Quarterly Bulletin

March 2004

South African Reserve Bank

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Quarterly Economic Review

Introduction

Following a protracted period of hesitant growth, global economic activity picked up noticeably during the second half of 2003. The cumulative effect of the sustained application of expansionary monetary and fiscal policies in a number of key economies and in the United States in particular, contributed to the welcome acceleration in economic activity, as did the strong economic growth in China and India, the solid revenues befalling oil-exporting countries and, more generally, the relatively high prices received by commodity exporters.

Inflationary pressures, however, were kept at bay in most parts of the world. Canada in fact lowered its short-term interest rates in the first quarter of 2004 in order to counter a possible undershooting of its inflation target, while the United States kept short-term interest rates unchanged at historically low levels. In the final months of 2003 the Reserve Bank of Australia and the Bank of England were the first central banks among the developed economies to raise their official interest rates.

In South Africa, output growth fell significantly behind growth in real domestic expenditure during the course of 2003. Despite the acceleration in global economic activity, South African export volumes remained subdued. This was partly a consequence of the usual time delay before stronger global activity spills over into higher domestic exports. Furthermore, in some of South Africa's important export markets on the European continent the stagnation in income and production continued throughout last year. The significant recovery of the exchange rate of the rand in 2002 and 2003 also reduced South Africa's price competitiveness in the world market, dampening exports and boosting imports.

Under these circumstances the goods-producing sector in South Africa performed poorly, with production volumes in manufacturing contracting during all four quarters of 2003. Real value added in agriculture also declined, suppressed by adverse climatic conditions and lower product prices. In mining real production rose somewhat in 2003, while the services sector, and especially communication services, recorded firm growth. In 2003 as a whole real gross domestic product rose by roughly 2 per cent, while on a quarter-to-quarter basis the lowest annualised growth rate recorded was ½ a per cent in the second quarter, picking up to 1 per cent in the third quarter and 1½ per cent in the final quarter of 2003.

Against this lacklustre production performance, real domestic expenditure rose considerably in 2003. For the year as a whole real expenditure advanced by around 4 per cent, while in the fourth quarter of 2003 its annualised growth rate amounted to 7 per cent. If the effect of the surge in real expenditure on account of the delivery of a new vessel, the SAS Amatola, to the South African Navy is excluded from the final quarter's expenditure total, the annualised rate of growth in the remaining real expenditure total amounted to 6 per cent.

In the fourth quarter of 2003 real final consumption expenditure by general government recorded its highest rate of increase in 13 years due to the purchase of the new naval vessel. Excluding the purchase of this item, underlying growth in real consumption expenditure by government still accelerated slightly further from the third to the fourth quarter. Real final consumption expenditure by households continued to grow at a brisk pace in the fourth quarter, shored up by advances in real disposable income and lower interest rates.

Real fixed capital formation also recorded a brisk increase in the final quarter of 2003, led by public corporations which, *inter alia*, acquired new aircraft during the quarter. Fixed capital formation in both the private sector and the government sector also expanded somewhat in the fourth quarter, with private business enterprises in the mining sector responsible for the highest rate of increase. Real inventory levels continued to rise in the fourth quarter of 2003, possibly in response to the continued strong increases in real final sales in the economy.

The higher growth in domestic expenditure than in production was reflected in the deficit on the current account of the balance of payments, which rose to almost 2 per cent of gross domestic product in the final quarter of 2003. While import volumes rose significantly during the course of 2003, export volumes remained essentially unchanged. Favourable prices for export commodities to some extent helped to contain the current-account deficit in the fourth quarter. The deficit on the current account was easily financed by financial-account inflows, which made it possible for South Africa's gross gold and other foreign reserves to rise by a record amount in the fourth quarter of 2003.

While the significant recovery in the exchange rate made South African exports less competitive, it was nonetheless an important force in bringing down the inflation rate through heightened competition from imports. Over the twelve months to January 2004 the production prices of imported goods in rand terms declined by almost 9 per cent. Production prices of domestically produced goods rose at a subdued pace, reflecting stiffer competition from abroad but also the effect of prudent monetary and fiscal policies. Developments in production prices were also reflected in consumer prices, as twelve-month CPIX inflation receded to 4,0 per cent in December 2003 – its lowest since CPIX data became available in 1997 – before accelerating marginally to 4,2 per cent in January 2004. Simultaneously, headline inflation reached 0,2 per cent in January 2004, its lowest twelve-month value since August 1954. Being less susceptible to the forces of international competition, however, inflation in most services prices remained well above inflation in the prices of goods.

Growth in the broad monetary aggregate M3 and in bank loans and advances converged recently, each recording twelve-month rates of increase of around 12 per cent in most of 2003 and January 2004. This partly reflected the influence of brisk growth in domestic expenditure and lower nominal interest rates. The income velocity of circulation of M3 reached a record low value in the third quarter and fourth quarter of 2003, suggesting ample underlying liquidity in the economy.

Following an extended bull run in the bond market, long-term interest rates edged marginally higher in the early months of 2004 as inflation declined to the point where most market participants expected it to bottom out while the public sector also started to borrow more funds in the domestic capital market. Short-term interest rates also edged up somewhat since mid-December 2003, following the less-than-expected 50-basis-point reduction in the repurchase rate of the South African Reserve Bank announced after the December meeting of the Monetary Policy Committee. Nevertheless, most short-term interest rates were at their lowest levels since the early 1980s because of the cumulative 550-basis-point reduction in the repurchase rate from early June 2003.

In step with equity markets in most other parts of the world, share prices on the JSE Securities Exchange SA recovered significantly from the low levels that they had reached during the second quarter of 2003 despite the fact that the exchange rate of the rand, with its important bearing on exporters and import-competing firms, remained relatively firm. Sustained strong increases in house prices had positive wealth effects and were also reflected in the increased use by households of credit facilities, particularly mortgage advances.

The national Budget, announced in February 2004, continued to be formulated within a framework of fiscal discipline. Projecting a more expansionary fiscal stance, with higher growth in expenditure than in revenue, it is expected that the national government's deficit before borrowing will rise to a level fractionally above 3 per cent of estimated gross domestic product in the fiscal year 2004/05. However, a sustained primary surplus is expected and the ratio of government debt to gross domestic product is projected to remain fairly low.

Apart from driving CPIX inflation down into the target range from September 2003, another monetary policy milestone was reached in February 2004 when the South African Reserve Bank closed out its oversold forward foreign exchange book, by so doing no longer exposing the taxpayer to exchange rate risk through running a large position in such contracts. With this book having been reduced from more than US$25 billion in 1998, perceptions of vulnerability in this area have finally been put to rest. Going forward the Bank is now focusing on gradually strengthening its gold and foreign exchange reserves.

Domestic economic developments

Domestic output[1]

1 The quarterly growth rates referred to in this section are based on seasonally adjusted data.

Real production increased further in the fourth quarter of 2003, the twenty-first successive increase since the third quarter of 1998. Having increased at an annualised rate of only ½ a per cent in the second quarter of 2003, growth in *real gross domestic product* accelerated to 1 per cent in the third quarter and 1½ per cent in the fourth quarter. While the tertiary sector continued to grow at a steady pace, the decline in the real value added by the primary sector moderated from the third to the fourth quarter of 2003. However, the contraction in the secondary sector worsened.

Notwithstanding the pick-up in real economic growth in the third and fourth quarters of 2003, the South African economy grew by close to 2 per cent in 2003 as a whole – considerably slower than the growth rate of 3½ per cent attained in 2002. This was recorded against the background of a recovery in the global economy which gained momentum in the second half of 2003, but was not evenly distributed among the various countries and regions. For example, the European economy – South Africa's largest trading partner – is still emerging from the economic downturn of 2002.

The sturdy performance of the economy in 2002 was partly due to strong growth in the agricultural and manufacturing sectors, which, especially in the case of the manufacturing sector, benefited somewhat from the depreciation of the exchange rate of the rand in that year. When these circumstances were reversed in 2003, the manufacturing sector subtracted roughly ½ a percentage point from real economic growth compared with a positive contribution of 1 percentage point in 2002. Likewise, real agricultural output subtracted nearly ½ a percentage point from total real output growth after contributing ½ a percentage point in 2002.

Production in the *primary sector* contracted further in the fourth quarter of 2003 albeit at a more restrained pace than in the third quarter. The quarter-to-quarter decline moderated from an annualised rate of 6½ per cent in the third quarter of 2003 to 4 per cent in the fourth quarter. This was mainly due to a significantly lower rate of contraction in the real value added by the agricultural sector. After increasing at a rate of 3 per cent in 2002, the real value added by the primary sector declined by 1 per cent in 2003.

The real value added by the *agricultural sector* contracted in all four quarters of 2003. The decline, however, moderated from an annualised rate of 22 per cent in the third quarter of 2003 to 9½ per cent in the fourth quarter. Although real output in most subsectors of the agricultural sector remained weak, livestock production held up fairly well, mitigating the rate of contraction in the fourth quarter. Real value added by the agricultural sector declined by 6 per cent in 2003 compared with an increase of 6½ per cent recorded in 2002. This effectively put the level of real agricultural output on a par with that of 2001. Poor weather conditions affected most of the country in 2003 and had an adverse effect on both livestock and field crop production. The field crops bearing the brunt of the bad weather were wheat, sugar, groundnut, sunflower and maize. Although a larger area was planted in 2003 than in 2002, the size of the 2003 maize crop was smaller.

Following an increase of just ½ a per cent in 2002, real *mining output* increased by 2½ per cent in 2003. The firm growth in the real value added by the mining sector in 2003 was mainly due to buoyant activity in diamond and coal mining which was supported by stable growth in platinum production. In addition, strong US dollar commodity prices and increased demand from China, in particular, underpinned mining production. Real gold mining output, however, fell back from 2002 to 2003 partly as a result of unfavourable conditions brought about by the significant recovery of the rand and the gradual depletion of shallow ore deposits with a high gold content.

Real gross domestic product

Percentage change at seasonally adjusted annualised rates

	2002					2003				
Sectors	1st qr	2nd qr	3rd qr	4th qr	Year	1st qr	2nd qr	3rd qr	4th qr	Year
Primary sector	7	7½	5½	3	3	-2½	-6½	-6½	-4	-1
Agriculture	13½	14	9½	5½	6½	-5½	-19½	-22	-9½	-6
Mining..........................	2	3	2½	1½	½	½	5	6	0	2½
Secondary sector	4½	8½	6	1½	4½	-3	-3	-½	-1½	0
Manufacturing	5	10	7½	0	5½	-4½	-4½	-1½	-3½	-1
Tertiary sector	3	3½	3	3	3½	3	3	3	3	3
Non-agricultural sector......	*3½*	*5*	*4*	*2½*	*3½*	*1*	*1½*	*2*	*1½*	*2*
Total.................................	4	5	4	2½	3½	1	½	1	1½	2

Having increased at an annualised rate of 6 per cent in the third quarter, real value added by the mining sector stagnated in the fourth quarter of 2003. This was the net result of a decline in the real value added by the gold and platinum mining sectors which counteracted increases in real output by the diamond and coal mining sectors. The high demand from the Far East provided the impetus for increased diamond output volumes.

The real value added by the *secondary sector* contracted further in the fourth quarter of 2003. Following a modest contraction at an annualised rate of ½ a per cent in the third quarter, the negative rate of growth worsened to 1½ per cent in the fourth quarter. This can be attributed to a further contraction in the real value added by the manufacturing sector which more than offset solid growth by the construction sector and the sector that supplies electricity, gas and water.

The real value added by the *manufacturing sector* contracted for the fifth successive quarter. Subsequent to a moderate decline at an annualised rate of 1½ per cent in the third quarter, manufacturing output contracted at a rate of 3½ per cent in the fourth quarter of 2003. The slump in the manufacturing sector was evident in production volumes of several subsectors. It was particularly pronounced in the manufacturing of food and food products, clothing and textile products, chemicals and chemical products, electrical machinery and apparatus, and in transport equipment. However, these declines were partially counteracted by brisk increases in the real value added by the basic metals and radio, television and computer equipment subsectors.

Following quarter-to-quarter annualised declines ranging between 4½ and 1½ per cent throughout 2003, real manufacturing output for the year as a whole contracted by 1 per cent, compared to a robust growth rate of 5½ per cent recorded in 2002. The weakness in manufacturing production in 2003 was a result of:

- reduced exports compared with the previous year as South African producers became less price competitive because of the significant recovery in the exchange value of the rand;
- the inability to take advantage of strong domestic demand which was mainly satisfied by cheaper imports; and

- lags in the translation of stronger global growth into effective demand for South African exports.

Following an increase of 2½ per cent in the third quarter of 2003, growth in the real value added by the sector that supplies *electricity, gas and water* accelerated to an annualised rate of 3 per cent in the fourth quarter. This can be attributed to lower imports from neighbouring countries, which boosted domestic production. The level of real output in this sector was 2½ per cent higher in 2003 compared with 2002.

Growth in the real value added by the *construction sector* accelerated from 4 per cent in the third quarter of 2003 to an annualised rate of 6½ per cent in the fourth quarter. The solid performance of the construction sector was underpinned by strong demand for residential and non-residential buildings. Household confidence was bolstered by lower interest rates and the sustained increases in house prices. This contributed to demand for new housing units. The increase in the construction of non-residential buildings came mostly from the addition and modernisation of retail space. These developments contributed to growth in the real value added by the construction sector accelerating from 4½ per cent in 2002 to 5 per cent in 2003.

The real value added by the *tertiary sector* recorded its sixth consecutive quarter of growth at an annualised rate of 3 per cent in the fourth quarter, raising the real output level in this sector in 2003 by 3 per cent above that of the previous year. The fourth quarter performance was mainly underpinned by solid growth in real output by the commerce and the finance, insurance, real-estate and business services sectors.

Although growth in the real value added by the *commerce sector* slowed down from 4½ per cent in the third quarter of 2003 to 3½ per cent in the fourth quarter, activity remained lively in this sector. This was mainly evident in the retail trade and catering and accommodation subsectors. The retail sector continued to benefit from strong consumer demand for furniture and household equipment, semi-durable and non-durable goods. In addition, the tourism industry flourished in the fourth quarter of 2003. Although activity in the vehicle trade sector remained strong, sales volumes receded somewhat on a quarter-to-quarter basis in the fourth quarter following the very high growth rate recorded in the third quarter of 2003.

The quarter-to-quarter growth rate in the real value added by the *transport, storage and communication sector* amounted to an annualised rate of 6 per cent in all four quarters of 2003. As a result, the annual rate of increase in 2003 as a whole amounted to 6 per cent, edging just below the 6½ per cent rate posted in 2002. The main drivers of growth in the fourth quarter of 2003 were firm increases in real output in the private transport and cellular communication subsectors.

Growth in the real value added by the *finance, insurance, real-estate and business services sector* accelerated from 1½ per cent in the third quarter to an annualised rate of 3 per cent in the fourth quarter of 2003. This can mainly be ascribed to a solid expansion in the real output of private banks. In addition, higher trading volumes on the JSE Securities Exchange SA (JSE) in the fourth quarter boosted the real output of share dealers. Activity in the real-estate sector also remained lively. However, as a result of somewhat lower quarterly growth rates attained, the annual growth in 2003 amounted to 3 per cent compared with an increase of 4 per cent recorded in 2002.

The real value added by *general government* increased at an annualised rate of ½ a per cent in the fourth quarter of 2003 – the same rate attained in the previous three quarters.

The stable rate of output by general government is a reflection of fiscal restraint as the government seeks to contain the growth in the civil service, mindful of the need for greater efficiency in public service delivery. Annual growth in this sector has remained below 2 per cent since 1992 and amounted to only ½ a per cent in 2003.

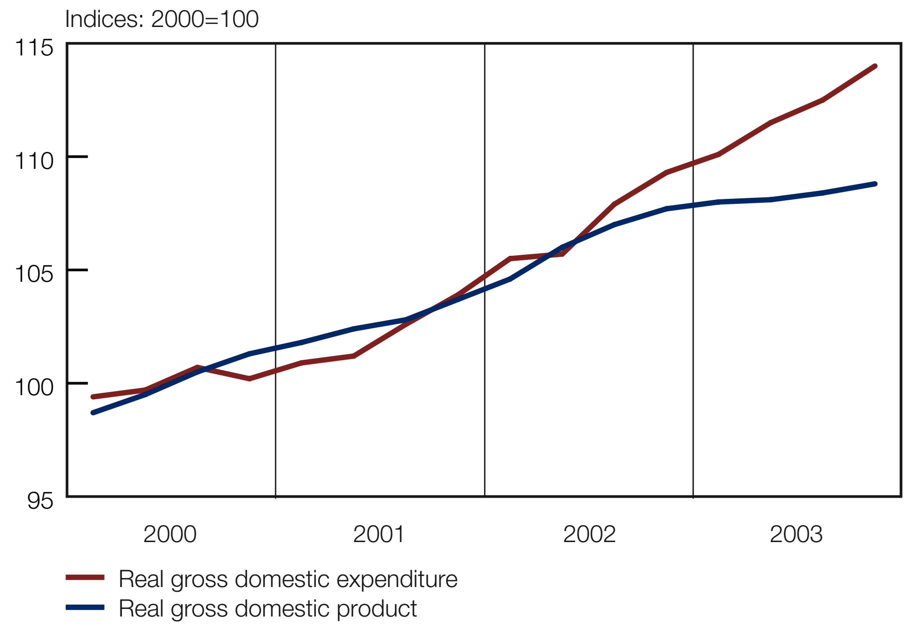
A more subdued trajectory for living standards in 2003 was implied by a slowdown in the growth in *real gross national income* from 5 per cent in 2002 to 3 per cent in 2003. The weaker growth in real gross domestic product more than offset the smaller amount of net primary income payments to the rest of the world. The terms of trade improved in 2003, enabling the same volume of exports to pay for a larger volume of imports. As a net result of these forces, the growth in real gross national income *per capita* slowed down from a rate of 3 per cent in 2002 to 1 per cent in 2003.

Domestic expenditure[2]

Following an increase of 4½ per cent in the third quarter of 2003, growth in *aggregate real gross domestic expenditure* accelerated to an annualised rate of 7 per cent in the fourth quarter. This can be attributed to robust growth in real domestic final demand which was underpinned by a faster pace of consumption expenditure by general government. Despite these developments, growth in real gross domestic expenditure for 2003 as a whole amounted to 4 per cent, just below the rate of 4½ per cent attained in 2002.

2 The quarterly growth rates referred to in this section are based on seasonally adjusted data.

Real gross domestic product and expenditure



Real final consumption expenditure by households increased at an annualised rate of 4 per cent in the fourth quarter of 2003 – the same rate as had been attained in the third quarter. This was mainly a result of robust growth in real outlays on semi-durable and non-durable goods. Growth in real household expenditure on durable goods slowed down on a quarter-to-quarter basis, but was still relatively strong in the fourth quarter of 2003. The annual growth in real final consumption expenditure by households in 2003 amounted to 3 per cent, similar to the rate attained in 2002.

Annualised growth in real expenditure by households on *durable goods* slowed down from 17 per cent in the third quarter of 2003 to 3½ per cent in the fourth quarter. This can be attributed to a decline in real outlays on personal transport equipment, particularly sales of new motorcars which had been at a high level in the third quarter of 2003. However, households stepped up real outlays on furniture and household appliances as well as on recreational and entertainment goods.

Real gross domestic expenditure

Percentage change at seasonally adjusted annualised rates

	2002					2003				
Components	1st qr	2nd qr	3rd qr	4th qr	Year	1st qr	2nd qr	3rd qr	4th qr	Year
Final consumption expenditure by households	3½	3½	3	2½	3	2½	3	4	4	3
Final consumption expenditure by general government	3½	3½	4	4	3½	4	4½	4½	13	4½
Gross fixed capital formation	6	9	13½	16	6	5	3	7½	8½	8½
Change in inventories (R billions)*.........................	8,8	0,2	7,3	6,6	5,7	6,3	9,2	7,9	7,9	7,8
Gross domestic expenditure	**7½**	**1**	**7**	**5**	**4½**	**2½**	**3½**	**4½**	**7**	**4**

* At constant 1995 prices

Growth in real household expenditure on *semi-durable goods* increased strongly in the fourth quarter of 2003. This was mainly evident in real outlays on clothing, footwear and household textiles. The absolute decline in the prices of many of these commodities kept demand firm. Accordingly, the annualised quarter-to-quarter growth in the real expenditure on semi-durable goods accelerated from 8 per cent in the third quarter to 13 per cent in the fourth quarter of 2003. The increase in real household spending on *non-durable goods* in the fourth quarter of 2003 was supported by strong demand for food and household fuel and petroleum products.

3 For example, the First National Bank consumer confidence index edged higher from the third to the fourth quarter of 2003.

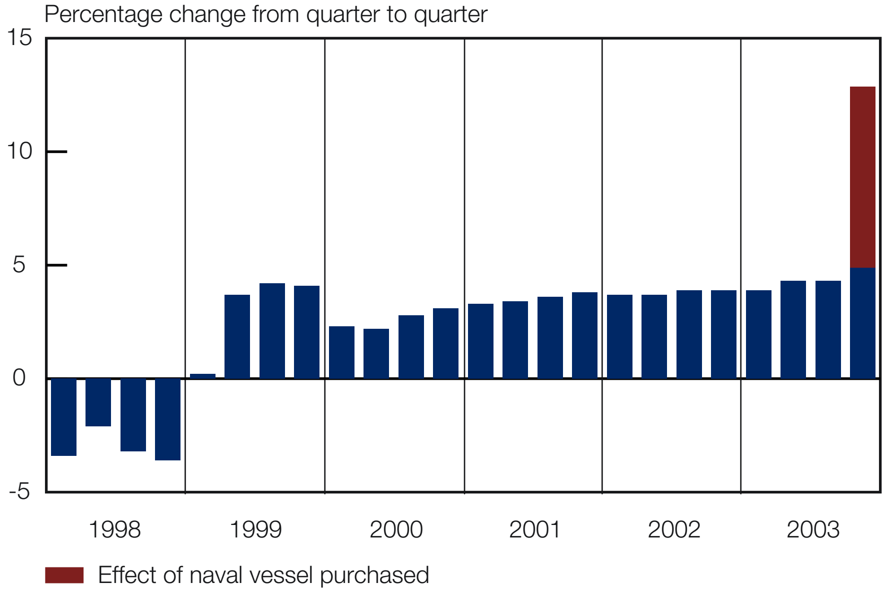
The firm expansion in real final consumption expenditure by households was underpinned by rising consumer confidence[3]. In turn, this was the result of a number of factors, including:

- the declining prices of various consumer items, especially those with a high import content;
- the decline in interest rates which reduced the ratio of debt servicing cost to disposable income from 8 per cent in the third quarter to 6½ per cent in the fourth quarter – the lowest quarterly ratio since the first quarter of 1988; and
- high wage settlements relative to the inflation rate.

A notable development in the fourth quarter of 2003 was that the increase in household expenditure did not translate into undue upward pressure on household debt levels. The ratio of household debt to disposable income declined from 53½ per cent in the third quarter to 52½ per cent in the fourth quarter of 2003. This was partly due to the strong increase in real household disposable income which accelerated from an annualised rate of 3½ per cent in the third quarter to 4 per cent in the fourth quarter.

Real final consumption expenditure by general government increased at an annualised rate of 13 per cent in the fourth quarter of 2003, compared with a growth rate of 4½ per cent attained in the third quarter. This is the highest quarterly growth rate recorded since the first quarter of 1990. The sturdy increase in real outlays by the general government was boosted by the delivery of a vessel to the South African Navy. However, even when excluding this extraordinary item, real government consumption expenditure still increased at an annualised rate of 5 per cent in the fourth quarter of 2003. Meanwhile, general government continued to contain the growth in its wage bill. As a result of these developments, the ratio of final consumption expenditure by general government to gross domestic product edged up from 19 per cent in the third quarter to 19½ per cent in the fourth quarter. For 2003 as a whole the ratio amounted to 19 per cent compared with 18½ per cent in 2002.

