July. Investec's Purchasing Managers Index (PMI) presents an even murkier picture of underlying conditions in the manufacturing sector, with the index well below the key 50 level since April this year. If production comes under more

pressure and earnings growth stagnates further, existing and future expansion plans may be scaled down or reconsidered altogether.

There are also other signs of softer capital expenditure, especially within the private sector. Cement sales have been falling since May. Sales of medium commercial vehicles have also dropped sharply over July and August, while sales of heavy commercial vehicles have slowed significantly over the same period. Added to this, residential investment, which accounted for almost 12% of total fixed investment in 2007, is weak. The value of residential buildings completed has been contracting unabated since September last year, while the value of new residential building plans passed has been on a gradual downward path since June last year, before dropping sharply over the three months to July.

Graph 11: Strong investment pipeline



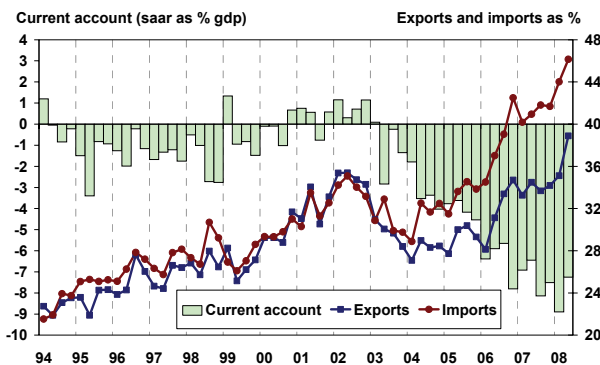
Source: Nedbank Group Economic Unit

**Nedbank's Capital Expenditure Project Listing –** a record of expansionary capital projects valued at over R20 million – still reflects a fairly upbeat overall picture, but there are signs of uncertainty creeping into some sectors. About 80 new projects of R336 billion were announced in the first half of the year, which still compares favourably with the 128 projects valued at about R194 billion announced in 2007 as a whole. However, the rise is mainly due to the extension of Eskom's capacity expansion programme from R113 billion in 2007 to a staggering R343 billion in 2008. Excluding Eskom and other public sector projects, expansion plans by the private sector generally remained quite ambitious. The private sector announced 64 new projects valued at R72 billion in the first half of this year, compared with 93 projects of about R105 billion in 2007 as a whole. Manufacturing again featured strongly, with R25 billion worth of new projects, up from R15 billion over the same period last year. However, this rise was almost entirely due to a few big projects in isolated industries, mostly petroleum refineries and chemicals. The appetite for expansion in most other industries in the sector appeared limited. The mining sector was also more cautious, with investment plans dropping sharply to only R6,5 billion

worth of new projects, down from R27 billion over the same period last year. Anecdotal evidence therefore seems to indicate some easing in capital outlays in the private sector, which accounts for over 73% of total capital formation. This suggests that fixed investment is likely to grow at a slower pace in the second half of this year, even though infrastructure spending by government and public corporations is expected to continue at a brisk pace. Fixed investment should accelerate again in 2009 as general financial conditions improve and the deadlines for the FIFA World Cup draw closer.

The **trade deficit** narrowed in the second quarter. Export volumes rose as production at mines and factories recovered from the electricity supply difficulties of the first quarter, while export prices were propped up by a weaker rand and still high global commodity prices. In contrast, import volumes largely stagnated on weaker demand, but import prices shot up sharply on surging global oil prices and a weaker rand, which kept the overall import bill at high levels. The services deficit was little changed, resulting in an improved, albeit still high, current account deficit, which narrowed to R164,4 billion or 7,3% of gdp from the record high of R194,7 billion or 8,9% of gdp in the first quarter.

Graph 12: Current account deficit narrows slightly



Source: South African Reserve Bank

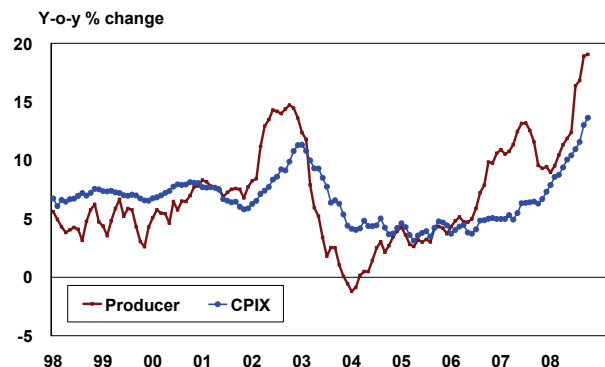
**Net capital inflows** were again more than sufficient to cover the shortfall on the current account. The main source of funding came from **portfolio investments**, which increased by R22,5 billion as foreigners climbed back into local equities and bonds after significant selling in the first quarter following growing concerns over domestic growth prospects and future economic policies under the new ANC leadership. Investors' nerves settled somewhat in the second quarter, probably aided by urgent attempts to address structural shortcomings, less frequent power outages and repeated assurances from the new ANC leadership that it remains committed to sound macroeconomic policies. Surging global commodity prices probably also helped, resulting in renewed interest in local mining counters.

