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INSURANCE SECTOR EDUCATION
AND TRAINING AUTHORITY

LEARNER GUIDE

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| Unit Standard Title: | Apply basic economic principles to the financial services sector |
| Unit Standard No: | 230071 |
| Unit Standard Credits: | 5 |
| NQF Level: | 5 |

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Apply basic economic principles to the financial services sector

Introduction

Following the global economic recession, South Africa's economy slowed in 2008/09 from almost 5% a year to 2.5% in 2012. The IMF expects South Africa's economy to grow to 2.8% in 2013.

This module looks at the application of the basic economic principles to the financial sector.

Module 1

The basic principles of economics

This Module deals with:

- The economic cycle with reference to recession, depression, recovery and boom.
- The concepts of demand, supply and equilibrium with examples from a selected sector.
- The concepts of nominal and effective/real compared with reference to interest rates and how these affect the Gross Domestic Product (GDP).

1.1 The economic cycle with reference to recession, depression, recovery and boom.

The term economic cycle refers to economy-wide fluctuations in production or economic activity over several months or years. These fluctuations occur around a long-term growth trend, and typically involve shifts over time between periods of relatively rapid economic growth (expansion or boom), and periods of relative stagnation or decline (contraction or recession).

These fluctuations are often measured using the growth rate of real gross domestic product. Despite being termed cycles, most of these fluctuations in economic activity do not follow a mechanical or predictable periodic pattern.

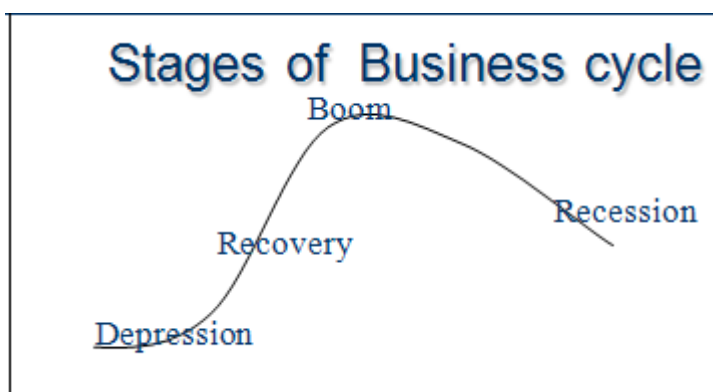
Four phases of an economic cycle:

The "four-phases" of a cycle: boom- recession-depression-recovery. Starting from the mean, a boom is a rise which lasts until the peak is reached; a recession is the drop from the peak back to the mean; a depression is the slide from the mean down to the trough; a recovery is the rise from the trough back up to the mean. From the mean, we then move up into another boom and thus the beginning of another four-phase cycle. In a sense, any cycle of whatever duration can be described as going

through these four phases - otherwise the fluctuations cannot really be described as "cycles".

The belief of the business cycle theorist is that the economy, somehow, goes through such waves of economic activity. However, what precisely causes the economy to exhibit this type of activity has been a source of many divisive, yet imaginative, exercises.

Like all business cycle theorists of old, we should be acquainted with a few empirical facts. First and foremost, empirical evidence shows that throughout the 19th Century, the price level oscillated heavily while output was much less subject to fluctuations. Thus, the early analysis of "cycles" was based precisely on their definition as swings in price levels and not output. However, during the 20th Century, save for a few exceptions, there has normally been a constant upward trend in prices. Prices varied, of course, but only around this upward trend. Output, however, oscillated heavily in the 20th century - thus what were defined as "cyclical" were movements in output: in recessions and depressions, output would collapse; in the recovery and boom, output would increase. Thus, defining the "cycle" or even a "crisis" as a movement in output is a rather recent phenomenon.



- **Recession**

In economics, a **recession** is a business cycle contraction, a general slowdown in economic activity over a period of time. During recessions, many macroeconomic indicators vary in a similar way. Production as measured by Gross Domestic Product (GDP), employment, investment spending, capacity utilization, household incomes, business profits and inflation all fall during recessions; while bankruptcies and the unemployment rate rise.

Recessions are generally believed to be caused by a widespread drop in spending. Governments usually respond to recessions by adopting expansionary macroeconomic policies, such as increasing money supply, increasing government spending and decreasing taxation.

Predictors of a recession

Although there are no completely reliable predictors, the following are regarded to be possible predictors.

- Inverted yield curve, the model uses yields on 10-year and three-month Treasury securities as well as the Fed's overnight funds rate. It is, however, not a definite indicator
- The three-month change in the unemployment rate and initial jobless claims.
- Index of Leading (Economic) Indicators
- Lowering of Home Prices. Lowering of home prices or value, too much personal debts.

Impact of recessions

Unemployment

The full impact of a recession on employment may not be felt for several quarters. Research in Britain shows that low-skilled, low-educated workers and the young are most vulnerable to unemployment in a downturn. After recessions in Britain in the 1980s and 1990s, it took five years for unemployment to fall back to its original levels.

Business

Productivity tends to fall in the early stages of a recession, and then rises again as weaker firms close. The variation in profitability between firms rises sharply. Recessions have also provided opportunities for anti-competitive mergers, with a negative impact on the wider economy: the suspension of competition policy in the United States in the 1930s may have extended the Great Depression.

Social effects

The living standards of people dependent on wages and salaries are more affected by recessions than those who rely on fixed incomes or welfare benefits. The loss of a job is known to have a negative impact on the stability of families, and individuals' health and well-being.

- **Depression**

In economics, a depression is a sustained, long-term downturn in economic activity in one or more economies. It is a more severe downturn than a recession, which is seen by economists as part of a normal business cycle.

Considered a rare and extreme form of recession, a depression is characterized by its length, and by abnormal increases in unemployment, falls in the availability of credit, shrinking output and investment, numerous bankruptcies, reduced amounts of trade and commerce, as well as highly volatile relative currency value fluctuations, mostly devaluations. Price deflation, financial crisis and bank failures are also common elements of a depression.

- **Recovery**

Economic recovery is the end of a recession or depression, marked by renewed growth after the slump in the business cycle.

- **Boom Phase**

As the recovery gather momentum, obstructions begin to appear in economy. Higher demand of goods and services leads to shortage of labour and materials. Companies will not be able to produce the required quantities. The price will increase in response and also there will be an increase in import of the services and goods to satisfy the demands. This will lead to current account surplus to fall or even become negative.

Demands for goods and service will remain high and interest rate will increase due to high demand for credits.

1.2 The concepts of demand, supply and equilibrium with examples from a selected sector.

In economics, demand is the desire to own anything and the ability to pay for it and willingness to pay. The term demand signifies the ability or the willingness to buy a particular commodity at a given point of time. Demand is also defined elsewhere as a measure of preferences that is weighted by income.

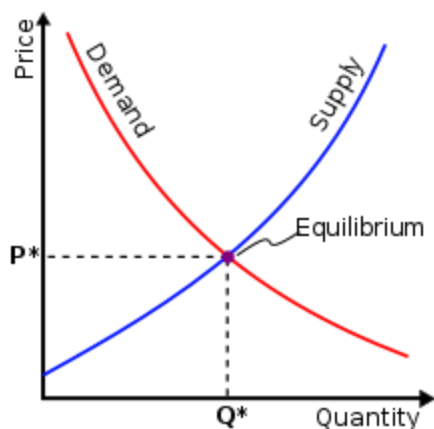
Economists record demand on a demand schedule and plot it on a graph as an inverse (downward sloping) demand curve. The inverse curve reflects the relationship between price and quantity demanded: as price decreases, quantity demanded increases. The demand curve is equal to the marginal utility (benefit) curve. If there are no externalities, the demand curve is also equal to the social utility (benefit) curve.

