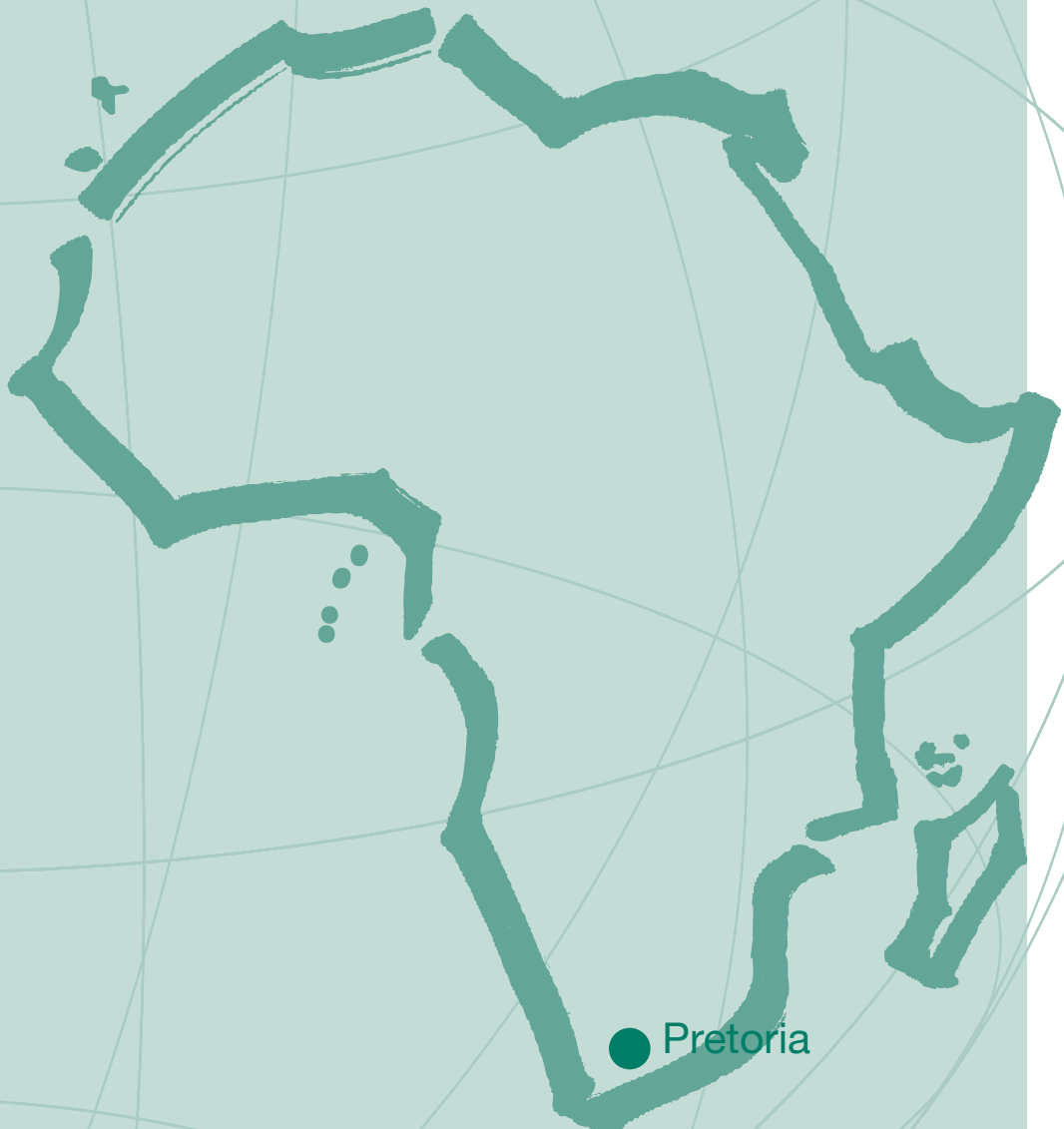


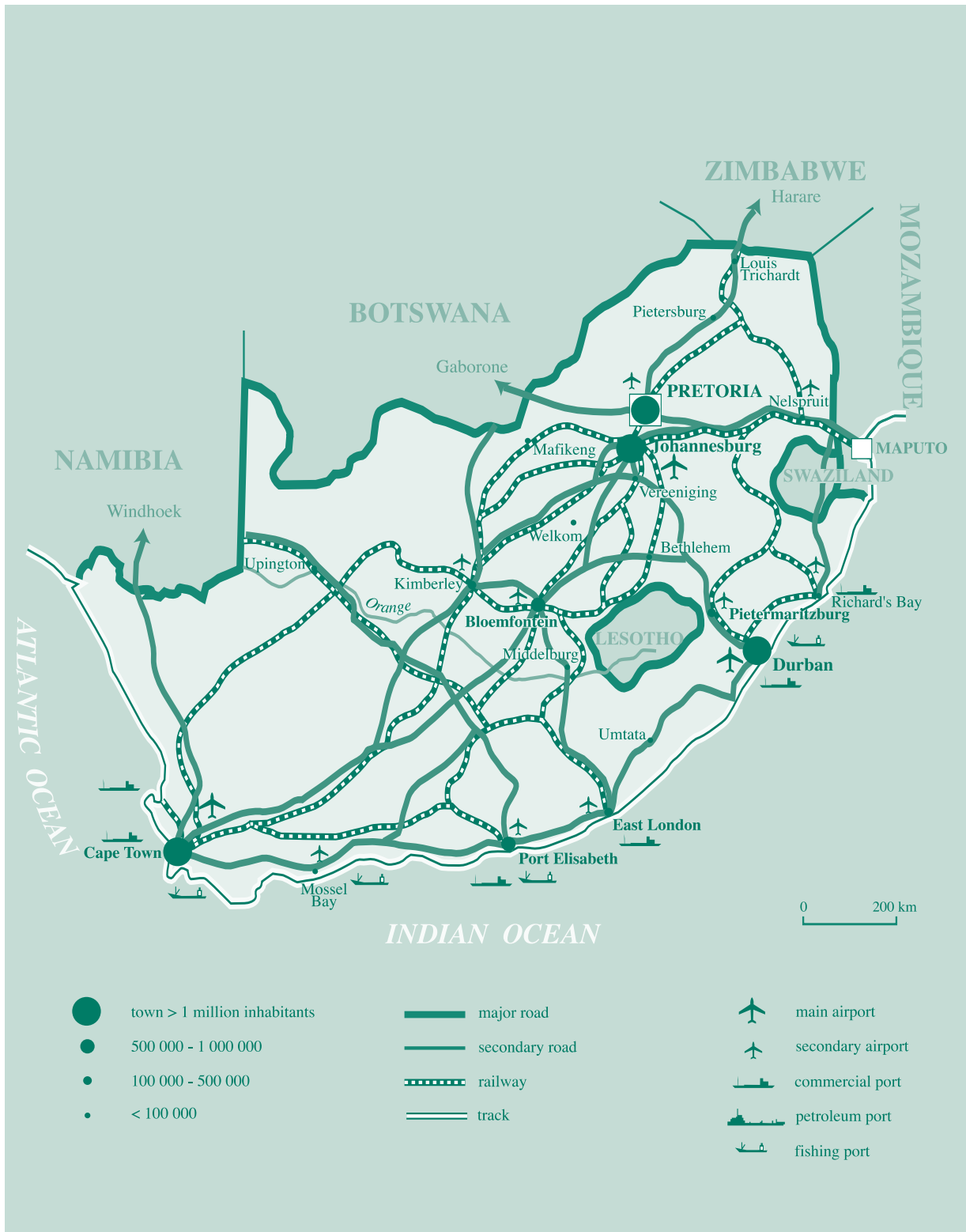
South Africa



key figures

• Land area, thousands of km ²	1 221
• Population, thousands (2006)	47 594
• GDP per capita, \$ PPP valuation (2006)	12 857
• Life expectancy (2006)	45
• Illiteracy rate (2006)	17.6