Real final consumption expenditure by general government

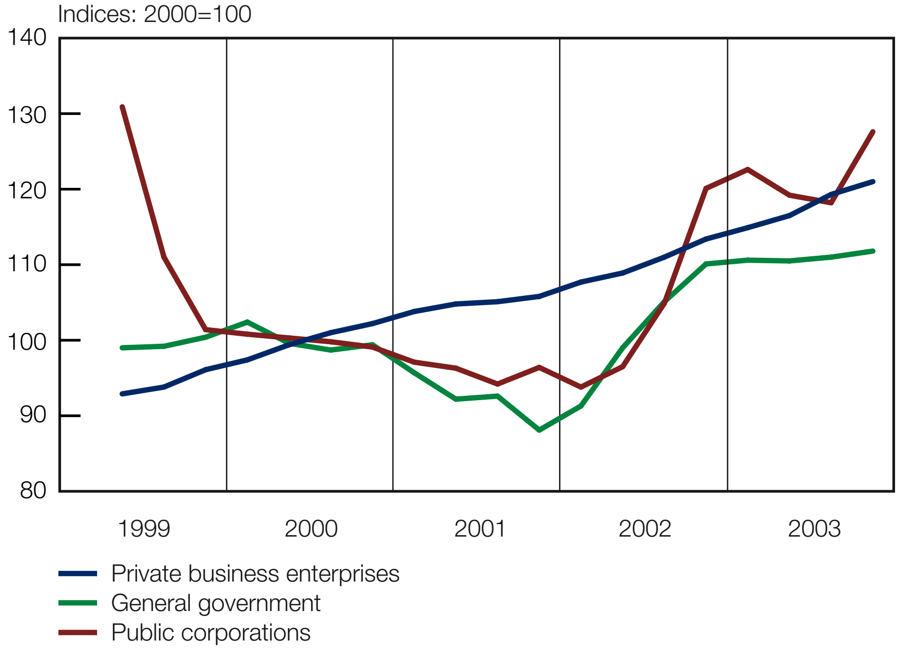


Seasonally adjusted annualised rates

Real gross fixed capital formation recorded a further solid increase in the fourth quarter of 2003. Following annualised increases of 3 per cent and 7½ per cent in the second and third quarters, respectively, growth in real fixed capital expenditure accelerated to an annualised rate of 8½ per cent in the fourth quarter of 2003. Viewed by institutional sector, the major contributors to the robust growth in the fourth quarter were the government sector and public corporations. The contribution of private business enterprises to growth in real capital expenditure waned somewhat in the fourth quarter. Nevertheless, with quarterly annualised growth rates ranging between 3 and 8½ per cent in 2003, the year-to-year growth rate of total real gross fixed capital formation accelerated from 6 per cent in 2002 to 8½ per cent in 2003.

Following an increase of 10 per cent in the third quarter, growth in real fixed capital outlays by *private business enterprises* slowed down to an annualised rate of 5½ per cent in the fourth quarter of 2003. This can be attributed to a contraction in real capital expenditure by the agricultural sector. However, strong increases in real capital outlays by the mining and transport and communication sectors more than offset the decline in agriculture. The mining sector benefited from ongoing capacity expansion, particularly in platinum mines. Cellular telephone companies were engaged in infrastructure expansion to meet ongoing strong demand for their services.

Real gross fixed capital formation



The acquisition of aircraft by South African Airways gave a fillip to real gross fixed capital formation by *public corporations*. This, together with the continued expansion of the Coega development project, reversed the decline of 3 per cent in real capital outlays by public corporations in the third quarter to an annualised growth rate of 35½ per cent in the fourth quarter of 2003.

Real fixed capital expenditure by *general government* remained relatively strong in the fourth quarter, mainly due to increased expenditure by provincial and local governments. Local government stepped up real capital expenditure to improve and maintain infrastructure – crucial to the success of service delivery by government.

Real inventory investment was virtually of the same magnitude in the fourth quarter of 2003 as in the third quarter. The further accumulation of inventories was mainly concentrated in the commerce sector and was probably fuelled by the high volume of imports. The ratio of industrial and commercial inventories to real gross domestic product amounted to 16 per cent in both the third and the fourth quarters of 2003.

Inventory accumulation in 2003 as a whole amounted to R7,8 billion at 1995 prices, compared with R5,7 billion in 2002, thus contributing ½ a percentage point to real economic growth. The build-up in inventories during 2003 took place against the background of an environment of comparatively lower prices, particularly of imports, as well as lower holding costs of inventories due to lower interest rates.

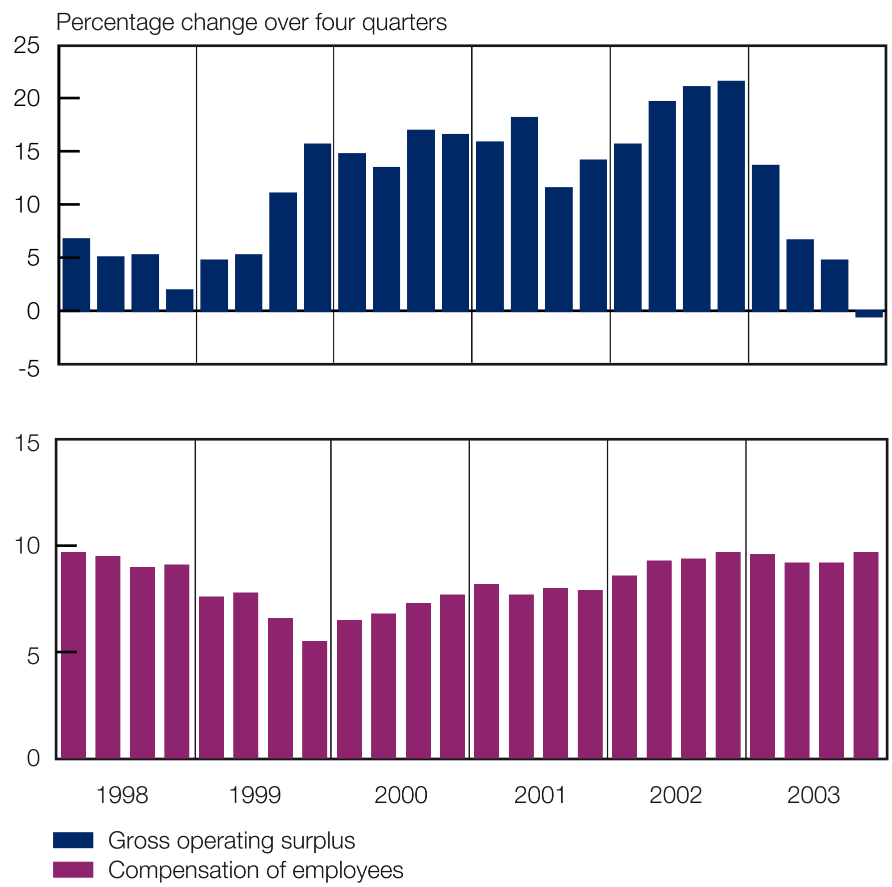
Factor income

The growth over four quarters in *total nominal factor income* decelerated from 8 per cent in the second quarter of 2003 to 7 per cent and 4½ per cent in the third and fourth quarters, respectively. The weaker total nominal factor income was mainly the result of an actual decline in gross operating surpluses of business enterprises which more than offset strong growth in compensation of employees. For 2003 as a whole, nominal factor income rose by 7½ per cent, well below the 14 per cent attained in 2002.

The total *gross operating surpluses* of business enterprises measured over a year declined by ½ a per cent in the fourth quarter of 2003. Profit margins were compressed throughout virtually all sectors, but most prominently in the agricultural, mining and manufacturing sectors. Profit margins in agriculture came under pressure partly due to reduced field crop production brought about by adverse climatic conditions and also on account of lower commodity prices. Domestic manufacturing sales were considerably weaker than before. Mining operating surpluses were heavily affected by the recovery of the exchange rate of the rand, the effects of which were not fully offset by stronger global demand and higher commodity prices. In addition, input costs continued to rise. Accordingly, the level of total gross operating surpluses in 2003 increased at a rate just under 6 per cent, considerably lower than the rate of increase of 19½ per cent in 2002.

The growth over four quarters in total *compensation of employees* accelerated from 9 per cent in the third quarter of 2003 to 9½ per cent in the fourth quarter. The increase in compensation of employees was evident throughout all sectors of the economy. Demands for salary increases were not adjusted in step with the slowdown in inflation. Consequently, the growth in compensation of employees accelerated from 9 per cent in 2002 to 9½ per cent in 2003. This increased the employees' share of factor income from 50 per cent in 2002 to 51 per cent in 2003.

Gross operating surplus and compensation of employees



Gross saving

The ratio of gross saving to gross domestic product declined substantially from 16½ per cent in the third quarter of 2003 to 15 per cent in the fourth quarter. The weakness in gross saving was apparent throughout all the institutional sectors – the household sector, the corporate sector as well as general government. Accordingly, the ratio of gross saving to gross domestic product edged down from 16½ per cent in 2002 to 16 per cent in 2003. South Africa did not finance all its capital formation from domestic resources – some R10 billion in financing was obtained from abroad to supplement domestic resources. The ratio of gross saving to gross capital formation fell from 104 per cent in 2002 to 95 per cent in 2003.

The weakness in the gross operating surpluses of business enterprises took its toll on *corporate saving*. Gross corporate saving as percentage of gross domestic product fell back from 12 per cent in the third quarter of 2003 to 11 per cent in the fourth quarter. Nonetheless, the annual corporate saving in 2003 still compares well with that of 2002 as both years' corporate saving equalled 11½ per cent of gross domestic product.

The ratio of *gross household saving* to gross domestic product declined from 3½ per cent in the third quarter of 2003 to 3 per cent in the fourth quarter. Despite the sustained strong growth in household disposable income, final consumption spending by households increased somewhat faster, resulting in a lower saving ratio.

Higher consumption expenditure by general government, concomitant with the purchase of a corvette class vessel by the South African Navy, resulted in a reduction in the level of *government saving*. As a result, the ratio of gross government saving to gross domestic product declined from just over 1 per cent in the third quarter of 2003 to 1 per cent in the fourth quarter. Despite the sustained higher growth in government expenditure, this was the fourteenth successive quarter in which gross saving by general government remained positive.

Employment

Enterprise-surveyed *employment* in the main non-agricultural sectors picked up somewhat in the second and third quarters of 2002, following a prolonged period of decline. Subsequently, however, employment numbers again fell back as job prospects in the labour market deteriorated within an environment of lacklustre domestic economic growth, reduced international competitiveness and subdued world demand.

According to the new expanded *Survey of Employment and Earnings in Selected Industries* (SEE) by Statistics South Africa, employment numbers, when allowing for seasonal variation, decreased by about 106 000 during the first half of 2003. The loss in employment occurred in the private sector, with the construction and the financial intermediation and insurance services sectors shedding more jobs than any of the other sectors. Private-sector employment fell by as much as 121 000 in the first half of 2003. Preliminary evidence suggests that labour market prospects have not improved in the ensuing months. Subdued conditions in the labour market were also manifested by the Investec Purchasing Managers Index which indicates that employment levels in the manufacturing sector deteriorated further in the five-month period to January 2004, and by indications of a reduced volume of advertisements for jobs in the print media since November 2003.

Unlike the deterioration in private-sector job prospects, public-sector employment started to increase from the fourth quarter of 2002, after it had decreased continuously during the preceding five-and-a-half years. When measured from quarter to quarter, public-sector employment rose by 18 000 in the first quarter of 2003 before falling back by 3 000 from the first to the second quarter. These employment losses occurred at national department level and among the public-sector businesses involved in transport, storage and communication.

Long-term agreements and better dispute resolution procedures contributed much to the reduction in the number of workdays lost due to strikes and other forms of industrial action in 2003. According to Andrew Levy Employment Publications (a private-sector institution), the number of workdays lost fell from 945 000 in 2002 to 700 000 in 2003.

The latest *Human Resources Development Survey* of the Human Sciences Research Council (HSRC) found that in all sectors, apart from retail trade and tourism, output growth and employment display little if any correlation. Advances that had been made in terms of growth in recent years did not translate into employment gains of the same magnitude. The survey found that it was especially true for the financial sector, banking, energy, manufacturing and engineering industry – sectors that face a limited supply of appropriate skills in the labour market.

The tourism sector expanded vigorously between 1994 and 2003. According to the World Travel and Tourism Council's forecast, an expansion of approximately 27 000 jobs per year in the next five years is envisaged in the tourism industry.

Labour cost and productivity

Following the abrupt rise in inflation in 2002, *average nominal remuneration per worker* accelerated from a year-on-year rate of increase of 8,8 per cent in the fourth quarter of 2002 to 9,4 per cent and 9,7 per cent in the first and second quarters of 2003, respectively. The increase in nominal remuneration growth in the second quarter of 2003 resulted essentially from higher remuneration growth in the public sector – private-sector remuneration growth slowed down somewhat over this period.

The rise in nominal remuneration growth in 2003 is corroborated by the results from the *Wage Settlement Survey* as published by Andrew Levy Employment Publications. According to this survey, the average level of wage settlements in collective bargaining agreements in 2003 amounted to 8,9 per cent, compared with 8,0 per cent in the preceding year. The lowest settlement rate in 2003 of 6,0 per cent occurred in the food manufacturing sector while the highest settlement rate of 12 per cent occurred in the municipal utility sector. Almost half – i.e. 43 per cent – of all wage settlements during 2003 were between 9 and 9,9 per cent.

Notwithstanding the rise in nominal wage growth in 2003, information obtained from the Automated Clearing Bureau about average salaries, wages and pensions deposited into the bank accounts of almost 5 million salaried and retired workers suggests that the pace of increase in nominal wage growth probably slowed down towards the end of 2003. The rate of increase in payments moderated from 7,9 per cent in the year to the third quarter of 2003 to 5,7 per cent in the year to the fourth quarter.

According to the latest survey by Deloitte and Touche Human Capital Corporation on *Salary Movements and Labour Trends*, companies expect that basic salary increases will range between 5,3 per cent and 9,3 per cent from February to July 2004, with an average increase of 7,3 per cent, some 1,7 percentage points lower than the actual outcome for the same period in 2003. The slowdown in expected salary increases is consistent with the moderation of inflation in recent months.

Given the decline in the level of formal non-agricultural employment, the rate of increase in *real output per worker*, which had slowed down during the past two years, rose somewhat in the course of 2003. In the second quarter of 2003, production per worker increased by 3,2 per cent compared with the same period in the previous year as employment fell back by 0,9 per cent while output increased by 2,3 per cent over the same period. This rate of increase in labour productivity is somewhat higher than what had been recorded in the preceding two quarters.

The cost of labour per unit of production increased somewhat during the first half of 2003. Higher salary and wage increases would have resulted in a more sizeable increase in nominal unit labour cost in the formal non-agricultural sectors, had it not been for the improvement in labour productivity. Increases in nominal unit labour cost were contained at year-on-year rates of 6,4 per cent and 6,3 per cent in the first and second quarters of 2003, respectively. These rates of increase are higher than the upper limit of the inflation target range of 3 to 6 per cent. Increases in nominal unit labour cost have remained fairly constant at around the 6 per cent mark over the past year – somewhat higher than the rates of increase in preceding years.

The decrease in manufacturing production during 2003, accompanied by a slight increase in employment, resulted in a sharp decline in *labour productivity in the manufacturing sector* during the first half of 2003. This decrease in the volume of production per worker, combined with an acceleration in nominal wage growth, propelled the pace of increase in *nominal unit labour cost in the manufacturing sector* from a year-on-year rate of 2,5 per cent in the fourth quarter of 2002 to 11,7 per cent in the second quarter of 2003.

Prices

Price inflation moderated to historically low levels in recent months following the waning of inflationary pressures. Declines were recorded in the prices of goods, especially at the production level. This resulted mainly from the substantial appreciation in the international exchange rate of the rand from about the second half of 2002. Lower food and oil price inflation also helped to dissipate price pressures in 2003.

Consistent with the significant appreciation in the exchange rate of the rand, year-on-year inflation in the *prices of imported goods* fell from a high of 17,4 per cent in April 2002 to 0,5 per cent in March 2003. From April 2003, the price index of imported goods consistently fell below its level in the corresponding period of the preceding year. The prices of imported goods actually fell by as much as 9,6 per cent in the year to November 2003 and by 8,9 per cent in the year to January 2004.

Measured from quarter to quarter and annualised, the rate of decline in the prices of imported goods moderated from 10,4 per cent in the second quarter of 2003 to 6,9 per cent in the fourth quarter. For 2003 as a whole, the prices of imported goods declined by 4,2 per cent, having increased by 15,5 per cent in the preceding year.

While the imported goods component of the production price index only accounts for 27 per cent of the all-goods production price index, secondary feed-through effects have driven the prices of many *domestically produced goods* lower in recent months. In fact, domestically produced goods inflation fell back from a year-on-year rate of 15,3 per cent in August 2002 to only 0,6 per cent in December 2003 and 1,4 per cent in January 2004. Falling food prices at both the agricultural and manufactured level as well as moderate capacity utilisation levels in industry assisted meaningfully in the rapid deceleration in domestically produced goods inflation. Declining inflationary pressures were, however, more pervasive as the prices of non-food products also receded from a year-on-year rate of increase of 9,7 per cent in August 2002 to 2,6 per cent in January 2004.

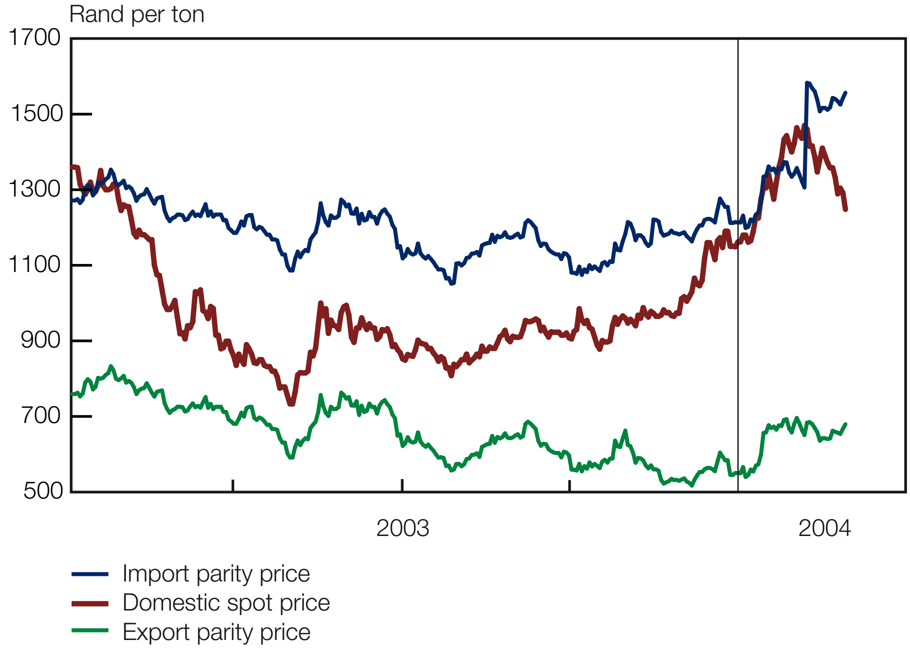
Production prices

Quarter-to-quarter percentage changes at annualised rates

Period		Domestically produced goods	Domestically produced goods excluding food	Imported goods	Overall production prices
2002:	1st qr.....................................	21,9	17,3	37,5	26,3
	2nd qr	14,9	13,8	12,6	13,9
	3rd qr	11,8	3,9	6,7	10,4
	4th qr	6,1	2,2	1,6	5,1
	Year.......................................	**13,5**	**8,6**	**15,5**	**14,2**
2003:	1st qr.....................................	-0,4	10,1	-9,7	-2,8
	2nd qr	0,3	7,4	-10,4	-3,0
	3rd qr	5,8	6,8	-8,4	2,0
	4th qr	-3,1	-6,5	-6,9	-4,0
	Year.......................................	**3,9**	**6,0**	**-4,2**	**1,7**

More recently, unfavourable climatic conditions have exerted upward pressure on food prices. From early December 2003, the domestic spot price of yellow maize, for instance, started to rise rapidly and early in 2004 briefly surpassed its import parity price level. International food prices have also risen in recent months.

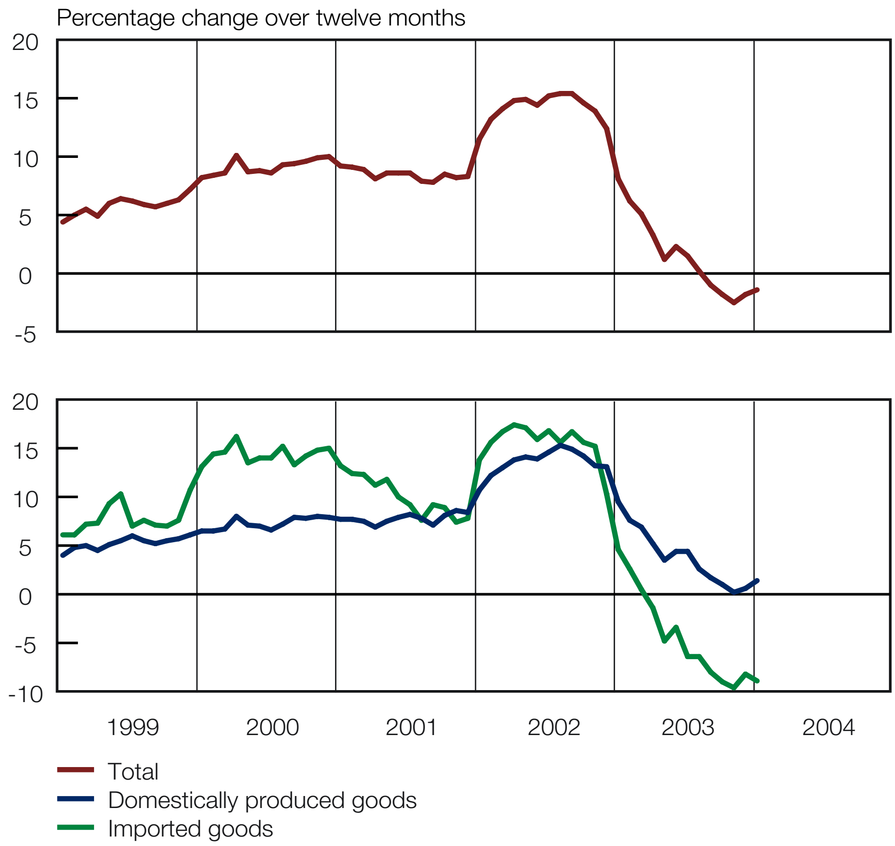
Price of yellow maize



Initially, the short-term pace of increase in the prices of domestically produced goods remained almost unchanged in the first and second quarters of 2003. Following increases in the prices of electricity, gas, water and mining products, alcoholic beverages and tobacco and basic metal and metal products, the quarter-to-quarter pace in domestically produced goods inflation picked up to 5,8 per cent in the third quarter of 2003. Subsequently, the average level of prices for domestically produced goods in the fourth quarter of 2003 fell below that in the preceding quarter, recording an annualised rate of decline of 3,1 per cent. The average increase in the prices of domestically produced goods amounted to 3,9 per cent in 2003 – the lowest rate of increase in the past five years.

Driven by the slowdown in domestically produced goods inflation and *declining* prices of imported goods, the year-on-year rate of increase in the *all-goods production price index* slowed down from 15,4 per cent in September 2002 to 0,2 per cent in August 2003 and turned negative in the five-month period to January 2004. When measured from quarter to quarter, all-goods production prices fell back in all but one of the four quarters of 2003, ending the year at an annualised rate of decline of 4,0 per cent in the fourth quarter. The average increase in overall production prices amounted to 1,7 per cent in 2003 – the lowest rate of increase in the past thirty-five years.

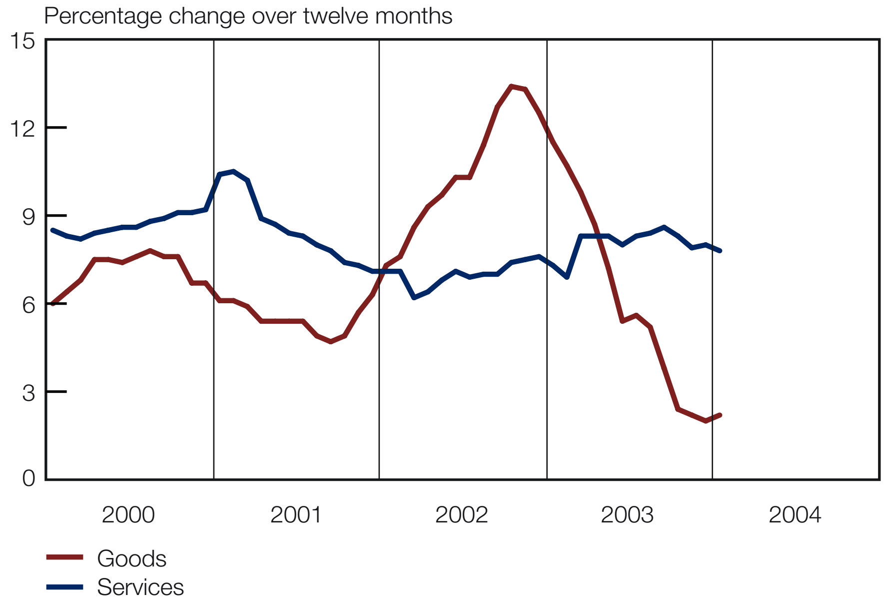
Production prices



Twelve-month CPIX inflation (i.e. changes in the overall consumer price index for metropolitan and other urban areas, excluding the interest cost of mortgage bonds) fell from a recent peak value of 11,3 per cent in October 2002 to 6,3 per cent in August 2003. Subsequently, this rate of increase entered the inflation target range of between 3 and 6 per cent and reached 4,0 per cent in December 2003. The general deceleration in CPIX inflation was mainly due to a moderation in food price inflation, assisted by declines in the prices of clothing, footwear and petrol and lower increases in the prices of furniture and equipment and vehicles. All these categories benefited from the favourable effects of exchange rate pass-through. Following increases in the price indices for housing, medical care and health expenses and food, year-on-year CPIX inflation rose to 4,2 per cent in January 2004.