Factors affecting demand

- Innumerable factors and circumstances could affect a buyer's willingness or ability to buy a good. Some of the more common factors are:
- Good's own price: The basic demand relationship is between the price of a good and the quantity supplied.
- Price of related goods: The principal related goods are complements and substitutes. A complement is a good that is used with the primary good.
- Income: The more money you have the more likely you are to buy a good.
- Taste or preferences: The greater the desire to own a good the more likely you is to buy the good. There is a basic distinction between desire and demand. Desire is a measure of the willingness to buy a good. Demand is the willingness and ability to affect one's desires. It is assumed that tastes and preferences are relatively constant.
- Consumer expectations about future prices and income: If a consumer believes that the price of the good will be higher in the future he is more likely to purchase the good now. If the consumer expects that her income will be higher in the future the consumer may buy the good now. In other words positive expectations about future income may encourage present consumption (Demand increases).

This list is not exhaustive. All facts and circumstances that a buyer finds relevant to his willingness or ability to buy goods can affect demand. For example, a person caught in an unexpected storm is more likely to buy an umbrella than if the weather were bright and sunny.

In economics, supply is the amount of some product which will be available to customers. Usually, supply is plotted as a supply curve showing the relationship of price to the amount of product businesses are willing to sell.



Factors affecting supply

Innumerable factors and circumstances could affect a seller's willingness or ability to produce and sell a good. Some of the more common factors are:

- **Goods own price:** The basic supply relationship is between the price of a good and the quantity supplied.
- **Price of related goods:** For purposes of supply analysis related goods refer to goods from which inputs are derived to be used in the production of the primary good. **Technology:** Technology is the way inputs are combined to produce a final good. A technological advance would cause the average cost of production to fall which would be reflected in an outward shift of the supply curve.
- **Expectations:** Sellers expectations concerning future market condition can directly affect supply. If the seller believes that the demand for his product will sharply increase in the foreseeable future the firm owner may immediately increase production in anticipation of future price increases. The supply curve would shift out. Note that the outward shift of the supply curve may create the exact condition the seller anticipated, excess demand.
- **Price of inputs:** Inputs include land, labour, energy and raw materials. If the price of inputs increases the supply curve will shift in as sellers are less willing or able to sell goods at existing prices. For example, if the price of electricity increased a seller may reduce his supply because of the increased costs of production. The seller is likely to raise the price the seller charges for each unit of output.
- **Government policies and regulations:** Government intervention can have a significant effect on supply.

- Government intervention can take many forms including environmental and health regulations, hour and wage laws, taxes, electrical and natural gas rates and zoning and land use regulations.

It should be emphasized that this list is not exhaustive. All facts and circumstances that are relevant to a seller's willingness or ability to produce and sell goods can affect supply. For example, if the forecast is for snow retail sellers will respond by increasing their stocks of snow sleds or skis or winter clothing or bread and milk.

In economics, economic equilibrium is simply a state of the world where economic forces are balanced and in the absence of external influences the (equilibrium) values of economic variables will not change. It is the point at which quantity demanded and quantity supplied is equal. Market equilibrium, for example, refers to a condition where a market price is established through competition such that the amount of goods or services sought by buyers is equal to the amount of goods or services produced by sellers. This price is often called the equilibrium price or market clearing price and will tend not to change unless demand or supply change.

When the price is above the equilibrium point there is a surplus of supply; where the price is below the equilibrium point there is a shortage in supply.

Different supply curves and different demand curves have different points of economic equilibrium. In most simple microeconomic stories of supply and demand in a market a static equilibrium is observed in a market; however, economic equilibrium can exist in non-market relationships and can be dynamic. Equilibrium may also be multi-market or general, as opposed to the partial equilibrium of a single market.

In economics, the term equilibrium is used to suggest a state of "balance" between supply forces and demand forces. For example, an increase in supply will disrupt the equilibrium, leading to lower prices. Eventually, a new equilibrium will be attained in most markets. Then, there will be no change in price or the amount of output bought and sold — until there is an exogenous shift in supply or demand (such as changes in technology or tastes). That is, there are no endogenous forces leading to the price or the quantity.

Not all economic equilibria are stable. For an equilibrium to be stable, a small deviation from equilibrium leads to economic forces that returns an economic sub-system toward the original equilibrium. For example, if a movement out of supply/demand equilibrium leads to an excess supply (glut) that induces price declines which return the market to a situation where the quantity demanded equals the quantity supplied. If supply and demand curves intersect more than once, then both stable and unstable equilibria are found.

1.3 The concepts of nominal and effective/real compared with reference to interest rates and how these affect the Gross Domestic Product (GDP).

In finance and economics nominal interest rate or nominal rate of interest refers to the rate of interest before adjustment for inflation (in contrast with the real interest rate); or, for interest rates "as stated" without adjustment for the full effect of compounding (also referred to as the nominal annual rate). An interest rate is called *nominal* if the frequency of compounding (e.g. a month) is not identical to the *basic time unit* (normally a year).

- **Nominal versus real interest rate**

The real interest rate includes both inflation and the real rate of interest. In the case of a loan, this real interest the lender receives as income. If lender is receiving 8 percent from a loan and inflation is 8 percent, then the real rate of interest is zero because nominal interest and inflation are equal. A lender would have no net benefit from such a loan because inflation fully diminishes the value of the loan's profit.

The relationship between real and nominal interest rates can be described in the equation:

$(1 + r)(1 + i) = (1 + R)$ where r is the real interest rate, i is the inflation rate, and R is the nominal interest rate.

A common approximation for the real interest rate is:

real interest rate = nominal interest rate - expected inflation

In this analysis, the nominal rate is the stated rate, and the real interest rate is the interest after the expected losses due to inflation. Since the future inflation rate can only be estimated, the *ex ante* and *ex post* (before and after the fact) real interest rates may be different; the premium paid to actual inflation may be higher or lower. In contrast, the nominal interest rate is known in advance.

- **Nominal versus effective interest rate**

The nominal interest rate is the periodic interest rate times the number of periods per year. For example, a nominal annual interest rate of 12% based on monthly compounding means a 1% interest rate per month (compounded). A nominal interest rate for compounding periods less than a year is always lower than the equivalent rate with annual compounding. A nominal rate without the compounding frequency is not fully defined: for any interest rate, the effective interest rate cannot be specified without knowing the compounding frequency *and* the rate. Although some conventions are used where the compounding frequency is understood, consumers in particular may fail to understand the importance of knowing the effective rate.

Nominal interest rates are not comparable unless their compounding periods are the same; effective interest rates correct for this by "converting" nominal rates into annual compound interest. In many cases, depending on local regulations, interest rates as quoted by lenders and in advertisements are based on nominal, not effective interest rates, and hence may understate the interest rate compared to the equivalent effective annual rate.

The term should not be confused with simple interest (as opposed to compound interest). Simple interest is interest that is not compounded.

