An overview of the
South African (SA) economy

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SA's economic growth forecasts are slipping for 2012.

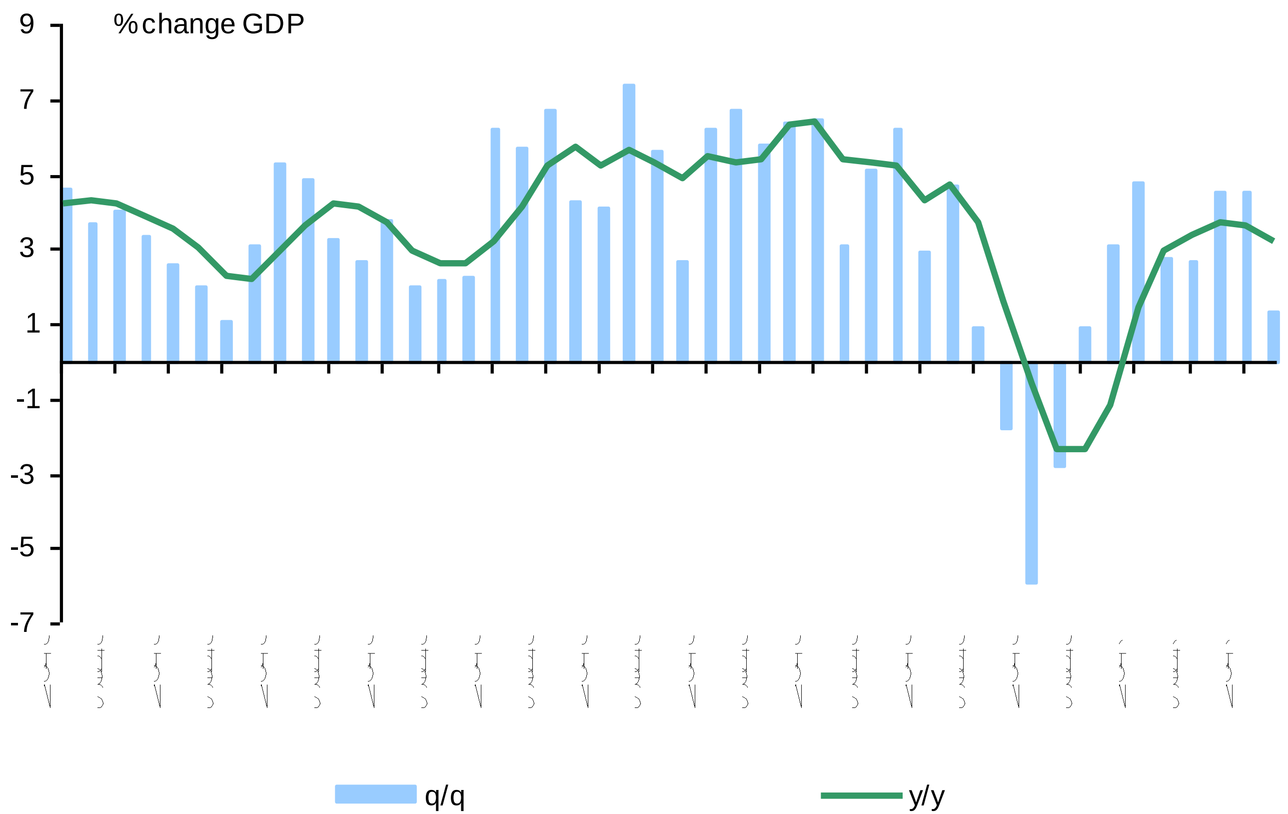
- As a small, open economy SA's performance is heavily influenced by global conditions and the worsening of the sovereign debt crisis has taken its toll. Asia replaced Europe as SA's chief export market in 2009, but this was due to the shrinkage of the European economy, and not the outperformance of Asia on its own. Indeed, SA is now exporting less in real terms than it did in 2006, and economic growth has suffered as a result.

- The growing middle class and counter-cyclical government spending (including rapidly increasing job creation and salary levels in the public sector) are providing support to growth. The private sector has become financially healthier over the last few years, spending on the back of rising real incomes, not credit. Consumer spending remains the driver of growth in the absence of much needed spend on fixed investment.

- The biggest risk is that a euro zone (or worse global) recession causes SA's economy to stall, or contract. We ascribe a 35% chance of a SA recession next year, in other words we believe there is a greater chance of no recession in SA than one occurring in 2012. However, growth could slow and we are in the process of revising down our current growth forecast of 3.5% for GDP in 2012, to 2.5% on the deteriorating growth outlook – we do not see a SA recession yet as the central case.

SA's most recent growth rate of 3.1% y/y is above that of most advanced economies.

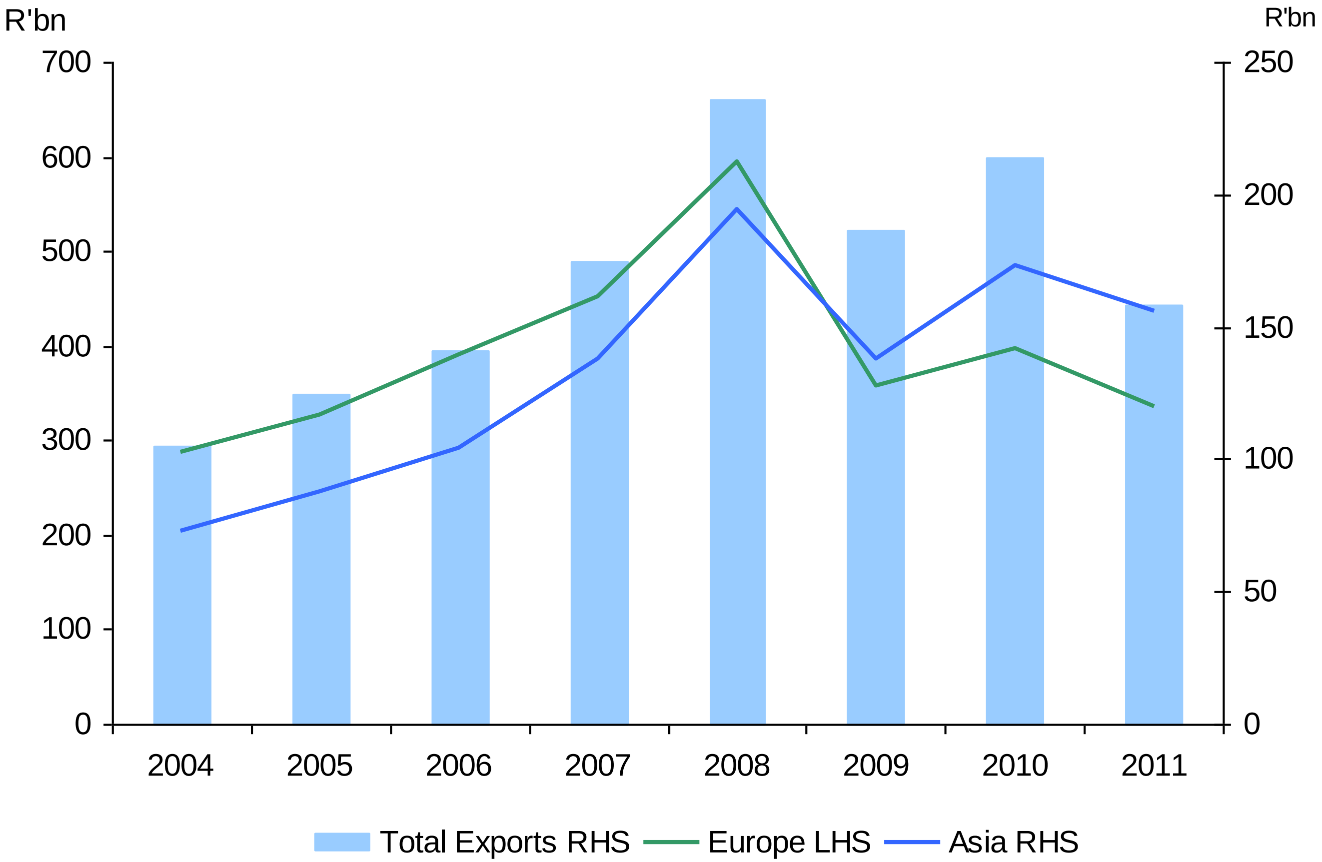
- The slower than expected global recovery means 2011 is likely to see SA growth of only 3.2% y/y.
- This is still above last year's outcome of 2.8% y/y, but below both trend and the rate (of 7.0% y/y) needed to meaningfully reduce unemployment.



Source: SARB

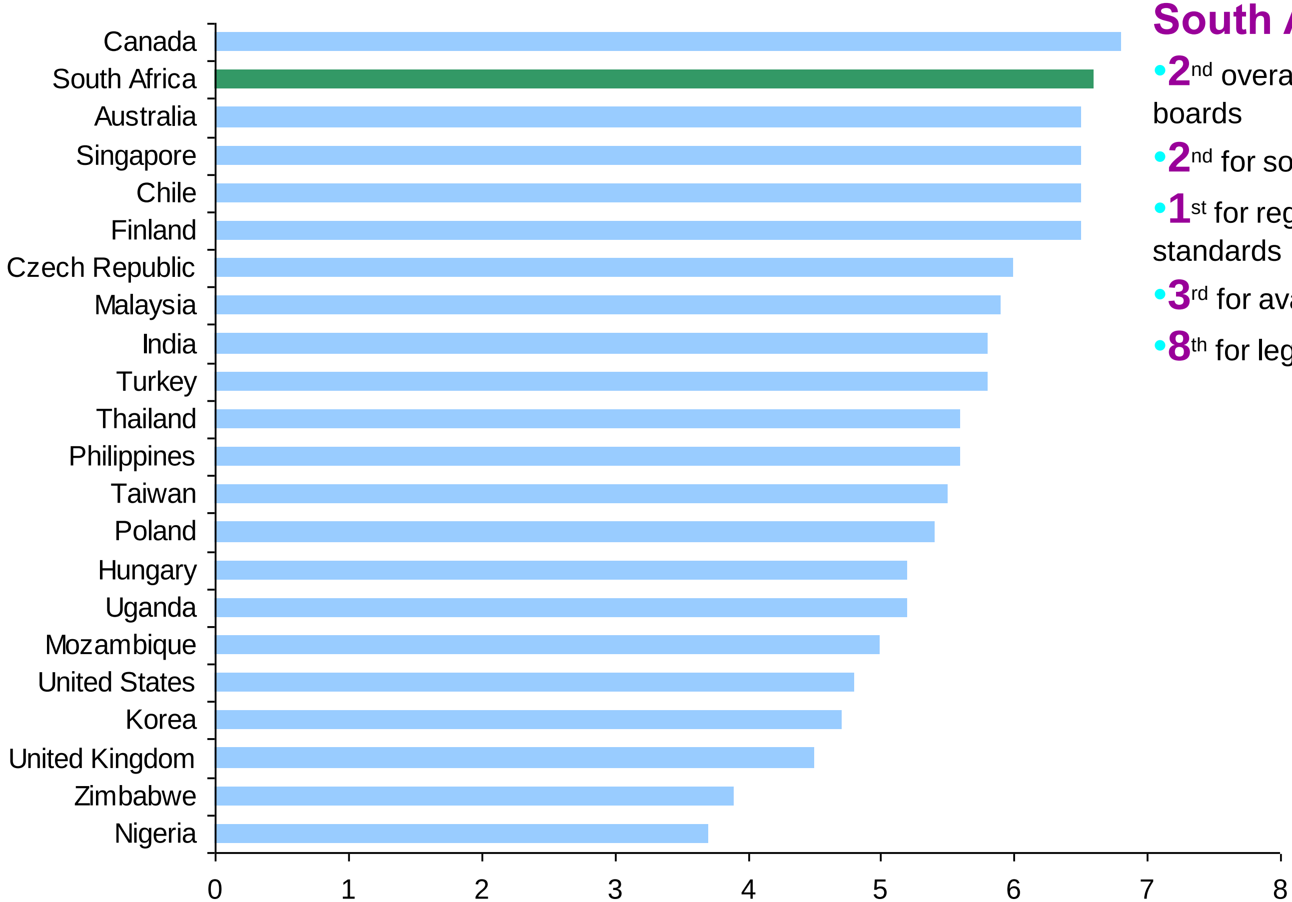
But, looking forward, worsening export performance in 2012 could pull SA's economic growth below 3.0%.