CPIX services price inflation did not benefit much from the exchange-rate driven disinflationary process, recording a year-on-year rate of increase of 7,8 per cent in January 2004. Increases in the wages of domestic workers by as much as 16,6 per cent in the year to January 2004, which might have been partly related to the introduction of minimum wage legislation in September 2003, contributed significantly to the increases in services prices. By contrast, *CPIX goods price inflation* moderated significantly from a recent peak of 13,4 per cent in October 2002 to 2,2 per cent in January 2004.

Components of CPIX



The quarter-to-quarter pace of total CPIX inflation fell from an annualised rate of 12,4 per cent in the second quarter of 2002 to only 1,2 per cent in the fourth quarter of 2003 – the lowest rate of increase in this measure of inflation since its establishment in 1997. For 2003 as a whole, CPIX inflation amounted to 6,8 per cent compared with 9,3 per cent in the preceding year.

Consumer prices

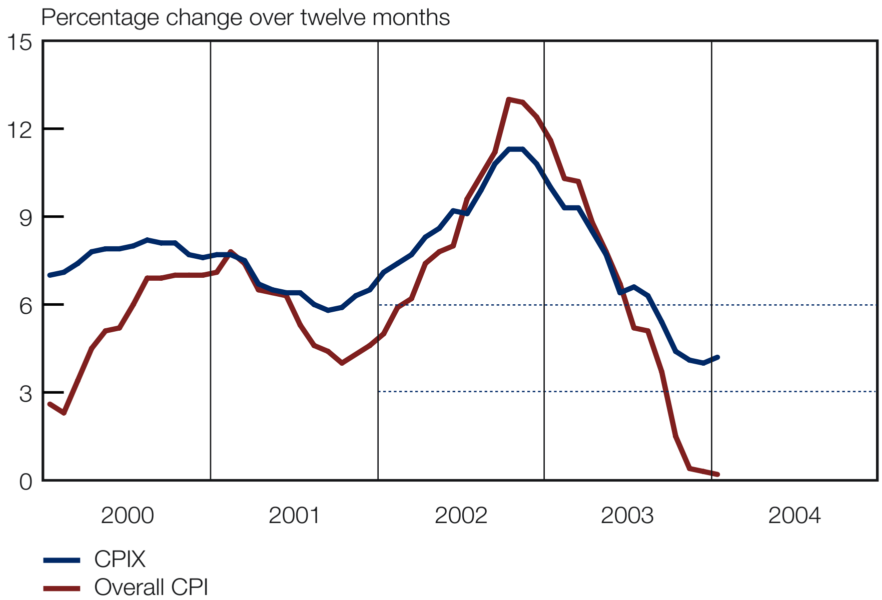
Quarter-to-quarter changes at seasonally adjusted annualised rates

Period		Goods	Services	Overall CPI	CPIX
2002:	1st qr	12,8	10,2	11,2	10,2
	2nd qr	13,2	10,4	12,5	12,4
	3rd qr	10,9	15,6	12,4	10,2
	4th qr	12,8	15,4	14,1	8,4
	Year	**10,2**	**7,8**	**9,2**	**9,3**
2003:	1st qr	3,2	5,6	4,1	7,3
	2nd qr	-0,8	3,4	1,4	4,2
	3rd qr	3,5	-2,6	0,6	4,4
	4th qr	2,5	-8,5	-2,0	1,2
	Year	**5,7**	**6,2**	**5,8**	**6,8**

Overall consumer price inflation decelerated from 13,0 per cent in the year to October 2002 to only 0,3 per cent in the year to December 2003 and 0,2 per cent in the year to January 2004. The slowdown in the year-on-year measure of overall consumer price inflation in 2003 not only resulted from the high base values in the preceding year, but also from falling month-to-month inflation in major categories. The decline in housing services prices in the fourth quarter of 2003 counteracted the acceleration in the short-term pace of increase in the prices of food and other goods. Accordingly, overall price inflation declined from an annualised rate of 14,1 per cent in the fourth quarter of 2002 to prices falling at a rate of 2,0 per cent in the fourth quarter of 2003. For 2003 as a whole, overall consumer price inflation amounted to 5,8 per cent.

The decline in the prices of *consumer services* at annualised rates of 2,6 per cent in the third quarter of 2003 and 8,5 per cent in the fourth quarter largely reflected the five-and-a-half percentage-point cut in mortgage interest rates since early June 2003. The pace of price increases for services, excluding housing and transport, remained high at an annualised rate of 14,8 per cent in the fourth quarter of 2003. However, these prices' twelve-month rate of increase of 4,7 per cent in January 2004 was almost half the rate observed in March 2003. Overall services prices fell by 2,6 per cent in the year to January 2004.

Consumer prices



As mentioned above, *consumer goods price inflation* benefited most from the disinflationary effect of exchange rate appreciation, declining to an annualised rate of 2,5 per cent in the fourth quarter of 2003 from 12,8 per cent in the fourth quarter of 2002.

Declines in the prices of petrol, vehicles and footwear, coupled with lower inflation in the prices of furniture and equipment as well as alcoholic beverages and tobacco, underpinned the waning of consumer goods price inflation in the closing quarter of 2003. Consumer goods price inflation remained subdued at year-on-year rates of 2,1 per cent in the three closing months of 2003, down from a rate of increase of 13,0 per cent just more than a year earlier. In January 2004 it rose slightly to 2,3 per cent.

Foreign trade and payments

International economic developments

Global economic conditions improved significantly in the second half of last year and growth should gain further momentum during 2004. The improvement was led by the United States, but also occurred in varying degrees in many other regions and countries.

The pace of economic expansion in the United States strengthened considerably in the second half of 2003 due to a combination of rapid gains in productivity and stimulatory macroeconomic policies. The US labour market began to recover, with the unemployment rate declining from 6,3 per cent in June 2003 to 5,6 per cent in January 2004. A gradual economic recovery started in the euro area in the second half of 2003. The upturn in economic activity in this region was driven primarily by increased global demand for goods and services. Japanese growth at an annualised rate of 7 per cent during the fourth quarter of 2003 exceeded expectations, resulting in real gross domestic product increasing by 2,7 per cent in 2003 as a whole, compared with a contraction of 0,4 per cent in 2002.

Growth in the Asian emerging-market economies picked up significantly in the second half of 2003 following the containment of *Severe Acute Respiratory Syndrome* (SARS). Exports continued to be the main engine of growth for the region. Growth was also reinforced by strong domestic demand, benign inflation and low interest rates. The Chinese economy continued to grow strongly in the fourth quarter of 2003, playing an increasingly important role in driving growth across the region. The recent outbreak of avian flu has affected several Asian countries during the early months of 2004. The mass culling of birds in the affected countries, however, seems to have largely contained the spread of the virus. Growth in Latin America has been less robust than in Asia during the second half of 2003.

Non-oil commodity prices rose briskly in response to the acceleration in global economic activity. As far as oil is concerned, the price of brent crude declined to around US$29 per barrel towards the end of January 2004 and early February due to warmer weather conditions in the United States and speculation that Iraq will boost oil production in the coming months. Oil prices have, however, increased again to levels above US$30 following OPEC's decision in early February 2004 to cut production quotas by 1 million barrels per day beginning from 1 April 2004 and to immediately eliminate its current excess production by 1,5 million barrels to match the current output quotas.

Most central banks maintained or eased their monetary policies further during the first half of 2003 as inflationary pressures remained in abeyance and economic growth failed to gather momentum. However, expectations of monetary tightening began to build in the second half of 2003 and official interest rates were raised by year-end in Australia and the United Kingdom. Authorities in both countries cited the pick-up in the domestic economy, rapid growth in household borrowing and the global economic recovery as the main reasons for increasing their respective official interest rates. The Reserve Bank of New Zealand also raised its official cash rate at the beginning of 2004 to ensure that inflation remains within its target range.

Current account[4]

Given the openness of the South African economy, the trade performance of the country is in most instances positively correlated with the growth in the global economy. The

4 The current-account flows referred to in this section are all seasonally adjusted and annualised.

improvement in global macroeconomic conditions in the latter part of 2003 could therefore potentially benefit South African exports.

However, the potential positive impact of these global developments on South Africa's tradeables sector was diluted by the continuous appreciation of the rand throughout 2003.

Balance of payments on current account

Seasonally adjusted and annualised
R billions

	2002	2003				
	Year	1st qr	2nd qr	3rd qr	4th qr	Year
Merchandise exports	286,4	262,8	258,3	258,5	244,5	256,0
Net gold exports	43,1	36,6	34,2	34,7	35,9	35,3
Merchandise imports	-280,6	-262,0	262,1	-260,9	-266,2	-262,8
Trade balance	**48,9**	**37,4**	**30,4**	**32,3**	**14,2**	**28,5**
Net service, income and current transfer payments	-42,2	-37,8	-40,7	-40,0	-36,3	-38,6
Balance on current account	**6,7**	**-0,4**	**-10,3**	**-7,7**	**-22,1**	**-10,1**

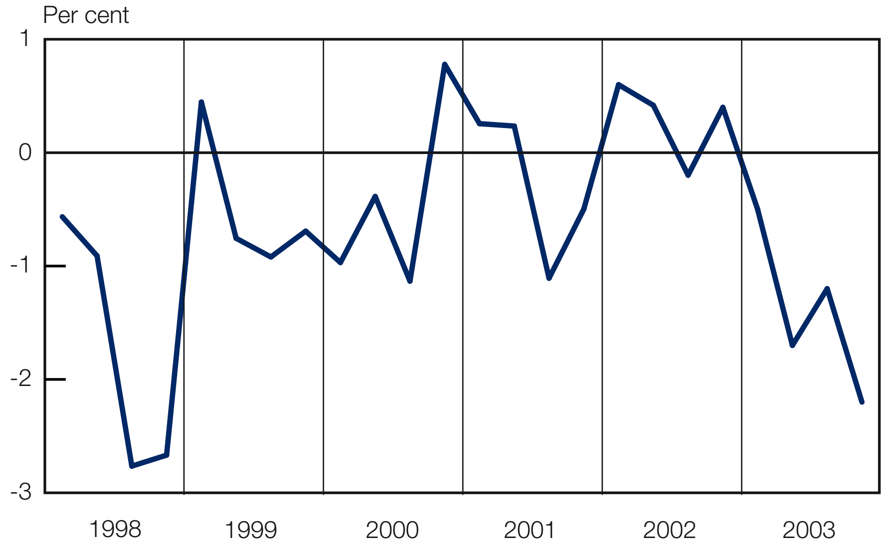
The small surplus on the current account of the balance of payments in 2002 became a deficit in 2003 as aggregate domestic expenditure exceeded domestic production. Measured as a percentage of gross domestic product, the current-account deficit in the year 2003 was nevertheless clearly within the boundaries of sustainability, being equal to 0,8 per cent.

After a slight improvement in the third quarter of 2003, the balance on the current account widened to a record deficit of R22,1 billion in the fourth quarter. Higher growth in fixed capital formation, which resulted in higher imports, coincided with a contraction in the value of merchandise exports in the fourth quarter of 2003. The seasonally adjusted trade surplus consequently more than halved from the third to the fourth quarter. A slightly smaller shortfall in net service payments to non-residents helped to contain the widening of the current-account deficit. As a percentage of gross domestic product, the current-account deficit amounted to 1,8 per cent in the fourth quarter of 2003.

The marked widening of the deficit on the current account in the second half of 2003 was mainly brought about by a decline in the total value of merchandise exports. At the same time somewhat firmer growth in the physical quantity of imported goods, partly due to continuous robust growth of aggregate domestic expenditure, also contributed to the larger current-account deficit.

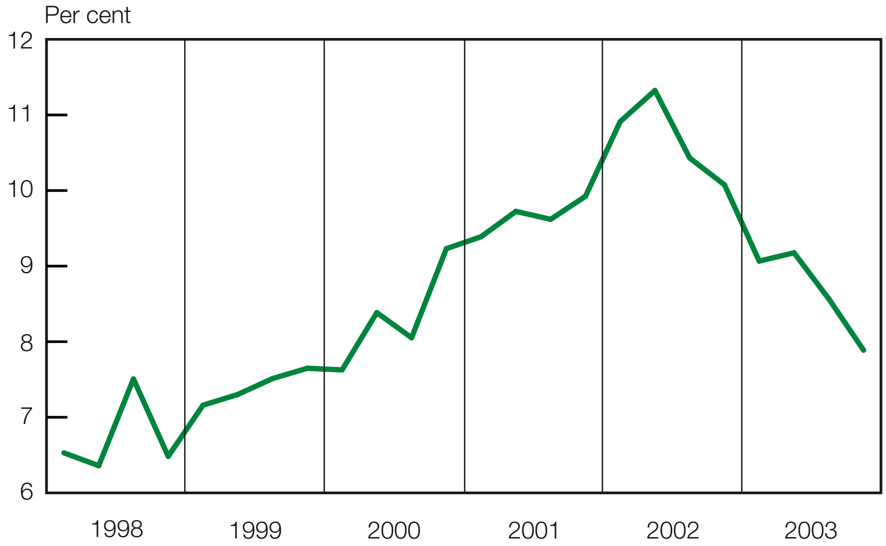
The value of *merchandise exports*, which had advanced in the third quarter of 2003, receded by 5½ per cent to R244,5 billion in the fourth quarter. This was mainly due to a decline of 5 per cent in the physical volume of exports over the period. The volume of exported manufactured goods, which had been declining consistently since the first quarter of 2003, contracted further in the fourth quarter. Exports of chemicals, textile articles, vehicles and transport equipment declined materially. Exports of precious and semi-precious stones and pearls also registered a sizeable decline. Although declines in the physical quantity of exports were recorded in some of the quarters of 2003, the overall volume of goods exported for the year as a whole was still 1 per cent higher than in 2002.

Ratio of current-account balance to gross domestic product



Notwithstanding the higher dollar level of international commodity prices, the rand prices of merchandise exports fell by some ½ a per cent in the fourth quarter of 2003 following the appreciation of the exchange rate of the rand against the major international currencies. For the calendar year 2003 the rand prices of all exported goods declined by about 12 per cent, while the rand prices of commodity exports declined by about 18½ per cent as a consequence of an appreciation of 25 per cent in the average nominal effective exchange rate of the rand over the same period.

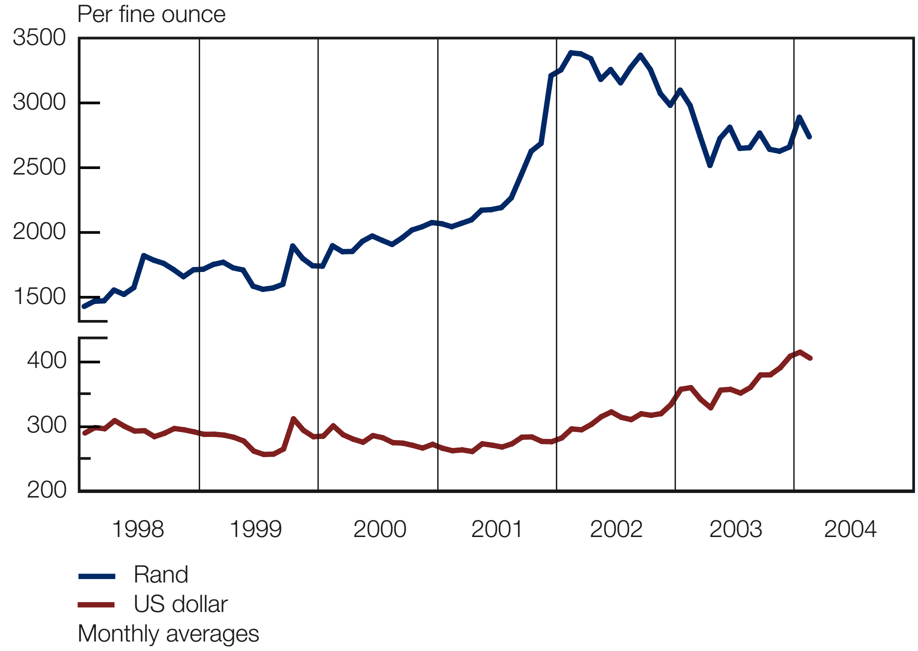
Ratio of exports of manufactured goods to gross domestic product



The widening of the deficit on the current account in 2003 was also significantly influenced by a decline of 18 per cent in the value of *net gold exports*. Although the average fixing price of gold on the London market rose from US$310 per fine ounce in 2002 to US$364 per fine ounce in 2003, in rand terms the average realised price declined from R3 256 in 2002 to R2 749 in 2003, i.e. a decrease of almost 16 per cent. The physical quantity of gold exported decreased by 2½ per cent in 2003.

The annualised value of net gold exports increased by 3½ per cent from R34,7 billion in the third quarter of 2003 to R35,9 billion in the fourth quarter, partly owing to a rise of 1½ per cent in the physical volume of net gold exports. However, as a result of the further appreciation of the exchange rate of the rand which almost fully neutralised the higher US dollar price of gold on the London market, the average realised price of gold increased by only 1,6 per cent to R2 655 per fine ounce in the fourth quarter of 2003. On 12 January 2004 the fixing price of gold reached US$427 per fine ounce – its highest level since February 1990 – before it again receded to US$398 on 11 March 2004.

London gold price



The annualised value of *merchandise imports,* which had remained relatively subdued in the first three quarters of 2003, increased by about 2 per cent to R266,2 billion in the fourth quarter. Increases occurred in the value of most of the import categories, except mineral products. Imports of vehicles and transport equipment increased strongly in the fourth quarter of 2003 mainly due to the importation of aircraft and a naval vessel.

Apart from the influence of fairly robust domestic final demand in the fourth quarter of 2003, the increase of 3½ per cent in the volume of merchandise imports was also spurred by a decline in the prices of imported goods relative to the prices of domestically produced goods. Consequently the import penetration ratio of South Africa (i.e. the ratio of real merchandise imports to real gross domestic expenditure) rose from 19,4 per cent in the first quarter of 2003 to 20,7 per cent in the fourth quarter. For the year as a whole the volume of merchandise imports rose by 8½ per cent, which increased the import penetration ratio from 19,2 per cent in 2002 to 20,0 per cent in 2003.

The prices of imported goods and services receded somewhat more than the prices of merchandise, gold and non-factor services exported, resulting in an improvement in South Africa's terms of trade for the year 2003. This helped to increase the real national disposable income of the country.

The deficit on the service and income account narrowed from R40,0 billion in the third quarter of 2003 to R36,3 billion in the fourth quarter. Although both investment income payments and receipts contracted, the magnitude of decline in investment income receipts exceeded that of investment income payments. Investment income receipts declined from R17,2 billion in the third quarter of 2003 to R16,4 billion in the fourth quarter, partially on account of the strengthening rand exchange rate. Following non-residents' net sales of shares and bonds listed on the JSE Securities Exchange SA (JSE) and the Bond Exchange of South Africa (BESA) and a decline in dividends declared on foreign direct investment during the fourth quarter of 2003, investment income payments contracted.

Despite higher net investment income payments recorded in the fourth quarter of 2003, the contraction in the net services deficit in the fourth quarter of 2003 was assisted by higher expenditure by foreign tourists in South Africa. For 2003 as a whole the shortfall on the services and income account amounted to R38,6 billion, compared with a deficit of R42,2 billion in 2002.

Financial account

The global economic recovery had a positive effect on the financial account of the balance of payments. Strong financial inflows to South Africa during the first half of 2003 gained momentum in the second half of the year when foreign investors increased their investment into South Africa. After having recorded net financial inflows of R18,5 billion in the first half of the year, these inflows more than doubled to R44,9 billion during the second half of the year, of which R34,5 billion was recorded in the fourth quarter. This surge in financial inflows occurred mainly in the *other investment* category, which on a net basis increased from an inflow of R10,4 billion in the first half of the year to an inflow of R26,5 billion in the second half. Net direct investment also contributed to the inflow by an amount of R1,9 billion in the second half of 2003, after having recorded a net outflow of R1,6 billion in the first half. Net portfolio investment turned around from net purchases of R18,2 billion by non-residents in the first half of 2003 to net sales of R11,3 billion in the second half.

Net financial transactions not related to reserves
R billions

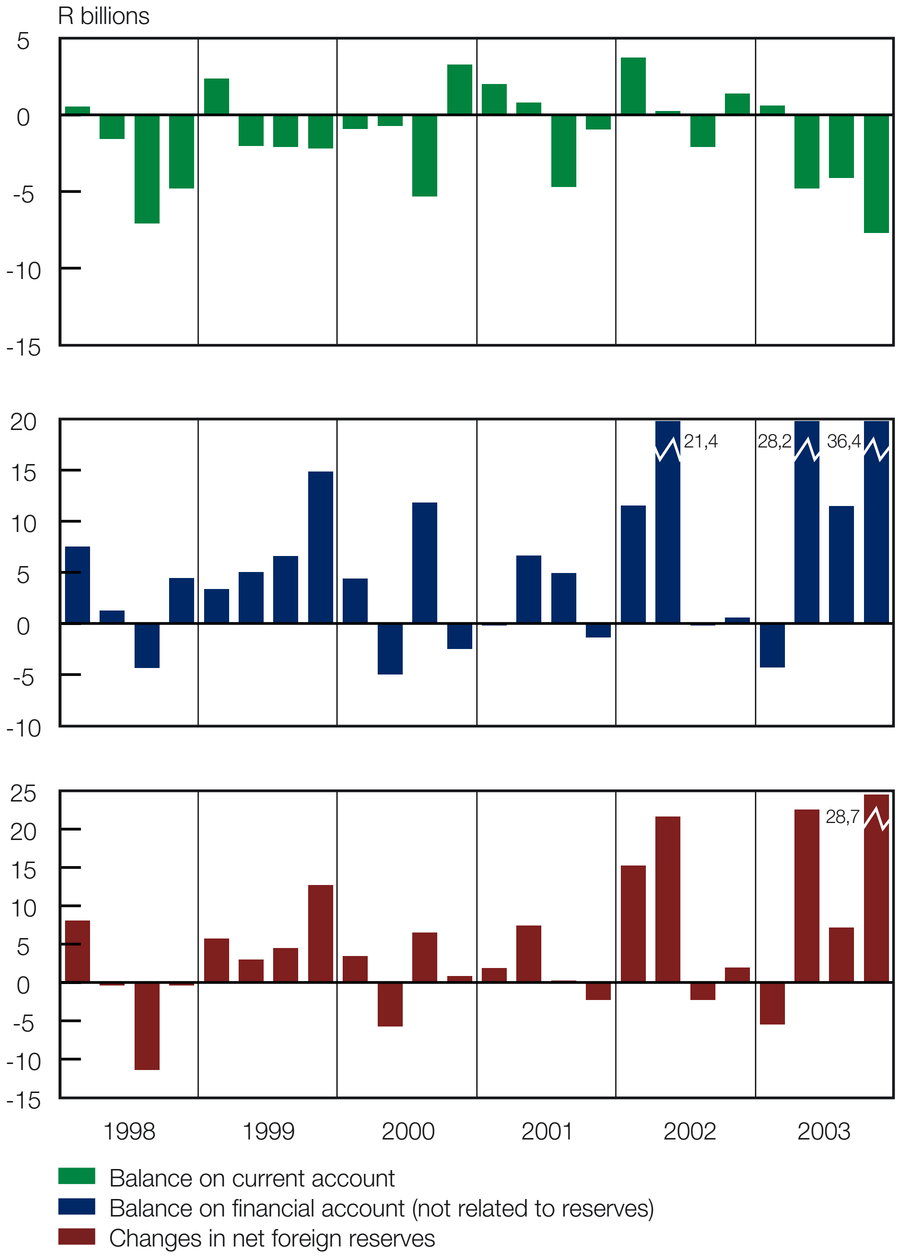
	2002	2003				
	Year	1st qr	2nd qr	3rd qr	4th qr	Year
Change in liabilities						
Direct investment	7,9	0,1	0,4	1,8	3,4	5,7
Portfolio investment	5,4	-4,0	22,4	-4,3	-6,2	7,9
Other investment	0,3	-1,2	4,8	-1,7	11,6	13,5
Change in assets						
Direct investment	4,2	-2,8	0,7	-1,5	-1,8	-5,4
Portfolio investment	-9,7	-0,4	0,2	-0,3	-0,5	-1,0
Other investment	16,7	5,2	1,7	5,8	10,8	23,5
Total financial transactions*	**30,6**	**-7,5**	**26,0**	**10,4**	**34,5**	**63,4**

* Including unrecorded transactions

In line with national government's approach to the gradual liberalisation of exchange control, the Minister of Finance announced further relaxations in the 2004/05 Budget Speech. The measures announced were:

- an increase in the percentage of the excess cost of outward foreign direct investment that can be funded from South Africa from 10 to 20 per cent;
- foreign companies or foreign-owned South African companies may now, for productive investment, borrow locally up to 300 per cent of the total shareholders' funds brought into South Africa;
- foreign firms will be allowed to list on South African capital markets during 2004; and
- institutional investors will be allowed to invest up to an additional 5 per cent of their total retail assets in African securities listed on the JSE or BESA.