The effective interest rate is always calculated as if compounded annually. The effective rate is calculated in the following way, where r is the effective rate, i the nominal rate (as a decimal, e.g. 12% = 0.12), and n the number of compounding periods per year (for example, 12 for monthly compounding):

$$r = (1 + i/n)^n - 1$$



Module 2

The use of economic indicators

This Module deals with:

- The concept of inflation in terms of headline inflation, core inflation, CPIX and deflation
- The concept of GDP in terms of consumer expenditure, government expenditure, investment and export minus trade balance (C+I+G+(X-M).
- The concept of interest rates in terms of prime, money markets, repro and borrowing rates.
- The concept of an economic indicator and an indication of the relationship between inflation, GDP, interest rates, money supply, debt, currency, current account, trade account, gold, platinum and oil

2.1 The concept of inflation in terms of headline inflation, core inflation, CPIX and deflation

Headline inflation is a measure of the total inflation within an economy and is affected by areas of the market which may experience sudden inflationary spikes such as food or energy. As a result, headline inflation may not present an accurate picture of the current state of the economy. This differs from core inflation which excludes factors, such as food and energy costs.

Core inflation is a measure of inflation which excludes certain items that face volatile price movements, notably food and energy.

The consumer price index (CPI) is the official measure of inflation in South Africa. One variant, the consumer price for all urban areas (CPIX), is officially targeted by the South African Reserve Bank and a primary measure that determines national interest rates.

In connection with inflation the Consumer Price Index (1) (CPI) shows the movement of retail prices and is published monthly in the Government Gazette. These figures, provided as a month-on-month as well as a year-to-year change, give an indication of the degree of inflation.

The Consumer Price Index is reflected as two different figures. The first of these is – (2) “Headline Inflation” - is the official inflation rate and is based on an average of the prices of goods and services as compiled by Statistics South Africa.

The (3) “Core’ inflation rate is measured by removing from the index goods with volatile prices such as fresh meat, fish and vegetables, interest rates, VAT and municipal rates. This rate is meant to capture the underlying inflation pressures in the economy.

When the South African authorities decided to adopt inflation targeting in 2000, they had to choose between headline and core inflation or something in-between. It was decided to use the rate calculated on the basis of CPI or headline inflation but to exclude mortgage rates only, and this rate is called the (4) CPIX. In 2009 this was again revised in what is generally known as the new weighted CPI. (In reality in some ways it doesn't really matter which index one uses, as it is simply a measure of the changes in prices, which will obviously affect different people in different ways, depending on what they spend their money on.)

Economists generally agree that the "core" rate of inflation is of far greater importance as an economic indicator and an indicator of government, and the SA Reserve Bank's monetary policies.

Another related measure is the (5) Producer or Production Price Inflation rate (PPI), which tracks the escalation in costs at the level of the source producer.

In economics, deflation is a decrease in the general price level of goods and services. Deflation occurs when the annual inflation rate falls below zero percent (a negative inflation rate), resulting in an increase in the real value of money – allowing one to buy more goods with the same amount of money. This should not be confused with disinflation, a slow-down in the inflation rate (i.e. when inflation decreases, but still remains positive). As inflation reduces the real value of money over time, conversely, deflation increases the real value of money – the functional currency (and monetary unit of account) in a national or regional economy.

Deflation is also linked with recessions and with the Great Depression, as banks defaulted on depositors. Additionally, deflation also prevents monetary policy from stabilizing the economy because of a mechanism called the liquidity trap. However, historically not all episodes of deflation correspond with periods of poor economic growth.

2.2 The concept of GDP in terms of consumer expenditure, government expenditure, investment and export minus trade balance (C+I+G+(X-M).

The gross domestic product (GDP) or gross domestic income (GDI) is a measure of a country's overall economic output. It is the market value of all final goods and services made within the borders of a country in a year. It is often positively correlated with the standard of living, though its use as a stand-in for measuring the standard of living has come under increasing criticism and many countries are actively exploring alternative measures to GDP for that purpose.

GDP can be determined in three ways, all of which should in principle give the same result. They are the product (or output) approach, the income approach, and the expenditure approach.

The most direct of the three is the product approach, which sums the outputs of every class of enterprise to arrive at the total. The expenditure approach works on the principle that all of the product must be bought by somebody, therefore the value

of the total product must be equal to people's total expenditures in buying things. The income approach works on the principle that the incomes of the productive factors ("producers," colloquially) must be equal to the value of their product, and determines GDP by finding the sum of all producers' incomes.

Example: the expenditure method:

$GDP = \text{private consumption} + \text{gross investment} + \text{government spending} + (\text{exports} - \text{imports})$, or

$$GDP = C + Inv + G + (eX - i)$$

In the name "Gross Domestic Product,"

"Gross" means that GDP measures production regardless of the various uses to which that production can be put. Production can be used for immediate consumption, for investment in new fixed assets or inventories, or for replacing depreciated fixed assets. If depreciation of fixed assets is subtracted from GDP, the result is called the Net domestic product; it is a measure of how much product is available for consumption or adding to the nation's wealth. In the above formula for GDP by the expenditure method, if net investment (which is gross investment minus depreciation) is substituted for gross investment, then net domestic product is obtained.

"Domestic" means that GDP measures production that takes place within the country's borders. In the expenditure-method equation given above, the exports-minus-imports term is necessary in order to null out expenditures on things not produced in the country (imports) and add in things produced but not sold in the country (exports).

Economists have preferred to split the general consumption term into two parts; private consumption, and public sector (or government) spending. Two advantages of dividing total consumption this way in theoretical macroeconomics are:

Private consumption is a central concern of welfare economics. The private investment and trade portions of the economy are ultimately directed (in mainstream economic models) to increases in long-term private consumption.

If separated from endogenous private consumption, government consumption can be treated as exogenous, so that different government spending levels can be considered within a meaningful macroeconomic framework.

- **Expenditure approach**

In contemporary economies, most things produced are produced for sale, and sold. Therefore, measuring the total expenditure of money used to buy things is a way of measuring production. This is known as the expenditure method of calculating GDP. Note that if you knit yourself a sweater, it is production but does not get counted as GDP because it is never sold. Sweater-knitting is a small part of the economy, but if one counts some major activities such as child-rearing (generally unpaid) as production, GDP ceases to be an accurate indicator of production.

- **Components of GDP by expenditure**

GDP (Y) is a sum of Consumption (C), Investment (I), Government Spending (G) and Net Exports (X - M).

$$Y = C + I + G + (X - M)$$

Here is a description of each GDP component:

C (consumption) is normally the largest GDP component in the economy, consisting of private (household final consumption expenditure) in the economy. These personal expenditures fall under one of the following categories: durable goods, non-durable goods, and services. Examples include food, rent, jewellery, gasoline, and medical expenses but do not include the purchase of new housing.

I (investment) include business investment in equipment for example and do not include exchanges of existing assets. Examples include construction of a new mine, purchase of [software], or purchase of machinery and equipment for a factory. Spending by households (not government) on new houses is also included in Investment. In contrast to its colloquial meaning, 'Investment' in GDP does not mean purchases of financial products. Buying financial products is classed as 'saving', as opposed to investment. This avoids double-counting: if one buys shares in a company, and the company uses the money received to buy plant, equipment, etc., the amount will be counted toward GDP when the company spends the money on those things; to also count it when one gives it to the company would be to count two times an amount that only corresponds to one group of products. Buying bonds or stocks is a swapping of deeds, a transfer of claims on future production, not directly an expenditure on products.

G (government spending) is the sum of government expenditures on final goods and services. It includes salaries of public servants, purchase of weapons for the military, and any investment expenditure by a government. It does not include any transfer payments, such as social security or unemployment benefits.