- The production of goods in the mining, manufacturing and agricultural sectors contracted sharply in Q3.11, as global economic conditions weakened. Activity has been progressively slowing, with 3.1% y/y recorded in Q3.11 from 3.2% y/y in Q1.11 (3.8% y/y in Q4.10).
- SA's real value of exports (R437bn) has not regained levels experienced in 2005 (R444), let alone the heady pace in 2008 (R522bn). SA is exporting less in real terms.



Source: SARS

SA's financial system has weathered the storms in global markets …



(1 = insolvent and may require a government bailout; 7 = generally healthy with sound balance sheets) 2010-11 weighted average

South Africa's rankings:

- **2**nd overall for efficacy of its corporate boards
- **2**nd for soundness of banks (see chart)
- **1**st for regulatory and reporting standards
- **3**rd for availability of financial services
- **8**th for legal rights

Source: Global Competitiveness Report

… and the financial system (banking and insurance sectors) remains well capitalised, with no liquidity problems and a low level of gearing.

- The financial system's low exposure to eurozone sovereigns means that a repeat financial crisis of the magnitude of 2008/2009 will again likely have very limited direct impact. Indirectly however, the likely ensuing global downturn would push SA into recession.

South African banking sector's credit exposure to selected peripheral European countries

	Number of South African banks with exposure	Net exposure (including collateral)[1] (R millions)
Greece	3	98.17
Ireland	4	242.24
Portugal	5	86.15
Spain	3	516.64
Total exposure to selected peripheral European Economies		**943.21[2]**

[1] Net exposure refers to aggregate on and off-balance-sheet credit exposure, repurchase agreements and derivative instruments after applying collateral

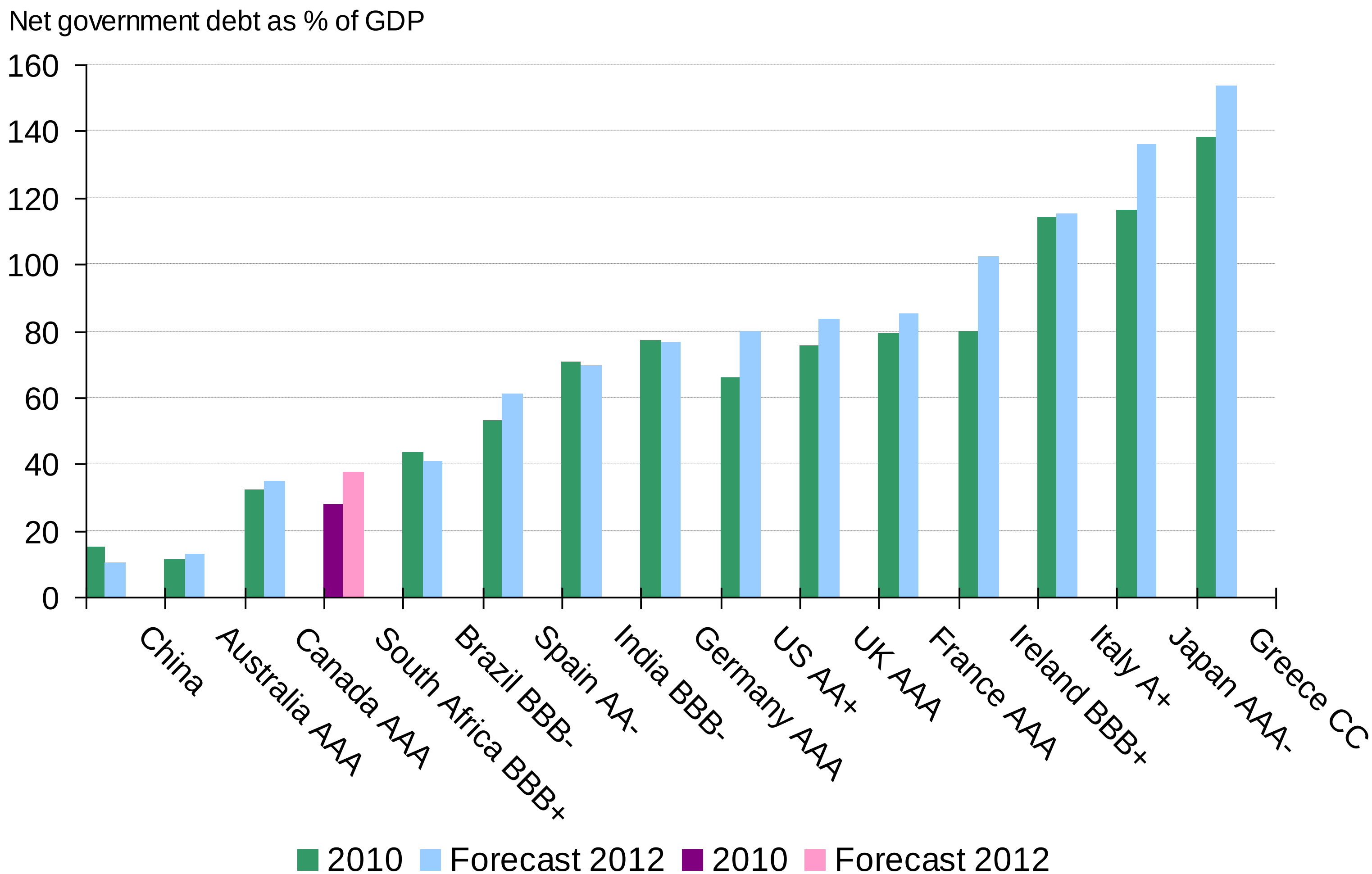
[2] The South African banking sector's total credit exposure to selected periphery European economies amounts to 0.03% of total-banking sector credit exposure. The majority of this exposure is to financial institutions (including banks) with limited exposure to corporates. **No direct exposure was reported to sovereign counterparties**.

Figure may not add up due to totals in rounding

Source: SARB

South Africa’s sound balance sheet is due in part to its very low debt levels ...

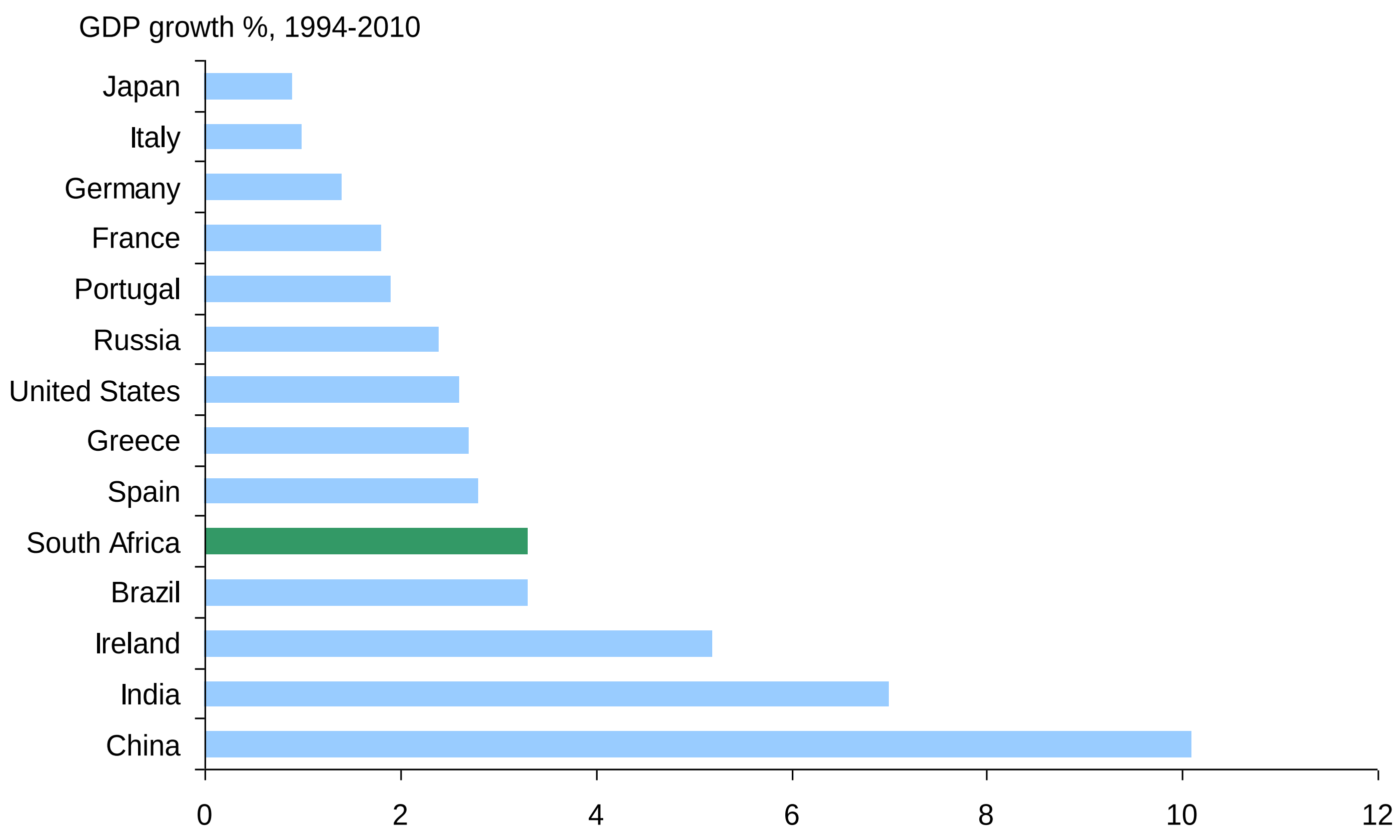
- Although government debt to GDP is now expected to rise to 40% by 2014/15.



Source: Standard and Poor’s

… persistent economic growth...