Balance of payments: Overall balance



Foreign-owned assets in South Africa

Inflows of *foreign direct investment* capital of R0,5 billion in the first two quarters of 2003 picked up to a value of R1,8 billion in the third quarter, culminating in an inflow of R3,4 billion in the fourth quarter of 2003. The increased inflows were mainly attributable to an increase of the investment by a foreign company in a local steel producer, as well as the takeover of a domestic information technology company by a United Kingdom-based company.

Foreign portfolio investors, who had increased their holdings of South African securities by R18,4 billion during the first half of 2003, reduced their investment during the third quarter by R4,3 billion, followed by a further R6,2 billion during the fourth quarter of 2003. Net sales of domestic debt securities by non-residents and the maturing of a Deutsche Mark bond of the national government to the value of 256 million euro during the fourth quarter contributed to the outflow of capital.

Other foreign investment liabilities recorded an inflow of R11,6 billion in the fourth quarter of 2003, following an outflow of R1,7 billion in the third quarter. This resulted in a net inflow of R9,9 billion in the second half of the year, compared with an inflow of R3,6 billion during the first half of the year. The inflow during the fourth quarter was mainly related to drawings on short-term loans by the banking sector, an increase in long-term loan finance by the private non-banking sector as well as drawings by the national government on financing facilities under its defence procurement agreements.

South African-owned assets abroad

Outward direct investment recorded outflows in three of the four quarters of 2003. After a R2,1 billion outflow was recorded in the first half of 2003, this increased to R3,3 billion during the second half, with the fourth quarter contributing R1,8 billion towards the outflow. South African companies continued to increase their equity and loan capital investments in the rest of the world during 2003.

Portfolio investment abroad by South African investors remained subdued during the whole of 2003, recording outflows in three of the four quarters. During the fourth quarter an outflow of R0,5 billion was recorded, following an outflow of R0,3 billion in the third quarter.

Other foreign investment assets recorded an inflow of R10,8 billion in the fourth quarter of 2003 after recording an inflow of R5,8 billion in the third quarter. This inflow resulted partly from the repatriation of export proceeds by South African exporters.

Foreign reserves

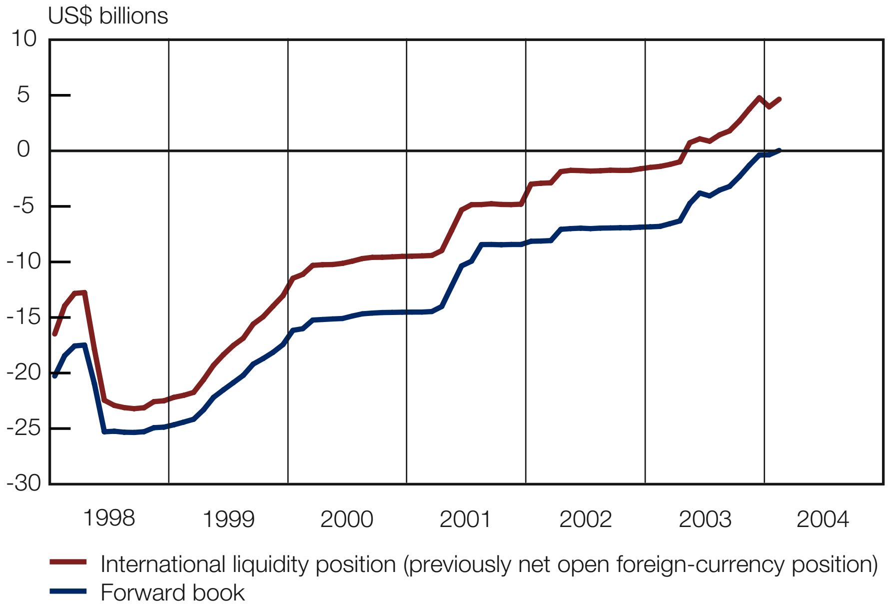
During the fourth quarter of 2003 South Africa's net international reserves increased by R28,7 billion, exceeding by far the R7,3 billion increase recorded in the third quarter. For 2003 as a whole there was a record increase in the country's net international reserves of R53,3 billion, surpassing the R37,1 billion increase recorded in 2002.

In US dollar terms, South Africa's gross gold and other foreign exchange reserves increased by 23,1 per cent from US$20,2 billion at the end of September 2003 to US$24,9 billion at the end of December. Due to the appreciation of the exchange rate, the increase in rand terms was less significant, rising by only 17,3 per cent from R140,9 billion to R165,3 billion over the same period. The level of import cover (i.e. the value of gross international reserves expressed in relation to the value of imports of goods and services) increased from 20 weeks' worth at the end of September 2003 to 23½ weeks' at the end of December.

Valued in US dollars, the gross gold and foreign exchange reserves of the Reserve Bank increased slightly from US$7,8 billion at the end of September 2003 to US$8,0 billion at the end of December before declining to US$7,9 billion at the end of January 2004. Short-term credit facilities utilised by the Reserve Bank remained virtually unchanged at US$3,0 billion from the end of September 2003 to the end of December. However, the Reserve Bank's liabilities related to reserves increased to US$3,7 billion at the end of January 2004 as the Bank took over and drew down a foreign credit facility that had previously been on the books of the national government.

The Reserve Bank's international liquidity position (previously referred to as the net open position in foreign currency) increased from an overbought position of US$1,8 billion at the end of September 2003 to US$4,8 billion at the end of December before declining to US$4,0 billion at the end of January 2004. Its forward book, which in 1998 had been oversold to the amount of US$25,3 billion, was finally brought to a balanced position on 18 February 2004.

The international liquidity position and forward book of the South African Reserve Bank



Exchange rates

The weighted average exchange rate of the rand, which had increased by 24,2 per cent from the end of December 2001 to the end of December 2002, continued this trend during 2003 and rose by 16,2 per cent from the end of December 2002 to the end of December 2003. While on a quarterly basis the largest appreciation in 2003 was the 7,5 per cent recorded in the first quarter, this was dwarfed by the appreciation of 17,7 per cent in the fourth quarter of 2002. From the end of December 2002 to the end of December 2003 the rand appreciated by 30,1 per cent, 17,4 per cent, 8,0 per cent and 17,2 per cent against the US dollar, UK pound, euro and Japanese yen, respectively.

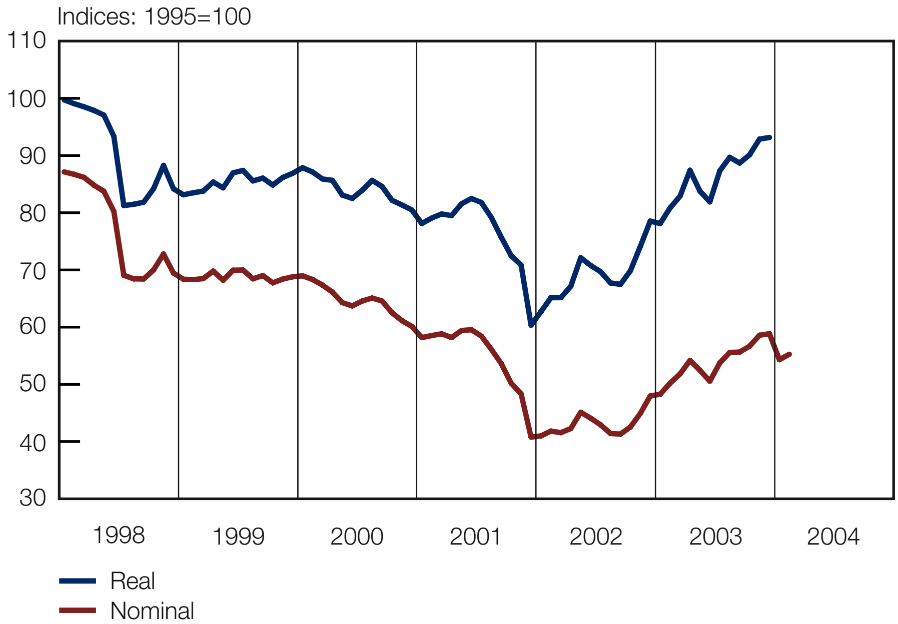
Exchange rates of the rand
Percentage change

	31 Dec 2002 to 31 Mar 2003	31 Mar 2003 to 30 Jun 2003	30 Jun 2003 to 30 Sep 2003	30 Sep 2003 to 31 Dec 2003	31 Dec 2003 to 29 Feb 2004
Weighted average*	7,5	4,4	3,2	0,3	0,5
Euro	4,8	2,3	3,5	-2,7	1,6
US dollar	8,9	7,6	5,5	5,2	0,2
British pound	11,0	2,9	3,9	-1,2	-4,1
Japanese yen	9,0	8,6	-2,9	2,0	2,2

* The weighted exchange-rate index is calculated with reference to a basket of 13 currencies

Factors that probably contributed to the continued recovery of the external value of the rand during 2003 were:
- the continued weakness of the US dollar;
- the upgrading by Standard & Poor's and Fitch Ratings of South Africa's foreign and local currency sovereign debt ratings in May 2003;
- the closing out during 2003 of the Reserve Bank's net oversold international liquidity position, formerly referred to as the net open foreign-currency position;
- rising foreign-currency prices of South Africa's export commodities;
- the positive, although shrinking, interest rate differential between South Africa and its main trading partners; and
- the continued commitment of national government and the Reserve Bank to prudent fiscal and monetary policies.

Effective exchange rates of the rand



During January 2004 the external value of the rand declined by 5,9 per cent. This was reversed during February when the weighted average exchange rate of the rand rose by 6,9 per cent.

The net average daily turnover in the domestic market for foreign exchange, which had increased to US$10,6 billion in the third quarter of 2003, rose further to US$11,3 billion in the fourth quarter of 2003 – its highest level to date. The value of transactions in which non-residents participated, increased from US$7,2 billion per day to US$7,6 billion over the same period. Participation by resident parties increased from US$3,4 billion per day in the third quarter of 2003 to US$3,6 billion in the fourth quarter.

The average monthly real effective exchange rate of the rand increased by 19 per cent from December 2002 to December 2003. In December 2003 the real effective exchange rate reached its highest level since May 1998.

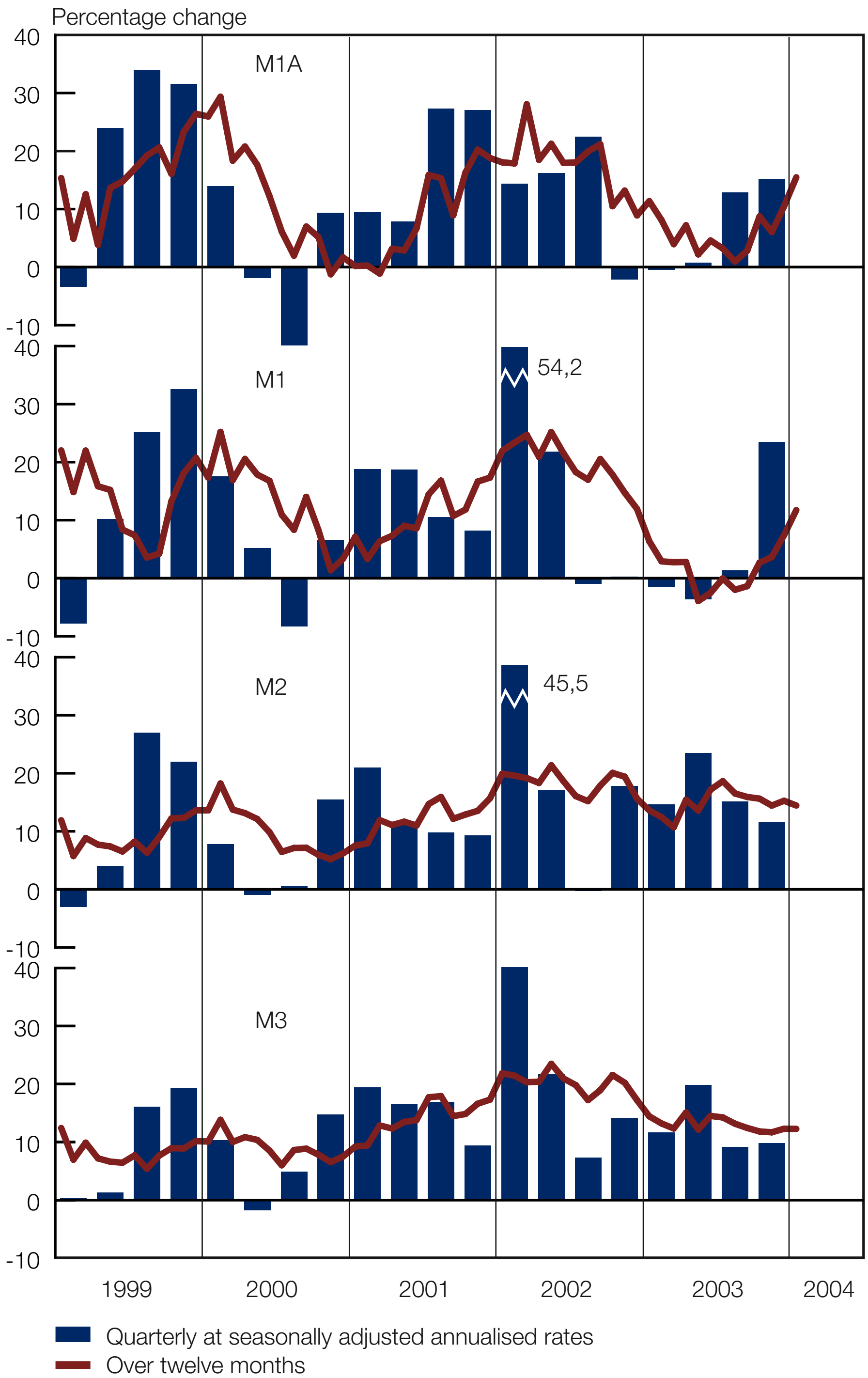
Monetary developments, interest rates and financial markets

Money supply[5]

Throughout 2003 growth in the broadly defined money supply (M3) was fairly brisk. Measured over twelve months, growth in M3 has remained around 12 per cent since September 2003 and amounted to 12,3 per cent in January 2004. The growth in M3 during 2003 was shored up by the firm growth in domestic expenditure and a slight pick-

5 *The analysis in this section is based on revised data, as discussed in the note on the revision of the monetary aggregates elsewhere in this* Quarterly Bulletin. *Annualised growth rates referred to in this section are based on seasonally adjusted data.*

Monetary aggregates



up in production, both of which benefited from the reduction in the level of interest rates in the second half of the year. However, the effects of these factors on money supply growth were counteracted to some extent by an increase in government deposits, gradual portfolio shifts favouring non-monetary assets, and by profits realised on the Reserve Bank's forward foreign exchange transactions which reduced both M3 deposits and the balance on the Gold and Foreign Exchange Contingency Reserve Account.

Quarter-to-quarter growth in M3 receded somewhat in the second half of 2003. Having accelerated to a level of 19,8 per cent in the second quarter of 2003, annualised quarterly growth in M3 decelerated to 9,2 per cent in the third quarter but accelerated somewhat to 10,4 per cent in the fourth quarter. Quarter-to-quarter growth in the narrower and more transactions oriented M1A and M1 aggregates accelerated strongly towards the year-end, consistent with brisk domestic expenditure during the fourth quarter of 2003.

The twelve-month growth rate in the narrower monetary aggregates gained significant momentum towards the end of 2003. For instance, M1A accelerated from a low of 1,0 per cent in August 2003 to 10,5 per cent in December and 15,5 per cent in January 2004. After five consecutive months of displaying negative growth rates, M1 growth accelerated to 3,0 per cent in October 2003, 7,4 per cent in December and 11,7 per cent in January 2004. Growth in M2 broadly resembled that in M3 and amounted to 15,3 per cent in December 2003 and 14,4 per cent in January 2004.

The level of the corporate sector's M3 deposits increased by R28,8 billion in the fourth quarter of 2003 compared with R1,6 billion in the third quarter. Non-financial companies accounted for the bulk of the increase in the corporate sector's M3 holdings. Their cheque, other demand and other short-term deposits in particular rose significantly. Against the background of declining interest rates, such shifts of funds to the very short end of the maturity spectrum by the corporate sector may reflect a combination of the transactions, precautionary and speculative motives for holding money. The level of household-sector deposits increased by R4,0 billion in the fourth quarter of 2003 and was aligned with brisk growth in domestic expenditure.

Annualised quarter-to-quarter growth in nominal gross domestic product exceeded growth in M3 by 1,6 percentage points in the fourth quarter of 2003. Nevertheless, the income velocity of circulation of M3 remained unchanged at 1,61 in the third quarter and fourth quarter of 2003. The income velocity of circulation of M3 was previously at such low levels during 1965.

In a statistical sense, the increase of R32,7 billion in M3 during the fourth quarter of 2003 may be attributed to a significant increase in net foreign assets of the banking sector and in banks' claims on the private sector, as shown in the table on the following page. These increases were partly counteracted by a decline in *net other assets and liabilities*. However, it should be noted that the balance sheet values of banks' claims on the private sector and net other assets and liabilities continued to display fairly large fluctuations due to mark-to-market revaluation of financial instruments.

The net foreign assets of the monetary sector continued to benefit from the dispensation that allows South African branches of foreign banks to invest offshore up to 40 per cent of deposits raised domestically. The increase in net foreign assets also reflected the overall surplus recorded on the balance of payments during the fourth quarter of 2003 and the shift of the oversold forward book of the Reserve Bank to the private banking sector.

Counterparts of changes in M3
R billions

Counterparts	2003			
	3rd qr		4th qr	
Net foreign assets		17,3		21,0
Net claims on the government sector		-1,2		3,8
Gross claims	1,9		8,6	
Government deposits (+ decrease; - increase)	-3,1		-4,8	
Claims on the private sector		24,7		18,8
Net other assets and liabilities		-35,1		-10,9
Total change in M3		5,7		32,7

Net claims of monetary institutions on the government sector increased by R3,8 billion in the fourth quarter of 2003. Gross claims on government rose notably but were partly offset by the increase in government deposits with banks which started well ahead of the bond redemption and coupon interest payments at the end of February 2004.

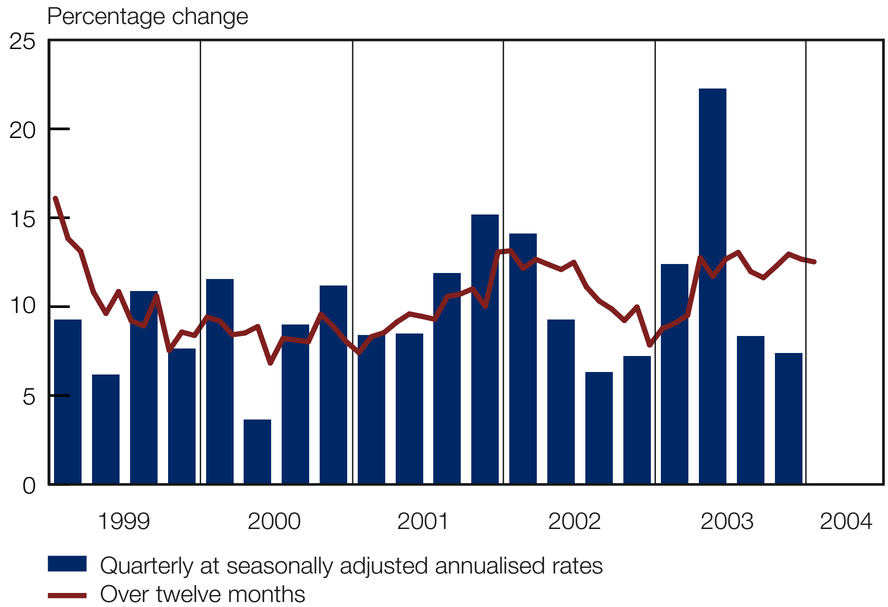
Credit extension

Growth in banks' total loans and advances[6] to the domestic private sector accelerated to and remained above the 10 per cent mark during 2003. Firm growth in loans and advances was supported by, among other factors, the decline in interest rates, rising real disposable income, strong growth in domestic expenditure and the wealth effects associated with rising homeowners' equity following sustained increases in fixed property prices.

6 *Total loans and advances to the domestic private sector consist of instalment sale credit, leasing finance, mortgage advances, overdrafts, credit card and general advances. The first three categories together are referred to as* asset-backed credit, *while the last three categories together are referred to as* other loans and advances.

Twelve-month growth in total loans and advances picked up from 7,8 per cent in December 2002 to levels of around 12 per cent since April 2003. It amounted to 12,5 per cent in January 2004. However, quarterly growth receded from a high annualised rate of 22,3 per cent in the second quarter of 2003 to 8,3 per cent in the third quarter and further to 7,4 per cent in the fourth quarter. During the fourth quarter of 2003, growth in banking-sector assets was restrained to some extent by disintermediation and the securitisation of loans.

Total loans and advances to the private sector



Growth in total loans and advances in the fourth quarter of 2003 was mainly driven by the brisk demand for asset-backed credit. Measured over twelve months, growth in this category accelerated from 15 per cent in October 2003 to 15,8 per cent in January 2004. Similarly, quarterly growth accelerated from 15,3 per cent during the third quarter of 2003 to 17,3 per cent in the fourth quarter.

A large share of credit extension during the fourth quarter of 2003 was in the form of mortgage advances. Growth in *mortgage advances* contributed R12,6 billion to the overall increase in total loans and advances during the quarter, with the corporate sector accounting for R8,8 billion of the total increase. Mortgage flow data also indicated brisk conditions, with the seasonally adjusted amount of credit granted through mortgage accounts recording an all-time high in December 2003. Measured over twelve months, growth in mortgage advances accelerated from 13,1 per cent in September 2003 to 15,1 per cent in December and further to 15,5 per cent in January 2004. This trend was in line with buoyant trading conditions in the real-estate market supported by a low interest rate environment and sustained increases in fixed property prices.

Credit extended to the private sector by type of credit

Percentage change over twelve months

Period		Asset-backed credit				
		Instalment sale credit and leasing finance	Mortgage advances	Total asset-backed credit	Other loans and advances	Total loans and advances
2003:	Jan	14,0	10,2	11,2	5,4	8,8
	Feb	14,7	9,9	11,2	6,1	9,1
	Mar	13,4	10,7	11,4	6,8	9,5
	Apr	14,8	11,2	12,2	13,6	12,7
	May	15,0	11,2	12,2	10,9	11,7
	Jun	14,8	11,0	12,0	13,6	12,7
	Jul	15,4	11,3	12,4	14,0	13,0
	Aug	16,1	11,7	12,9	10,6	12,0
	Sep	17,3	13,1	14,3	7,8	11,6
	Oct	17,7	14,0	15,0	8,3	12,3
	Nov	14,6	14,5	14,5	10,6	13,0
	Dec	17,2	15,1	15,7	8,3	12,7
2004:	Jan	16,7	15,5	15,8	7,8	12,5

Instalment sale credit and leasing finance, which is mainly directed at financing expenditure on vehicles and other durable goods, remained buoyant, consistent with the strong growth in domestic expenditure. Twelve-month growth in this category receded briefly from 17,7 per cent in October 2003 to 14,6 per cent in November 2003 before reaccelerating to 16,7 per cent in January 2004. The temporary deceleration during November was a result of the issuance of bonds backed by instalment sale agreements by one of the banks.

The strong growth in *instalment sale credit and leasing finance* was also reflected in the seasonally adjusted value of banks' new payouts of such finance, which reached a record level of R8,8 billion in December 2003. During the fourth quarter of 2003, a significant share of instalment sale credit and leasing finance was directed towards vehicle finance. Financing of new and used motor vehicles contributed 21,4 per cent and 31,2 per cent, respectively, to the increase in such credit.

In contrast to developments in the third quarter of 2003 when a decline of R6,1 billion was recorded in the *other loans and advances* category, an increase of R5,3 billion was registered in the fourth quarter. The corporate sector, in particular the non-bank financial institutions, accounted for the bulk of the increase. This growth trend partly reflected the financing requirements associated with a strong expansion in gross fixed capital formation. Accordingly, twelve-month growth in *other loans and advances* accelerated from 7,8 per cent in September 2003 to 10,6 per cent in November but decelerated to 7,8 per cent in January 2004.

Composition of credit extended to the private sector by type of credit
R billions

Component	2003	
	3rd qr	4th qr
Mortgage advances	11,6	12,6
Instalment sale credit and leasing finance	-0,9	4,3
Other loans and advances	-6,1	5,3
Total change	4,6	22,2

During the fourth quarter of 2003, total loans and advances extended to the private sector increased by R22,2 billion, with the corporate sector accounting for R18,6 billion and the household sector for the remaining R3,6 billion.