X (exports) represents gross exports. GDP captures the amount a country produces, including goods and services produced for other nations' consumption, therefore exports are added.

M (imports) represents gross imports. Imports are subtracted since imported goods will be included in the terms G, I, or C, and must be deducted to avoid counting foreign supply as domestic.

A fully equivalent definition is that GDP (Y) is the sum of final consumption expenditure (FCE), gross capital formation (GCF), and net exports (X - M).

$$Y = FCE + GCF + (X - M)$$

FCE can then be further broken down by three sectors (households, governments and non-profit institutions serving households) and GCF by five sectors (non-financial corporations, financial corporations, households, governments and non-profit institutions serving households). The advantage of this second definition is that expenditure is systematically broken down, firstly, by type of final use (final consumption or capital formation) and, secondly, by sectors making the expenditure,

whereas the first definition partly follows a mixed delimitation concept by type of final use and sector.

Note that C, G, and I are expenditures on final goods and services; expenditures on intermediate goods and services do not count. (Intermediate goods and services are those used by businesses to produce other goods and services within the accounting year).

- **Examples of GDP component variables**

C, I, G, and NX (net exports): If a person spends money to renovate a hotel to increase occupancy rates, the spending represents private investment, but if he buys shares in a consortium to execute the renovation, it is saving. The former is included when measuring GDP (in I), the latter is not. However, when the consortium conducted its own expenditure on renovation, that expenditure would be included in GDP.

If a hotel is a private home, spending for renovation would be measured as consumption, but if a government agency converts the hotel into an office for civil servants, the spending would be included in the public sector spending, or G.

If the renovation involves the purchase of a chandelier from abroad, that spending would be counted as C, G, or I (depending on whether a private individual, the government, or a business is doing the renovation), but then counted again as an import and subtracted from the GDP so that GDP counts only goods produced within the country.

If a domestic producer is paid to make the chandelier for a foreign hotel, the payment would not be counted as C, G, or I, but would be counted as an export.

2.3 The concept of interest rates in terms of prime, money markets, repro and borrowing rates.

An interest rate is the price a borrower pays for the use of money they borrow from a lender, for instance a small company might borrow capital from a bank to buy new assets for their business, and the return a lender receives for deferring the use of funds, by lending it to the borrower. Interest rates are fundamental to a capitalist society. Interest rates are normally expressed as a percentage rate over the period of one year.

Interest rates targets are also a vital tool of monetary policy and are taken into account when dealing with variables like investment, inflation, and unemployment.

- **Market interest rates**

There is a market for investments which ultimately includes the money market, bond market, stock market and currency market as well as retail financial institutions like banks. The money market is used by participants as a means for borrowing and lending in the short term, from several days to just under a year.

Exactly how these markets function is a complex question. However, economists generally agree that the interest rates yielded by any investment take into account:

- The risk-free cost of capital
- Inflationary expectations
- The level of risk in the investment
- The costs of the transaction
- This rate incorporates the deferred consumption and alternative investments elements of interest.

Prime rate, or Prime Lending Rate, is a term applied in many countries to a reference interest rate used by banks. The term originally indicated the rate of interest at which banks lent to favoured customers, i.e., those with high credibility, though this is no longer always the case. Some variable interest rates may be expressed as a percentage above or below prime rate.

The prime rate is used often as an index in calculating rate changes to adjustable rate mortgages (ARM) and other variable rate short term loans. It is used in the calculation of some private student loans. Many credit cards and home equity lines of credit with variable interest rates have their rate specified as the prime rate (index) plus a fixed value commonly called the spread or margin.

The repo rate may be termed as the discount rate at which a Reserve bank repurchases government securities from the commercial banks that largely depends on the level of money supply it decides to maintain in the country's monetary system. It is when banks have any shortage of funds they borrow it from the Reserve bank. Any reduction in repo rate helps the bank to avail funds at cheaper rates. An increase in repo rate, on the other hand, curtails the borrowing power of banks as borrowing becomes quite expensive.

This Reserve bank acts as a banker for private banks. The last destination of banks when they fall short of cash or need liquidity on a regular basis is the Reserve bank. The repo rate system works on the temporary sale of financial asset by the bank in return for the needed cash from the lender. Thus, borrowing and lending works largely on the policy of give and take.

It is when repo rate increases banks have to pay more for repo funds. Thus, for maintaining their existing profit they raise the interest rates and charge high rate of interest from their customers to balance the profit margin. This in turn, facilitates a rise in the interest rate and helps to control inflation by reducing the demand for the credit which could be spent on the purchase of goods and services. Thus, repo rate not only serves as a benchmark for the level of short-term interest but also for deciding and balancing inflation.

In order to tame inflation, banks sell their securities at a discount price called repo rate. They sell their securities like treasury bills for a limited short period of time. Banks are eligible for repurchasing the bill at its face value after specified amount of time. Therefore, high repo rate absorb the liquidity from the bank to lend more money to the customers and thus it helps to stabilize the rising inflation.

Repo rate is determined at each meeting by the bank of its Monetary Policy Committee which is generally known as the formulation and implementation of monetary policy. Monetary policy is conducted with the objective of targeting inflation.

At the time of setting monetary policy the Bank decides and focuses on the short-term interest rates which are all the more necessary to meet the inflation target. The Monetary Policy Committee of the Bank is looking after a range of economic factors with domestic and internationally that has a bearing on future inflation. The demand for the money, overall lending policies of the banks, and credit in the economy is influenced by the monetary policy committee decisions. If the MPC indicates that with an unchanged repo rate inflation decline, the committee will reduce the repo rate, and if committee indicates that with an unchanged repo rate inflation rise, it tends to rise.

Since the Reserve Bank efficiently permits repo rate to be transmitted to the economy, it plays an active and vital role in stimulating the development of the effective application of monetary policy measures which are the capital markets and relatively free and efficient money. At last, Repo rate cut will encourage the banks to prepare their deposits rates in advance, eventually bringing down the cost of funds.

2.4 The concept of an economic indicator and an indication of the relationship between inflation, GDP, interest rates, money supply, debt, currency, current account, trade account, gold, platinum and oil

Most of these factors are predictable. The traditional “predictable” economic cycles experienced during the period when SA ran only closed economy due to forced sanctions, have no become far less predictable:

- **Inflation** affects the availability of cash, but tends to improve shares market prices
- **Unemployment rates** impact on investment and sentiment
- **Mergers and takeovers** have a direct effect on the market
- **The economic cycle** affects availability of money and investment returns, while changes in the general investment arena may either cause clients to switch in or out of equities.
- **The commodities price** affects the economy as a whole as well as shares in that specific sector. Platinum, coal and gold for South Africa.

The main effect of government policy on equity markets is as follows:

- **Interest rates**

The market is adversely affected when the ruling interest rate is raised. Higher interest rates dampen consumer demand and because the higher cost of capital will push the corporate cost up, thereby negatively impacting on the profit margin. This, coupled with the attraction of the higher interest rate, will also tend to see investment money channelled into fixed interest avenues, thereby further depressing the market as demand for shares falls off.

- **Taxation**

The tax structure of a company can impact on shares:

- Through impacting on the actual bottom line of the company; and
- How the investors experience tax on the shares

At a lower level the different tax treatment of different industries may make the shares of companies in those industries more or less attractive to investors.

- **International aspects**

The extent to which international investment is attracted is an important influence on the stock market and shares in general. In turn, this will depend on a variety of factors, including currency exchange rates, tax treatment and the extent to which free trade and movement of funds is allowed between countries.