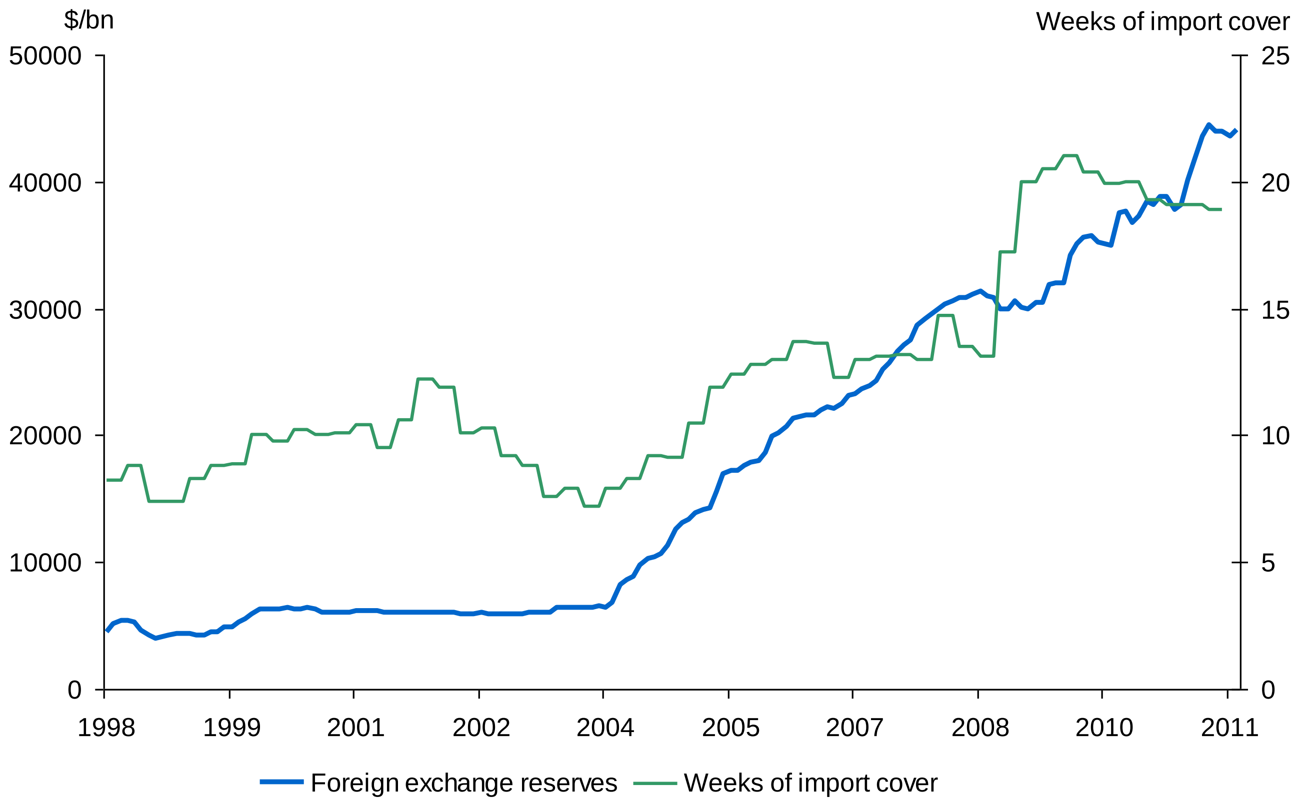
- We expect economic growth of 2.5% for 2012 despite the likelihood of the eurozone entering recession.



Source: IMF

… and sharp rise in foreign exchange reserves, which are all underpinning the country's BBB+ rating (Standard & Poor's and Fitch). Moody's rates SA higher at A3...

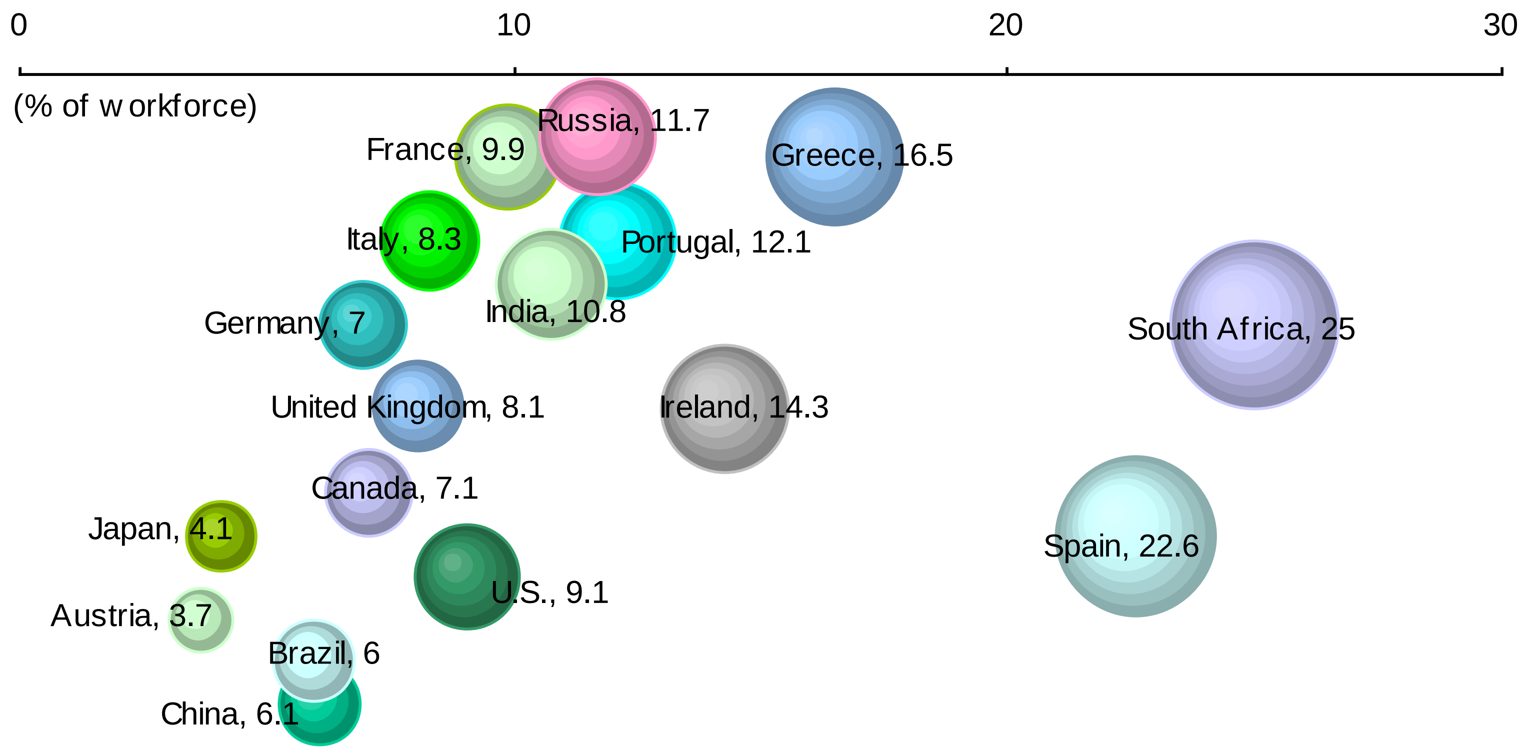
- The SARB and National Treasury's substantial purchases of hard currency has been to improve the national balance sheet .
- The authorities do not have a specific level where they want the rand to trade, but are looking at smoothing out volatility if markets permit.



Source: SARB

… but it has placed SA on credit watch with the view to downgrading its rating due to: heightened political risk stemming from SA's high unemployment rate ...

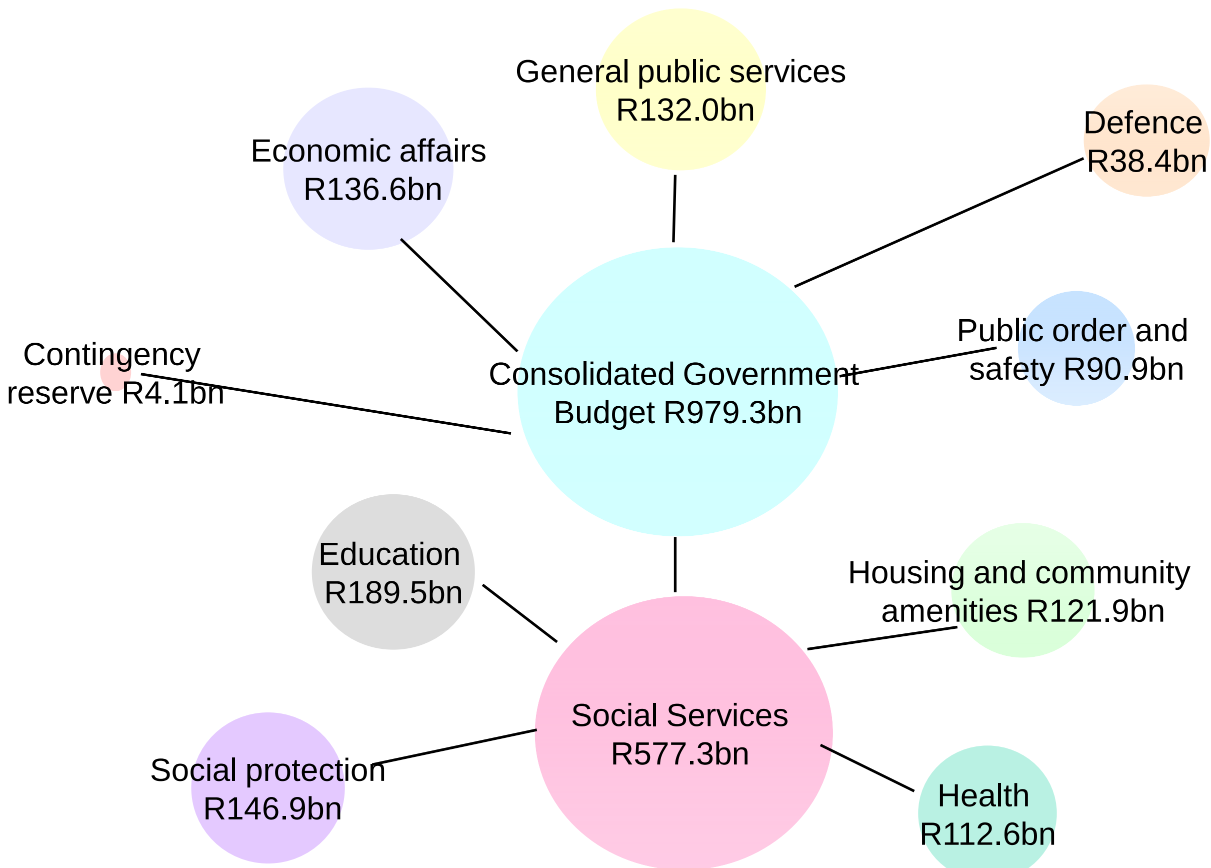
- Moody's is concerned there will be a further deterioration in public finances to stem rising disaffection.
- SA has been placed on a ratings watch, which means that we will not necessarily receive a downgrade but the heightened scrutiny means that further fiscal slippage could result in one.



Source: Economist

… and poverty which are placing pressure on government's finances, as expenditure remains high to meet these needs despite lower revenue collection.