South Africa



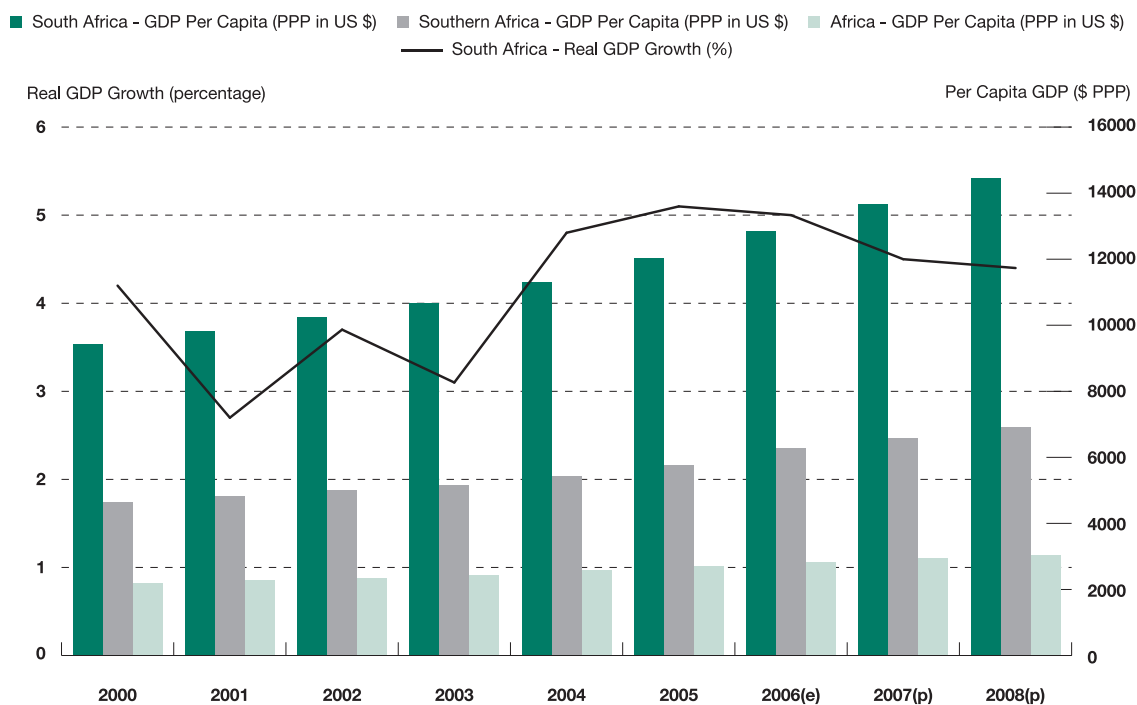
THE MOST RECENT HISTORY OF SOUTH AFRICA highlights both the buoyancy of its economic performance and the increasingly risky environment with which it is confronted. By South African standards, the country experienced high real GDP growth in 2005 and 2006 at around 5 per cent, fuelled mainly by booming consumption and vigorous investment. The emergence of a black middle class, boosted by the Black Economic Empowerment (BEE) measures, and increased social expenditures are stimulating private consumption and, in turn, the services and construction sectors. By contrast, gold mining and agriculture are largely underperforming owing to structural bottlenecks and diminishing prospects. As a result of growing incomes, South Africa is experiencing significant tax overruns, with the fiscal deficit shrinking to a mere 0.3 per cent of GDP in 2005/06 and an estimated 0.4 per

cent in the following years. The strong growth is also leading to increased imports and a widening current account deficit, estimated at 4.6 per cent of GDP in 2006.

The current account deficit mostly reflects structural factors which are limiting export competitiveness and constitute a major challenge for policy makers. Inputs are costly, especially in telecoms and transport, adversely affecting all other industries. Poverty remains very high, as do crime figures and HIV/AIDS statistics. Although declining, unemployment remains at around 26 per cent (and close to 40 per cent if the discouraged unemployed are included).

Steady growth based on internal demand in 2006 caused a current-account deficit, underlining the need to hasten structural reform.

Figure 1 - Real GDP Growth and Per Capita GDP
(\$ PPP at current prices)



Source: IMF and local authorities' data; estimates (e) and projections (p) based on authors' calculations.

<http://dx.doi.org/10.1787/645266545018>

In May and June 2006, the turbulence of emerging financial markets affected South Africa, pushing the rand to a depreciation of some 20 per cent. South Africa was one of the most impacted emerging markets due to its large current account deficit and, possibly, perceived, heightened political risk. The domestic financial system was not damaged, however, highlighting the increased resiliency of the South African economy. The South African Reserve Bank (SARB) and the fiscal authorities are working together to dampen domestic demand. The SARB raised interest rates by 200 basis points in the last six months of 2006 while the government is keeping expenditure growth under control. The government is making some efforts to tackle structural bottlenecks: the Accelerated and Shared Growth Initiative for South Africa (ASGISA) programme is aimed at identifying and remedying the binding structural constraints to long-run growth.

The short term outlook continues to be largely positive, with investment, both public and private, expected to replace consumption as the engine of growth. Growth rates are therefore expected to remain high at around 4.5 per cent in 2007 and 2008. The outlook could be clouded, however, by international risks associated with rising interest rates in the United States, fresh oil price increases, a downturn in raw materials markets and domestic uncertainty regarding the succession of President Thabo Mbeki (selection of the next ANC president is scheduled for the end of 2007).

Recent Economic Developments

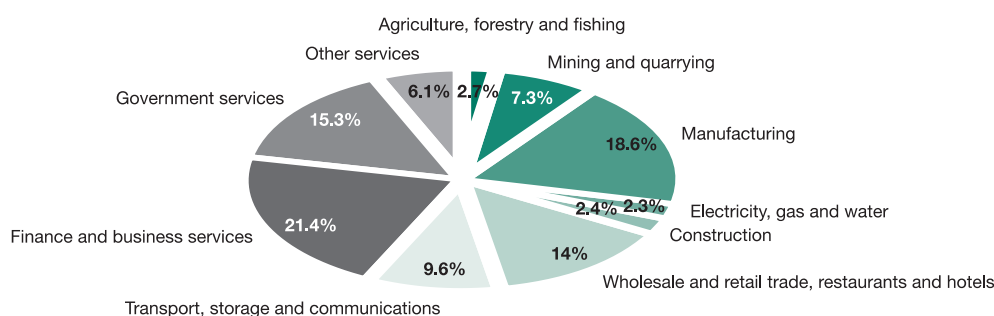
In 2006, real GDP growth remained at around 5 per cent after 5.1 per cent in 2005. Growth was led by domestic demand-driven sectors (construction, manufacturing and services), while export-oriented sectors (agriculture, mining) lagged behind.