- **Economic Indicators**

This refers to key statistics which indicate the direction an economy is going. Economic indicators allow analysis of economic performance and predictions of future performance. In investment decisions, economic factors are very important. Example: The trends in interest rates and industrial production are items of concern for the investor. Interest rates can be directly influenced by government policy but other questions arise, such as trends in consumer sales and capital investment, as the different aspects are all intertwined.

For comparing the prospect for one industry against another these factors are relevant to a consideration of individual industries.

Example: The prospect for a particular company, which operates in a specific sector of industry.

From an investment viewpoint the purpose of studying economic data is, however, usually to forecast the future. Consequently the greatest care is essential, bearing in mind that forecasts are necessarily based on assumptions, and this raises questions as to the validity of the assumptions made.

- **Money Supply**

The money supply is regarded as being relevant. One view is that many economic problems, including inflation, can be traced to excess in money supply, although others doubt this. Most, however, probably feel that the supply of money affects the fixed interest market more directly than the general equity market.

- **Balance of payments**

South Africa trades internationally, therefore the balance of payments figures are of great importance. Trade depends on imports and exports and, while internal policies can influence both, external influences, such as a recession in other parts of the world, and particularly the state of the economy of the USA, have significant effect.

- **Commodity Prices**

The balance of payments and the economic welfare of South Africa are greatly impacted by the gold price. The world prices of platinum, diamonds and other minerals that are exported, such as coal, also have a significant effect, while the

importance of the oil price is not to be forgotten. Commodity prices and their effect on the general economy can have an impact on interest rate decisions.

- **Reserves**

The figures relating to the level of South Africa's reserves, which are published by the SA Reserve Bank, must be monitored closely as they are of importance to investors and can also result in interest rate changes.

- **The Consumer Price Index**

The Consumer Price Index shows the movement of retail prices and is the measure used for inflation. There is typically quite a strong correlation between the rate of inflation and interest rates, since interest rates are often raised in order to dampen inflationary pressures in the market.

- **Other indicators**

Figures are also published by the SA Reserve Bank when there is a new issue of stock to investors for cash. In times of heavy new issue activity, large sums of money can be taken out of investor's pockets and this usually has an effect on stock exchange prices. Consumer expenditure is another statistic relevant to an investment. Cars and household wares are more important as they are more sensitive to economic cycle. Hire purchase sales, which are published monthly, are an important indicator of consumer durable expenditure. The Central Statistics Services publishes detailed figures covering a wide range of activities.

- **Currencies**

The stability of the rand against major international currency also has a direct effect on our market. A foreign investor would require a currency to be stable to obtain maximum benefit from the return received in Rands.

- **Foreign Markets**

South Africa is one of the major emerging markets in the world. A large number of our stocks are dual listed on other stock markets in the world. Negative or positive sentiments on these markets will also influence share prices.

- **Sentiment or optimism**

Investor's sentiment can be affected by reports and company results.

- **Political Stability**

Political stability plays an important role in setting the climate for business confidence in a country and also supporting positive sentiment towards the region within the country is situated.

- **Climate**

Even the country's climate can have an effect on equities, either in the broader sense or on specific shares. Example: a serious drought will adversely affect the share price of food producers and heavy rains or other natural events may have negative effects on the share price of insurers.

Module 3

The importance of government policies in the investment environment

This Module deals with:

- The concept of monetary policy with reference to interest rates and inflation.
- The concept of fiscal policy in terms of GDP components, spending and tax.
- The government stance on fiscal and monetary policy and an indication of the implications of current policies for the investment environment.
- Current government initiatives that potentially impact on the economic environment with examples.

3.1 The concept of monetary policy with reference to interest rates and inflation.

Monetary policy is the process a government, Reserve bank, or monetary authority of a country uses to control (i) the supply of money, (ii) availability of money, and (iii) cost of money or rate of interest to attain a set of objectives oriented towards the growth and stability of the economy. Monetary theory provides insight into how to craft optimal monetary policy.

Monetary policy is referred to as either being an expansionary policy, or a contractionary policy, where an expansionary policy increases the total supply of money in the economy, and a contractionary policy decreases the total money supply. Expansionary policy is traditionally used to combat unemployment in a recession by lowering interest rates, while contractionary policy involves raising interest rates to combat inflation. Monetary policy is contrasted with fiscal policy, which refers to government borrowing, spending and taxation.

- **Inflation targeting**

Under this policy approach the target is to keep inflation, under a particular definition such as Consumer Price Index, within a desired range.

The inflation target is achieved through periodic adjustments to the Reserve bank interest rate target. The interest rate used is generally the interbank rate at which banks lend to each other overnight for cash flow purposes. Depending on the country this particular interest rate might be called the cash rate or something similar.

The interest rate target is maintained for a specific duration using open market operations. Typically the duration that the interest rate target is kept constant will vary between months and years. This interest rate target is usually reviewed on a monthly or quarterly basis by a policy committee.

The contraction of the monetary supply can be achieved indirectly by increasing the nominal interest rates. Monetary authorities in different nations have differing levels of control of economy-wide interest rates. This rate has significant effect on other

market interest rates, but there is no perfect relationship. In the open market operations are a relatively small part of the total volume in the bond market. One cannot set independent targets for both the monetary base and the interest rate because they are both modified by a single tool — open market operations; one must choose which one to control.

In other nations, the monetary authority may be able to mandate specific interest rates on loans, savings accounts or other financial assets. By raising the interest rate(s) under its control, a monetary authority can contract the money supply, because higher interest rates encourage savings and discourage borrowing. Both of these effects reduce the size of the money supply.

3.2 The concept of fiscal policy in terms of GDP components, spending and tax

In economics, fiscal policy is the use of government expenditure and revenue collection to influence the economy.

Fiscal policy can be contrasted with the other main type of economic policy, monetary policy, which attempts to stabilize the economy by controlling interest rates and the supply of money. The two main instruments of fiscal policy are government expenditure and taxation. Changes in the level and composition of taxation and government spending can impact on the following variables in the economy:

- Aggregate demand and the level of economic activity;
- The pattern of resource allocation;
- The distribution of income.

Fiscal policy refers to the overall effect of the budget outcome on economic activity. The three possible stances of fiscal policy are neutral, expansionary, and contractionary:

- A neutral stance of fiscal policy implies a balanced budget where $G = T$ (Government spending = Tax revenue). Government spending is fully funded by tax revenue and overall the budget outcome has a neutral effect on the level of economic activity.
- An expansionary stance of fiscal policy involves a net increase in government spending ($G > T$) through rises in government spending, a fall in taxation revenue, or a combination of the two. This will lead to a larger budget deficit or a smaller budget surplus than the government previously had, or a deficit if the government previously had a balanced budget. Expansionary fiscal policy is usually associated with a budget deficit.
- A contractionary fiscal policy ($G < T$) occurs when net government spending is reduced either through higher taxation revenue, reduced government spending, or a combination of the two. This would lead to a lower budget deficit or a larger surplus than the government previously had, or a surplus if the government previously had a balanced budget. Contractionary fiscal policy is usually associated with a surplus.

The idea of using fiscal policy to combat recessions was introduced by John Maynard Keynes in the 1930s, partly as a response to the Great Depression.

Government's fiscal policy seeks to support structural reforms of the South African economy consistent with long run growth, employment creation and an equitable distribution of income. It aims to promote investment and export expansion while enabling Government to finance public services, redistribution and development in an affordable and sustainable budget framework.