Interest rates and yields

Consistent with maintaining inflation within the target range, the Reserve Bank's Monetary Policy Committee (MPC) reduced the repurchase rate by 50 basis points on 11 December 2003 to 8 per cent. Based on a more neutral assessment of inflationary pressures, the MPC left the repurchase rate unchanged at 8 per cent on 26 February 2004. (The full text of the December 2003 and February 2004 MPC statements discussing factors underlying the respective decisions are reproduced elsewhere in this *Quarterly Bulletin*.) The December reduction brought the cumulative decline in the repurchase rate to 550 basis points since June 2003 and also brought the Reserve Bank's intervention rate to its lowest level since the end of February 1981.

From the beginning of November 2003 rates in the money market signalled expectations of easing in monetary policy by up to 100 basis points at the December MPC meeting. This was evident in the 1x4-month rate on forward rate agreements (FRAs) which receded by 108 basis points from 7,88 per cent on 20 October to 6,80 per cent on 10 December 2003.

Such expectations were also confirmed by the results of surveys conducted by the media which indicated that the majority of economists and analysts polled expected a 100-basis-point reduction in the repurchase rate. The magnitude of the expected reduction in the repurchase rate could have been fuelled by, amongst other factors, the favourable inflation data that were released.

However, shortly before the December 2003 MPC meeting the downward trend displayed by the FRA curve turned around, contrary to that displayed by other money-market interest rates at the time. Other money-market rates lagged behind and only started to rise

after the announcement of the December 2003 MPC decision. Possible explanations for the turnaround in the movement of the FRA rates include:
- the early turnaround in the global interest rate cycle following increases in the official rates of the United Kingdom and Australia; and
- the risks posed to overall inflation by rising grain prices following the paucity of rain during the traditional planting season of key agricultural crops.

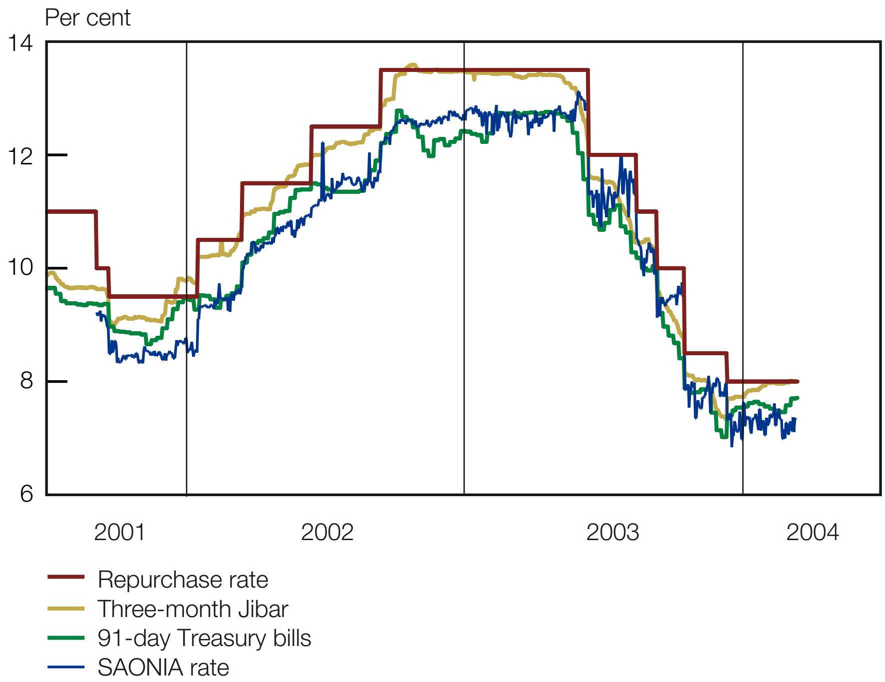
Rates on forward rate agreements

This upward trend in forward rates became more pronounced following the lower-than-expected 50-basis-point reduction in the repurchase rate on 11 December 2003. For instance, the 9x12-month FRA rate increased from 7,12 per cent on 10 December 2003 to 7,78 per cent on 12 December. In the subsequent three months, progressively reduced optimism about further monetary policy easing and discounting of possible future policy tightening were evident in the movement of money-market interest rates generally.

The South African Overnight Interbank Average (SAONIA) rate continued to be aligned with movements in the repurchase rate and conditions in the interbank funding market. Having amounted to 7,98 per cent on 11 December, the rate receded to 7,32 per cent on 13 December 2003 and amounted to 7,16 per cent on 25 February 2004. With the repurchase rate left unchanged at the February 2004 MPC meeting, the SAONIA rate tended sideways and came to 7,58 per cent on 12 March.

Having declined by 82 basis points from 8,14 per cent on 17 October 2003 to 7,32 per cent on 11 December, the downward movement in the three-month Johannesburg interbank agreed rate (Jibar) reversed in line with the correction in other money-market interest rates and amounted to 7,68 per cent on 12 December 2003. The upward movement was maintained ahead of the February 2004 MPC meeting when the rate increased further, amounting to 7,96 per cent on 24 February 2004. In the absence of an adjustment to the repurchase rate at that meeting, the rate remained roughly unchanged and stood at 8,00 per cent on 12 March 2004.

Money-market interest rates



During the three months to December 2003, the amount of 91-day Treasury bills on offer at the weekly tender remained unchanged at R1,5 billion but was increased to R1,8 billion from 2 January 2004 to supplement government funding needs ahead of the redemption and coupon interest payment on major government bonds at the end of February 2004. The rate on 91-day Treasury bills declined from 8,41 per cent on 10 October 2003 to 7,88 per cent on 17 October and, on balance, receded further to a low point of 7,02 per cent on 5 December. Together with other money-market rates this rate adjusted upwards from 12 December and amounted to 7,54 per cent at the last auction for 2003. It reached 7,64 per cent on 12 January and amounted to 7,71 per cent on 12 March 2004.

Commercial banks adjusted their prime overdraft rates in accordance with changes in the repurchase rate, resulting in a cumulative decline of 5½ percentage points from its plateau level of 17 per cent which prevailed up to early June 2003, to 11½ per cent from 15 December 2003.

Other lending and deposit rates of private-sector banks also closely followed the reductions in the repurchase rate during 2003. The private banks lowered their *predominant rate on mortgage loans* in five steps from 17 per cent in May 2003 to 11½ per cent in December 2003. This rate remained unchanged to February 2004.

In anticipation of monetary policy easing, banks reduced the *predominant rate on twelve-month fixed deposits* from 12 per cent in April 2003 to 11 per cent in May, followed by seven further reductions to 6,1 per cent in December – a total reduction of 590 basis points. This level of deposit rates was last experienced in 1966. The predominant rate on twelve-month fixed deposits increased by 90 basis points to 7 per cent in February 2004.

The *official rate of interest* applicable to fringe benefit taxation, as defined by the Income Tax Act, was reduced from 9½ per cent to 9 per cent, effective from 1 March 2004. On 6 February 2004 the *maximum annual finance charges rates* on money loans and credit and leasing transactions, as laid down by the Usury Act, were lowered by one percentage point to 21 per cent for amounts of less than R10 000 and to 18 per cent for amounts above R10 000, but not exceeding R500 000. The decrease brings the total reduction to 800 basis points for each category since June 2003.

The strengthening in the exchange value of the rand and the deceleration in inflation contributed to the decline in long-term bond yields during 2003. The *monthly average yield on long-term government bonds* declined from 12,6 per cent in March 2002 to 9,1 per cent in October 2003 – its lowest level since 1979. Domestic bond yields edged gently upward to 9,3 per cent in November and fluctuated within a narrow range to 9,4 per cent in February 2004. The levelling out of long-term bond yields occurred alongside:

- indications of an increase in the domestic funding requirement of government in the *Medium Term Budget Policy Statement* of November 2003;
- wide fluctuations in the value of the rand in December and the early part of 2004; and
- a lower-than-expected 50-basis-point reduction in the repurchase rate in December 2003.

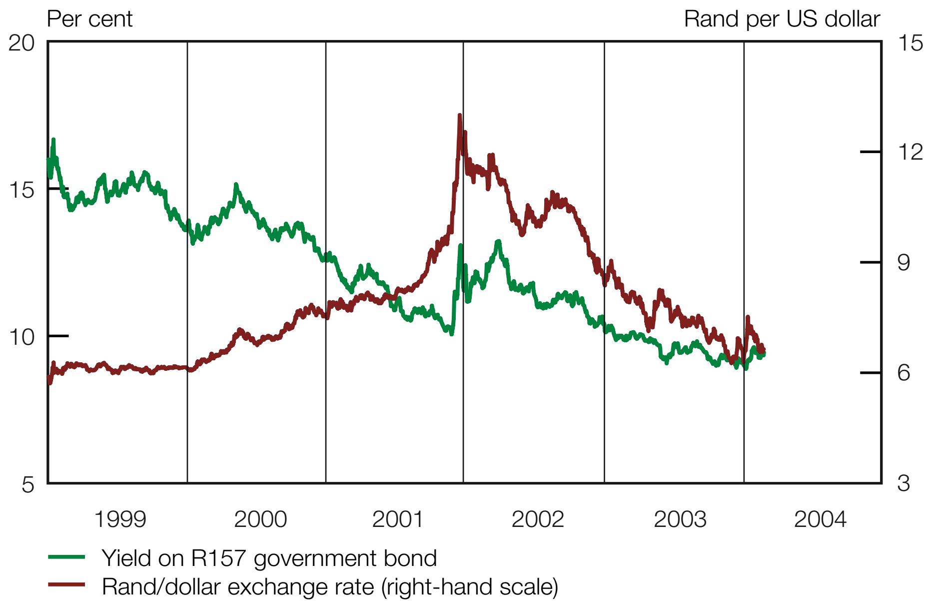
On 28 February 2004 South Africa's financial markets had to cope with the biggest inflow of funds from government in a single day, amounting to R41,3 billion. The redemption of the first of three tranches of the R150 government bond amounted to R26,4 billion and coupon payments on the R150, R153 and R194 bonds amounted to R14,9 billion. The inflow was alleviated somewhat by National Treasury's rollover offer on 27 February whereby R4,5 billion was switched into longer-term bonds. The remaining daughter tranches of the R150 government bond, namely the R151 and R152, mature on 28 February 2005 and 2006, respectively.

The split of the short-term R150 government bond necessitated BESA to modify the duration of the All Bond Index (ALBI) over a five week period from 8 January 2004 to 5 February. Demand for bonds across the maturity spectrum was affected as investors adjusted their portfolios accordingly. The ALBI – widely used as a benchmark for measuring portfolio performance – is discussed in the box on page 38.

In the wake of monetary policy easing from early June 2003 the *daily average yield* on long-term government bonds initially fluctuated upwards from 9,07 per cent on 17 June 2003 to 9,82 per cent on 4 September. The daily average bond yield then drifted lower to 8,92 per cent on 17 December. Briefly interrupted by the less-than-expected 50-basis-point reduction in the repurchase rate in December, long-term bond yields continued to decline to a recent low of 8,88 per cent on 12 January 2004. The decline in yields was the result of improved inflation expectations following the release of low and declining inflation figures, the sustained strength of the exchange value of the rand and the 300-basis-point reduction in the repurchase rate between 11 September and 12 December 2003. The noticeable depreciation of the exchange value of the rand during January 2004 resulted in bond yields increasing to 9,62 per cent on 2 February, before declining to 9,44 per cent at the end of February after some appreciation of the exchange value of the rand during the month and an unchanged repurchase rate verdict at the February MPC meeting.

The *yield curve* became less downward sloping from June 2003 and changed to upward sloping from 9 September following successive relaxations in the monetary policy stance. The level of the yield curve continued to move downwards until 12 January 2004 – more at the short end than at the long end – as bond yields across the maturity spectrum declined to levels last experienced in the 1980s. Partly in reaction to the fluctuating exchange value of the rand the slope of the yield curve subsequently

Long-term bond yield and exchange rate



steepened somewhat when bond yields over the three-to-twenty-year maturity intervals moved upwards. By contrast, long-term bond yields remained within a narrow range. The recent resilience of bond yields beyond twenty years' maturity in the wake of the fluctuating exchange value of the rand was supported by, amongst other things, the cautious approach of the MPC in December 2003 and February 2004, reinforcing favourable long-term inflation expectations. In the week prior to the February 2004 MPC meeting yields at the short end of the maturity spectrum traded only 35 basis points below the repurchase rate as the softer undertone in the exchange value of the rand, higher fuel prices and higher-than-expected inflation data for January 2004 dampened market expectations of a further reduction in the repurchase rate.

After becoming positive on 9 September 2003 the *yield gap*, i.e. the difference between bond yields at the extreme long and short ends of the yield curve, progressively increased to 214 basis points on 3 December, before narrowing to 55 basis points on 13 February 2004. It again widened to 92 basis points at the end of February.

After declining from 4,8 per cent in December 2001 to a negative value of 0,4 per cent in November 2002, the *real* or *inflation-adjusted yield on long-term government bonds* (using historical year-on-year increases in CPIX as an indicator of future price changes) increased markedly and reached 4,9 per cent in both December 2003 and January 2004 as the brisk deceleration in CPIX inflation exceeded the decline in long-term bond yields.

The *currency risk premium* on South African government bonds (measured as the differential between yields on rand-denominated South African government bonds in the five-to-six-year maturity range issued in the domestic market and those issued in the United States market and denominated in dollar) narrowed significantly from an average level of 562 basis points in September 2002 to 404 basis points in October 2003. This improvement was the result of the sustained strengthening in the exchange value of the rand and lower measured and expected inflation experienced in 2003. In February 2004 the currency risk premium had again widened by 87 basis points following the fluctuations in the exchange value of the rand during December 2003 and January 2004.

BEASSA Total Return Indices*

BEASSA Total Return Indices, launched in July 2000 by the Bond Exchange of South Africa (BESA) and the Actuarial Society of South Africa (ASSA), provide a benchmark for measuring investment performance in the South African bond market. The current BEASSA Total Return Indices are the third generation of a family of indices for the South African bond market and aim to improve on the shortcomings of the previous actuarial indices by measuring total returns in the bond market more accurately.

BESA publishes three main indices. The All Bond Index, or ALBI, is the main index and normally consists of the top twenty listed bonds, ranked by market capitalisation and liquidity combined. The Government Bond Index, or GOVI, contains those government bonds which fall within the ten highest ranking bonds included in the ALBI. Finally, the Other Bond Index, or OTHI, consists of the remainder of the bonds included in the ALBI. The current constituents of the ALBI include seven government bonds and thirteen bonds of both financial and non-financial public enterprises.

The indices are reconstituted quarterly based on liquidity, the total amount in issue and the term to maturity. Reconstitution coincides with options and futures expiry dates in order to encourage and facilitate the development of derivative products. Re-selection of constituents may also be done in special circumstances, such as the unbundling of a bond. The split of the R150 government bond, of which the first one-third matured on 28 February 2004, necessitated the BEASSA Index Committee to declare this an extraordinary event. The R150 and R151 government bonds were removed from the All Bond Index from 5 February 2004 due to term-to-maturity considerations. As a consequence the constituents of the GOVI changed. Bonds with a maturity of less than one year are excluded as, amongst other things, their behaviour tends to emulate that of money-market instruments.

GOVI constituent bonds

From 6 November 2003			From 5 February 2004		
Bond		Weight Per cent	Bond		Weight Per cent
R150	(28 Feb 2005)	23,5	R152	(28 Feb 2006)	9,9
R194	(28 Feb 2008)	16,8	R194	(28 Feb 2008)	21,9
R153	(31 Aug 2010)	30,7	R153	(31 Aug 2010)	34,2
R201	(21 Dec 2014)	2,2	R201	(21 Dec 2014)	4,1
R157	(15 Sep 2015)	17,2	R157	(15 Sep 2015)	19,0
R186	(21 Dec 2026)	9,6	R186	(21 Dec 2026)	10,9
		100,0			100,0

The BEASSA bond indices are published daily and are widely accepted as the standard against which investment performance in the bond market is measured. The BEASSA Total Return Indices facilitate performance measurement between any two periods. The indices provide investment managers with, among other things:

- a barometer to measure daily movements in the bond market;
- a benchmark against which portfolio performance can be measured;
- a basis for funds tracking the bond market;
- a means to analyse the subsectors of the bond market; and
- a basket for bond futures and other derivatives.

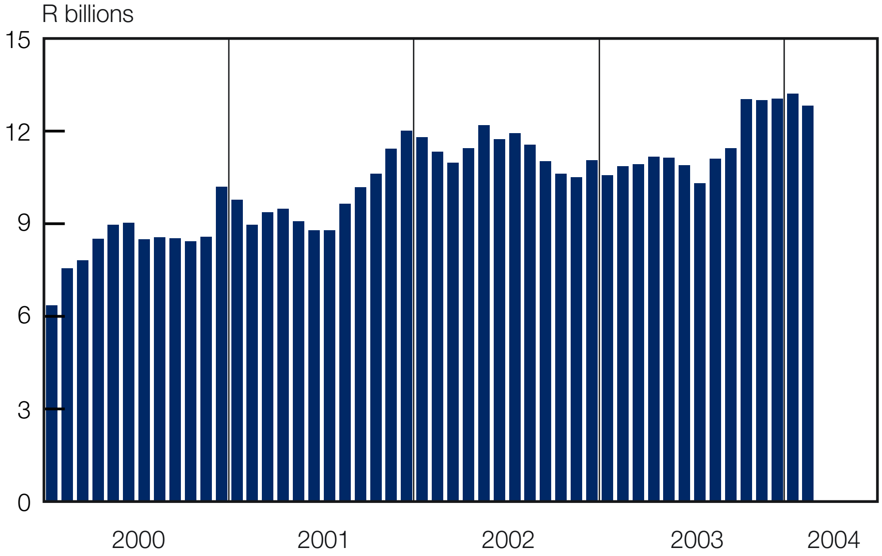
* Based on information made available by the Bond Exchange of South Africa

D H Meyer and B C Badsha

Money market

The level of the private-sector banks' average daily liquidity requirement increased during the period under review, from R11,4 billion in September 2003 to around R13 billion in the ensuing months to February 2004.

Total liquidity requirement



Monthly averages of daily values

The Reserve Bank continued to actively employ various liquidity management instruments which were mainly aimed at maintaining the liquidity requirement of banks at levels deemed appropriate. However, several factors that continually drained excess liquidity from the money market helped the Bank in this regard. This liquidity tightening process was significantly assisted by, among other factors:

- profits generated on the Bank's oversold forward book;
- outright sales of various government bonds worth R2,5 billion from the Reserve Bank's monetary policy portfolio during December 2003 and January 2004;
- increases in government deposits in preparation for the redemption and coupon interest payments on major domestic bonds and for the premature redemption of the syndicated loan which was due only on 30 July 2004;
- the payment received by the Bank from government at maturity of the first tranche of the R150 bonds held by the Bank, and coupon interest received on other government bonds in the Bank's monetary policy portfolio;
- an increase in the third quarter of 2003 in the reserve balances that banks are required to hold with the Reserve Bank following a further reduction of 25 per cent of vault cash eligible for reserve asset holdings;
- increases in notes and coin in circulation outside the Bank; and
- repayment of lender-of-last-resort assistance provided to certain banks early in 2002.

The tightening effect of these factors effectively allowed the Bank to unwind and lower the level of its liquidity draining instruments from R19,2 billion at the end of October 2003 to R8,0 billion at the end of February 2004. In particular, the Bank managed to reduce its foreign-currency swap transactions with private-sector parties from a peak of

R54,8 billion at the end of August 2002 to R3,6 billion at the end of October 2003. These transactions were brought down to nil at the end of November 2003, and are discussed further in the accompanying box.

The phasing out of foreign-currency swap transactions with counter deposits as predominant instrument for domestic liquidity management

In order to make its repurchase rate effective, the Reserve Bank prefers to manage the money market in such a way that banks virtually always have to borrow some funds through the repurchase window. Due to various episodes of depreciation of the exchange rate of the rand, large losses on maturing foreign exchange forward cover contracts provided by the Reserve Bank were incurred. These losses injected liquidity into the money market, and without countermeasures would have caused the banks' combined liquidity requirement to revert to a liquidity surplus. As this problem worsened and was exacerbated by other forces expanding money-market liquidity, foreign-currency swap transactions with counter deposits was one of the instruments employed to sterilise excessive money-market liquidity.

Swaps with counter deposits involve that the Bank first sells US dollar for rand to authorised dealers, thereby draining rand liquidity, and, as second leg of the swap, buys US dollar against the rand for delivery and payment on a future date. However, authorised dealers are obliged to place the US dollar they receive from the Bank back on deposit with the Bank for the duration of the contract. This leg of the transaction is mainly meant to avoid the loss of foreign exchange reserves associated with conventional money-market swaps. The rand equivalent of the foreign-currency deposits made by banks is reflected in the monthly balance sheet of the Bank as banks' deposits with the Reserve Bank.

Following their inception in May 1999, swaps with counter deposits rose rapidly. At the height of their use, their cumulative outstanding level rose to R54,8 billion at the end of August 2002. Aligned with this increase was the level of banks' deposits with the Reserve Bank and consequently also the size of its balance sheet.

From September 2002 onward circumstances arose and actions were taken which made it possible to work down the level of swaps with counter deposits. These, *inter alia*, included the remarkable recovery of the exchange rate of the rand, leading to profits on maturing forward contracts which drain money-market liquidity; the repayment of liquidity assistance previously provided to troubled banks; the partial settlement by government of the losses incurred on forward cover through issuing bonds to the Reserve Bank, such bonds after conversion being usable in reverse repurchase agreements or open-market operations; and higher effective cash reserve requirements.

The combination of these circumstances and factors ultimately culminated in the complete phasing out of swaps with counter deposits at the end of November 2003. In the process over-reliance on a single liquidity-management instrument was ended, the size of the balance sheet of the Bank was reduced significantly, and the management of domestic liquidity conditions was improved. Conventional instruments such as outright sales of government securities in the Bank's monetary policy portfolio, repurchase agreements in government bonds, and the issuing of Reserve Bank debentures now provide an adequate arsenal for managing liquidity, while the closing out of the Bank's forward book in February 2004 also implies that a disruptive liquidity injection arising from forward cover losses will not recur.

N Nhlapo and N Gumata

To avoid undue tightening in money-market liquidity conditions over the festive season and at the end of February 2004 with the redemption of and coupon interest payments on major government bonds, the Bank reduced the outstanding amount of its debentures and reverse repurchase transactions in government securities. Intervention by type of instrument is reflected in the table on the following page.

Outstanding balances of selected money-market intervention instruments

R billions

End of		Foreign-currency swaps with deposits	Reserve Bank debentures	Reverse repurchase agreements	Total instruments outstanding
2003:	Jan.....................	45,3	7,6	10,5	63,3
	Feb	42,9	8,0	10,0	60,9
	Mar	34,9	7,9	10,3	53,1
	Apr.....................	30,1	8,0	10,3	48,3
	May....................	27,3	8,0	10,3	45,5
	Jun	20,6	8,0	9,0	37,8
	Jul......................	17,6	8,0	10,3	35,9
	Aug....................	15,3	8,0	10,3	33,6
	Sep....................	11,0	7,8	9,7	28,5
	Oct.....................	3,6	7,0	8,6	19,2
	Nov....................	0,0	6,7	8,6	15,3
	Dec....................	0,0	3,2	5,2	8,4
2004:	Jan.....................	0,0	6,9	3,4	10,3
	Feb	0,0	5,0	3,0	8,0

Notes and coin in circulation outside the Reserve Bank increased significantly over the review period. Following the usual seasonal pattern, currency in circulation increased by R5,1 billion from R39,6 billion at the end of September 2003 to R44,7 billion at the end of December, shortly after having reached a peak level for 2003 of R47,8 billion on 24 December. This upward trend was reversed as notes and coin in circulation outside the Bank declined during January and February 2004, thus easing liquidity conditions and assisting the Bank in its effort to counteract undue tightening in the banks' liquidity position. In the final quarter of 2003, January and February 2004, year-on-year growth in notes and coin fluctuated around 14 per cent, reflecting strong expenditure growth supported by a lower interest rate environment.

In an effort to shorten the maturity of the Bank's portfolio of government bonds and to further enhance the conduct of monetary policy, National Treasury and the Bank announced an agreement on 20 October 2003 *inter alia* allowing the Bank to restructure its holdings of interest-bearing government bonds held in its monetary policy portfolio, by conducting cash-neutral switch auctions. The Bank has from 22 October 2003 to the end of January 2004 conducted six such auctions involving government securities to the value of R9,6 billion. A further switch auction on 5 February 2004, where the Bank was offering to exchange R153 government bonds worth R1 billion for R006 bonds, was unsuccessful, as there were no tenders received from the market.