Other sources of capital also remained positive, but generally recorded smaller inflows in the second quarter. **Net direct investment** rose by only R1 billion, while net other investments rose by around R19 billion as local banks increasingly drew on foreign credit facilities. As a result, net reserves increased further although at a slower pace. The international liquidity position increased from US\$33,1 billion at the end of March to US\$33,8 billion at the end of June, providing cover for about five months of imports. More recently the international liquidity position eased to US\$33,5 billion or 4,6 months of import cover in August.

Exporters are likely to struggle for the rest of this year and much of next year. Weaker global demand will contain growth in export volumes and prices. The world economic outlook looks tenuous at best. The global credit crunch has increased the chances of recession in the US, the UK, Europe and even Japan. It seems unlikely that emerging markets, including China and India, will escape completely unscathed, which implies that commodity prices will probably moderate further and may even decline quite sharply. A weaker rand should offer some support to local exporters by propping up margins. On the upside, growth in import volumes should also moderate as domestic spending slows. Added to this, import prices are likely to decline as falling global oil and commodity prices are expected to outweigh the impact of a weaker rand. The current account should therefore improve somewhat. The deficit is forecast to be around 8,3% of gdp in 2008 as a whole before narrowing to about 7,4% of gdp in 2009.

**Credit demand** moderated further. Private sector credit extension eased to 18,6% y-o-y by the end of August from 22,6% at the end of March. Household demand for credit faded, reflecting the impact of rising interest rates and tighter access to credit. As a result, instalment sales, leasing finances and mortgages advances grew at a much slower pace. In sharp contrast, corporate demand for credit remained robust, with the 'other loans and advances' category still growing at a rate of over 26% y-o-y, boosted by the ongoing investment boom. Credit demand will continue to shrink in line with the slowdown in economic activity.

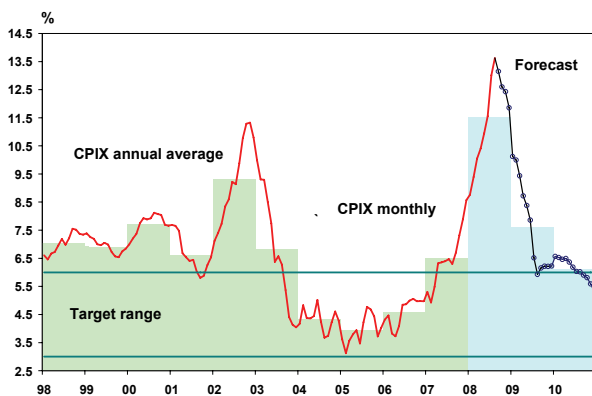
Graph 13: Consumer and producer inflation still high



Source: Statistics South Africa

**Inflation** surged to new heights. CPIX, which excludes the interest costs on mortgages, rose to a record high of 13,6% y-o-y in August. Rising food prices and sharply higher local electricity tariffs were mainly to blame. Despite the gloomy numbers, the outlook for inflation has improved significantly since late July. Global oil prices started to recede in late July, before dropping to below the \$100 a barrel mark in mid-September and is now down about 32% off its peak in early July. This has already translated into three cuts in local petrol and diesel prices. Global food prices have also started to ease, although the retreat has not been universal. Grain futures have come down considerably, but meat and sugar futures have continued to climb higher. Nonetheless, the softer trend should intensify and spread as the world economy loses momentum. This, coupled with another year of good domestic crops, should eventually result in some easing in local food prices towards the end of this year and throughout next year.

Graph 14: Inflation likely to fall



Source: Statistics South Africa, Nedbank Group Economic Unit

More importantly, weak domestic demand will increasingly limit retailers' pricing power, while a faltering global economy and falling asset prices are likely to contain import price increases. Added to this, the worst of the rise in electricity tariffs has also been absorbed for now, although more increases are scheduled for the next four years. Finally, various technical factors, including a very high base, the new CPI weightings and the new basis for calculation, should all help to force inflation down to lower levels.