The primary sector was a drag on growth in the first three quarters of 2006. Agricultural output fell by 14.9 per cent over the period due to low crop prices, notably of maize. However, a rebound in food prices in the second half of 2006 helped reinvigorate production in late 2006.

The mining sector contracted in the first nine months of 2006 by 3.4 per cent after recording a lacklustre growth rate of 2.3 per cent in 2005. In the same year, gold production receded by 13 per cent to 297.3 tons, its lowest level since 1923. These poor performances point to the structural difficulties of a sector that remains vital to the South African economy: both directly (7.3 per cent of GDP, 6.2 per cent of non-agricultural formal sector and 30 per cent of exports of goods) and through major induced and multiplier effects. The mining industry undoubtedly suffered from the appreciation of the rand against the US dollar up to July 2005 but it was subsequently unable to reap the benefits of higher rand-denominated metal prices (which rose 66 per cent between July 2005 and June 2006) and, in particular, a bull gold market. The industry reported a sharp 32.7 per cent decline in fixed investment in real terms between early 2004 and early 2006. As a consequence, South Africa slipped from fourth to seventh position in country rankings for exploration spending. The internal capital investment survey of the South African Chamber of Mines points to red tape and regulatory uncertainties, associated in particular with the Mining Charter, Royalty Bill, legal titles and mining prospecting rights, as the main constraints on mining activity. The Chamber estimates that these constraints are responsible for a ZAR 10 billion annual reduction in capital investment in mining. The sector is also confronted with constraints in rail and port capacity and rising water and transport costs. However, the comprehensive restructuring of the industry carried out in recent years and rising international prices are expected to result in a recovery in production in 2007 and beyond.

The labour-intensive construction sector showed 13.2 per cent growth in the first three quarters of 2006 and reported a 22 per cent increase in employment, equivalent to 87 000 new jobs. Manufacturing experienced a 4.2 per cent growth in the nine months to September 2006. The highest rate of manufacturing capacity utilisation in 35 years was reported in June 2006 at 86.3 per cent, while the Investec Purchasing Managers Index (PMI), which measures confidence in the manufacturing sector, reached a record high in July 2006. Similarly, services benefited from vibrant domestic

Figure 2 - GDP by Sector in 2005 (percentage)



Source: Authors' estimates based on National Institute of Statistics data.

<http://dx.doi.org/10.1787/247765010430>

demand, growing 5.9 per cent over the first three quarters of 2006. As a result of sustained vigorous growth, services contributed 66.4 per cent of GDP in 2005 compared to 60 per cent in 1994.

Following the weakening of the rand and interest rate hikes in 2006, a rebalancing of growth in favour of export-oriented manufacturing industries and away from domestic-demand-driven sectors is anticipated in 2007. On the other hand, import-competing domestic industries should remain dynamic thanks to the delayed effect of depreciation of the rand.

All the components of domestic demand proved vigorous in 2006 with real increases in final consumption expenditure by households and government of 4.2 per cent and 7.2 per cent respectively and a 10.6 per cent jump in gross capital formation. As a result, gross fixed investment reached an all-time high of 18.7 per cent of GDP in the third quarter of 2006, up from 15 per cent of GDP in 2002. Household consumption has been boosted by higher real disposable income and outstanding consumer confidence: the FNB/BER Consumer Confidence Index registered the longest continuous period – 10 quarters – of positive consumer expectations since 1994. Confidence and consumer spending have been supported by subdued inflation and a strong rand. They have also been bolstered by a 6 per cent increase in private sector real wages in 2005, substantial personal income tax relief over the past five years, rising government transfers, and a 5 per cent increase in employment since the beginning of 2005, equivalent to almost 350 000 jobs. The emergence of a growing black middle class, aided by black empowerment programmes, also contributed to

the vitality of consumption. Targeting a lucrative and vibrant domestic market, cash-flush local corporations have undertaken large fixed investments, supplemented by rising public investment. Finally, domestic demand has been fuelled by an accommodating monetary policy and strong credit expansion. Inexpensive credit allowed household consumption to exceed disposable income: 2006 marked the first episode of “dissaving” by South African households since 1984.

Overall, South Africa's national savings rate fell to a historical low of 13 per cent in first quarter 2006, which was reflected in a dramatic widening of the current account deficit to 6.1 per cent of GDP in the first quarter – its highest level since 1994 – and 4.6 per cent over the year as a whole. The strength of the rand up to mid-2006 did not help exports and undoubtedly contributed to this deficit.

Monetary tightening in the second half of 2006, along with depreciation of the rand and rising inflation should dampen consumer spending, especially for durables and semi-durables which are very currency- and interest rate-sensitive. Combined with the prudent medium-term fiscal strategy unveiled in October 2006, these factors should help narrow the current account deficit. Yet, the latter is expected to remain large, between 4.6 and 5 per cent of GDP, as investment continues to be buoyant over the next four to five years. Investment is forecast to expand by around 10 per cent annually under the impact of preparations for the 2010 FIFA World Cup and large-scale infrastructure and social project spending by the government and state-owned enterprises such as Transnet and Eskom. These public

Table 1 - Demand Composition (percentage of GDP)

	1998	2005	2006(e)	2007(p)	2008(p)
	Percentage of GDP (current prices)		Percentage changes, volume		
Gross capital formation	16.8	17.7	10.6	9.9	9.9
Public	5.8	4.9	15.0	12.0	12.0
Private	11.0	12.9	9.0	9.0	9.0
Consumption	82.1	83.7	4.9	4.2	4.5
Public	18.8	20.2	7.2	5.0	5.0
Private	63.3	63.5	4.2	3.9	4.3
External sector	1.1	-1.5			
Exports	25.7	27.1	2.2	2.3	2.1
Imports	-24.5	-28.6	5.3	4.9	6.1

Source: Statistics South Africa data; estimates (e) and projections (p) based on authors' calculations.

<http://dx.doi.org/10.1787/388260456467>

investment programmes are expected in turn to leverage complementary private sector investments. Although investment constitutes a small share of GDP and exhibits lower import content than consumption, the import leakage of large investment programmes such as those planned by Eskom and Transnet is far from negligible. The Industrial Development Corporation estimates it at ZAR 53 billion out of overall capital outlays totalling ZAR 134 billion.

The widening of the current account deficit in 2006 underlines some of the structural weaknesses of the South African economy. Growth in South Africa is limited by supply-side bottlenecks and external constraints. Potential growth and export orientation has admittedly increased over the last five years, owing to improved macroeconomic policies, trade liberalisation and structural reforms, including the restructuring of the manufacturing sector since 2003. Yet, potential growth in South Africa is estimated at only four to 4.5 per cent, and, although up from about 3 per cent in the late 1990s, is still below the level needed to make a major dent in poverty and unemployment.