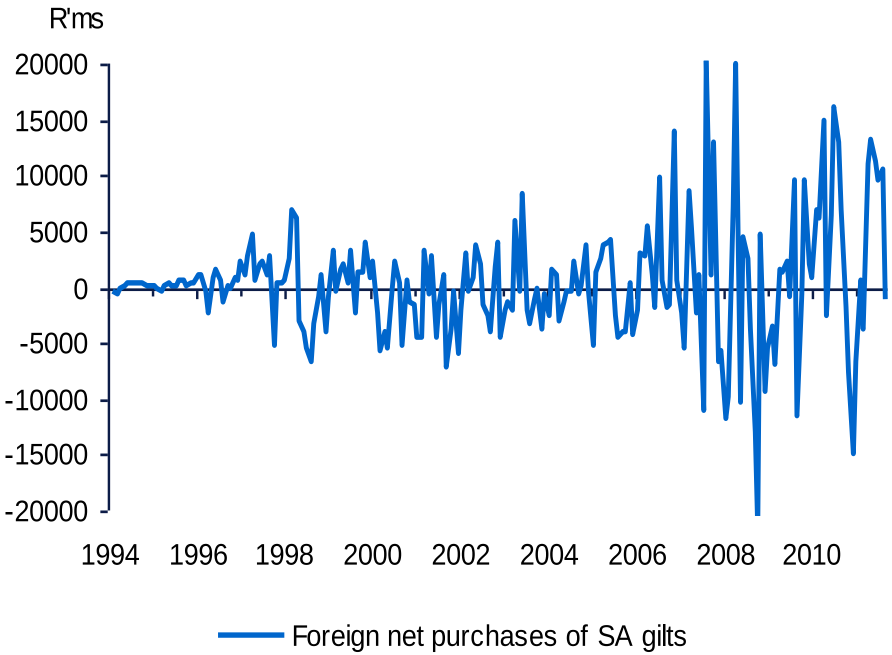
- South Africa holds a BBB+ rating from both Standard and Poor's and Fitch, which are both one notch lower than the current A3 rating SA holds from Moody's.
- If Moody's current warning translates through into SA's sovereign credit rating being lowered, then it would likely drop to Baa1. Baa1, or the equivalent BBB+ of Standard and Poor's and Fitch, is still an investment grade rating – the markets have factored in this potential downgrade.

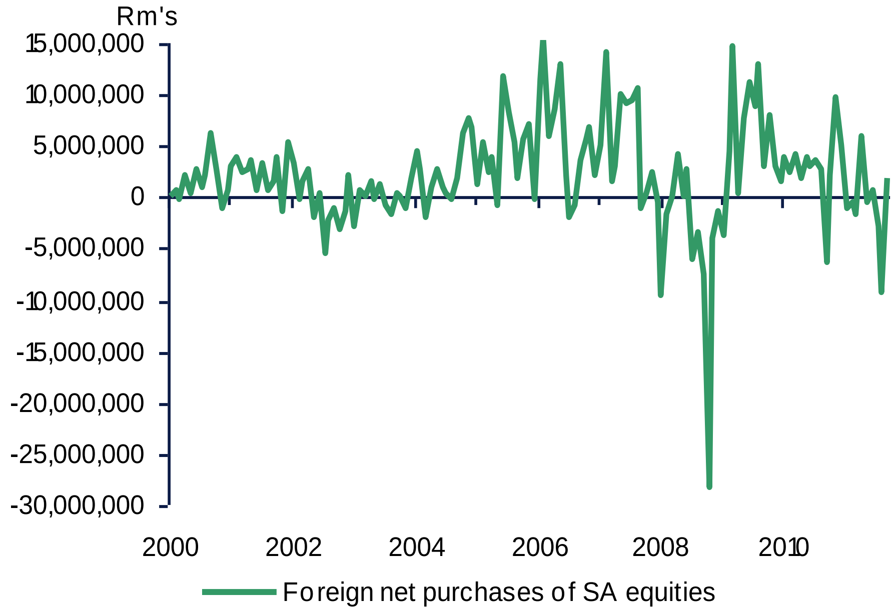


Source: MTBPS

The financing of the current account is chiefly reliant on portfolio inflows (the rating agencies see this as another weakness) ...

- Foreigners are net sellers on soaring risk aversion levels due to the lack of resolution of the EU crisis.
- A general EM sell off occurred with the advent of operation twist as the previous QE2 trade of selling the weakening dollar and buying commodities and EM debt under conditions of high liquidity reversed. As no new liquidity is created, there is little reason to continue the purchase of risky (EM) assets.

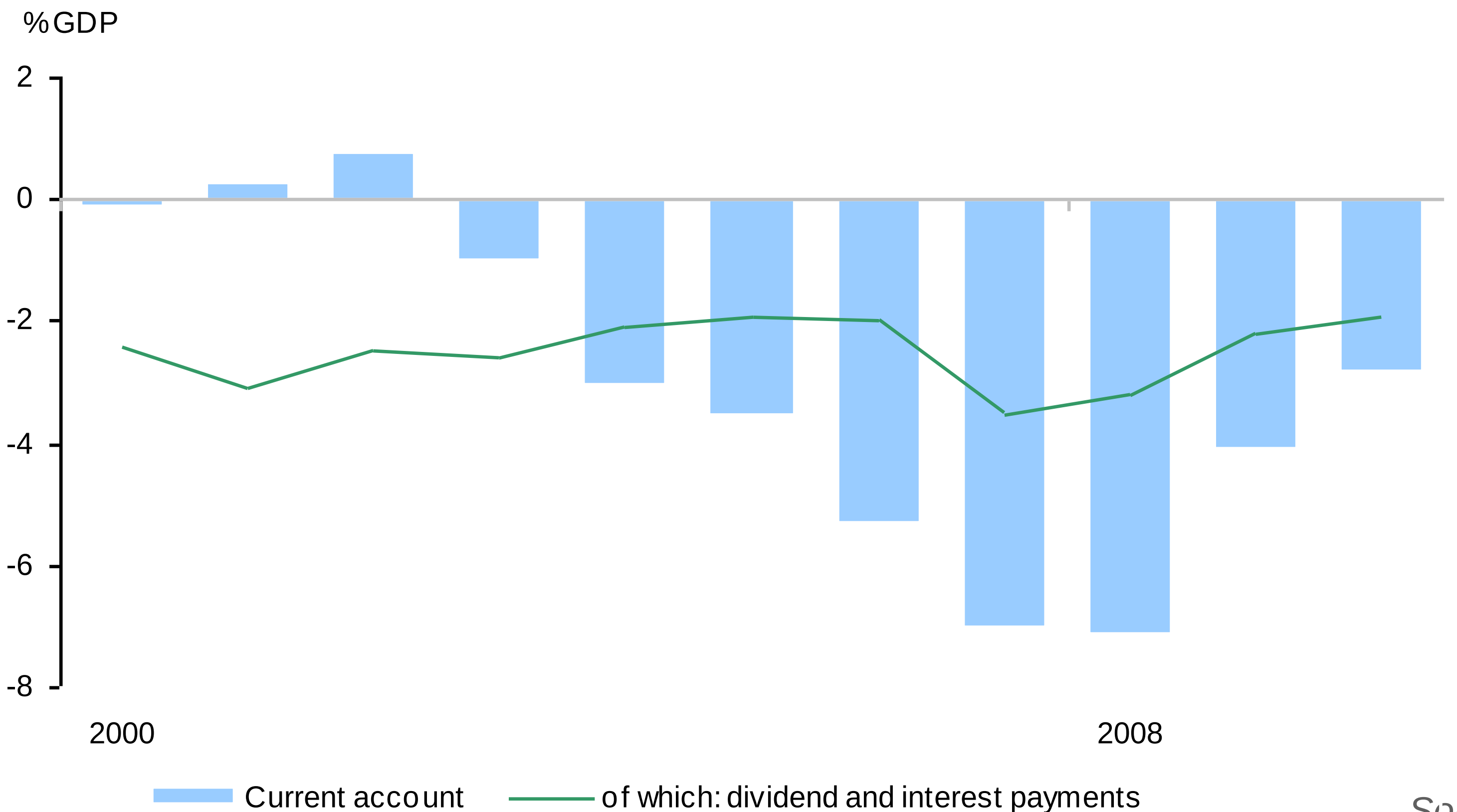




Source: I-Net

… but it is mainly coupon and dividend payments to foreigners. When portfolio flows reverse, so does the deficit (while the trade account tends run in surplus).

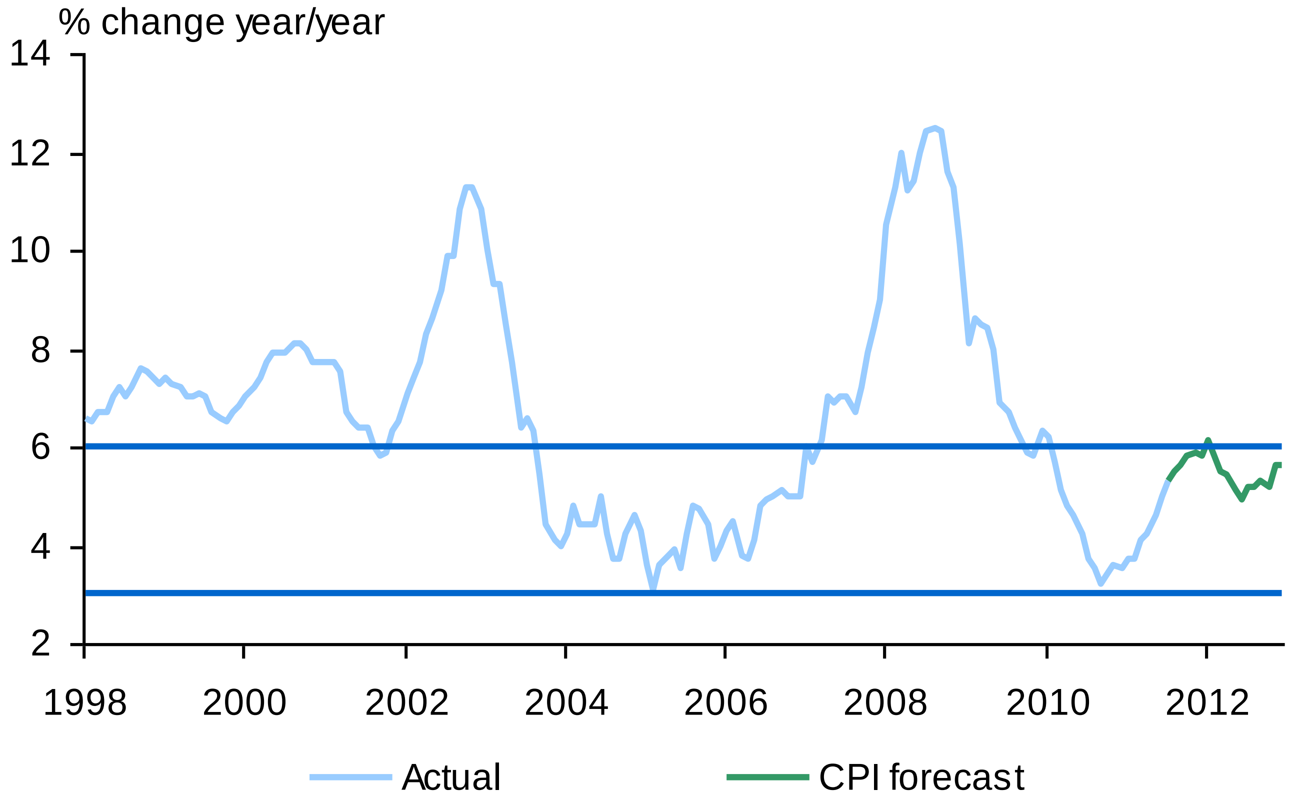
- At best weak growth to a mild recession in the euro area for 2012 seems likely, subduing global demand, and demand for SA's exports and its economic growth, further.
- At worst, a Lehman style default - plunging financial markets into crisis and causing risk aversion levels to spiral. Under this worst case SA would likely experience the last few months of 2008 once again, where the rand leapt to R11.00/USD from R7.00/USD. The ensuing global recession led to SA experiencing just three quarters of contraction, but losing close to a million jobs that are yet to be replenished.



Source: SARB

Inflation is likely to only temporarily breach the upper limit of the target range …

- The Reserve Bank recently revised its inflation forecast to a more protracted breaching of the inflation target, with CPI inflation peaking at 6.3% in Q1.12 and only returning to target by the end of 2012.
- Normally this would have increased pressure for monetary tightening, but the weakening economic growth outlook, both domestically and globally, on the escalation of the sovereign debt crisis means there is no chance the MPC will raise interest rates.