Significant upside risks remain. Global oil and food prices remain risk factors, but any significant and sustained resurgence now seems very unlikely given an unravelling world economy. The rand is probably the biggest worry. Although the rand is expected to remain relatively steady, a sudden and sharp collapse is not unlikely given rising risk aversion, weaker commodity prices, a large current account deficit and continued political and policy uncertainty. Overall CPIX **inflation** is forecast to remain high for next two months or so, before easing to about

11,9% by the end of year. Thereafter CPIX should dip sharply in January 2009 as the new weightings and methodology come into effect and should edge down gradually over the rest of the year to end 2009 at about 6,2%. Inflation is expected to be back in the 3% to 6% target range by the third quarter of 2010.

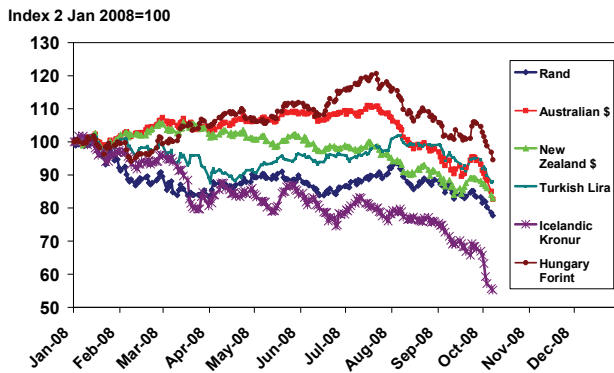
The Reserve Bank's **Monetary Policy Committee (MPC)** left interest rates unchanged at its August meeting, after hiking rates aggressively by 50 basis points at both the April and the June meetings. The neutral stance was mainly the result of an improved inflation outlook, slower domestic demand and moderating inflationary expectations. The Reserve Bank has also revised its inflation forecast down after taking the new CPI weightings and basis for calculation into account, with CPIX now expected to decline sharply in early 2009 before sliding back below the upper 6% limit of the target range in early 2010. Although Governor Mboweni has warned that 'we are not out of the wood yet', monetary policy is likely to be on hold for the rest of this year. By early 2009 inflation will be much lower and falling, while the economy will still be weak and fading, setting the scheme for monetary easing that should take prime lending rates down to about 13,5% by the end of 2009.

**Local financial markets** have been exceptionally erratic for much of the year, largely reflecting severe volatility on global markets. More recently the global credit crunch, which first emerged in August last year, took another turn for the worse. Bank failures in the US and elsewhere resulted in widespread fear and suspicion, a renewed liquidity freeze in the interbank markets, soaring US Treasury prices and plunging global equity prices. As a result, the FTSE/JSE all-share index lost a massive 16,7% of its value in September alone, taking the ALSI down a relatively steep 20,3% since the start of the year. Resources took the hardest beating, dropping by 24,4% in September as fears of weak world growth pushed global commodity prices sharply lower. Industrials and financials also lost significant value in September, but the decline was less dramatic, partly because shares prices in these industries have already been adjusted down quite aggressively earlier this year. For the year to date resources, financials and industrials are now 23,8%, 23,1% and 19,3% lower. Local bond prices rose as the short-term inflation outlook improved, investors started to see the end of the rate tightening cycle and expectations of monetary easing started to rise. The yields on the R153 2010 and the R157 2015 fell to 9,51% and 8,89% by the end of September from 11,75% and 10,72% at the end of June.

The **rand** has been volatile and weaker for much of the year. More recently, the rand lost significant ground against major currencies, with the trade-weighted rand having fallen by 7% in September and by a relatively sharp 16,7% since the start of the year. The bulk of the

depreciation was against the Japanese yen, the Swiss franc and the US dollar. Rising risk aversion among international investors and concerns over the impact of a possible recession in the US and other industrialised countries on commodity prices and growth prospects in emerging markets knocked all emerging and commodity-based currencies over the past months. Fragile investor sentiment will probably continue to weigh on the rand over the short term, and the risk of a sudden sharp depreciation has also increased in recent months. The rand is vulnerable given the large current account deficit and continued political and policy uncertainty ahead of next year's election. However, in the medium term the rand's depreciation is expected to be contained as relative growth prospects remain favourable.