Investment rates of below 20 per cent of GDP, themselves attributable to insufficient savings and foreign direct investment, are low by emerging market economies' standards. As a result, the availability of critical infrastructure is insufficient and the quality of service is poor. Inadequate investment, along with

limited competition, explains the high costs of services, particularly transport and telecommunications, and of intermediate inputs, in steel and chemicals for instance.

The ASGISA initiative aims to address these problems and to lift average growth to 6 per cent over the 2010-14 period. It is estimated that achieving this target will require an increase in investment to 25 per cent of GDP by 2014. Based on a realistic scenario of investment growth of 10 per cent, however, reaching an investment ratio of over 22 per cent by then promises to be a challenge and, in the period to 2010, growth looks unlikely to exceed 5 per cent.

Macroeconomic Policies

Fiscal Policy

Prudent policies have resulted in a dramatic consolidation of South Africa's fiscal position since 1996. Budget deficits have recently hovered in a range between 1.5 per cent of GDP in 2004/05 and 0.4 per cent in 2006/07, while national government debt has been scaled back from 45.3 per cent of GDP in late 2001 to 34.8 per cent in the second quarter of 2006. The country now enjoys a good international credit standing: its long-term foreign currency debt is rated investment grade by S&P's (BBB+), Moody's (Baa1) and Fitch (BBB+). The risk premium on South Africa's

Table 2 - Public Finances (percentage of GDP)

	1998/99	2003/04	2004/05	2005/06	2006/07(e)	2007/08(p)	2008/09(p)
Total revenue and grants^a	24.7	23.8	25.1	26.3	26.3	26.2	26.2
Tax revenue	24.0	23.3	24.6	25.8	25.7	25.7	25.7
Consolidated expenditure^{ab}	28.5	27.7	27.8	29.1	29.0	28.8	28.7
Current expenditure	26.9	26.6	26.6	27.5	27.3	26.9	26.7
<i>Excluding interest</i>	21.3	22.9	23.1	24.2	24.3	24.1	24.1
Wages and salaries	10.8	9.5	9.4	9.8	9.6	9.4	9.4
Interest	5.6	3.7	3.5	3.3	3.0	2.8	2.6
Capital expenditure	1.6	1.2	1.2	1.7	1.8	1.9	2.0
Consolidated balance^b	-3.9	-3.9	-2.7	-2.8	-2.8	-2.6	-2.5
Main budget balance	-2.7	-2.3	-1.5	-0.3	-0.4	-0.4	-0.5

a. Only major items are reported.

b. Includes expenditure by national and provincial government, social security funds and selected public entities.

Source: : South African National Treasury data; estimates (e) and projections (p) based on authors' calculations.

<http://dx.doi.org/10.1787/706773153276>

long term foreign currency debt reached an all time low 68 basis points in February 2006 and widened to a mere 115 basis points in July 2006, following the May-June 2006 turbulence in emerging markets. This risk premium narrowed again to 98bps in October 2006. In short, the government has a significant margin for increasing public expenditures.

As in 2004/05, the budget deficit turned out to be far lower in 2005/06 at 0.3 per cent of GDP than the expected 3.5 per cent of GDP. The situation is likely to repeat itself in the following years with a likely closing of the fiscal deficit.

The unexpectedly low deficit in 2006 was due to very strong revenue growth of 13.5 per cent in 2006, far above anticipated 4.5 per cent growth, and almost double GDP growth. Indirect taxes (VAT in particular) grew 14.5 per cent, while personal income and corporate tax receipts showed an 18.1 per cent increase. The surge in tax revenues has been driven by dynamic domestic demand but also by structural factors¹, namely the continued broadening of the tax base, partly attributable to a progressing formalisation of the economy, and the strong tax compliance efforts made by the South African Revenue Services in recent

years. Despite tax relief for individuals and a tax amnesty for small businesses, the tax revenue to GDP ratio has risen from 21.2 per cent in 1996/97 to 26.2 per cent in 2006/07. The cyclical component of this rise in tax revenues is fairly small, according to the IMF². At the same time, expenditures (capital outlays included) turned out to be broadly in line with the initial budget forecast.

For the future, the government is aiming to increase the share of investment in public expenditure. Public investment is forecast to rise by 9.8 per cent annually from 2005 to 2009, so as to prepare the 2010 FIFA World Cup, improve public service delivery and achieve the priorities set out in the ASGISA. Capital outlays are set to reach 7.2 per cent of total expenditure and 2.2 per cent of GDP by 2009/10 compared to 4.5 per cent and 1.2 per cent respectively in 2004/05. Priority sectors are public works, housing, water, education and health services (including a hospital revitalisation programme). They will be supplemented by massive investment planned by Eskom in electricity generation and electrification, as well as significant spending by Transnet, aimed at improving the quality and efficiency of the country's rail network, major ports and harbours.

1. Tax revenues in South Africa have been consistently higher than expected by government in recent years.

2. 'South Africa: Selected Issues', September 2006, IMF Country Report No. 06/328

While increasing the share of capital expenditure, the government aims to keep total expenditure below 30 per cent of GDP, by restraining the growth of current expenditure in line with GDP. In particular, the wage bill and transfers to households are expected to remain stable as a share of GDP. The roll-out of the government social grant programme is nearing completion and its impact on the budget is flattening out. There are no clear indications that the initiative will be extended further as the government intends to avoid the emergence of a dependency culture and to prevent the financial cost of the scheme from spinning out of control. In other words, spending plans by the fiscal authorities continue to strike a sensible balance between fiscal stability and social objectives. This strategy should result in narrow fiscal gaps over the period to 2009-10 – no higher than 0.5 per cent of GDP. Yet fiscal policy remains expansionary when cyclically adjusted, with a structural deficit estimated by the IMF at 2 per cent of GDP.

The authorities make the case for a prudent fiscal stance by stressing that the scope for increasing tax revenues further is limited because all feasible measures to improve tax compliance have already been undertaken. Cautious expenditures plans are also underpinned by a realistic assessment of South Africa's capacity for absorption, skill constraints and limited administrative capacities at the municipal and provincial levels. The government also stresses the need for coordinating fiscal and monetary policies to relieve pressure on the current account, slow growth to its potential rate and dampen inflation.

Monetary Policy

Monetary authorities were confronted with rising inflation in 2006: in September 2006, the Consumer Price Index (CPIX) inflation rate reached 5.1 per cent – its highest level in two years – and averaged 4.9 per cent over 2006 as a whole. Inflation could again be at the top of the targeted 3 to 6 per cent band in 2007, averaging out at about 5 per cent. The increase in inflation is attributable largely to strong domestic demand resulting in high capacity utilisation (86.2 per cent in June 2006, 88.6 per cent in durable goods) and in growth exceeding its long term potential. As a result

of labour-market pressures, growth in unit labour costs accelerated in the formal non-agricultural sector to 7.6 per cent in the year to the first quarter 2006. In addition, rising prices of imported goods (oil in particular), transport and food, at a rate well above 6 per cent, drove the overall inflation index up. The rise in the price of inputs, energy and labour were easily passed on to consumers.