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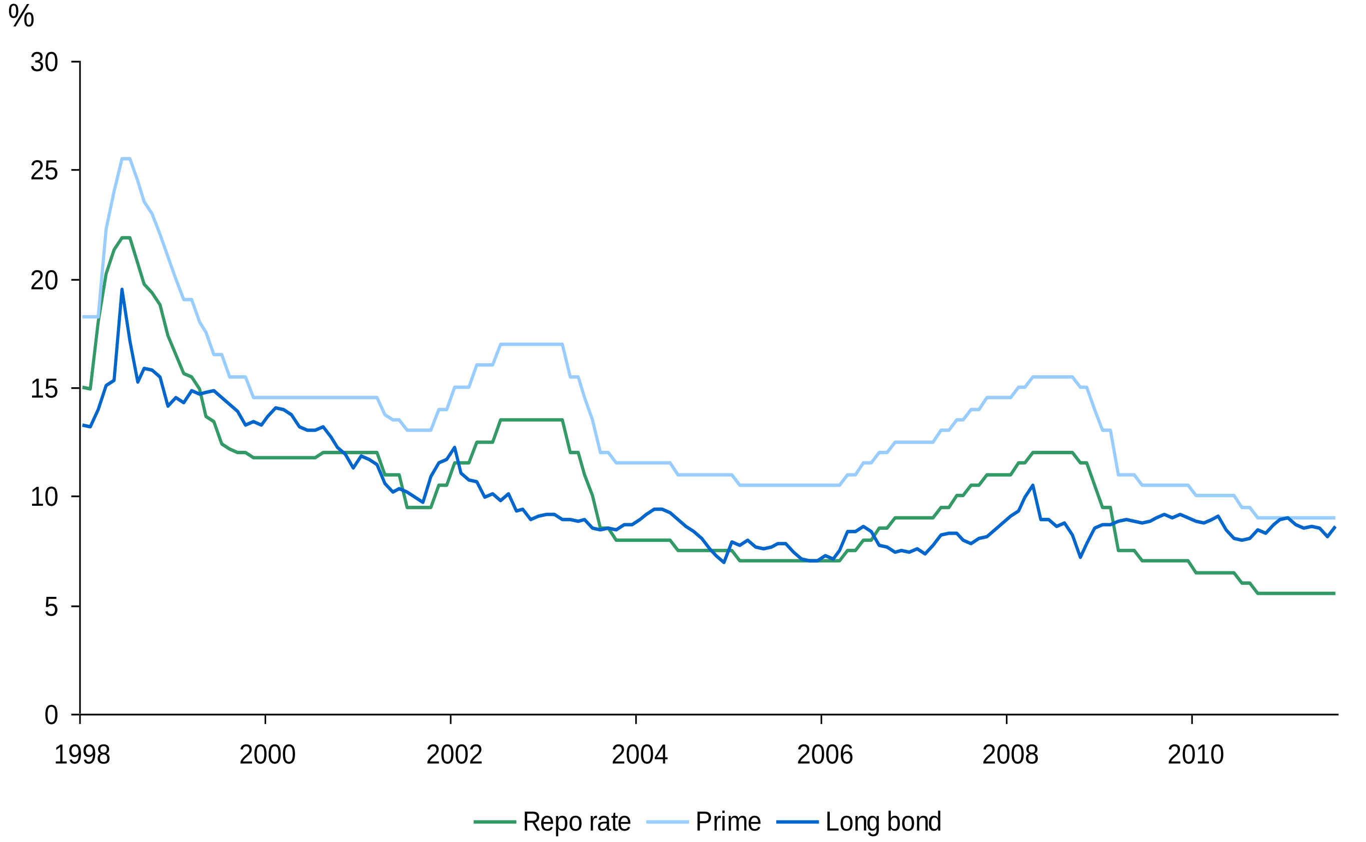
Source: Stats SA, Investec

... meaning interest rates are likely to stay low for longer.

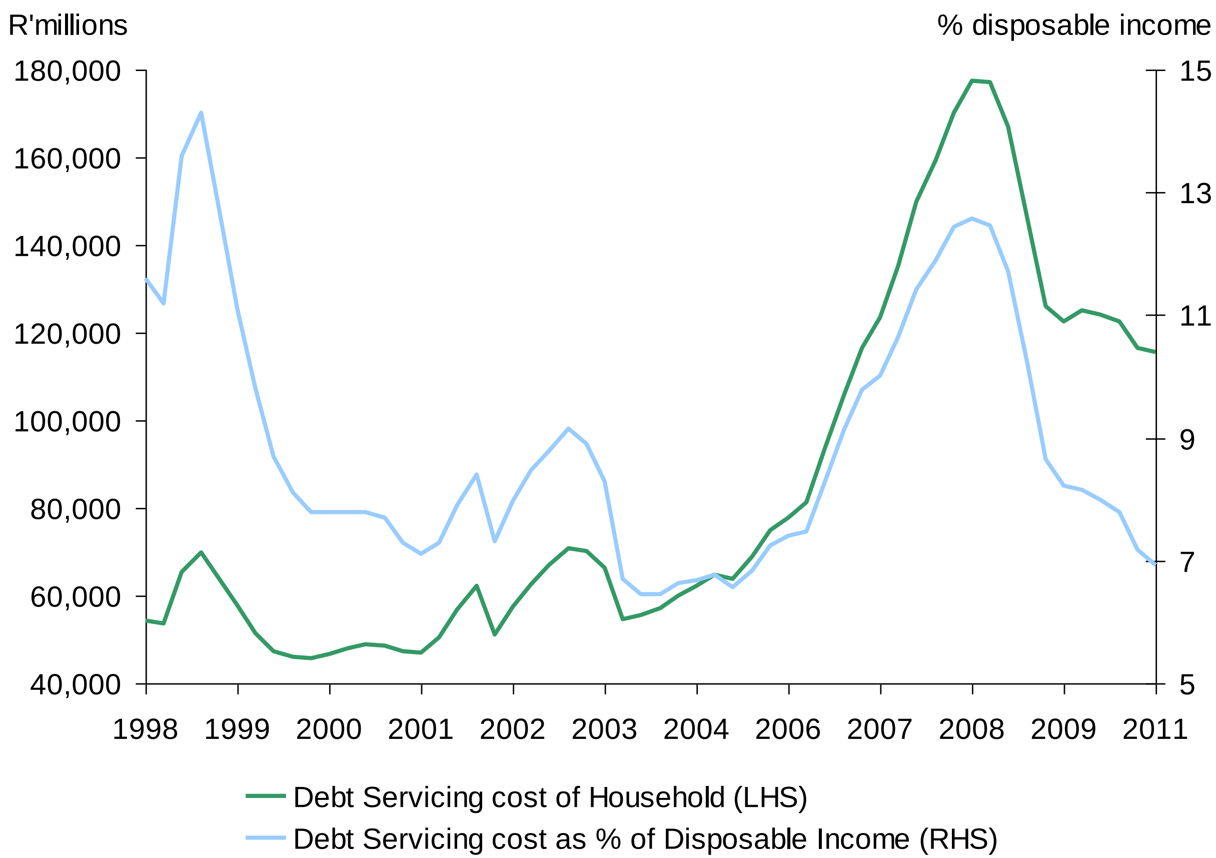
- We continue to expect interest rates will remain unchanged this year and most of next.
- Should growth deteriorate substantially, a global downturn will translate into a similar drop in economic activity locally and domestic interest rates are likely to be cut, despite climbing inflation. The SARB has already communicated this.



Source: I-net

Debt servicing costs are falling, due both to the moderation in private sector debt levels and low interest rates, ...

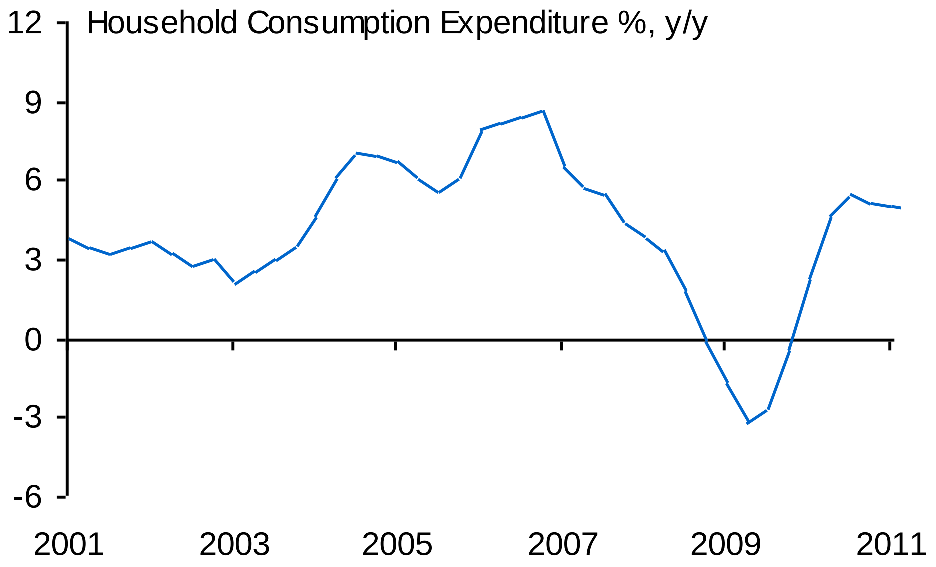
- SA's household debt levels are low in comparison to advanced economies (but our interest rates are much higher) and debt servicing costs are falling due both to a moderation in debt accumulation and lower interest rates.
- Household debt to disposable income has receded. Rising real disposable incomes are driving spend, as opposed to higher debt levels, making the growth more sustainable. However, debt levels are still high historically and will limit the growth in consumption.

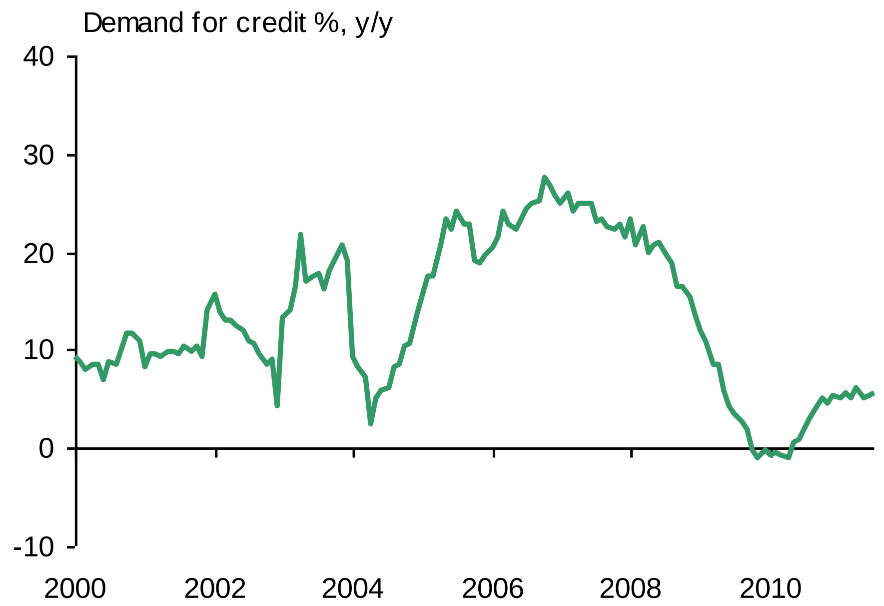


Source: SARB

… while growth in private sector spending has picked up, along with demand for credit, although the later to a lesser extent.