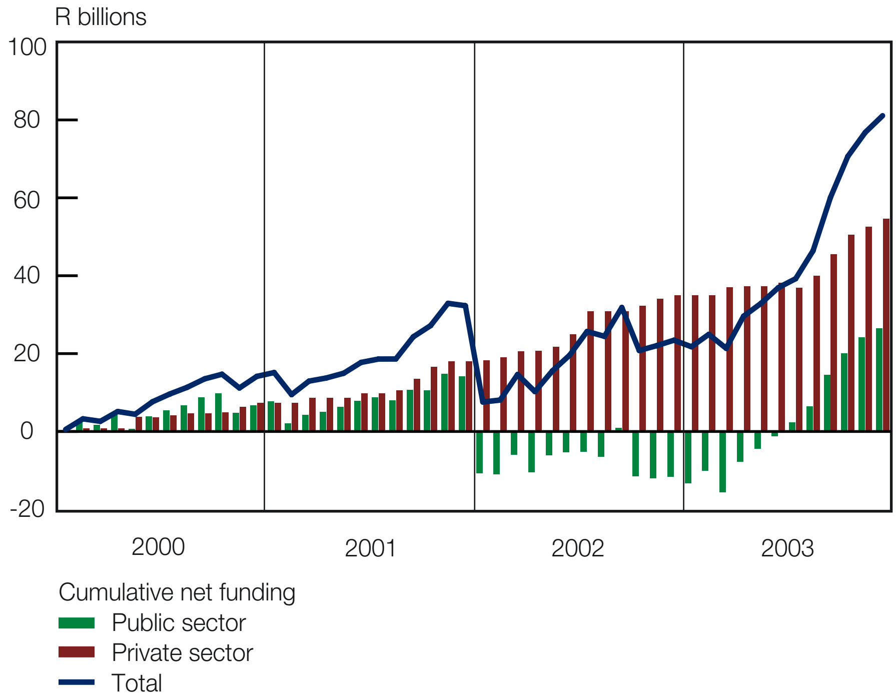
Bond market

Net issues of fixed-interest securities by the *public sector* in the *domestic primary bond market* increased noticeably during 2003, primarily due to national government directing its funding strategy more towards the domestic market. Net redemptions of R4,1 billion in the first quarter of 2003 were followed by sizeable net issues in each of the last three quarters of 2003, bringing the total net issuance of public-sector securities in 2003 to R38,1 billion. This contrasts with the net redemptions of R25,8 billion recorded in 2002.

In the 2004/05 Budget of National Government, presented in February 2004, a budgeted net borrowing requirement of R46,2 billion was announced, compared with

R37,9 billion in the current fiscal year. The funding strategy includes an increase of R6 billion in domestic short-term loans, R5,9 billion to be raised through foreign loans, and a projected R34,3 billion to be raised through net domestic bond issues.

Funding in the domestic primary bond market

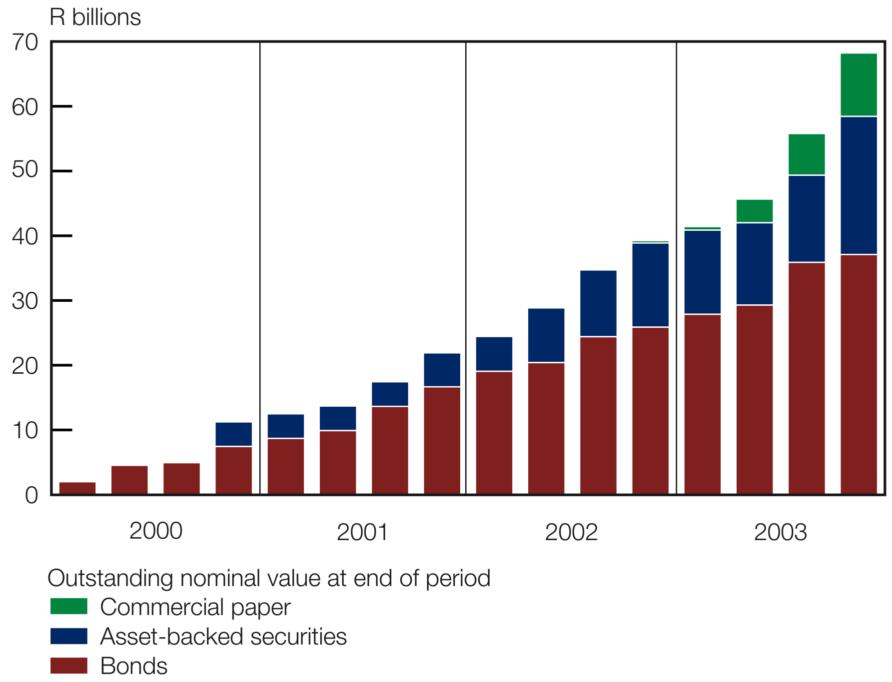


National government aims to expand its sources of funding and simultaneously encourage saving through the launch of a retail government bond market in May 2004. The retail bonds will have a maturity of up to five years and will allow for investments of as little as R1 000. The new bonds, to be marketed through the Post Office, will have a guaranteed interest rate and no transaction fees. The bonds will not be tradeable or listed on BESA, but will be redeemable after 12 months. Countries with established retail bond markets readily accessible by individuals include the United Kingdom and the United States.

The *outstanding nominal value of private-sector loan stock* listed on BESA increased from R38,9 billion in December 2002 to R58,4 billion in December 2003, with most of the increase recorded in the second half of the year. Issuers took advantage of investor appetite for higher-yielding securities in an environment of low interest rates and declining yields on government securities. New issues slowed down in the first two months of 2004, increasing the amount listed to R59,6 billion in February 2004. Of the total amount in issue 36 per cent, or R21,3 billion, was in the form of asset-backed securities, compared with 33 per cent at the end of 2002. These instruments include mortgage-backed securities and collateralised debt obligations.

Private-sector interest in short-term funding in the form of *commercial paper* similarly gained momentum during 2003 with the amount in issue increasing from R0,4 billion in December 2002 to R9,8 billion in December 2003, and increasing further to R9,9 billion in February 2004.

Private-sector funding in the interest-bearing securities markets



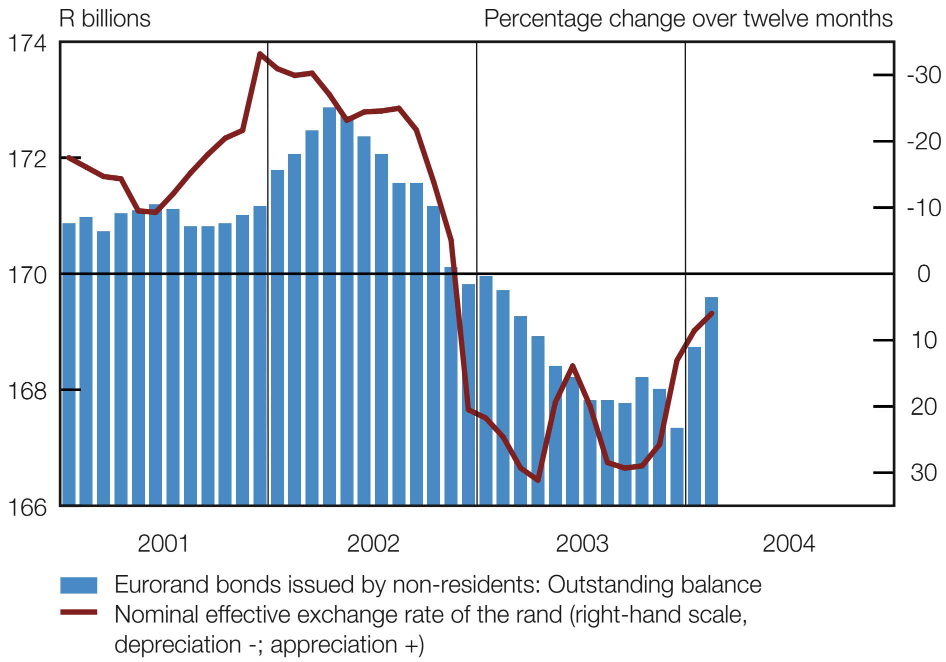
After raising R10,6 billion through a foreign-currency denominated debt issue in the *international bond market* during May 2003, *national government* refrained from further issues in international markets in fiscal 2003/04. Foreign debt was reduced by R8,7 billion in July 2003 with the partial redemption of a dual-currency loan and by a further R2,1 billion in October when a Deutsche Mark bond, issued in 1996, matured. In January 2004 foreign debt declined by a further R5,2 billion when the remaining half of the dual-currency loan, due in July 2004, was prematurely redeemed. *Public corporations* steered clear of the international bond markets in 2003 and the first months of 2004.

In the *European bond markets* non-resident issuer interest in rand-denominated bonds waned during 2003 and scheduled redemptions exceeded new issues by R2,5 billion, substantially exceeding the net redemptions of R1,4 billion for 2002. Net issues by non-residents in these markets rebounded to R1,4 billion in January 2004, probably partly in response to the weaker rand, and came to R0,9 billion in February. The European Investment Bank (EIB) was responsible for eight of the fourteen issues thus far in 2004.

Turnover in the *domestic secondary bond market* declined by 2 per cent from R12,2 trillion in 2002 to just below R12,0 trillion in 2003. Turnover increased markedly from R2,6 trillion in the first quarter of 2003 to R3,4 trillion in the third quarter before slowing to R2,9 trillion in the fourth quarter. The increase occurred alongside an easing of monetary policy and the appreciating exchange value of the rand. In January and February 2004 turnover on BESA slowed down further to a quarterly rate of R2,6 trillion.

*Non-resident*s reduced their holdings of South African debt securities by R8,1 billion in 2003 through BESA, compared to small net purchases of R0,3 billion in 2002. Net purchases of R2,7 billion in the first half of 2003 were followed by net sales of R10,8 billion in the second half of the year and R1,1 billion in January and February 2004. Non-resident participation on BESA, measured as purchases and sales as a percentage of total purchases and sales of bonds, amounted to 10,9 per cent of the total turnover in 2003, compared with 11,5 per cent in 2002.

Eurorand bond market



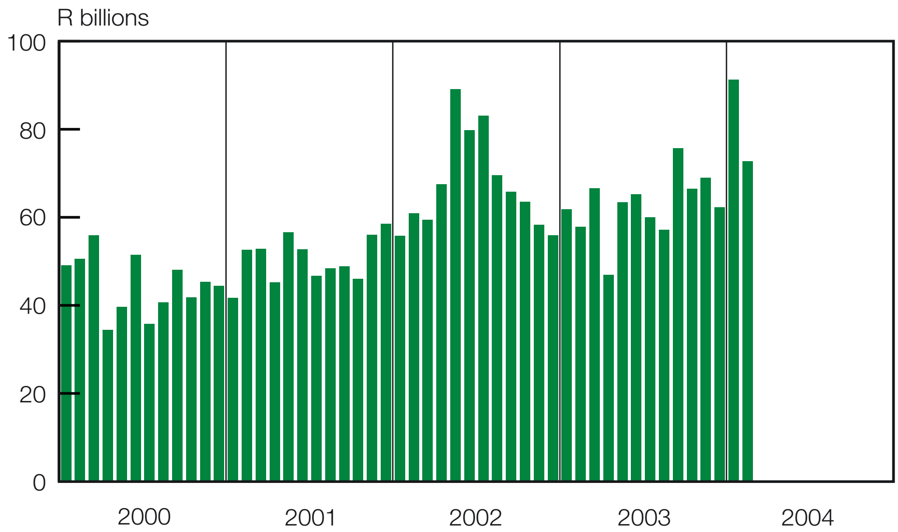
Share market

The total value of equity capital raised in the domestic and international *primary share markets* by companies listed on the JSE Securities Exchange SA (JSE) amounted to R22,7 billion in 2003, well down from the R59,9 billion raised in 2002. However, the quarterly value of capital raised improved from a low of R2,2 billion in the second quarter of 2003 to R7,4 billion in the fourth quarter. Equity financing receded to a quarterly rate of R2,3 billion in January and February 2004.

The *AltX* alternative exchange, launched by the JSE on 27 October 2003, saw its first listings on 29 January 2004 when Beige Holdings and Insurance Outsourcing Managers Holdings (Insure) transferred their listings to the new market. Both companies were previously listed on the JSE, with Beige listed on the venture capital board and Insure on the main board. Further listings are expected in the coming months. The JSE has given notice to the 37 companies currently listed on the venture capital and development capital boards of its intention to close these boards due to their limited success and low liquidity, and proposed 30 July 2004 as the date for such closure. The companies can either move to the main board or to the alternative exchange, AltX, if they meet the listing requirements.

Turnover in the *secondary share market* declined from a high value of R809 billion in 2002 to R752 billion in 2003. However, the quarterly value of shares traded rebounded from R176 billion in the second quarter of 2003 to R198 billion in the fourth quarter. Turnover subsequently increased to a record monthly high of R91 billion in January 2004, followed by R73 billion in February.

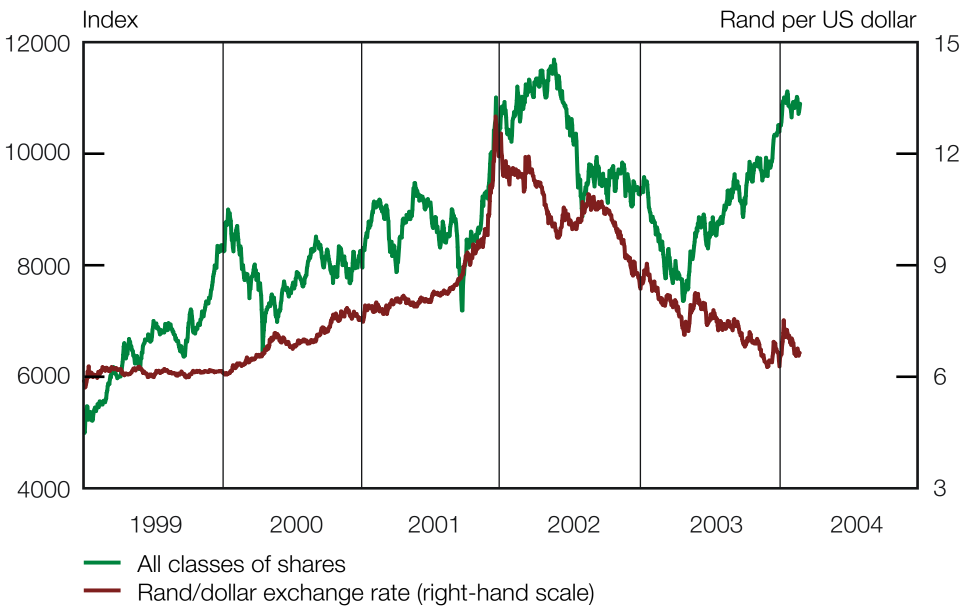
Turnover in the secondary share market



Non-resident net purchases of R0,6 billion of South African shares through the JSE in the first half of 2003 were followed by net sales of R1,1 billion in the second half of the year. Their net sales of R0,4 billion in 2003 were, however, far lower than the net sales of R5,6 billion recorded in 2002. Non-resident participation in the share market, measured as purchases and sales as a percentage of the total value of shares traded on the JSE, has however moderated from 26 per cent in 2002 to 22 per cent in 2003. From the beginning of 2004 to the end of February, non-residents' net cumulative purchases of shares amounted to R7,1 billion.

Steadily increasing international share markets, coupled with a more accommodative monetary policy environment and rising commodity prices, helped mitigate the effect of a strong exchange value of the rand on domestic share prices in 2003. After falling by 37 per cent from an all-time high on 22 May 2002 to 25 April 2003 the *daily closing level of the JSE all-share price index* recorded a gain of 41 per cent to 31 December 2003.

Share prices and the exchange rate



Share prices increased by a further 4 per cent in January 2004, supported by rising international equity markets, high commodity prices and a weaker rand, before levelling out in February when the rand appreciated. This brought the total market capitalisation of shares listed on the JSE to R1 869 billion, compared with R1 303 billion in April 2003.

The monthly average price level of the *resources sector's shares* increased by 33 per cent from April 2003 to February 2004, benefiting from the improved global economic outlook, rising commodity prices and the depreciation of the exchange value of the rand during December 2003 and January 2004. The announcement in the 2004/05 *Budget Review* that government is continuing to consider revisions to its proposed Mineral and Petroleum Royalty Bill, opting for a broader revenue base but at lower rates, remained a concern for the mining industry. The delay in the implementation of the mining royalties to 2009 was however welcomed, ensuring that the change in tax regime does not interfere with the conversion to new-order mineral rights in terms of the Mineral and Petroleum Resources Development Act.

Mirroring the movement in share prices, the *dividend yield* on all classes of shares increased from 3,0 per cent in May 2002 to 4,6 per cent in April 2003, the highest level since 1990, before receding to 2,8 per cent in February 2004. The *earnings yield* on all classes of shares increased from 7,3 per cent in May 2002 to 10,3 per cent in April 2003, before receding to 6,7 per cent in February 2004. Conversely, the *price-earnings ratio* of all classes of shares increased to 15,0 in February 2004, from a recent low of 9,7 in April 2003.

Market for derivatives

The total number of *futures and options on futures contracts* traded on the Financial Derivatives Division of the JSE increased by 4 per cent from 29,4 million in 2002 to 30,7 million in 2003. After increasing from 6,4 million contracts in the first quarter of 2003 to 8,5 million contracts in the third quarter, trade slowed down to 7,9 million contracts in the fourth quarter. In January and February 2004 trade at a quarterly rate came to 9,7 million contracts.

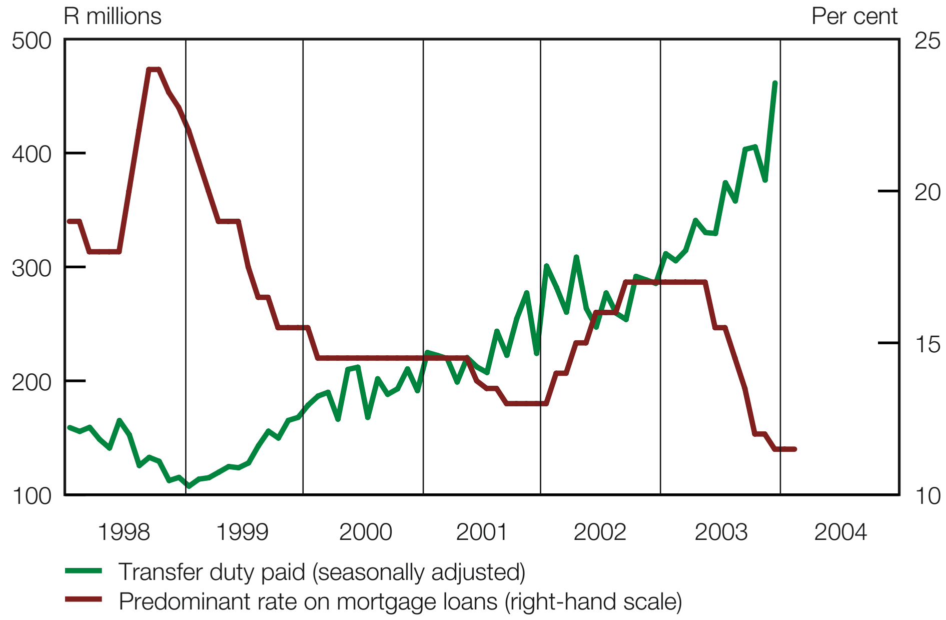
Adverse weather conditions and fluctuations in the exchange value of the rand impacted on the prices of agricultural products during 2003. For example, the spot price of *white maize* as quoted by the JSE Agricultural Products Division fluctuated considerably and reached a two-year low of R719 per ton on 30 April 2003, before rising to around R1 328 per ton in February 2004. These developments ultimately influenced trade on the Agricultural Products Division of the JSE. The number of *commodity futures contracts and options* on such contracts traded declined from a record turnover of 652 000 contracts in the first quarter of 2003 to 499 000 in the third quarter, before improving to 519 000 in the fourth quarter. In total the 2,3 million contracts traded in 2003 represents an increase of 17 per cent over the nearly 2 million traded in 2002. Trade increased to a quarterly rate of 596 000 contracts in the first two months of 2004.

The number of *warrants* traded on the JSE fell by 70 per cent from 19,6 billion contracts in 2002 to 5,8 billion contracts in 2003 as interest waned and the number of warrants listed fell back. Trading activity in this market, however, gradually improved from a low of 1,1 billion contracts in the second quarter of 2003 to 1,6 billion contracts in the fourth quarter. Trade slowed to a quarterly rate of 1,4 billion contracts in January and February 2004.

Real-estate market

The lowering of the cost of mortgage finance from June 2003 buoyed trading activity and prices in the *real-estate market*. The value of turnover in the real-estate market, measured by *transfer duty paid*, increased by 29,2 per cent in 2003. In 2002 an increase of 21,7 per cent had been recorded. In the 2004/05 Budget of National Government the transfer duty exemption threshold was raised from R140 000 to R150 000 and stamp duties on mortgage loans were eliminated. Year-on-year increases in *residential property prices*, as measured by Absa Bank, averaged 19,2 per cent in 2003, against an average of 15,3 per cent recorded in 2002.

Real-estate market activity



Despite the robust turnover and increasing property prices, the *monthly average price level* of companies listed on the *real-estate holding and development sector* of the JSE increased by only 15 per cent from a low in April 2003 to February 2004. This compares with an increase of 38 per cent in the monthly average price level of all classes of shares over the same period. The subdued performance of real-estate shares may be due to their exposure to the risks and uneven returns of the commercial property market where oversupply in some areas depresses returns on industrial, office and retail properties.

Public finance

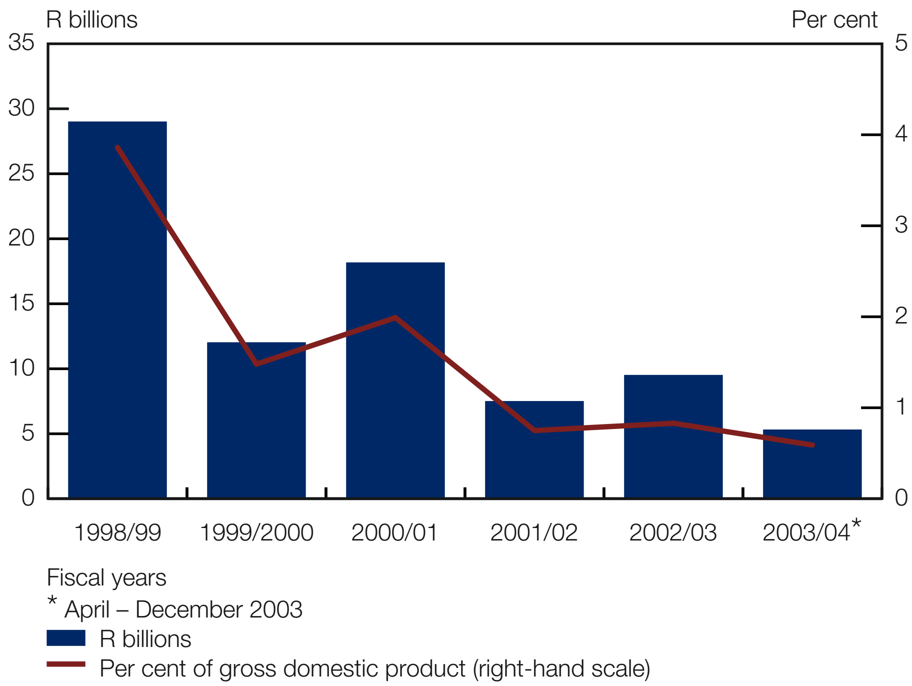
Non-financial public-sector borrowing requirement

The *non-financial public sector* (i.e. the consolidated central government, provincial governments, local governments and non-financial public-sector business enterprises) recorded a cash *surplus* of R4,3 billion in the October-December quarter of 2003 – R9,3 billion less than the cash surplus recorded in the corresponding quarter of 2002. For the first nine months of fiscal 2003/04, the non-financial public-sector cash *deficit* amounted to R5,4 billion – a turnaround from the cash *surplus* of R4,2 billion in the first nine months of fiscal 2002/03. As a ratio of gross domestic product, the non-financial public-sector cash deficit amounted to 0,6 per cent in the first nine months of fiscal 2003/04 compared with a cash surplus of 0,5 per cent in the corresponding period of the previous fiscal year.

The financial activities of *national government* resulted in a cash deficit of R21,9 billion for the first nine months of fiscal 2003/04, compared with a cash deficit of only R3,9 billion in the same period of the previous fiscal year.

The activities of the *consolidated general government* (i.e. public-sector entities other than non-financial public enterprises) in the October-December quarter of 2003 resulted in a negligible cash deficit, bringing the consolidated general-government borrowing requirement to R15,6 billion in the first nine months of fiscal 2003/04 compared with a borrowing requirement of R5,3 billion recorded in the same period of the previous fiscal year.

Non-financial public-sector borrowing requirement



The cash surplus of the non-financial public enterprises increased from R9,5 billion in the first nine months of fiscal 2002/03 to R10,2 billion in the same period of the current fiscal year, despite an increase in investment in non-financial assets.

An analysis of the *Statement of revenue, expenditure and borrowing of the provincial governments* indicated a small cash deficit of R0,8 billion in the October-December quarter of 2003, bringing the provincial cash surplus for the first nine months of fiscal 2003/04 to R3,0 billion compared with a cash deficit of R2,0 billion recorded in the same period of the previous fiscal year. This cash surplus was realised despite a substantial increase in net investment in non-financial assets to R5,7 billion over the nine-month period from April to December 2003 – a consequence of heightened infrastructural investment.