The growth in credit to the private sector has been consistently higher than 20 per cent since January 2006 and reached a record 25.3 per cent in September 2006, as the SARB accommodated the increase in money demand accompanying growing nominal GDP. Previously disadvantaged sections of the population which were entering the credit market for the first time in 2005 and 2006 largely accounted for the sharp increase in credits. Monetary policy was the most expansionary since 1994: from April 2005 to June 2006, the repurchase rate of the central bank stood at an all-time low 7 per cent.

The inflationary pressures were compounded by the sharp 20.6 per cent depreciation of the rand between April and October 2006 and ensuing pass-through effects. Global factors, such as the tightening of US monetary policy and concerns about a drop in international investors' appetite for emerging markets assets played a role in the weakness of the rand. The rand proved particularly vulnerable to the sell-off of emerging markets' assets due to very large current account deficits and declining prices for key South African export commodities in 2006. However, the rand bounced back later in the year to such an extent that overall depreciation in 2006 was only 8.6 per cent.

The challenge now faced by the monetary authorities is to keep inflation in check, to engineer a soft landing of the economy and in due course to narrow the current account deficit and reduce the rand's instability. Achieving these objectives requires that the SARB tread a fine line between a too soft monetary response and the risk of a hard landing. In other words, the tightening of the monetary stance must dampen domestic demand while avoiding a crash on the property market, which is vulnerable to interest rate swings due to a high volume

of mortgage debt at variable interest rates. Also, the central bank intends to dampen damaging interest-rate volatility. The strategy so far has consisted in a gradual tightening of the monetary stance: policy interest rates were raised in June 2006 for the first time in almost four years. Tightening in 2006 reached 200 basis points overall. This strategy started to bear fruit in early 2007. Despite the depreciation of the rand and the rise in inflation in 2006, stable nominal wage settlements in the third quarter 2006 and an inverted interest rates curve are indications that expectations regarding inflation remained stable. Also, as real interest rates rise, domestic demand and credit were expected to slow down in early 2007. Combined with softening international oil prices in early 2007, the latter developments improved the inflation outlook and led the SARB's monetary policy committee not to raise interest rates further on 15 February 2007.

External Position

The trade liberalisation programme pursued by South Africa since 1994 has resulted in a more open economy: the import penetration ratio was estimated at an all-time high of 25.1 per cent in 2006 while the exports-to-GDP ratio (including services) increased from 22 per cent in 1994 to an estimated 23.8 per cent in 2006. However, upstream sectors are over-protected. The tariff structure is also too complex with too many tariff bands and spikes.

In March 2006, the SADC Economic Partnership Agreement (EPA) Group proposed that South Africa became a full participant in the Southern African

Development Community (SADC) – European Union (EU) EPA negotiations (it had previously been only an observer), even though trade between South Africa and the EU is already governed by the Trade, Development and Cooperation Agreement (TDCA) which came into force in January 2000. Botswana, Lesotho, Namibia and Swaziland (BLNS) make the case for special treatment of their sensitive products. The European Commission (EC) made it clear however that South Africa could not benefit from such special treatment and would remain subject to the existing TDCA regime. In turn, South African trade officials rule out such a possibility. Also, the aim of the SADC EPA group is that in due course all its members (and not only its least developed members – Angola, Mozambique and Tanzania) should benefit from an Everything But Arms (EBA) access to the EU market, even though this is unlikely to be endorsed by the EC.

In 2005 and 2006, vibrant domestic demand combined with the lagged effects of the strong rand to boost imports. At the same time, the value of oil imports has been driven up by high prices. Overall, the value of imports increased by about 17 per cent in 2006. Exports, especially in manufacturing, grew less rapidly at 14.8 per cent, hampered as they were by the effects of the strong rand, while local producers tended to serve the booming domestic market instead of expanding their market shares abroad. As a result, the country's merchandise trade deficit widened from 0.8 per cent of GDP in 2005 to 1.3 per cent in 2006.

The widening gap in services also contributed to growth in the current account deficit in 2006 to 4.6 per

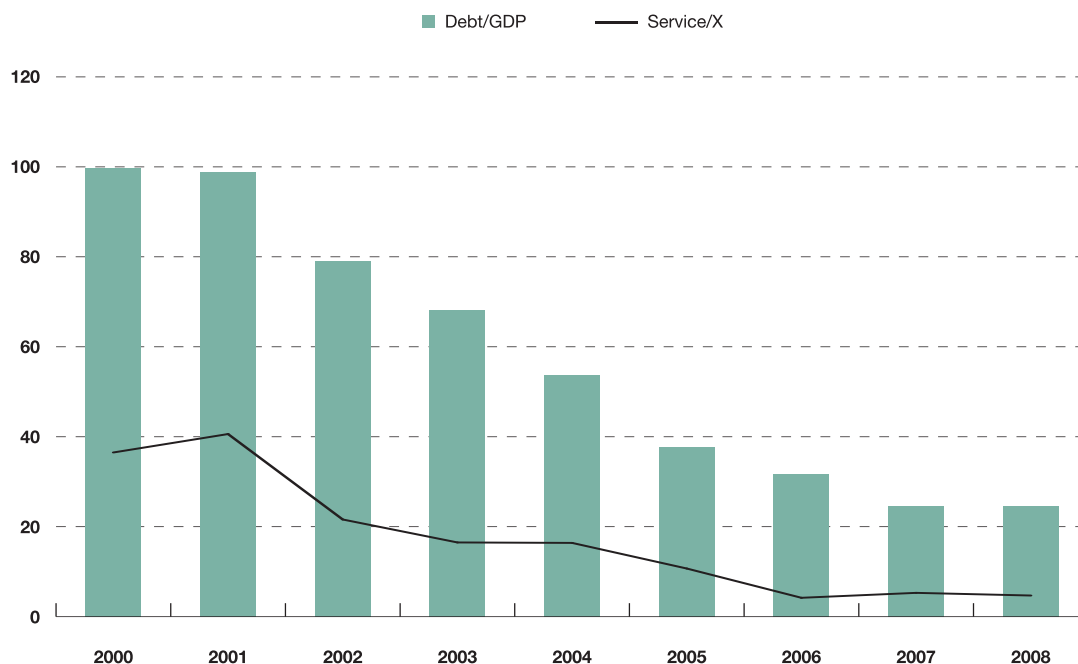
Table 3 - Current Account (percentage of GDP)

	1998	2003	2004	2005	2006(e)	2007(p)	2008(p)
Trade balance	1.4	2.1	-0.1	-0.8	-1.3	-1.5	-2.3
Exports of goods (f.o.b.)	21.7	23.2	22.4	22.8	23.8	23.5	22.4
Imports of goods (f.o.b.)	20.3	21.1	22.5	23.6	25.1	25.0	24.7
Services	-0.2	-0.2	-0.6	-0.7	-0.9	-0.9	-0.7
Factor income	-2.4	-2.8	-2.0	-2.0	-1.8	-1.7	-1.5
Current transfers	-0.6	-0.5	-0.7	-0.7	-0.7	-0.6	-0.5
Current account balance	-1.8	-1.3	-3.4	-4.2	-4.6	-4.6	-5.1

Source: South African Reserve Bank data; estimates (e) and projections (p) based on authors' calculations.