Fiscal policy aims Fiscal policy seeks to:

- ensure a sound and sustainable balance between Government's spending, tax and borrowing requirements;
- improve domestic savings to support a higher level of investment and reduce the need to borrow abroad;
- keep government consumption spending at an affordable level, contributing to lower inflation and a sustainable balance of payments;
- support an export-friendly trade and industrial strategy to improve South Africa's competitiveness; and
- ensure that pay increases within the public sector are market and productivity related, and are fiscally sustainable.

3.3 The government stance on fiscal and monetary policy and an indication of the implications of current policies for the investment environment.

Fiscal contraction, or fiscal consolidation, refers to fiscal policy that reduces the budget deficit.

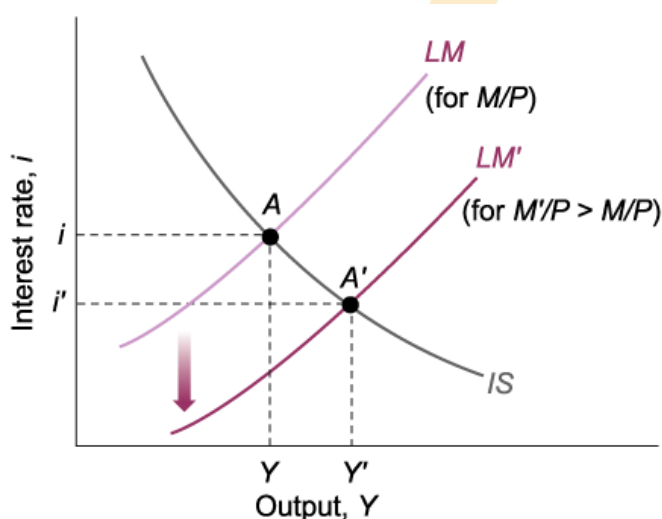
An increase in the deficit is called a fiscal expansion.

Monetary contraction, or monetary tightening, refers to a decrease in the money supply.

An increase in the money supply is called monetary expansion.

- **The Effects of a Monetary Expansion**

Monetary expansion leads to higher output and a lower interest rate.



The period of fiscal expansion, made possible by considerable economic expansion from 2001 to 2006 led to both optimism and disappointment. With four years of plus

5 per cent growth, government was confident that if it did certain things, it could accelerate growth further, sustainably. The so-called 3 per cent ceiling evident during the 1990s had been smashed. Even the most pessimistic of commentators agreed that the economy could sustain higher levels of growth without the occurrence of macroeconomic imbalances.

At the same time, government was disappointed that despite rapid economic growth and growth in public spending, many of the poorest were still not seen to be benefiting from the economic upswing. Employment was growing but not fast enough. Demand was expanding but supply could not keep up. Major areas of public service delivery were not making progress (education and the criminal justice sector being just two prominent examples). Investment was rising but savings still lagged and the export performance was moribund.

Like monetary policy, fiscal policy has long leads and lags. While government tried to increase capital spending from 2001, capital spending only really started rising in 2004. Tax cuts take time to feed into either higher consumption or higher savings. Given the nature of our budgeting system, reducing public spending growth could take two to three years to achieve.

South Africa finds itself in a very difficult economic predicament. It must slow the economy down gradually to prevent economic imbalances from destabilising the economy but at the same time, it has to increase spending significantly on the infrastructural constraints that prevent higher growth. Eskom alone intends to spend about 3 per cent of GDP a year on infrastructure in the next five years (and these investments are estimated to have about 50 per cent import intensity). Slowing government consumption expenditure is extremely difficult, especially without reducing staff numbers. The only two options out of the predicament – higher savings and faster export growth – take many years to achieve.

At present, fiscal policy has to contend with both shocks; a negative demand shock from the global economy and a negative supply shock on the domestic front. The appropriate fiscal stance is less than obvious. On balance, it would appear that a neutral fiscal stance may be appropriate. That is, a fiscal position that does not see major changes in the fiscal balance one way or the other.

3.4 Current government initiatives that potentially impact on the economic environment with examples.

Over the past years, government has been involved in processes that have formulated a number of initiatives to accelerate, deepen and share our economic growth. Central to these policy initiatives is the intention to create an enabling environment in which businesses can operate optimally.

The Local Enterprise Fund has been made possible by financial contributions jointly made by Khula Enterprise Finance under the Department of Trade and Industry, Limpopo Department of Economic Development, Environment, and Tourism and its agency, Limpopo Economic Development Enterprise.

Looking at the performance of the South African economy in the past few years, one feels that there is a great deal to be positive about. Economic growth is at its highest level in almost 2 decades, business confidence has also risen considerably since the present government took office.

Our current growth trajectory is further being sustained by inflows of foreign investment, epitomising the confidence which foreign investors continue to display in the performance and sustainability of the South African economy. However, if we look closely at the performance of our economy, we certainly note that there are areas that require further work that is aimed at improving our performance as follows:

- Firstly, although current growth is coupled with positive net job creation, the rate at which it is increasing is not yet one that yields significant impact on our goal of halving unemployment and poverty by 2014.
- Secondly, it is characterised by two drivers. One is consumption expenditure, which is characterized by a credit boom that is not only used to buy locally produced goods, but also absorbing an increasing volume of imports. The one potentially worrying factor in our Macro-Economic landscape is the widening deficit in the balance of trade, which essentially means that we are importing more goods than we are currently exporting.

This is contrary to the past, where the apartheid regime was forced to intervene and hived off any growth path that reached above 3 percent as a deficit on the balance of trade could not be sustained. Today we are able to do so due to high levels of confidence, which generates short-term inflows of portfolio investment from abroad. However, concerns still lie in the fact that consumption growth is outstripping production growth, creating inflationary pressures in the process, and this is a matter we need to address.

The second main driver of our current growth is the commodities boom. The rise of China and India as major economic powers that are industrialising rapidly means that there is a new and increased demand for mineral products and other primary products that are being generated.

This has caused prices for mineral products to increase, which we as South Africa are a major producer of, and has had an impact on the exchange rate movement (what kind of effect?)

Following from these observations, it has become evident that the South African economy is capable of higher levels of economic performance. Through ASGISA, Government aims to achieve its 2014 vision of 6% growth in Gross Domestic Product from 2010 onwards, as well as that of halving unemployment and poverty. In order to achieve this higher growth and development trajectory, the South African economy needs to undergo some fundamental restructuring (is this not a bit too strong? I don't think ASGISA alone entails fundamental restructuring).

In this regard, the emergence of the ASGISA initiative has enabled us to focus our minds in respect of the nature of interventions by government that can unlock challenges faced by businesses, and as well as that can take advantage of

opportunities that exist in domestic, regional and global markets. Most importantly, this initiative has forced us to revisit our patterns of targeted policy development and programmes so as to give effect to the developmental objectives that the ASGISA initiative espouses.

- **Current policy environment**

One of the interventions that ASGISA states clearly is the need for a robust industrial policy that can articulate the country's industrial development path, build on sustainable industrial capabilities.

It is important to note that the Industrial policy is not aimed at replacing the existing policy initiatives, such as Customised Sector Programmes; Integrated Small-Enterprise Development Strategy; the emerging Broad-based Black Economic Empowerment (BBBEE) Codes of Good Practice; and the National Export Strategy.