Overall provincial government expenditure increased by 16,2 per cent in the first nine months of fiscal 2003/04, but this was exceeded by the 21,7 per cent expansion in their revenue received from national government as equitable share payments and conditional grants.

Provincial governments' bank deposits stayed broadly unchanged at around R8,3 billion between the end of March 2003 and the end of December 2003, while their overall indebtedness to banks decreased from R0,5 billion to R0,3 billion between these dates.

Preliminary data regarding the financial position of *local governments* indicate an improvement in their financial balance in the first nine months of fiscal 2003/04, compared with the corresponding period of the previous fiscal year.

National government finance

National government *expenditure* recorded a year-on-year rate of increase of 14,0 per cent in the first nine months of fiscal 2003/04, which was slightly lower than the originally budgeted increase of 14,6 per cent, but slightly higher than the rate of increase of 13,7 per cent projected in the Adjustments Budget for the fiscal year as a whole. The revised projections indicate that total national government expenditure for fiscal 2003/04 will amount to R331,5 billion, lower than the originally budgeted R334,0 billion, as inflation and interest rates turned out lower than originally projected.

The percentage increase in national government expenditure in the first nine months of the current fiscal year was the highest since 1996/97. As a ratio of gross domestic product, national government expenditure in the first nine months of fiscal 2003/04 amounted to 25,7 per cent, which was higher than the 24,1 per cent recorded in the corresponding period of the previous fiscal year.

Interest paid on government debt declined slightly from R27,9 billion in the first nine months of fiscal 2002/03 to R27,3 billion in the first nine months of fiscal 2003/04. This represents a decrease of 2,2 per cent. For the period under review interest paid on domestic debt amounted to R23,4 billion representing a slight decrease of 0,8 per cent from the corresponding period of fiscal 2002/03. Interest paid on foreign debt decreased by 15,4 per cent compared with the same period of the previous fiscal year, helped along by early repayment of foreign borrowings and the recovery of the exchange rate of the rand. Spending on capital projects amounted to R14,1 billion in the first nine months of fiscal 2003/04, representing only 62,0 per cent of the budgeted amount of R22,7 billion for the full year.

National government *revenue* increased at a year-on-year rate of 4,9 per cent in the first nine months of fiscal 2003/04, the lowest increase since fiscal 1968/69. It was also substantially lower than the originally budgeted increase of 9,4 per cent for the full fiscal year. The Adjustments Budget projected that total revenue collections would rise by 7,7 per cent in fiscal 2003/04 as a whole.

National government revenue

Revenue source	R billions: Fiscal 2003/04 Originally budgeted	R billions: April – Dec 2003 Actual	Percentage change*
Taxes on income and profits	177,9	126,2	2,4
Payroll taxes	3,6	2,9	19,6
Taxes on property	5,9	4,8	25,3
Domestic taxes on goods and services	109,6	78,2	11,5
Taxes on international trade and transactions	11,3	6,4	-18,4
Other revenue	5,9	7,6	4,4
Less: SACU** payments	9,7	7,3	17,7
Total revenue	**304,5**	**218,9**	**4,9**

* April – December 2002 to April – December 2003
** Southern African Customs Union

Taxes on income and profits, the principal source of revenue for national government, increased at a year-on-year rate of only 2,4 per cent in the first nine months of fiscal 2003/04. This increase was noticeably lower than the originally budgeted increase of 8,1 per cent for the full fiscal year. The main reason for the slow growth was the under-performance of company tax receipts. Company profits were adversely affected by the lower-than-anticipated growth of the economy and the strong recovery of the exchange rate of the rand. Domestic taxes on goods and services rose by 11,5 per cent compared with the same period of the preceding fiscal year. Value-added tax, which is a major component of this tax category, increased by 12,8 per cent.

As a ratio of gross domestic product, national government revenue amounted to 23,8 per cent in the first nine months of fiscal 2003/04 compared with 24,3 per cent in the corresponding period of the previous fiscal year.

The net result of the revenue and expenditure recorded in the *Statement of national government revenue, expenditure and borrowing* was a national government *deficit* of R16,9 billion in the first nine months of fiscal 2003/04 compared with a surplus of R1,8 billion in the same period of fiscal 2002/03. The *Budget Review 2003* projected a national government deficit of R29,5 billion in fiscal 2003/04 as a whole, whereas the revised estimates contained in the Adjustments Budget projected a deficit of R31,6 billion.

Due to the slowdown in the rate of increase in revenue collections, the primary balance of national government (i.e. the deficit recalculated by excluding interest payments from total expenditure) receded to a surplus of R10,4 billion in the first nine months of fiscal 2003/04, significantly lower than the surplus of R29,6 billion recorded in the same period of fiscal 2002/03. As a ratio of gross domestic product, the primary surplus amounted to 1,1 per cent for the period under review, markedly lower than the 3,5 per cent recorded in the corresponding period of the previous fiscal year.

The deficit before borrowing and debt repayment as a ratio of gross domestic product amounted to 1,8 per cent in the first nine months of fiscal 2003/04. This can be compared with a surplus ratio of 0,2 per cent recorded in the corresponding period of the previous fiscal year.

The cash deficit (i.e. the deficit before borrowing and debt repayment, adjusted for cash flows) amounted to R15,1 billion in the first nine months of fiscal 2003/04, compared with a surplus of R2,1 billion in the same period of the previous fiscal year. National government's net borrowing requirement was also affected by extraordinary payments and receipts. Government receipts were bolstered by a R2,3 billion profit resulting from the revaluation of maturing foreign loans in the first nine months of fiscal 2003/04. National government had to make an extraordinary payment in respect of R7,0 billion zero-coupon bonds issued to the South African Reserve Bank to defray part of the realised losses on the Gold and Foreign Exchange Contingency Reserve Account. This resulted in a net borrowing requirement of national government of R19,9 billion in the first nine months of fiscal 2003/04.

Financing of national government deficit

R billions

Instrument	Fiscal 2003/04 Originally budgeted	April – Dec 2003 Actual
Deficit	**29,5**	**15,1***
Plus: Extraordinary payments	7,0	7,1
Cost/profit of revaluation of foreign loans at redemption**	1,8	-2,3
Less: Extraordinary receipts	6,3	0,0
Net borrowing requirement	**32,0**	**19,9**
Treasury bills	6,0	3,2
Net receipts from domestic government bonds issued	9,3	41,7
Foreign loans	13,6	3,5
Changes in available cash balances***	3,1	-28,5
Total net financing	**32,0**	**19,9**

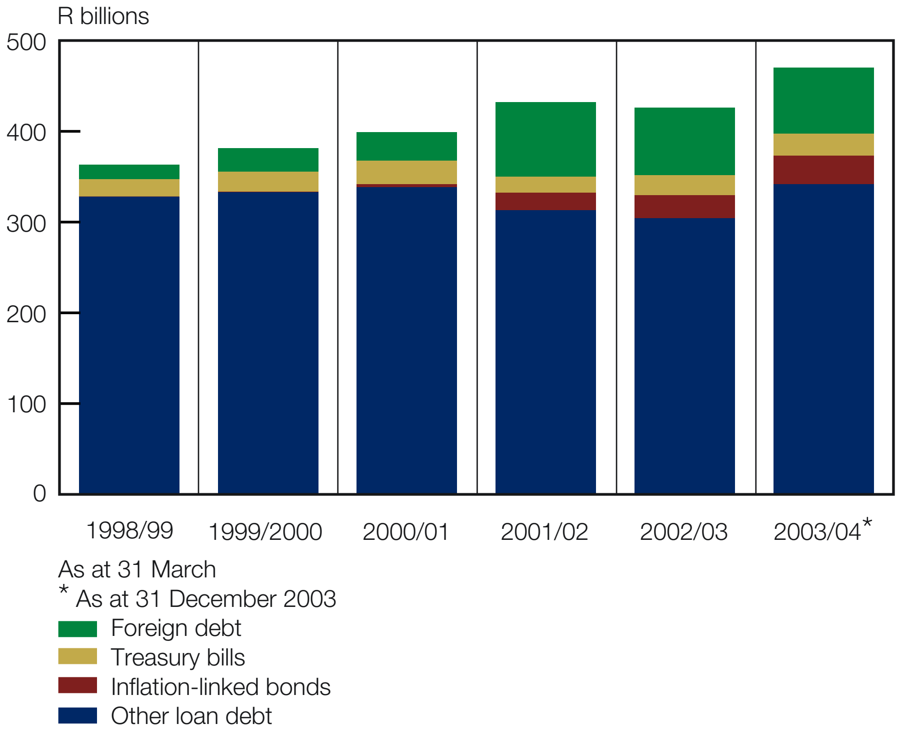
* Cash-flow deficit
** Cost +, profit -
*** Increase -, decrease +

The greater part of the borrowing requirement of national government in the first nine months of fiscal 2003/04 was financed through the issuance of bonds in the domestic capital market, as indicated in the accompanying table. Domestic long-term funding in the first nine months of fiscal 2003/04 was obtained at an average rate of 10,2 per cent per annum, as assumed in the Budget. Domestic short-term instruments were sold at an average rate of 10,5 per cent per annum, compared with a budget assumption of 12,1 per cent.

The foreign loans in the first nine months of fiscal 2003/04 include the amount of R3,4 billion drawn on the foreign export credit facilities for the financing of the Strategic Defence Procurement Programme. During January 2004 national government redeemed the remaining US$750 million of the US$1 500 million syndicated loan originally drawn down in April 2002. The initial redemption date of this loan was 30 July 2004. The total cash payment made at redemption was R5,2 billion: It comprised capital outstanding to the value of R6,4 billion (as recorded at inception of the loan) less a profit resulting from the revaluation at redemption of R1,2 billion. This revaluation was brought about by the appreciation of the exchange rate of the rand.

The contribution of foreign loans to the total loan debt of national government amounted to 15,4 per cent at the end of December 2003, compared with 17,4 per cent recorded at the end of March 2003. This decrease was mainly due to the effect of the recovery of the exchange value of the rand on the outstanding value of foreign loans, as well as the early partial redemption of a US$1 500 million syndicated loan and euro-denominated bond during July 2003 and October 2003, respectively. This also shows government's reduced reliance on foreign financing. Simultaneously inflation-linked bonds continued to increase in importance. With the first such bonds issued in March 2000, by the end of March 2003 they had risen to 6,0 per cent of total loan debt and by the end of December 2003 to 6,7 per cent.

National government loan debt



The net borrowing requirement of the national government, together with the discount on new government bonds issued, led to an increase in the total debt of national government from R462,6 billion at the end of March 2003 to R499,8 billion at the end of December 2003. As a ratio of gross domestic product, total government debt increased from 40,2 per cent at the end of March 2003 to 41,3 per cent at the end of December 2003.

The Budget for the fiscal years 2004/05 to 2006/07

The Minister of Finance presented his Budget Speech to Parliament on 18 February 2004, making use of the room for manoeuvre provided by the healthy fiscal position established over the past ten years. The government's fiscal stance aims to accelerate the pace of economic growth. In keeping with the more expansionary but still sustainable fiscal stance introduced in 2001, the period ahead is likely to witness strong social spending, infrastructure investment, a stable tax burden relative to gross domestic product and declining debt service costs.

The Minister emphasised that the key task for the future is to accelerate the pace of growth and job creation and to extend the scope of development and empowerment. Four key priorities for the decade ahead were identified, namely to:

- increase the share of investment and savings out of national income to provide the infrastructure and industrial capital formation required for sustained output growth;
- improve the quality of education and access to training opportunities to ensure that skills development and productivity enhancement contribute to expanding participation in social and economic development;
- reduce poverty by creating work opportunities and building sustainable communities, alongside consolidation of the social security system; and
- continue to build sound institutions characterised by competitive markets, support for emerging entrepreneurs, better governance and regulation, and vigorous monitoring and measurement of public service delivery.

The Minister indicated that over the medium term, provinces and municipalities will prioritise labour-based infrastructure projects as part of government's Expanded Public Works Programme. Key financial reforms for local authorities over the next three years will be driven by implementation of the Municipal Finance Management Act, which will take effect on 1 July 2004. The legislation allows for a municipality to borrow, but such borrowing will be undertaken without national or provincial government guarantees.

Since 1995, South Africa has steadily eased exchange controls in line with progress in achieving macroeconomic stability, strengthening the balance of payments and financial sector development. Measures to be implemented in the course of 2004 will enable foreign firms to list on the South African capital markets, thus allowing them to raise debt and equity finance on the JSE and BESA. South African individuals and institutional investors will be able to participate in such listings through their foreign investment allowances. A further contribution to the aims of the New Partnership for Africa's Development (NEPAD) is to develop a policy framework during 2004 to promote South Africa as a regional financial centre with the ability to cater more fully for the needs of the African continent.

In 2003, an announcement was made on the exchange control amnesty and accompanying tax measures to deal with the contravention of past exchange control transgressions. The exchange control and tax amnesty process commenced in June 2003 with the appointment of an independent amnesty unit. There have been several refinements to the regulations, and the deadline for submission of applications was extended to 29 February 2004. The revised estimates for revenue in fiscal 2003/04 included R100 million as being the proceeds derived from the foreign exchange amnesty.

The underlying goals of the medium-term expenditure framework (MTEF) remain broad-based growth and development as well as enhancing the social and economic rights of the population. Government therefore has committed itself to investment in job creation, poverty relief and social development, upgrading residential neighbourhoods, promoting the rule of law, development and peace on the African continent.

National government expenditure was budgeted to increase by 11,2 per cent in fiscal 2004/05 to a level equivalent to 27,7 per cent of the estimated gross domestic product, compared with a revised estimate of 27,1 per cent of the estimated gross domestic product in fiscal 2003/04. It was estimated that national government expenditure would increase at an average rate of 9,8 per cent and would be kept just above 27 per cent of the estimated gross domestic product over the three-year budget period.

As shown in the accompanying table, interest payments on government debt were budgeted to increase at rates of around 7 per cent per annum over the three-year budget period as relatively favourable interest rate levels and a well-contained level of debt are foreseen. Non-interest expenditure was expected to increase to R318,7 billion or by 12,0 per cent in fiscal 2004/05 and at an average annual rate of 10,2 per cent over the three-year budget period. Non-interest spending plans allow for an extension of key public services, particularly in the areas of social services and infrastructure. Government's wage bill as a percentage of gross domestic product peaked in fiscal 1997/98 at 14,1 per cent but was estimated to reach a record low of 11,4 per cent in fiscal 2006/07.

Fiscal projections: National government

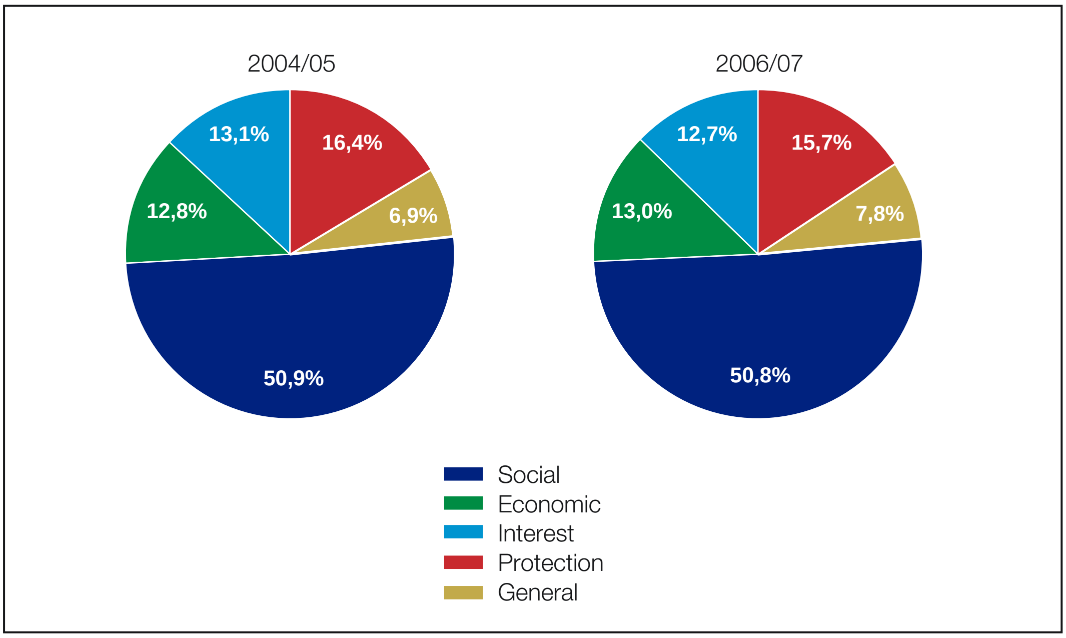
	2003/04 Revised estimate		2004/05 Medium-term estimates		2005/06		2006/07	
	R bn	Annual change Per cent	R bn	Annual change Per cent	R bn	Annual change Per cent	R bn	Annual change Per cent
Expenditure	**331,7**	**13,8**	**368,9**	**11,2**	**404,7**	**9,7**	**439,1**	**8,5**
Interest	47,1	1,0	50,2	6,6	53,9	7,4	57,9	7,4
Current payments	58,5	10,7	64,8	10,8	69,0	6,6	74,2	7,6
Transfers and subsidies	221,7	17,9	245,3	10,6	270,0	10,1	290,1	7,4
Payments for capital assets	4,5	9,6	5,2	16,2	5,7	10,5	5,9	2,7
Contingency reserve and unallocated funds	-		3,5		6,0		11,0	
Revenue	**300,3**	**7,8**	**327,0**	**8,9**	**360,3**	**10,2**	**394,0**	**9,4**
Deficit before borrowing and debt repayment	**31,4**		**41,9**		**44,4**		**45,1**	
Deficit as ratio of GDP (per cent)	*2,6*		*3,1*		*3,0*		*2,8*	

The division of revenue amongst the three spheres of government (national departments, provincial governments and local governments) once again reflected a shift in favour of provinces and local governments, which are at the centre of social service delivery. Provincial governments will receive more than half of the non-interest expenditure in the form of transfers. It was envisaged that these transfers, which include equitable and conditional transfers, will grow at an average rate of 10,3 per cent over the next three years. Transfers to local governments were projected to increase at an average rate of 11,4 per cent per year over the medium term. The increase in the equitable share transfer to local governments is intended to supplement municipalities' own revenue to subsidise basic services such as water supply, sanitation, electricity supply and refuse removal to poor households. Local government revenue is further increased by infrastructure transfers which enable municipalities to address backlogs and provide appropriate infrastructure for the delivery of essential services to the poor – this transfer is projected to increase at an average rate of 13,2 per cent per annum over the medium term.

Substantial increases were announced in allocations for capital expenditure in support of a number of government functions. Payments for the acquisition of capital assets by the consolidated national and provincial government and social security funds were expected to increase at a rate of 16,2 per cent per year over the medium term. Infrastructure investment, in support of the growth strategy of government, includes allocations for new office accommodation, upgrading of existing facilities and investment in technology.

As indicated in the accompanying graph, spending on *social services* remains the largest functional category of government spending, estimated to amount to 50,9 per cent of the consolidated national and provincial government and social security funds' expenditure in fiscal 2004/05. Spending on these services is expected to increase at an average annual rate of 9,5 per cent over the three-year budget period. In the area of *protection services*, provision was made for an average growth rate of 9,1 per cent per year for police services. Although the provision for general government services seems to be increasing, it is essentially due to the inclusion of a contingency reserve to the amount of R2,5 billion in fiscal 2004/05, R4,0 billion in fiscal 2005/06 and R8,0 billion in fiscal 2006/07. The contingency reserve provides for future unforeseen and unavoidable spending.

Functional classification of government expenditure*



* Consolidated national and provincial government and social security funds

The total *revenue of national government* was estimated to amount to R300,3 billion in the current fiscal year and R327,0 billion in fiscal 2004/05, representing a year-on-year rate of increase of 8,9 per cent. It was estimated that national government revenue would increase at an average annual rate of 9,5 per cent over the three-year budget period. National government revenue as a ratio of estimated gross domestic product was projected to amount to 24,6 per cent in fiscal 2003/04 and to be maintained at approximately that level in the ensuing years.

Specific tax adjustments were announced and it is expected that these adjustments will reduce total tax revenue by R2,3 billion in fiscal 2004/05. The tax relief was primarily associated with adjustments to personal income tax rates for the lower and middle-income group, rendering overall relief to the amount of R4,4 billion in fiscal 2004/05. Some of the major tax proposals are:

- A single rate scale for individuals reaching a maximum marginal rate of 40 per cent at a taxable income of R270 001 (previously R255 001) a year.

- The primary rebate was increased from R5 400 to R5 800 per year, increasing the tax threshold by R2 222 to R32 222, or by 7,4 per cent.

- The secondary rebate for individuals 65 years and older was increased to R3 200 a year raising the tax threshold to R50 000, or by 5,9 per cent.

- The interest and dividend exemption was increased from the current R10 000 to R11 000 for taxpayers under the age of 65 and from R15 000 to R16 000 for senior citizens.

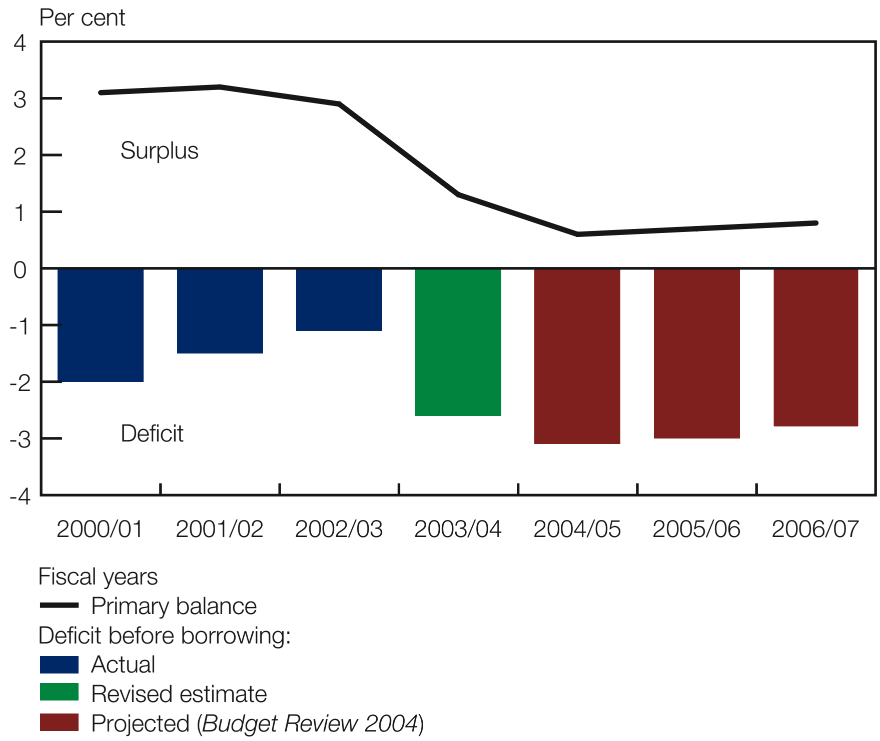
- In order to stimulate investment in home-ownership, the transfer duty exempt level of property transactions was increased from R140 000 to R150 000. The stamp duty on mortgages was also repealed from 1 March 2004.

- Alcohol and tobacco taxes were raised.

- Liquid fuel taxes and levies were increased by 15 cents a litre.

The net result of the revised estimates of the revenue and expenditure of national government in fiscal 2004/05 is an estimated deficit before borrowing and debt repayment of R41,9 billion, or 3,1 per cent of the projected gross domestic product. It was envisaged that this ratio will reduce slightly to 3,0 per cent in fiscal 2005/06 before decreasing to 2,8 per cent in fiscal 2006/07. The primary balance (i.e. the fiscal balance recalculated by excluding interest payments from total expenditure) was estimated to record a surplus of 1,3 per cent of gross domestic product in fiscal 2003/04. A decrease to 0,6 per cent was envisaged for fiscal 2004/05, to be maintained at approximately that level for the remainder of the budget horizon.

National government balances: Ratio of gross domestic product



As indicated in the accompanying table, the borrowing requirement of national government was determined after providing for certain extraordinary receipts and payments. Although extraordinary receipts of R6,3 billion were provided for in the original Budget for fiscal 2003/04, only R0,9 billion was expected to be paid into the National Revenue Fund. The restructuring of state assets would contribute R2,5 billion to the financing of national government in 2004/05 and again in 2005/06. The remaining amounts represent premiums on the issuance of bonds for financing. Provision was also made for R7,0 billion as part payment of the outstanding balance on the Gold and Foreign Exchange Contingency Reserve Account (GFECRA) for fiscal 2004/05.