<http://dx.doi.org/10.1787/756403288572>

Figure 3 - Stock of Total External Debt (percentage of GDP) and Debt Service (percentage of exports of goods and services)



Source: IMF.

<http://dx.doi.org/10.1787/272684865441>

cent of GDP – its highest level since 1982. Nevertheless, the latter was comfortably financed by portfolio capital inflows in the first three quarters of 2006, despite turbulence in emerging markets, and international reserves actually increased. But reliance on volatile capital inflows remains a source of vulnerability and a shift from portfolio to foreign direct investment (FDI) would be desirable. FDI inflows remain disappointing, however.

Despite the volatility of the rand and of South Africa's vulnerability to capital outflows, the authorities remain committed to liberalising capital controls and, in particular, to gradually lifting remaining ceilings on outflows. Their objective is to replace quantitative limits on outward investment with prudential regulations for institutional investors. This strategy is made possible by an increasingly comfortable stock of international reserves, which increased from \$18.7 billion in January 2006 to \$21.5 billion in October. As a result, reserve coverage of imports of goods and services rose from 7.9 weeks in 2003 to 14 weeks. Also, the ratio of gross foreign reserves (including gold) in the economy to gross external short-term debt stood

at 157 per cent in March 2006, up impressively from 71 per cent in December 2003. Hence, despite a ratio of reserves to imports relatively low by emerging markets standards, improving liquidity ratios have enabled South Africa to easily withstand the turmoil on emerging markets in 2006 and helped to retain the confidence of international investors.

South Africa's foreign debt was just 18.8 per cent of GDP in 2006 compared to 29.4 per cent in 1999 and an ever increasing share of it is rand denominated (43.8 per cent in the first quarter of 2006 compared to 37.5 per cent one year before). Debt service accounted for 8.8 per cent of export revenues in 2005.

Structural Issues

Recent Developments

With the macroeconomic situation stabilised and creditworthiness restored, the South African authorities are now focusing on structural obstacles to growth

and on equity. Despite the remarkable transformation undergone by the South African economy, the level of employment creation remains disappointing. With the ASGISA program unveiled by president Mbeki in February 2006, the South African authorities are pursuing the objective of halving poverty and unemployment by 2014. The document identifies six key constraints and related policy measures to address them: *a)* the cost, efficiency and capacity of infrastructures, *b)* the shortage of suitably skilled labour, *c)* barriers to market entry and competition, *d)* the regulatory environment and the burden on small and medium-sized businesses, *e)* deficiencies in government organisation, capacity and leadership, and *f)* the level and volatility of the exchange rate. ASGISA has been criticised as unfocused by some analysts. The authorities submitted their programme for review by experts from the Harvard Center for International Development³. Although generally supporting its approach, these experts lamented its excessive reliance on capital accumulation and its neglect of labour-market issues.

Reflecting government policies, transport infrastructure is improving. In line with the export-oriented strategy of the country, port development has become a priority. This is consistent with the importance of maritime transport for South Africa, which handled 96 per cent of imports and exports in 2005. The state-owned monopoly Transnet is allocating half of its ZAR 32 billion investment budget to restructuring and expanding port facilities in the coming five years. Although delayed, the deep water port in Coega is expected to start operating in early 2008. By end-2006, the Coega industrial development zone had attracted some 10 investors, including aluminium company Alcan which is investing some ZAR 16 billion in an aluminium smelter.

The 2010 World Cup is also generating investment in infrastructure. Some ZAR 15 billion have been earmarked by central government (and similar contributions are expected from other spheres of

government) for construction and upgrading of stadiums. After investing ZAR 3 billion in infrastructure over 1999-2003, Airports Company South Africa (ACSA) has allocated a further ZAR 5 billion for the period up to 2009 for upgrading airport terminals and runways. The O.R. Tambo Airport (Johannesburg International Airport) is already the busiest airport in Africa, with 13 million passengers in 2005 and 200 000 flight arrivals and departures. In 2006, six new airlines joined the 100 or so already present at JIA. JIA is also a major freight hub with more than 320 000 tons of cargo moved in 2005 – 7 per cent more than in 2004.

The much-delayed construction of the Gautrain fast rail link finally started in mid-2006. The first segment, linking the airport to Johannesburg, is to be completed by June 2010 for the World Cup and the remaining link between Johannesburg and Pretoria by 2011. To date, it represents the largest public-private partnership (PPP) signed on the African continent. The ZAR 21 billion contract for a 15-year concession was under negotiation for 15 months before it was finally signed in September 2006 by Gauteng province and the Bombela consortium led by Bouygues Construction and RATP International. The project is expected to provide transport for 60 000 to 70 000 passengers daily. In response to criticisms, the project has been further integrated in the existing transport system (with commuter trains, buses and with large car parking areas) and safety measures have been upgraded. However, the Gautrain project remains only a partial answer to the huge Johannesburg-Pretoria commuting problem, which concerns over 6 million commuters a day.

The upgrading of infrastructures and public services is limited by the limited capacities of local governments and skill shortages. This is a real challenge for the central authorities, given their commitment to increase provincial and local budgets by 58 per cent over the next three fiscal years. Several mechanisms have been developed to promote training and capacity building in local government. Technical assistance is provided

3. <http://www.cid.harvard.edu/southafrica/index.html>

by the Treasury in the fields of planning, budgeting and financial management. Also, the Development Bank of Southern Africa (DBSA) has started providing aid in basic service delivery through the deployment of experts in municipalities with the greatest needs (*Siyenza Manje* initiative). In March 2006, in order to tackle the mismatch of skills, the Deputy President launched the Joint Initiative for Priority Skills Acquisition (JIPSA). It focuses on skill development through improved alignment between higher education programmes and the needs of the public and private sectors, incentives for the repatriation of skilled South African expatriates and recruitment of retired experts.

Faced with very weak export performance since 1960 by international standards and a low level of export sophistication compared to its GDP level, the South African authorities are seeking to strengthen trade and industrial policy. The new national industrial policy framework attempts to better coordinate, focus, monitor and evaluate industrial policies so as to increase their impact. Fourteen priority sectors have been identified, with particular emphasis initially on business services and tourism. The authorities are aiming to diversify away from minerals and mineral-processing, while intensifying industrialisation and higher value activities in new areas of global growth. To that end, they are deploying a mix of incentives (including fiscal), large infrastructure investment and financing of priority sectors. They are also encouraging industrial development zones (ex. Coega). So far, however, there is a lack of co-ordination among the proliferation of initiatives. The approach of targeting certain sectors, while large unresolved economy-wide structural bottlenecks remain, is questionable. In that respect, the authorities are seeking to enhance competition through trade liberalisation and import tariffs on steel have been removed recently. A new competition law is under review by the Department of Trade and Industry.