We believe that the (approximately) R370 billion worth of public investment and infrastructure programmes, which is at the heart of ASGISA, is directed at both providing facilities that are needed for economic growth, and at making a significant contribution to reducing unemployment as well as providing individuals with the opportunity to improve their lives, and to acquire skills training in the process.



Module 4

Apply the fundamentals of economics to the financial services environment

This Module deals with:

- Market response to economic performance that is higher, lower or in line with anticipated results with reference to the effect on cash, bonds, stocks and properties.
- Economic indicators that affect asset classes and global geographic selection and economic forecast applied to asset classes in order to make an investment selection.
- The current economic forecast used to suggest and substantiate an asset selection proposal.

4.1 Market response to economic performance that is higher, lower or in line with anticipated results with reference to the effect on cash, bonds, stocks and properties.

The economic and political turmoil made SA investors nervous and liquidity was uppermost in their minds. Private investors wanted to have access to their money instantly if the country was swept into chaos, as many believed it would be. Owning an office building that might take six months to a year to sell didn't suit their needs. They turned to more liquid or mobile cash, bonds, equities, art and gold coins instead.

4.2 Economic indicators that affect asset classes and global geographic selection and economic forecast applied to asset classes in order to make an investment selection.

From an investment viewpoint the purpose of studying economic data is, however, usually to forecast the future. Consequently the greatest care is essential, bearing in mind that forecasts are necessarily based on assumptions, and this raises questions as to the validity of the assumptions made.

- **Money Supply**

The money supply is regarded as being relevant. One view is that many economic problems, including inflation, can be traced to excess in money supply, although others doubt this. Most, however, probably feel that the supply of money affects the fixed interest market more directly than the general equity market.

- **Balance of Payments**

South Africa trades internationally, therefore the balance of payments figures are of great importance. Trade depends on imports and exports and, while internal policies can influence both, external influences, such as a recession in other parts of the world, and particularly the state of the economy of the USA, have significant effect.

- **Commodity prices**

The balance of payments and the economic welfare of South Africa are greatly impacted by the gold price. The world prices of platinum, diamonds and other minerals that are exported, such as coal, also have a significant effect, while the importance of the oil price is not to be forgotten. Commodity prices and their effect on the general economy can have an impact on interest rate decisions.

- **Reserves**

The figures relating to the level of South Africa's reserves, which are published by the SA Reserve Bank, must be monitored closely as they are of importance to investors and can also result in interest rate changes.

- **The Consumer Price Index**

The Consumer Price Index shows the movement of retail prices and is the measure used for inflation. There is typically quite a strong correlation between the rate of inflation and interest rates, since interest rates are often raised in order to dampen inflationary pressures in the market.

- **Other Indicators**

Figures are also published by the SA Reserve Bank when there is a new issue of stock to investors for cash. In times of heavy new issue activity, large sums of money can be taken out of investor's pockets and this usually has an effect of raising interest rates.

- **Currencies**

The stability of the rand against major international currency also has a direct effect on our market. A foreign investor would require a currency to be stable to obtain maximum benefit from the return received in Rands.

- **Political Stability**

Political stability plays an important role in setting the climate for business confidence in a country and also supporting positive sentiment towards the region within the country is situated.

- **Climate**

Even the country's climate can have an effect on the economy.

The South African Bond Market is well established with about 75% of the bonds traded are government bonds with a term of to 20 years. Offshore players is now also an important player and at our interest rates very attractive for foreign investors if the currency remains stable against the main currencies of the world.

4.3 The current economic forecast used to suggest and substantiate an asset selection proposal.

Read the opinions of leading economists in the articles below in terms of the economic forecast for 2013 -2014:

Article 1: Source: www.property24.com

2013 South African economic outlook:

11 Feb 2013

The global downturn in GDP is set to continue in 2013 through to 2014 and is expected to ease in 2015, according to Dr Azar Jammine, chief economist at Econometrix.



According to Sizwe Nxedlana, FNB chief economist, the outlook for 2013 is positive despite a revised GDP growth from 3 percent to 2.7 percent.

Jammine was speaking at the Economic Outlook Conference 2013 held at the Gordon Institute of Business Science in [Illovo, Johannesburg](#).

According to the International Monetary Fund (IMF) revisions, world GDP is expected to reach 4.1 percent in April, 3.9 percent in July and 3.6 percent in October.

Furthermore, IMF forecast growth for South Africa to be 3.6 percent between 2012 and 2016.

Jammine points out that the economy in South Africa is growing slowly with more money being invested into the financial markets.

He believes that if interest rates continue at their lowest levels, 2013 could be a good year for South Africa, pointing out that foreign investors have been buying bonds hence the liquidity in the bond market.

The [Rand](#) will remain under pressure but will not crash. However, he reckons some changes will happen as the world recognises that there are opportunities in the emerging markets as it is cheaper to buy in those markets than the developed markets.

“You can buy more with a Dollar in SA than in the US,” he says.

Econometrix expects the Rand to reach R9.10 against the USD by the fourth quarter of 2013.

Other issues of concern include high levels of youth unemployment, increased dependency on social grants and social unrest due to low levels of service delivery.

He expects interest rates to remain low and against this background, he believes a three percent economic growth for South Africa is not impossible.



Econometrix expects the Rand to reach R9.10 against the USD by the fourth quarter of 2013.

Professor Adrian Saville, chief investment officer of Cannon Asset Managers, expects the economy to grow by 2.5 percent while the Sub-Saharan will reach 6.6 percent.

Saville says the economy is very sluggish, coupled with a weak Rand, however, he says interest rates will remain low in 2013.

For Annabel Bishop, group economist at Investec, the lowering of GDP forecast is a worry although interest rates will remain low.

Bishop is concerned about the Eurozone as investors are quite nervous and confidence is very low.

She expects the economy to grow by 3.1 percent pointing out that the government needs a flexible labour market (in light of [Marikana](#) in 2012) and there is a need to change its thinking in order to encourage investor appetite.

According to Sizwe Nxedlana, FNB chief economist, the outlook for 2013 is positive despite a revised GDP growth from 3 percent to 2.7 percent

Nxedlana expects household consumption to moderate and unsecured lending to be curbed.

On a scale of zero to 10, he would rate the economy at five saying the fundamentals are looking up.

Meanwhile, Nedbank senior economist Nicky Weimar says although the economy lost significant momentum in Q3 2012, it is still growing and she expects growth of 2.6 percent in 2013.

Weimar notes that domestic spending has been outpacing domestic production since the start of the recovery in 2010 and that the production of the economy has been under pressure for some time.

“Producers struggled with sluggish exports due to a weak global economy and the strikes aggravated circumstances,” says Weimar.

She too points to the fact that foreigners continue to buy [South African](#) bonds, and that the Rand will remain under pressure reaching R8.66 against the USD in 2013.

Weimar anticipates interest rates to be flat with the first hike expected in November although the market consensus is early 2014.

Article 2: 2013 State of Nation Address

This week will see focus shifting on President Jacob Zuma’s State of the Nation Address (SONA) to Parliament on Thursday, 14 February.



The 2013 SONA will be the first that is delivered in the context of the National Development Plan, which has been adopted as the high level framework and national roadmap to which all government programmes and plans will be aligned from 2013 with a focus on implementation, according to The Presidency.

According to Bishop, the presentation will likely affirm the policies that Government has put into place to address inequality, poverty and unemployment, and re-iterate the adoption of the National Development Plan (NDP) in this regard.