- The sharp, upward migration of individuals through the living standard measures has supported HCE (private sector spending), and hence improved GDP growth since 1994. This trend is likely to continue, compensating in part for the small size of the population, and in turn supporting industries benefiting from household spend.
- The very strong focus of government finances on social services, and the expansionary nature of government spending, means that HCE growth is likely to continue running at a faster pace than that of GDP – and that individuals are likely to continue leaving the extremely low income groups at a rapid pace.

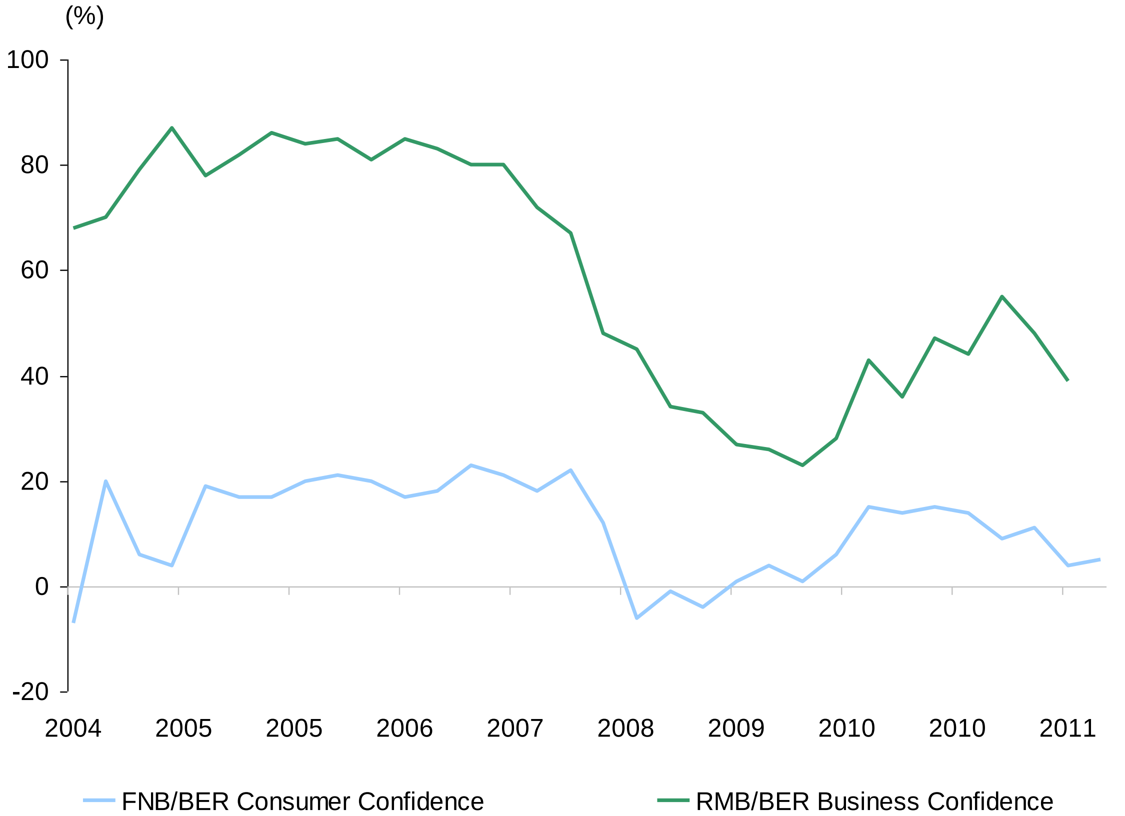




Source: SARB, Bloombergs

Confidence has not regained pre-recession levels, nor has growth in spending …

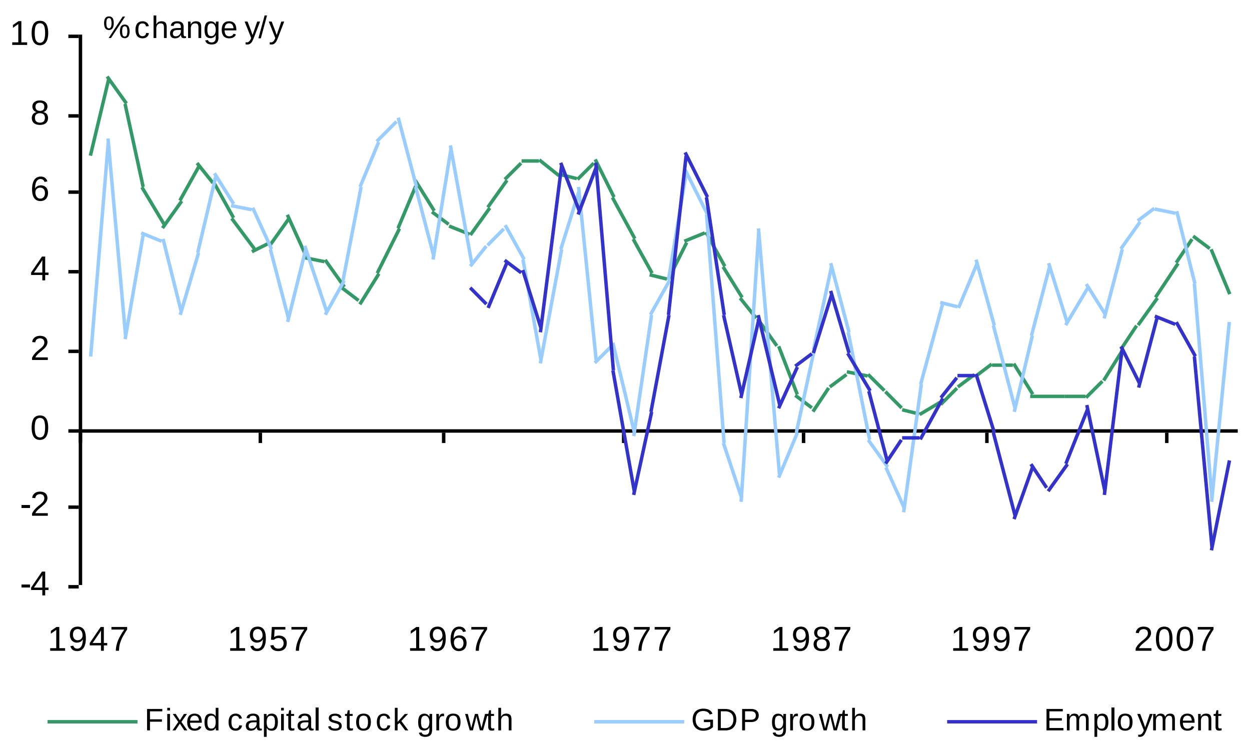
- While we feel there is only a 35% chance of a recession occurring, but should one occur we believe the impact on the SA economy will be more significant than in 2008/2009.
- With SA not having made up ground lost due to the previous recession on employment and real levels of exports, the impact on these indicators and GDP is likely to be more severe this time around.



Source: BER

… and investment in infrastructure weak. To achieve growth of 6-7% (meaningfully reduce unemployment)...

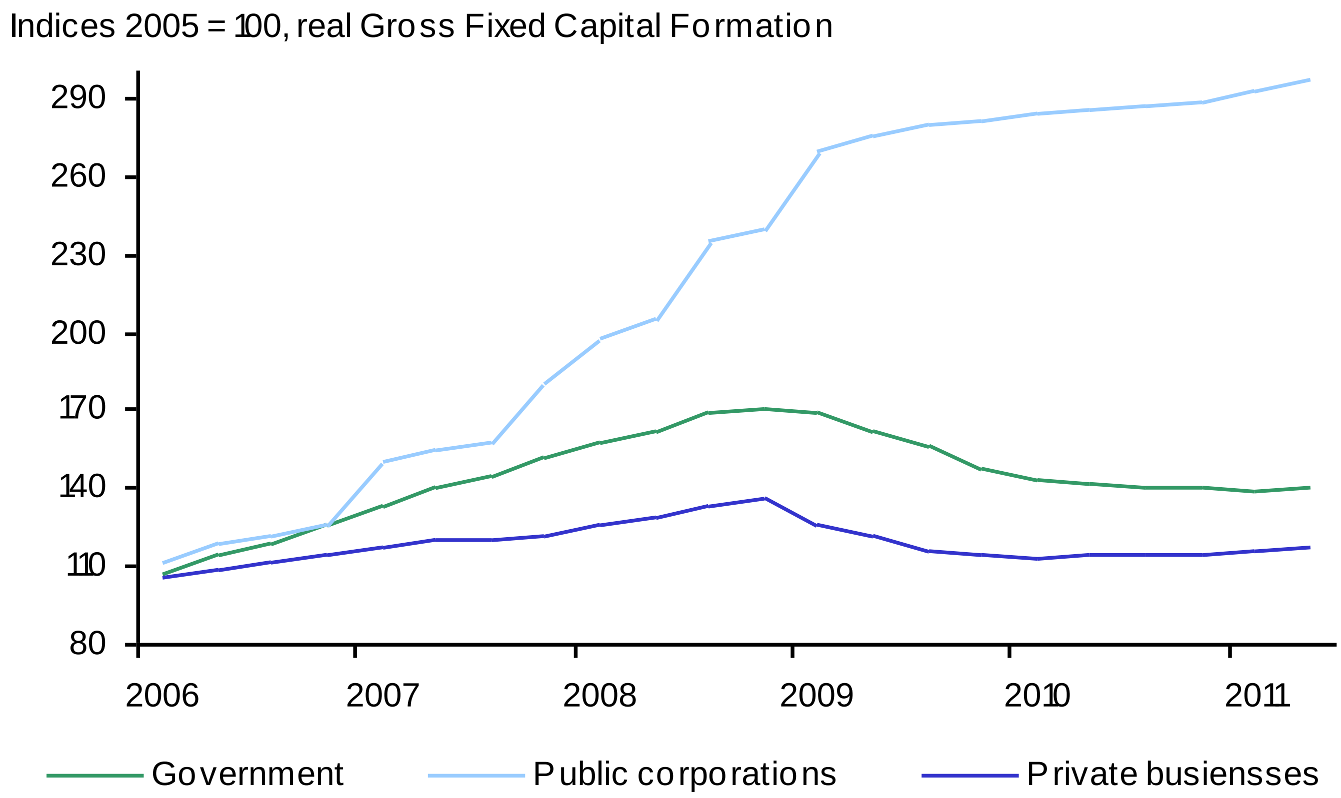
- Economic growth rate is constrained by the level of infrastructure. Public sector investment in infrastructure creates a virtuous cycle as it lifts economic growth and job creation, creates demand and so stimulates private sector investment in infrastructure with attendant benefits for growth and employment.
- With private sector investment only modest, constrained by the lack of economic growth it is impetrative government spends the monies allocated for fixed investment.