Graph 15: The rand and peer currencies against US dollar



Source: Reuters

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## FACTS AND FORECASTS OF KEY ECONOMIC VARIABLES

7 October 2008

	2004	2005	2006	2007	2008	2009	2010
<b>Growth (real, % change)</b>							
Gdp	4.9	5.0	5.4	5.1	3.5	2.6	4.7
Gde	7.9	5.7	9.2	6.0	3.8	2.9	4.7
Pce	6.7	6.9	8.2	7.0	2.7	1.6	4.2
Gdfi	8.9	8.9	13.8	14.8	12.0	6.9	4.1
Exports	2.9	8.0	5.6	8.3	2.6	3.0	6.5
Imports	14.5	10.3	18.8	10.4	3.6	4.0	6.0
<b>Balance of payments (Rbn)</b>							
Exports	310.5	352.2	434.5	535.7	686.4	824.4	954.4
Imports	311.8	358.5	476.5	576.0	721.1	847.3	965.9
Trade balance	-1.2	-6.4	-42.0	-40.2	-34.7	-22.9	-11.6
Net services	-43.4	-55.8	-70.3	-104.8	-146.8	-145.8	-160.6
Current account	-44.6	-62.2	-112.3	-145.0	-181.5	-168.7	-172.2
Capital account	82.2	96.4	142.1	192.8	197.2	190.0	210.0
Change net reserves	37.5	34.3	29.8	47.8	15.8	21.3	37.8
Gross reserves (eop)	82.8	130.5	178.3	221.2	300.5	318.7	358.1
Current account as a % of gdp	-3.2	-4.0	-6.5	-7.3	-8.3	-7.2	-6.6
<b>Gold price (average per ounce)</b>							
\$	410.4	445.7	605.1	699.0	904.3	938.1	1,036.0
Rand	2652	2844	4103	4937	7198	8229	8942
<b>Exchange rates</b>							
\$\$-Rand	6.46	6.38	6.78	7.06	7.96	8.77	8.63
Euro-\$	1.24	1.24	1.26	1.38	1.49	1.38	1.44
\$\$-Yen	108.2	110.2	116.3	117.7	105.3	105.1	104.2
GPB-\$	1.83	1.82	1.84	2.00	1.90	1.78	1.83
Euro-Rand	8.03	7.93	8.51	9.71	11.84	12.15	12.39
Rand-Yen	16.7	17.3	17.2	16.7	13.2	12.0	12.1
GBP-Rand	11.83	11.60	12.48	14.13	15.13	15.66	15.80
<b>Interest rates (end of period)</b>							
Three-month JIBAR	7.47	7.05	9.18	11.25	12.00	9.85	8.85
Prime	11.00	10.50	12.50	14.50	15.50	13.50	12.50
Long bond	8.15	7.43	7.76	8.35	8.60	7.89	8.07
<b>Inflation (average)</b>							
Headline CPI	1.4	3.4	4.6	7.1	11.8	6.8	4.9
CPIX (metro and other urban)	4.3	3.9	4.6	6.5	11.5	7.6	6.1

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## FACTS AND FORECASTS OF KEY ECONOMIC VARIABLES

7 October 2008

	2007				2008				2009			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
<b>Gdp (q-o-q annual %)</b>	5.5	4.0	4.6	5.1	2.1	4.9	2.0	1.4	1.2	3.3	3.8	5.0
<b>Interest rates</b>												
Three-month JIBAR	9.18	9.78	10.21	11.25	11.38	12.38	12.05	12.00	11.92	10.75	10.35	9.85
Prime	12.50	13.00	13.50	14.50	14.50	15.50	15.50	15.50	15.50	14.50	14.00	13.50
Long bond (10 yr)	7.77	8.40	8.16	8.35	9.19	10.69	8.83	8.60	8.31	7.97	7.79	7.89
<b>Inflation</b>												
CPI	6.1	7.0	7.2	9.0	10.6	12.2	13.2	11.6	8.0	5.6	4.3	4.3
CPIX	5.5	6.4	6.7	8.6	10.1	11.6	13.2	11.9	9.4	7.9	6.2	6.2
<b>Exchange rates</b>												
\$-Rand	7.29	7.099	6.88	6.81	8.16	7.86	8.35	8.77	8.94	8.76	8.72	8.67
Euro-\$	1.33	1.345	1.42	1.47	1.58	1.58	1.44	1.36	1.34	1.37	1.41	1.44
\$-Yen	117.9	123.4	115.3	112.0	99.6	105.6	104.5	105.5	106.6	105.5	104.5	103.4
GBP-\$	1.96	2.004	2.02	2.00	1.99	1.99	1.81	1.77	1.75	1.77	1.81	1.82
Euro-Rand	9.73	9.547	9.75	10.04	12.86	12.43	12.01	11.90	12.01	12.01	12.32	12.51
Rand-Yen	16.17	17.38	16.75	16.45	12.22	13.43	12.52	12.04	11.92	12.04	11.98	11.92
GBP-Rand	14.30	14.22	13.92	13.60	16.20	15.69	15.08	15.52	15.67	15.51	15.75	15.83
<b>Gold price per ounce</b>												
\$	663	648	737	834	934	930	901	883	888	923	979	1018
Rand	4834	4602	5074	5676	7618	7312	7524	7742	7937	8089	8531	8828

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