“While many will watch out for key issues such as the youth wage subsidy and reclassifying teaching as an essential service to reduce absenteeism from classrooms due to strike action and union meetings, these may not be elaborated on to avoid straining the relationship with Cosatu,” she says.

Bishop points out that South Africa has instances of significant wastage, inefficiencies and corruption, with a large number of schools failing to receive textbooks, high teacher absenteeism and a very poor quality of the maths and of the education system on an international comparison.

The NDP clearly identifies the failings of civil servants for the parlous state of the education system and it will be telling if the President focuses on this particular area of service delivery and the necessary steps which need to be taken to turn the system around from among the worst in the world to one of the best in the world. SA is a long way off from this turnaround, she says.

The 2013 SONA will be the first that is delivered in the context of the National Development Plan, which has been adopted as the high level framework and national roadmap to which all government programmes and plans will be aligned from 2013 with a focus on implementation, according to The Presidency.

Mac Maharaj, spokesperson for The Presidency says the Plan was endorsed by all political parties in the National Assembly on the 15 August 2012 and enjoys the support of all sectors of society.

The NDP was produced by the National Planning Commission (NPC) in the Presidency chaired by Minister Trevor Manuel with Cyril Ramaphosa as deputy chairperson.

The NPC was established by President Zuma in 2009 and was given the task of producing the national plan within 18 months, he explains.

“In SONA 2013, the President will provide an update on all key programmatic areas, especially the five priorities, education, health, creating decent work, the fight against crime as well as rural development and land reform.”

In addition, President Zuma will also outline progress made in the implementation of the New Growth Path (promotes inclusive growth and job creation in six job drivers - infrastructure development, agriculture, mining and beneficiation, manufacturing, the green economy and tourism), the economic strategy within the NDP, he adds. – **Denise Mhlanga**

About the Author



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Property journalist at property24.com

Article 3: Source: www.bdlive.co.za/economy/2013

THE International Monetary Fund (IMF) has slashed South Africa's economic growth forecast for 2014 to 3.3% from 4.1% earlier, the fund's latest World Economic Outlook (WEO) report showed on Tuesday.

The IMF still expects South Africa to grow 2.8% in 2013, from 2.5% in 2012.

It refers to the 2.8% growth projection as "muted" owing to sluggish mining production and demand weakness in the euro area, which is South Africa's main export market.

Work stoppages in the mining sector in the second half of last year led to significant production losses, declines in mining revenue estimated at R15bn, and lower contributions by the sector to economic growth.

South Africa's current account deficit is forecast to widen to 6.4% this year, rising to 6.5% next year. The deficit on the current account has been one of the major concerns for investors, evident from the depreciation of the rand against the dollar in the second half of last year and early this year.

The report says some current account balance deterioration will occur in the short term in a number of countries in sub-Saharan Africa, largely on account of an expected decline in the terms of trade, especially among oil exporters.

Inflation in South Africa as measured by the consumer price index (CPI) is seen averaging 5.8% this year and 5.5% next year, while unemployment is expected to remain at more than 25% this year and the next.

The IMF forecast sub-Saharan Africa growth of 5.6% this year, rising to 6.1% next year.

This generally strong performance is based, to a significant extent, on continuing investment in infrastructure and productive capacity, continuing robust consumption, and new capacity in extractive sectors, the global lender says.

"The external environment is the main source of risk to growth, particularly for middle-income and mineral-exporting economies," the IMF's report notes.

The main driver of next year's 6.1% growth in sub-Saharan Africa is expected to be the strengthening of activity in South Africa and other middle-income countries, the IMF says, predicated on improvements in the external environment.

Sub-Saharan Africa's growth is expected to outpace that of the global economy, which is forecast at 3.3% this year and 4% next year. The 3.3% is a 0.2 percentage

point downward revision from earlier forecasts as a result of fresh concern about eurozone growth.

Article 4: Source: <http://dx.doi.org/10.1787/888932602692>

South Africa

- The South African economy is estimated to have grown by 3.1% in 2011, up from 2.9% in 2010, but growth is expected to slow to 2.8% in 2012 because of the continued weakness in the global economy and domestic structural constraints.
- The business regulatory environment remains conducive, although lack of capacity in the public sector and deepening divisions within the governing coalition over the government's policy direction present a downside risk in the medium term.
- In spite of a comprehensive approach to eradicating extreme poverty and hunger through social protection measures, poverty and inequality still remain high and the country remains one of the most unequal societies in the world.

Gross domestic product (GDP) growth is estimated to have increased to 3.1% in 2011, up from 2.9% in 2010. Growth is expected to slow to 2.8% in 2012 mainly because of domestic structural weaknesses and the fragile global economic recovery. GDP growth is expected to rise to 3.6% in 2013, subject to global recovery taking place and an orderly resolution of the Eurozone fiscal and financial crisis during 2012.

The fiscal deficit rose from 4.2% in 2010 to 4.8% in 2011 and is expected to fall to 4.4% in 2012. The Reserve Bank's repo rate remained flat at 5.5%, a 30-year low, throughout 2011. The average annual inflation rate remained at 5.0% for 2011. It is expected to rise to 6.2% in 2012 before easing to 5.4% in 2013.

Consumption registered an estimated 3.5% growth rate in 2011 while investment grew by an estimated 5.2%. Foreign direct investment (FDI) into South Africa increased to USD 4.5 billion in 2011 from USD 1.2 billion in 2010. As domestic expenditure improves with the expected increase in fixed investment in 2013, South Africa's import intensity is expected to rise, putting some pressure on its trade balance over the next two years. This, together with increased outflows in service income and current transfers, is likely to raise the current account deficit to 3.9% in 2012 and 4.3% in 2013.

Borrowing from abroad by public corporations, which hold about 21% of external public debt, to finance infrastructure improvements and development of new projects led to a significant rise in foreign debt in fiscal year 2010/11 compared to the previous period. However, the debt burden indicators do not show any risk of debt servicing difficulties in the immediate term. Foreign debt remains less than 10% of total public debt while the government is able to borrow locally with relative ease.

Unemployment fell to 23.9% at the end of 2011, down from 25.0% in the third quarter. Over 1 million jobs were lost between the fourth quarter of 2008 and the third quarter of 2010. In a welcome development, 365 000 additional jobs were created in 2011. The government's broad strategy against unemployment is part of the New Growth Path (NGP), with an objective of creating 5 million jobs over a decade. A draft National Development Plan: Vision for 2030 drawn up by the National Planning Commission is currently undergoing public comment.

Figure 1: Real GDP growth (Southern)

Real GDP growth (%)Southern Africa – Real GDP growth (%)Africa – Real GDP growth (%)20032004200520062007200820092010201120122013–2%0%2%4%6%8%10%Real GDP Growth (%)
 Figures for 2010 are estimates; for 2011 and later are projections.

<http://dx.doi.org/10.1787/888932619317>

Table 1: Macroeconomic Indicators 2012

| | 2010 | 2011 | 2012 | 2013 |
|-----------------------------------|------|------|------|------|
| Real GDP growth | 2.9 | 3.1 | 2.8 | 3.6 |
| Real GDP per capita growth | 2.1 | 2.4 | 2.2 | 3.1 |
| CPI inflation | 4.3 | 5 | 6.2 | 5.4 |
| Budget balance % GDP | -4.2 | -4.8 | -4.4 | -4.2 |
| Current account % GDP | -2.8 | -3.1 | -3.9 | -4.3 |

Figures for 2010 are estimates; for 2011 and later are projections.

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