Source: SARB

… government must urgently spend the funds earmarked for fixed investment, and ensure the build takes place…

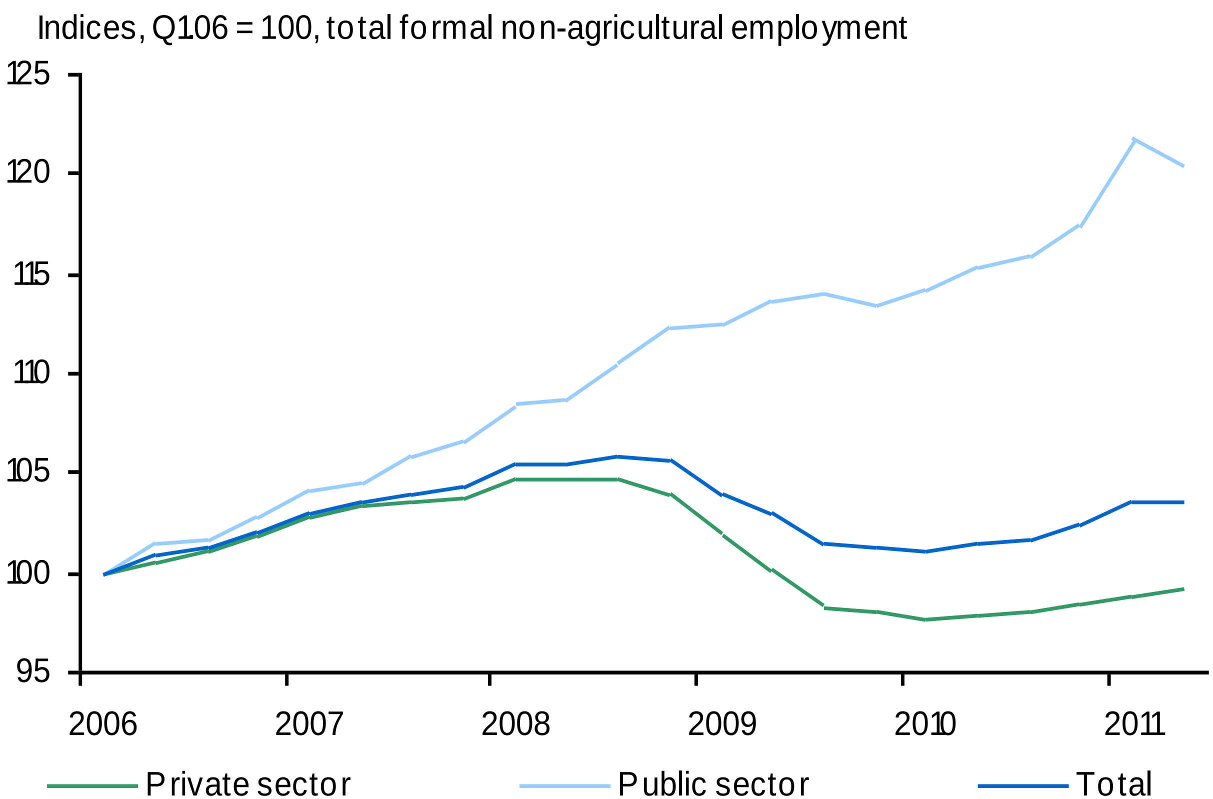
- Government needs to step back and stop micro-managing. Inadequate managerial capacity in government results in monies earmarked for infrastructure not being spent. The high level of corruption causes obstructions to competitive and productive industry.
- The unwieldy (and enormously expensive) management hierarchy in the government sector that is currently overseeing service delivery needs to be replaced with a flat structure that evaluates delivery, nothing more, facilitating and financing the private sector in the provision of national services where possible.



Source: SARB

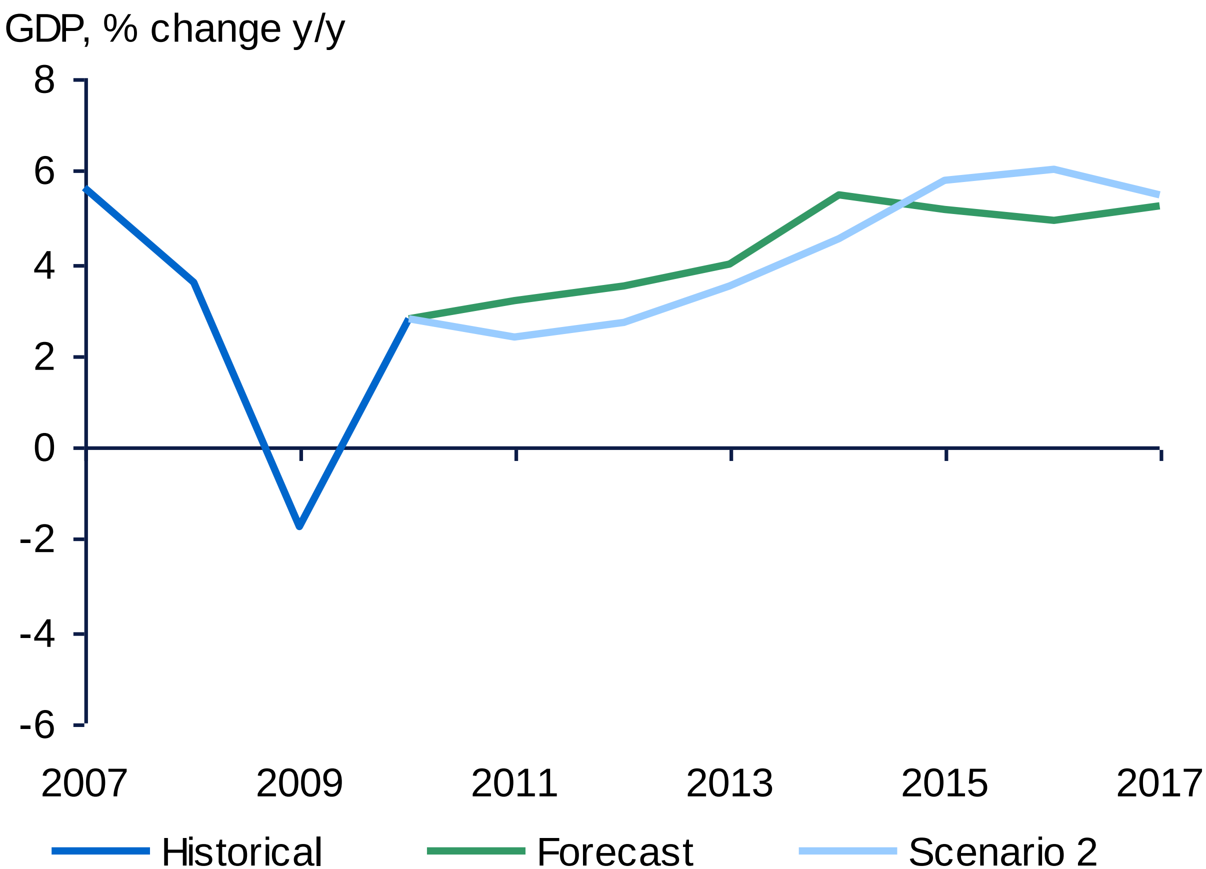
… while the private sector can do a lot more for job creation if the labour laws are relaxed.

- Economic growth needs to run above 3.5% in South Africa for net job creation to occur in the private sector – government needs to focus on enabling the private sector to do business.
- Government’s strong focus on job creation will be supportive of improved HCE growth, even slow but steady growth will aid HCE – making labour laws more flexible will increase hiring.



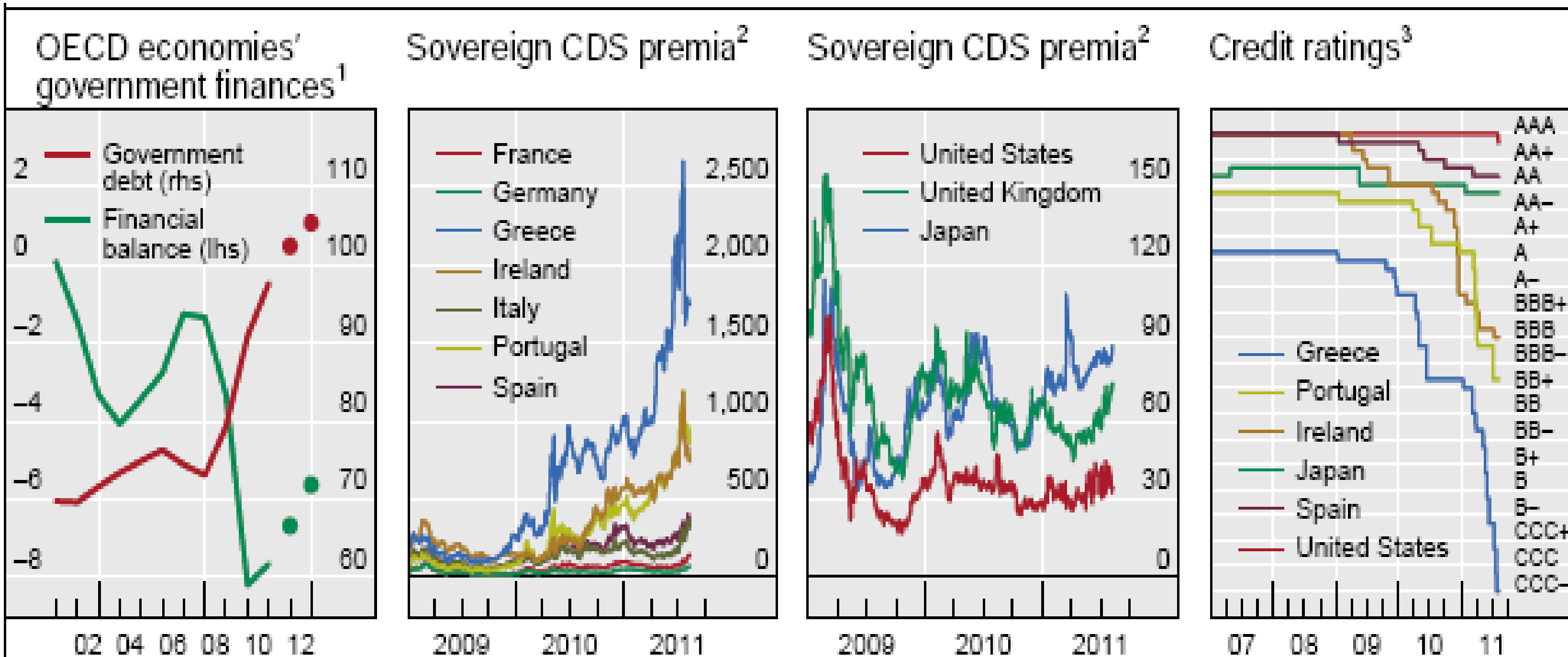
Source: SARB

In summary, our forecast for growth is at risk, GDP may only rise by 2.5% y/y next year, instead of our expected 3.5% y/y if …