Strengthening competition is especially needed in telecommunications, the cost of which remains a major concern for investors in South Africa. Even though South Africa ranks first in sub-Saharan Africa in terms of fixed line coverage (10 per 100 inhabitants), this ratio

is weak among emerging countries and even deteriorating. It is partly compensated by a high mobile phone penetration, with 31 million registered users and 65 mobiles per 100 inhabitants. The country has been trying to open the fixed line sector to competition since 2000 with the establishment of the Independent Communications Authority of South Africa. However, competition is only just developing with the entry in August 2006 of a second fixed-line operator, Neotel, led by the Indian group Tata. The new company has announced a ZAR 1 billion investment plan over the next 10 years to develop the network. A new Electronic Communications Act was also adopted in parliament in April 2006 to allow attribution of licences for both mobile and fixed systems. Besides the three existing mobile operators, three additional telecom groups are expected to benefit from the new act to offer some mobile phone services, which should help put further pressure on prices. Some uncertainties remain, however, notably regarding use of the West Africa / South Africa / Far East underwater high speed cable for which Telkom has a monopoly.

The market opportunities created by the emergence of the black middle class and large infrastructure projects are stimulating FDI. FDI is also facilitated by a sound governance and legal system. Some six major new investments worth a total ZAR 45 billion, notably in the retail, financial services and transportation sectors, are in the pipeline. Despite progress in diversification, FDI in South Africa is likely to remain concentrated on primary products and natural resource-intensive industries for some time. Domestic private investment is also picking up with new developments, notably shopping malls, in townships. Obstacles to higher foreign and domestic investment include the relatively small national and regional markets, factor costs (with the notable exception of electricity) and lack of skills.

The overall business environment is characterised by a continuous improvement in investor and consumer confidence, fuelled by rising growth. However, the selection of the new ANC president in 2007 is putting some pressure on the investment climate. Jacob Zuma, a possible successor to President Thabo Mbeki, has been critical of the government's liberal economic policies. His

accession to power might slow the pace of reforms, notably in the labour market, but would probably not dramatically reverse the government's policies.

High crime rates also remain a detriment to the attractiveness of the country, even though improvements are appearing. The Police Service's crime statistics released in September 2006 show a drop in the overall crime rate by 11.3 per cent between April 1994 and March 2006. Serious crimes also appear to have peaked. Nevertheless the number of serious crimes remained high at some 2.17 million in 2005/06, and some of them, including homicides, residential robberies and most of all drug-related crimes are still on the rise. The authorities have set a target of reducing "contact crimes"

by 7 to 10 per cent per year and are consequently strengthening the police.

South Africa's Black Economic Empowerment (BEE) programme continues to be an issue for debate in the country; although it is official government policy. There are encouraging signs that the black middle class is expanding thanks to affirmative action, particularly in the public sector. The government's official Codes of Good Practice on BEE, which will shape the racial transformation of South Africa in the coming decade, were gazetted early February 2007. The codes are the blueprint for implementation of government's "Balanced Scorecard" (the range of measures businesses must undertake).

Table 4 - The Balanced Scorecard

Elements	Definition	Weighting	Compliance Targets
Ownership	Voting rights	20 points	25% +1 vote
Management control	Representation in management	10 points	40% to 50%
Employment Equity	Weighted employment equity	15 points	43% to 80%
Skills Development	Skill development expenditure	15 points	3% of payroll
Preferential Procurement	Procurement from black-owned and empowered enterprises	20 points	70%
Enterprise Development	Investment in black-owned and empowered enterprises	15 points	3% (Net Profit After Tax)
Socio-Economic Development	Industry specific initiatives	5 points	1% (Net Profit After Tax)

Source: Authors based on DTI.

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Companies must score in each of the seven categories, including equity transfer or ownership. The exceptions are: multinationals which can prove that it is their standard practice not to have outside shareholders in subsidiaries; businesses with a turnover of less than ZAR 5 million which are excluded completely; businesses with a turnover of between ZAR 5 million and ZAR 35 million which can choose five elements of the scorecard to comply with. However, any company wishing to do business with government will have to comply with the broad-based BEE scorecard. Part of any such companies' "preferential procurement" compliance is to buy goods and services from other companies which comply with the codes, creating a cascade effect which will affect all but the smallest firms. Apart from its impact on small businesses,

questions remain about the extra regulatory burden of complying with a fairly complex set of rules.

The financial system remains sound and regulation is improving. At the end of June 2006, the capital adequacy ratio of the banks (regulatory capital over risk-weighted assets) stood at 12.4 per cent, well above the required 10 per cent. Asset quality also improved with non performing loans at 1.2 per cent of total loans compared to 1.5 per cent end of 2005. The most significant risk to the banking sector today lies in increasing household mortgage debt in a context of rising interest rates. Bank credit to households increased from 33 per cent of total credit in June 2005 to 43 per cent in June 2006. However, the number of insolvencies has steadily declined since 2003 and household debt

service remains low, making it unlikely that loan defaults would be widespread enough to cause systemic problems. Strengthened bank supervision, and enhanced bank risk management systems, notably to comply with the Basel II agreement, have also reduced the risk of a banking crisis.

Access to Drinking Water and Sanitation

South Africa is a semi-arid country, with rainfall well below the world average and unevenly distributed; available water resources are used very intensively. No fewer than 458 dams were commissioned between 1950 and 2000, initially for irrigation purposes but subsequently also for the provision of drinking water. These facilities were not initially located near population centres and therefore required heavy investment in piping. Water is also very inefficiently used with 60 per cent of available supply consumed by agriculture, which only accounts for 4 per cent of GDP. Water pollution remains an issue in a country in which agriculture, mining and energy are major sectors. With demand growing, South Africa faces a serious risk of shortages by 2020. To meet the challenge, the country is investing primarily in water use efficiency programmes (especially in the domestic and agricultural sectors) and secondarily in additional supply via recycling, desalination and new infrastructures.

At the end of the apartheid regime in 1994, South Africa inherited a backlog of some 15 million people with no access to safe water supply and more than 20 million with no access to sanitation services, most of them in the former homelands. The newly elected government instituted an overhaul, with the Department of Water Affairs and Forestry (DWAF) at the centre of the new system. The 1994 White Paper on Community Water Supply and Sanitation, the 1997 Water Services Act and the National Water Act of 1998 established the objective of access to basic water and sanitation services for all while ensuring environmental sustainability as well as economic efficiency. A 2001 White Paper introduced a free basic water allotment of 25 litres per day per person. The constitution vests the responsibility for water and sanitation services in local government. National government, however, is provided with the regulatory function.

Despite the official adoption of a decentralised approach to managing water and sanitation issues, the sector remains highly centralised with the DWAF overseeing both service provision and the institutional and policy framework. This reflects capacity constraints at the municipal level but also some reluctance on the part of the DWAF to relinquish its control. There is also very little co-operation with the private sector. The number of public-private partnerships fell to only three after the termination of the management contract between the municipality of Johannesburg and Suez affiliated JOWAM in March 2006. The government has shown a clear reluctance to transfer substantial responsibilities to private operators.