Source: SARB, Investec Group Economics

… the sovereign debt crisis worsens as this would…

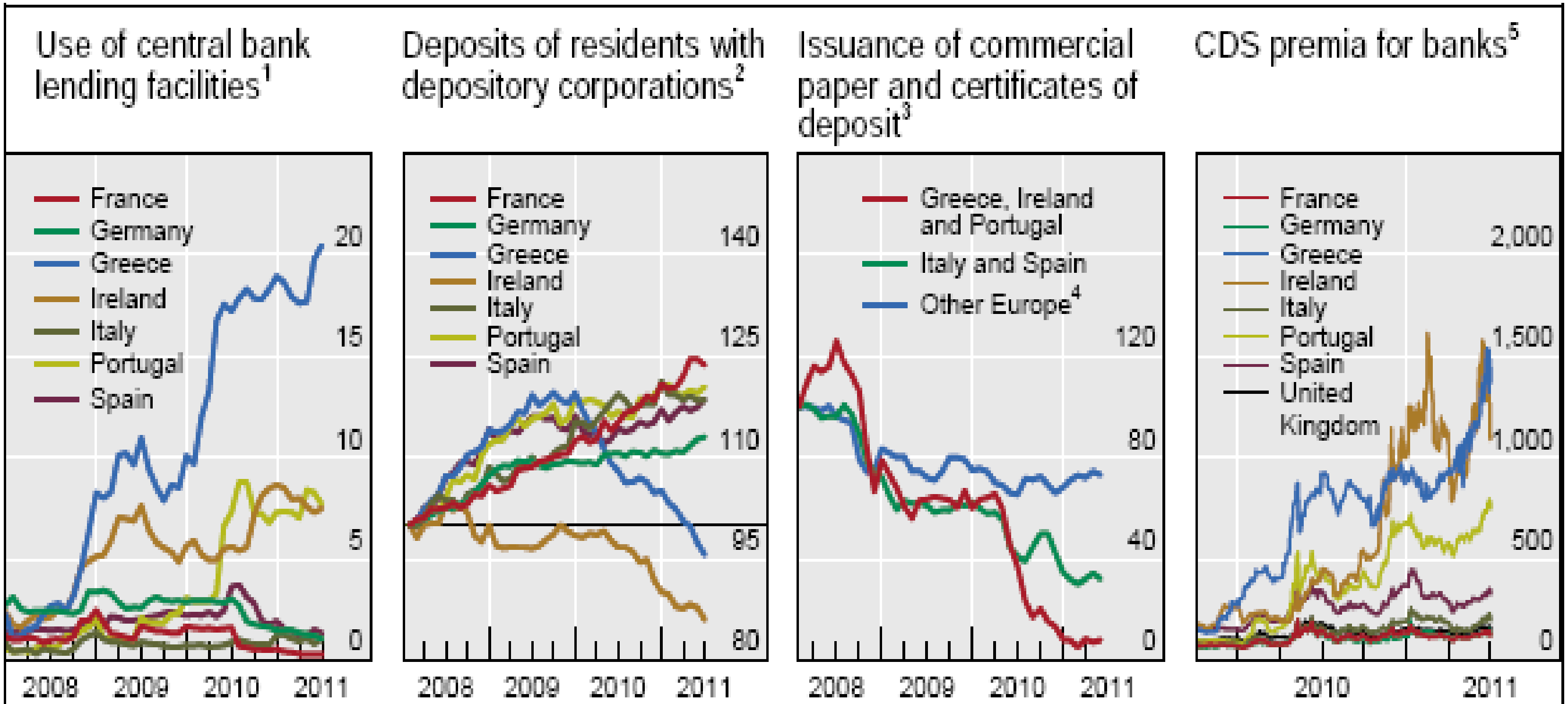


[1] OECD members aggregates; as a percentage of GDP. The financial balance is the headline surplus or deficit, including one-off items. Data for 2011 and 2012 are forecasts. [2] Five-year on-the-run CDS spreads, in basis points. [3] Average of Fitch, Moody's and Standard & Poor's foreign currency long-term sovereign ratings.

CDS, or credit default swaps, are premium paid by protection buyer to the seller

Source: Bank for International Settlements

…plunge Europe into recession. Indeed, the heightened sensitivity of rating agencies to sovereigns fiscal positions…



[1] Central bank loans as a share of total bank assets; in per cent. [2] Excludes deposits with central banks and other financial institutions; adjusted for securitisation; January 2008 = 100. [3] In the United States and euro markets. End-of-month outstanding stock; January 2008 = 100. [4] Includes the United Kingdom. [5] For each country, the simple average of five-year CDS premia on senior bonds issued by the major banks.

CDS, or credit default swaps, are premium paid by protection buyer to the seller

Source: Bank for International Settlements

… places SA at risk of multiple ratings downgrades as counter-cyclical fiscal policy has resulted in …

		S & P	Moody's	Fitch	R & I
Brazil	(BRICS member and 7th largest economy globally)	BBB-	Baa2	BBB	BBB
Russia	(BRICS member and 11th largest economy globally)	BBB	Baa1	BBB	NR
India	(BRICS member and 9th largest economy globally)	BBB-	Baa3	BBB-	BBB+
China	(BRICS member and 2nd largest economy globally)	AA-	Aa3	A+	A+
South Africa	(BRICS member and 29th largest economy globally)	BBB+	**A3**	BBB+	A-
Portugal	(PIIGS constituent and 38th largest economy globally)	**BBB-**	**Ba2**	**BBB-**	**BBB-**
Ireland	(PIIGS constituent and 38th largest economy globally)	**BBB+**	**Ba1**	**BBB+**	**BBB+**
Italy	(PIIGS constituent and 38th largest economy globally)	**Au**	**A2**	**A+**	**AA**
Greece	(PIIGS constituent and 38th largest economy globally)	**CC**	**Ca**	**CCC**	**CC**
Spain	(PIIGS constituent and 38th largest economy globally)	**AA**	**Aa2**	**AA-**	**AA**
US	(Largest economy)	AA+	Aaa	AAA	AAA
Japan	(Third largest economy)	AA-	Aa3	AA	AAA
Germany	(Fourth largest economy)	AAA	Aaa	AAA	AAA
France	(Fifth largest economy)	AAA	Aaa	AAA	AAA
UK	(Sixth largest economy)	AAA	Aaa	AAA	AAA
Canada	(Tenth largest economy)	AAA	Aaa	AAA	AAA
Australia	(Thirteenth largest economy)	AAA	Aaa	AA+	AAA

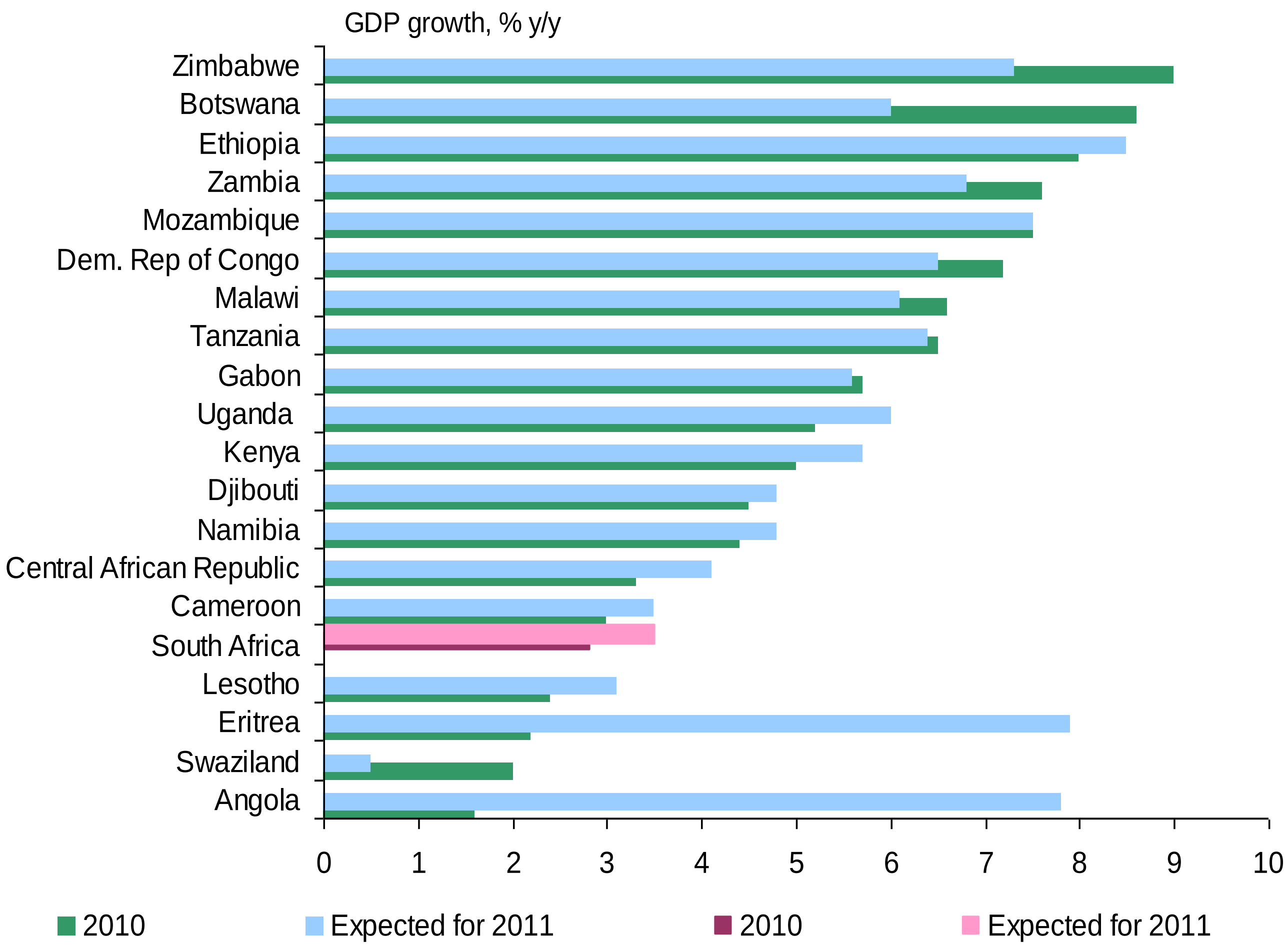
Source: SARB, Investec Group Economics

… fiscal slippage at the same time as political tensions within different factions of the ruling party have escalated.

	Australia (AAA) Stable outlook	Canada (AAA) Stable outlook	New Zealand AA+ Stable outlook	South Africa (BBB+) Stable outlook
Sound banking sector	Yes	Yes	Yes	Yes
Low government debt	Yes	Yes	Yes	Yes
Economic resilience	Yes	Yes	Yes	**Not as strong**
Stable government policies	Yes	Yes	Yes	Yes
Flexible monetary & fiscal policy	Yes	Yes	Yes	Yes
Open economy	Yes	Yes	Yes	Yes
Low unemployment rate	Yes	Yes	Yes	**No**
Politically stable	Yes	Yes	Yes	Yes
High GDP per capita	Yes	Yes	Yes	**No**
Efficient government bureaucracy	Yes	Yes	Yes	**No**
Independent central bank	Yes	Yes	Yes	Yes

Source: SARB, Investec Group Economics

SA is well placed to take advantage of Africa's growth potential but needs to build its export and productive capability to do so, particularly in services and tourism.



Source: IMF

Conclusion:

- SA fortunes are tied to the global economy. However, specific domestic factors, such as the growing middle class and counter-cyclical government spending (including rapidly increasing job creation and salary levels in the public sector), provide support to growth.

- The private sector has become financially healthier over the last few years, increasingly spending on the back of rising real incomes, not credit. Consumer spending remains the driver of growth in the absence of much spend on fixed investment.

- Inflation is rising in SA on the back of loose monetary and fiscal policy as growth slows. Stagflation is not the reality yet, but Moody's has put SA (and its large banks) on rating watch due to fiscal slippage: SA's has revised up both its fiscal deficits and the period over which fiscal consolidation occurs. A further loosening will likely be met by a downgrade from all the rating agencies, not just Moody's, and upward pressure on interest rates.

- The modest pace of economic activity will likely persist until the global recovery strengthens. However, on a longer-term basis stronger growth and improved job creation is likely, providing government quickly rectifies its management constraints which are so severely impeding service delivery. This can, and should, be done by rapidly partnering with the private sector.

- We expect economic growth of 3.2% y/y this year. Previously we forecast 3.5% in 2012 as the domestic economy returned to trend, but now it looks more likely this outcome will be closer to 2.5% y/y. However, the required growth of 6-7% (in order to meaningfully reduce unemployment) will not be sustainably achieved unless labour markets become flexible, and the capacity to effectively deliver strong growth in fixed investment improves substantially.

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