Overall, the country has made considerable progress in improving access to safe water and sanitation, especially considering the rising population: a total of 21.4 million people have been given access to improved water supplies since 1994, bringing the percentage of people without access from 39.9 per cent to 7 per cent. Meanwhile, 9 million people have been provided with improved sanitation, raising the percentage of people with access from 49 per cent to 69 per cent. In 2003, the DWAF established the Strategic Framework for Water Services, which set targets of universal access to water by 2008 and to sanitation by 2010, well ahead of the MDG targets of 80 per cent with access to water and sanitation by 2015. In practice, however, while South Africa will easily reach the MDG water supply target by 2015, it will find it difficult to meet the sanitation target and provision of a universal service is likely to take even longer.

After the remarkable progress of the last decade, tackling the remaining backlog of 5 million people without services represents a much more difficult challenge as this population is mostly rural and dispersed. Better rural access to water services will require substantial improvement in municipalities' managerial and engineering capacities. At the same time, urban water and sanitation systems are in urgent need of better maintenance. While government focuses mostly on the development of new infrastructure, maintenance of older networks, which today are between 50 and 100 years old, is neglected. All these problems

mean that it will be difficult to raise access levels much in the coming years.

Even though it remains largely state-owned, the sector is seeking financial sustainability but faces low willingness to pay on the part of population, partly as a result of historical resistance in the townships to the apartheid regime, and, in the case of smaller municipalities, limited collection capacity. Smaller municipalities face huge challenges in terms of covering operational and maintenance costs in a context of high poverty levels, existing free access to basic water services and plans on the government's part to phase out subsidies after five years. On the other hand, some of the bigger municipalities such as Johannesburg are seeking innovative financing schemes.

Political Context and Human Resources Development

South Africa's standing continues to rise on the African continent as well as in the international arena. In 2007, the country starts a two-year term on the United Nations Security Council. It has also become chair of the G20 forum of industrialised and developing economies. However, with the election of the next ANC president approaching, internal politics is moving under the spotlight.

The March 1 2006 municipal elections gave expression to a rise in popular discontent fuelled by a perception of limited progress in the provision of public services at local level, the slow pace of improvement in the majority of the black population's living conditions and pervasive unemployment. Rising dissatisfaction is putting pressure on the ANC coalition, deepening the divide between the current leadership and the left wing represented by the Congress of South African Trade Unions (COSATU) and the South African Communist Party (SACP). The coming selection of the ANC president in December 2007 prior to presidential elections in 2009 is exacerbating the tensions which have been further fuelled by the twists in the Zuma affair. After Jacob Zuma, then deputy president, was dismissed by President Mbeki in 2005 on allegations of fraud and

corruption and further indicted with rape charges, his political prospects as future ANC president seemed very slim. However, his case changed dramatically in September 2006 when the corruption charges against him were dismissed for lack of proof and he was acquitted of rape. Zuma is back in contention for the ANC presidency, a post which is virtually certain to lead to the presidency in 2009. Despite the trials, support for him has grown, especially among the unions and the communists which see in him the most credible alternative to the current business-oriented government.

Between 1995 and 2005, South Africa's population increased from 41.5 million to 46.9 million while average household size fell from 4.7 to 3.7 people. Demographic pressure, combined with a rise in the number of households and migration to urban areas, has partly offset the government's efforts to improve delivery of public services. For example, even though 2.5 million new formal housing units were built between 1995 and 2005, the proportion of households living in formal housing decreased from 72.9 per cent to 69.8 per cent and informal settlements mushroomed. This trend is making it increasingly difficult to meet demand for electricity and water services.

Despite the creation of 1.2 million jobs in the formal sector (excluding agriculture) between March 2001 and March 2006, the growth of the labour force has prevented unemployment from being significantly reduced and real wages from being increased. From 1995 to 2005, the active population rose by 65 per cent and the number of unemployed people increased by 168 per cent, from 1.6 million to 4.4 million. The stubbornly high unemployment rate also stems from the apartheid legacy of skill mismatch and inequalities. Nevertheless, encouragingly, the unemployment rate has started to decline in recent years, from a high of 30.2 per cent in 2002 to 25.6 per cent in March 2006.

Earnings inequality rose sharply during 1995-1999 and remained high but stable over 2000-04. South Africa's efforts to stimulate export-led growth have yielded limited gains in employment and incomes for unskilled workers due to the capital-intensive nature of exports. Clearly, skill development remains a key

priority and South Africa rightly devotes almost one fifth of budget spending to education. The government's efforts are directed at learners via the extension of free schooling, which is due to be made available to 40 per cent of learners in 2007, and teachers via improved qualifications.

Rising inequalities co-exist with the emergence of a black middle class. According to Cape Town University's Black Diamond marketing survey, the number of black households earning more than ZAR 154 000 a year increased by 368 per cent between 1998 and 2004. From next to nothing in the early 1990s, the middle class had grown to 10 per cent of the black adult population or 2 million individuals by 2004 and is currently growing at a rate of 50 per cent per year. Three quarters of the black middle class still live in the townships and the remaining quarter commute from the suburbs to the townships where they visit family and friends over week-ends.

In rural areas, though, little has changed. With only four per cent of land owned by the black population (compared to a target set in 1994 of reaching 30 per cent by 2015), land reform has made slow progress. The authorities are adopting a more pro-active policy, moving away from the initial approach based on voluntary transactions to relying more on expropriations and compensations.

A total of 5.4 million people are HIV-infected in South Africa, including 16.2 per cent of 15-49 year old adults and one third of young women aged 25 to 29, according to the 2005 South African National HIV survey commissioned by the Nelson Mandela Foundation. Some 2.2 million people were estimated to have died of AIDS by July 2006. The number of

dead in 2006 alone reached 350 000. Statistics also suggest that the epidemic is still worsening, even if at a slower rate. As a result, life expectancy has fallen from 57 years in 1995-2000 to under 50 in 2006. To tackle the tremendous challenges raised by the disease, South Africa has put in place a large anti-retroviral treatment plan, in which some 134 500 people have been enrolled through the public sector and a further 80 000 people by the private sector and NGOs. However, enrolment remains well short of needs with some 500 000 adults estimated to be still without access to treatment. More importantly, there are signs that the government is reversing its approach to HIV/AIDS. Following the uproar created by the South African display of vegetable "treatments" at the Toronto AIDS conference in August 2006 and under the pressure of NGOs (notably Treatment Action Campaign) and of 81 leading scientists who called for the sacking of controversial health minister Manto Tshabalala-Msimang, the cabinet formed an inter-departmental committee to oversee the government's response to the epidemic. Deputy President Phumzile Mlambo-Ngcuka, who heads the committee, has already made her mark through strong statements and symbolic gestures such as meeting AIDS specialists and walking arm in arm with TAC activists. The HIV/AIDS strategic plan for 2007-2011, due in December 2006, was postponed to March 2007 to allow for broader participation, notably by civil society. The two key objectives of the plan are a 50 per cent reduction of the new infection rate by 2011 through increased prevention and the extension of treatment, care and support to 80 per cent of the HIV-positive population. This policy reversal provides for greater availability of drugs and will encourage the population to make more use of conventional treatment, thus opening the way to much-needed progress.