Financing of national government deficit

R billions

	Revised estimate	Medium-term estimates		
	2003/04	2004/05	2005/06	2006/07
Deficit	**31,4**	**41,9**	**44,4**	**45,1**
Plus: Extraordinary payments[1]	7,4	7,0	7,0	-
Cost/profit on repayment of maturing foreign loans[2]	-3,5	2,2	1,0	3,1
Less: Extraordinary receipts[3]	0,9	2,7	2,6	0,1
Borrowing requirement	**34,4**	**48,4**	**49,8**	**48,1**
Treasury bills	6,0	6,0	8,0	8,0
Net receipts from domestic government bonds issued	26,0	34,3	30,7	32,6
Foreign loans[4]	-2,3	8,1	11,1	7,5
Changes in available cash balances[5]	4,7	-	-	-
Total net financing	**34,4**	**48,4**	**49,8**	**48,1**

1 Including payments on the GFECRA and premiums paid on debt portfolio restructuring previously included in state debt cost expenditure
2 Revaluation gains or losses. Cost +, profit -
3 Including premiums and book profits resulting from debt restructuring previously included in revenue
4 Excluding revaluation of maturing foreign loans
5 Increase-, decrease+

Government will commence issuing retail bonds in the first quarter of 2004/05. The objective of the issuance of retail bonds is to encourage ordinary wage earners to save, while providing government with a further source of funding.

Although government's reliance on foreign funding is estimated to decrease in fiscal 2006/07, foreign bond issues will contribute significantly towards financing government. Funding plans for fiscal 2004/05 indicated an envisaged foreign bond issue to the value of US$1,0 billion which will be utilised to refinance maturing foreign loans. A further disbursement of approximately US$0,6 billion is scheduled to be drawn on the arms procurement credit facilities.

It was estimated that national government loan debt will increase from R456,5 billion at the end of fiscal 2003/04 to R512,8 billion at the end of March 2005 and to R627,4 billion at the end of March 2007. As a ratio of estimated gross domestic product, national government loan debt was expected to increase from 37,3 per cent at the end of fiscal 2003/04 to 38,5 per cent at the end of fiscal 2004/05 and eventually to 39,4 per cent at the end of fiscal 2006/07. Medium-term estimates provided for a decrease of R7,0 billion a year in the outstanding balance on the Gold and Foreign Exchange Contingency Reserve Account.

The public-sector borrowing requirement as a ratio of estimated gross domestic product is projected to increase from 2,8 per cent in fiscal 2003/04 to 3,2 per cent in fiscal 2004/05. A decrease to 2,7 per cent is envisaged for 2006/07. The higher borrowing requirement of the public sector over the forecast horizon also reflects the more expansionary fiscal policy stance adopted by national government.

Public-sector borrowing requirement
R billions

	Revised estimate	Medium-term estimates		
	2003/04	2004/05	2005/06	2006/07
National government	38,0	46,2	48,8	44,9
Reconstruction and development fund	-0,6	-0,2	-0,2	-0,2
Extra-budgetary institutions	-1,6	-1,6	-1,5	-1,2
Social security funds	-3,7	-2,8	-3,2	-3,5
Provincial governments	3,9	-0,4	-0,5	-1,4
Local authorities and local enterprises	2,0	2,1	2,7	3,1
Non-financial public enterprises	-4,0	-1,2	-0,4	1,6
Public-sector borrowing requirement	34,0	42,1	45,7	43,3
Per cent of GDP	*2,8*	*3,2*	*3,1*	*2,7*

Statement of the Monetary Policy Committee
11 December 2003

Issued by Mr T T Mboweni, Governor of the South African Reserve Bank, at a meeting of the Monetary Policy Committee in Pretoria

Introduction

In the *Medium Term Budget Policy Statement* released on 12 November 2003 it was announced that the Bank's inflation target, previously specified as an annual average, will henceforth take the form of a continuous inflation target of between 3 and 6 per cent for CPIX inflation measured over a period of twelve months. It is the well-considered view of the Government and the South African Reserve Bank that this change should lead to a more effective management of monetary policy and inflation expectations. Since September, CPIX inflation has been within the target range and the Bank's task will continue to be to keep it within the lower and upper boundaries of the band.

Developments in inflation

Twelve-month CPIX inflation declined from a peak of 11,3 per cent in October 2002 to 5,4 per cent in September 2003. It then declined further to 4,4 per cent in October 2003. The inflation rate was brought to the mid-point of the target range by the sustained maintenance of prudent monetary and fiscal policies together with the recovery in the international exchange value of the rand and a moderation in food price increases. The quarter-to-quarter rate of change in CPIX inflation also declined sharply from a seasonally adjusted and annualised rate of 12,1 per cent in the fourth quarter of 2002 to 2,2 per cent in the second quarter of 2003, before rising to 5,1 per cent in the third quarter.

More particularly, a slower rate of increase in the prices of consumer goods was mainly responsible for the improvement in overall inflation. Measured over periods of twelve months, the rate of increase in the prices of consumer goods came down from a recent high of 13,0 per cent in October 2002 to 2,1 per cent in October 2003. The most significant deceleration was displayed by changes in food prices. The twelve-month rate of increase in food prices declined from 20,9 per cent in October 2002 to 2,4 per cent in October 2003.

As the prices of services respond with a delay to exchange rate changes and a number of service providers do not face much competition in the domestic market, the rate of increase in the prices of services excluding mortgage costs has on balance risen during 2003. Measured over a period of twelve months, service inflation rose from a low of 6,2 per cent in March 2002 to 8,6 per cent in September 2003, before declining marginally to 8,3 per cent in October. Household costs and the prices charged for communication, education and health services were mainly responsible for the rise in service price inflation. The stickiness of administered prices was therefore to a large extent responsible for the persistence of higher service price inflation.

The inflation outlook

The inflation outlook over the coming months as well as over the long term can be described as promising. The favourable short-term outlook is confirmed by recent developments in production price inflation, which generally affects consumer price inflation with a short lag. As a result of declines in the prices of imported goods and a considerable slowdown in the rates of increase in the prices of domestically produced goods, the year-on-year rate of increase in the all-goods production price index slowed down from 15,4 per cent in September 2002 to 0,2 per cent in August 2003. In September and October the twelve-month rate of change in production prices even became negative. These declines should contribute to a continuing moderation in consumer price inflation over the short term.

Over the longer term most conditions also seem favourable for the containment of CPIX inflation. The international economic environment has improved considerably in recent months. Indicators generally seem to signal stronger economic performance in the United States and a number of Asian countries, especially China. A stronger world economy should benefit international commodity prices, in particular, and South African exports in general. The acceleration in global growth is expected to have only a small impact on prices and world inflation will probably remain at low levels.

The expected acceleration in global economic growth will probably be accompanied by rising international interest rates. Both the Reserve Bank of Australia and the Bank of England have already increased their official interest rates.

Oil prices are not expected to be a major threat to domestic inflation in the coming months. The world oil demand and supply generally seem to be in balance, with relatively large oil inventories in OECD countries. Moreover, conditions favour a more rapid increase in production than in demand. Most analysts therefore expect oil prices to decline somewhat in the next two years.

Domestically, most conditions also seem to endorse the maintenance of price stability. The growth in real gross domestic product at 2 per cent in the first nine months of 2003 compared to the same period in the preceding year, is clearly well below the growth potential of the country. This is confirmed by the ample spare capacity in the manufacturing sector where the utilisation of production capacity amounted to 80,6 per cent in the third quarter of 2003.

In view of the success achieved with the lowering of the inflation rate, inflation expectations in South Africa have declined during the past year. The results of the Survey of Inflation Expectations undertaken for the South African Reserve Bank by the Bureau for Economic Research (University of Stellenbosch) show that inflation expectations have come down further in the fourth quarter of 2003. However, at 6,4 per cent in 2004 and 6,7 per cent in 2005, the public on average still expect the inflation rate to remain above the upper boundary of the inflation target in the next two years.

In addition, monetary conditions signal a continued positive environment for low inflation. Measured over twelve months, growth in the broadly defined money supply (M3) registered a ten-year low rate of 5,1 per cent in August 2003 before picking up somewhat to 5,5 per cent in September and 6,2 per cent in October. However, bank credit extension continued to increase at rates of about 12 per cent over a twelve-month period. Bank credit extension to households has increased strongly related to a corresponding relatively high growth in personal disposable income, lower interest rates and a prolonged period of high house price increases. In addition, companies made use of alternative sources of finance such as corporate bonds and commercial paper.

Fiscal policy is expected to remain disciplined. Although the *Medium Term Budget Policy Statement* 2003 sets out a strategy to endorse growth and development through investment in infrastructure, education and skills development, poverty reduction and public service delivery, the increased expenditure will be financed in such a way as not to threaten price stability. The national government deficit is projected to average about 3 per cent of gross domestic product over the next three fiscal years and will be financed mainly from domestic sources without crowding out the needs of the private sector.

Despite these favourable international and domestic conditions, projections made with the Reserve Bank's forecasting models indicate that inflation pressures could start to build up in 2005. These forecasts show that the rate of inflation in CPIX could reach a lower turning point in the course of 2004 and edge up to higher levels in 2005. CPIX inflation should, however, remain below the upper boundary of 6 per cent of the inflation target.

The main reason for this projected increase in inflation pressures is the strong domestic final demand for goods and services. In the first nine months of 2003, compared with the same period in the preceding year, the growth in domestic final demand amounted to no less than 4 per cent. Growth in personal disposable income and an increase in bank credit extension caused real private consumption expenditure to rise by about 3 per cent over this period, while real government consumption expenditure increased by 4 per cent and fixed capital formation by 9 per cent. The reduction of the repo rate by 500 basis points between June and October 2003 is expected to contribute to further increases in domestic final demand in 2004. Although some of this increased demand will be met by imported goods, domestic economic performance should eventually move closer to potential growth and start to put pressure on prices.

The foreseen strong domestic demand could also impact on the current account of the balance of payments through increased imports. However, this should be countered to a large extent by the expected international economic recovery and an increased demand for South African exports and rising international commodity prices. The projected deficit on the current account of the balance of payments should therefore not lead to inflation pressures provided that it continues to be financed by financial inflows.

Other risks to the forecasted inflation outcome over the next two years include:

- Changes in the rate of increase of food prices. A slowdown in the rate of increase in food prices was a major contributing factor to the lower rate of CPIX inflation achieved during 2003. At present, climatic conditions are generally viewed as being unfavourable and thus expectations are that crop output could be poor. Even if this situation should improve, it is unlikely that developments in food prices will again make such a major contribution to the lowering of inflation in the next year.

- The exchange rate. The recovery in the external value of the rand during both 2002 and 2003, had a major impact on the lowering of inflation in the course of the latter year. The appreciation in the exchange rate of the rand, together with low international inflation, has contributed to a decline in the measured prices of imported goods over twelve months since April 2003. It is impossible to predict what the external value of the rand will do over the coming months.

- Nominal unit labour cost. Wage settlements which exceed increases in labour productivity with a considerable margin can give rise to substantial increases in unit labour costs and price pressures. Wage settlements during the past year averaged around 9 per cent, while growth in labour productivity has continued to slow down to low levels. It is anticipated that wage settlement rates could decelerate significantly during 2004 as they will be negotiated against the background of lower rates of inflation. Wage increases could nevertheless still be well above productivity increases, leading to further increases in nominal unit labour costs.

Monetary policy stance

As already indicated, interest rates have been reduced significantly during the last half of 2003. These decreases in interest rates were undertaken after careful consideration of the inflation outlook at the time to ensure that CPIX inflation moves into and remains within the inflation target. With inflation expected to remain within the target range in the forecast period looking ahead, and taking the above-mentioned risks into account, the Monetary Policy Committee (MPC) has decided to reduce the repo rate by 50 basis points to 8,0 per cent per annum as of 12 December 2003. The MPC will continue to monitor all the risk factors to the inflation outlook. If the outlook deteriorates, the committee will not hesitate to change the monetary policy stance.

Statement of the Monetary Policy Committee

26 February 2004

Issued by Mr T T Mboweni, Governor of the South African Reserve Bank, at a meeting of the Monetary Policy Committee in Pretoria

Introduction

Since the previous meeting of the Monetary Policy Committee the rate of CPIX inflation has remained below the mid-point of the inflation target range. The success achieved in bringing inflation down to levels last experienced in the 1960s has been a major accomplishment of the macroeconomic policies pursued by the authorities, prudent monetary policy, disciplined fiscal policy, the significant recovery in the external value of the rand and the moderation in food price increases.

All indications are that, on the basis of this improved inflation performance, the pick-up in growth that is already evident is likely to improve during 2004 and 2005.

The inflation outcome

The twelve-month rate of increase in the consumer price index for metropolitan and other urban areas excluding the interest cost of mortgage bonds (the CPIX) decreased from 11,3 per cent in October and November 2002 to 6,3 per cent in August 2003, and moved below the 6 per cent upper limit of the inflation target range to a value of 5,4 per cent in September. CPIX inflation then slowed down further to a year-on-year rate of 4,0 per cent in December 2003, before increasing marginally to 4,2 per cent in January 2004. For the year 2003 as a whole CPIX inflation averaged 6,8 per cent, compared with 9,3 per cent in 2002.

Measured from quarter to quarter, the slowdown in CPIX inflation was even more impressive. This rate of increase in the CPIX decreased from a seasonally adjusted and annualised level of 12,4 per cent in the second quarter of 2002 to 1,2 per cent in the fourth quarter of 2003.

A number of factors contributed to the deceleration in the inflation rate in South Africa. Particularly important in this context was the 4 percentage points increase in the repo rate during 2002. This restrictive monetary policy stance and the discipline applied in government finances led to a decline in inflation expectations. The recovery in the exchange rate of the rand from the beginning of 2002 assisted in this process and eventually led to a decline in the prices of imported goods. In addition to these more fundamental factors, slower rates of increase in food and energy prices also contributed to the lowering of inflation. In fact, if energy and food prices are excluded from the CPIX, the twelve-month rate of increase in the prices of other goods and services declined from a peak of 8,0 per cent in November 2002 to 5,6 per cent in January 2004.

Prices for services excluding the cost of mortgage bonds remained sticky. After fluctuating around a level of 8 per cent in the first nine months of 2003, the twelve-month rate of increase in these prices moderated somewhat from a peak of 8,6 per cent in September 2003 to 7,8 per cent in January 2004. By contrast, the rate of increase over twelve months in the prices of consumer goods fell from 13,4 per cent in October 2002 to 2,2 per cent in January 2004.

A slowdown in the rate of increase in the prices of domestically produced goods and the decline in the prices of imported goods caused the year-on-year rate of increase in the all-goods production price index to decrease from 15,4 per cent in September 2002 to 0,2 per cent in August 2003. Subsequently, the production price index declined throughout the last five months of the year. For the year 2003 as a whole, overall production prices rose by (+)1,7 per cent compared to 14,2 per cent in 2002. The year-on-year rate of decrease in the all-goods production price index moderated from (-)1,8 per cent in December 2003 to (-)1,4 per cent in January 2004.

The inflation outlook

Not only did the inflation outcome improve since the previous meeting of the Monetary Policy Committee, but the inflation outlook generally also remained favourable. Most analysts and economic commentators expect CPIX inflation to remain within the inflation target range over the next two years. Inflation is projected to accelerate moderately in the course of 2004 to levels close to the upper limit of the inflation target, followed by somewhat slower rates of increase during 2005. These expected developments are consistent with projections made by the Reserve Bank's core econometric and other models.

A number of factors will probably help to keep inflation within the target range during the next two years. Firstly, the generally low inflation in the rest of the world will continue to assist South Africa in containing domestic inflation. Strong global economic growth driven by the United States and Asia is expected to occur in an environment of relatively stable prices which bodes well for domestic price increases.

Secondly, the slowdown in aggregate domestic production in 2003 has led to a decline in the utilisation of production capacity of manufacturing enterprises from a seasonally adjusted rate of 81,2 per cent in the third quarter of 2002 to 79,6 per cent in the fourth quarter of 2003. Although the world economic recovery has set in motion an upswing in international commodity prices, some of these benefits to economic growth in South Africa have been neutralised by the exchange rate developments. Moreover, real gross domestic fixed investment again increased significantly in 2003. As a consequence, the acceleration in domestic economic growth is unlikely to lead to capacity constraints in the near future.

Thirdly, the fiscal discipline applied by government has materially contributed to the lowering of inflation and the Budget for fiscal year 2004/05 is supportive of the inflation target.

Fourthly, oil prices are not expected to be a threat to domestic price increases in the next two years despite the recent increases in the retail prices of petrol and diesel. The world oil demand and supply seem to be more or less in balance and OPEC continues to manage production limits to avoid large disruptive price movements. Most analysts still expect oil prices to decline somewhat in the coming months.

Lastly, but by no means least, the recommended tariff increases of some public utility companies also auger well for the inflation outlook.

Although the inflation outlook is generally positive, certain recent developments signal a moderate increase in CPIX inflation during 2004, which will have to be carefully monitored by the Monetary Policy Committee. Of particular concern is the consistent tendency of the wage settlement process to ignore the forward-looking inflation target. The carry-over effect of these tendencies will continue to put pressure on price increases in 2004. An anticipated moderation in wage settlement rates in the course of the year in line with the inflation target and a rise in productivity could, however, lead to lower rates of increase in nominal unit labour costs.

Another development which could cause higher increases in consumer prices is the severe drought in some parts of South Africa. Low rainfall in important agricultural regions is expected to reduce the maize and other grain crops in 2004. This could be neutralised to a large extent by the run down of inventories or the increase in imports, but the future price of maize has already increased substantially from the beginning of December 2003. An anticipated rise in international food prices could also lead to an acceleration in the prices of domestic food products. Even if these effects on food prices are small, it seems unlikely that the positive impact that food prices had on the lowering of the inflation rate during 2003 will again occur in 2004.

Perhaps even more important for the future inflation outlook is the continued acceleration in the growth of domestic final demand for goods and services. National accounts statistics are not yet available for the fourth quarter of 2003. However, many indicators, such as retail trade at constant prices, the purchases of new and used vehicles, and electricity consumed, signal that domestic demand continued to increase at a high rate during the last half of 2003. Moreover, the full effect of the substantial reduction in interest rates from June 2003 will only become apparent in the course of 2004.

As the growth in domestic demand exceeded the rate of increase in production, the surplus on the current account of the balance of payments in 2002 changed to a deficit in the first quarter of 2003. Trade statistics for the fourth quarter of the year indicate that this deficit could have widened further to a preliminary estimated 2 per cent of gross domestic product. Although this is a sizeable deficit, it was easily financed by the surplus on the financial account. This financial inflow also paved the way for a build-up of net foreign reserves.

A further deficit on the current account of the balance of payments is projected for 2004, but this deficit is not expected to exceed 2 per cent of gross domestic product. However, it seems unlikely that the positive effect that the significant recovery in the exchange rate of the rand had on inflation during 2003 will be as pronounced this year.

The high domestic demand has been financed to some extent by means of bank credit extension and the issuing of bonds by government and the private sector. The total net issues of fixed-interest securities listed on the Bond Exchange of South Africa of both the public and private sector amounted to R59,1 billion in 2003, compared with net redemptions of R10,1 billion in 2002. The year-on-year growth in underlying bank credit extension to the private sector (i.e private-sector credit extension excluding investments and bills discounted) has risen from 7,8 per cent in December 2002 to around 12 per cent since April 2003 and amounted to 12,9 per cent in December. However, quarter-to-quarter growth in such advances slowed down from a seasonally adjusted and annualised rate of 22,3 per cent in the second quarter of 2003 to 7,4 per cent in the fourth quarter.

Growth in money supply remained relatively subdued. Growth over twelve months in the broadly defined money supply (M3) slowed down to a ten-year low of 5,1 per cent in August 2003, before picking up to 8,4 per cent in December. Similarly, the quarter-to-quarter seasonally adjusted and annualised growth in M3 declined from 13,1 per cent in the second quarter of 2003 to 4,4 per cent in the third quarter and rose to 9,5 per cent in the fourth quarter. This moderate growth in money supply reflected the low growth in domestic economic activity, the low inflation environment and lower interest rates on deposits of all maturities. To some extent it was also due to the substitution of investments in promissory notes of banks not included in money supply for investments in negotiable certificates of deposits which form part of money supply due to a change in the regulations regarding stamp duties payable on these instruments.

Monetary policy stance

Taking these factors into account, the central expectation of the Monetary Policy Committee is that CPIX inflation will remain within the target range during the forecast period while the economy continues to pick up momentum. Accordingly the Monetary Policy Committee has decided to maintain the current monetary policy stance and keep the repo rate unchanged at 8,0 per cent per annum. The Monetary Policy Committee will continue to monitor all the risk factors to the inflation outlook. If the outlook changes, the committee will not hesitate to change the monetary policy stance.

Note on the revision of composite leading and coincident business cycle indicators

by J C Venter and W S Pretorius

Introduction

Composite business cycle indicators are constructed by integrating various individual economic time series into a single indicator time series that mirrors the movement of and the turning points in the business cycle. The time series included in the composite business cycle indicators represent only a small sample of the total number of available indicators portraying various aspects of economic activity. Three groups of business cycle indicators are distinguished, namely those that change direction ahead of the business cycle (leading indicators), those that move more or less in conjunction with the business cycle (coincident indicators) and those time series that lag behind the business cycle (lagging indicators).

The South African Reserve Bank first published composite business cycle indicators in 1983[1]. Various factors, such as structural changes in the economy or the identification of new economic indicators, necessitate the frequent reassessment of the constituent time series of the composite business cycle indicators. The South African Reserve Bank's three composite business cycle indicators were last revised in 1994[2]. Since 1994 important structural changes have occurred in South Africa, both politically and economically. These developments suggested the need for a re-evaluation of all the component time series of the composite business cycle indicators.

The purpose of this note is firstly to describe the evaluation of the previous component time series of the composite leading and coincident business cycle indicators. Secondly, it describes the component time series of the revised composite leading and coincident business cycle indicators, comprising time series that have either been retained or included for the first time[3].

1 *Van der Walt, B. E. 1983. Indicators of business cycle changes in South Africa.* Quarterly Bulletin*, No 147, March. Pretoria: South African Reserve Bank.*

2 *Van der Walt, B. E. and Pretorius, W. S. 1994. Notes on revision of the composite business cycle indicators.* Quarterly Bulletin*, No 193, September. Pretoria: South African Reserve Bank.*

3 *The revised composite lagging business cycle indicator will be discussed separately in a later issue of the South African Reserve Bank's* Quarterly Bulletin.

The composite leading business cycle indicator

During the latter part of the 1990s it became apparent that some of the component time series of the composite leading business cycle indicator no longer reliably predicted movements in the business cycle. To a significant extent this had been a consequence of policies implemented since 1994 by South Africa's first democratically elected government. These included, among other things, the removal of many trade restrictions between South Africa and the rest of the world and the gradual liberalisation of exchange controls.

A total of 29 economic indicators, including the 21 components previously included in the composite leading business cycle indicator, were evaluated for possible inclusion in the revised composite leading business cycle indicator. All of these time series were subjected to the same evaluation system applied during the 1994 revisions. This evaluation system rates business cycle indicators according to:
- the economic significance of the process represented by the indicator,
- the statistical adequacy of the data,
- the historical conformity to and timing relationship with the business cycle,
- the smoothness of the time series, and
- the timeliness of the data.

Table 1 shows the 21 components that were previously included in the composite leading business cycle indicator and the 13 components that are now included in the revised composite leading business cycle indicator.

Table 1 Component time series of the composite leading business cycle indicator

Previous components	New components
Opinion survey of volume of orders in manufacturing	Opinion survey of volume of orders in manufacturing
Opinion survey of stocks in relation to demand: Manufacturing and trade	Opinion survey of stocks in relation to demand: Manufacturing and trade
Opinion survey of business confidence: Manufacturing, construction and trade	Opinion survey of business confidence: Manufacturing, construction and trade
International business cycle indicator: Industrial production	Composite leading business cycle indicator of major trading-partner countries: Percentage change over twelve months
Commodity prices in US dollars for a basket of South Africa's export commodities: Percentage change over twelve months	Commodity prices in US dollars for a basket of South Africa's export commodities: Six-month smoothed growth rate
Real M1 money supply (deflated with the CPI): Percentage change over twelve months	Real M1 money supply (deflated with the CPI): Six-month smoothed growth rate
Prices of all classes of shares	Prices of all classes of shares: Six-month smoothed growth rate
Number of residential building plans passed	Number of residential building plans passed for flats, townhouses and houses larger than $80m^2$
Tender Treasury bill discount rate	Interest rate spread: 10-year bonds less 91-day Treasury bills
Ratio of output prices to unit labour costs in manufacturing	Gross operating surplus as a percentage of gross domestic product
Number of new motor vehicles sold	Labour productivity in manufacturing: Six-month smoothed growth rate
Physical volume of mining production, excluding gold	Job advertisements in the *Sunday Times* newspaper: Six-month smoothed growth rate
Value of merchandise exports, excluding gold and agriculture	Opinion survey of the average hours worked per factory worker in the manufacturing sector
Overtime hours as percentage of ordinary hours worked in manufacturing	
Company profits, after tax	
Physical volume of gold ore milled	
Net number of new companies registered	
Number of real-estate transactions	
Net gold and other foreign exchange reserves	
Consumer credit at constant prices	
London gold price in rand	

Various previously used component time series were omitted in the new list of components of the composite leading business cycle indicator due to some inconsistencies in the timing relationship with the reference turning points of the business cycle. These were:

- the physical volume of gold ore milled,
- the physical volume of mining production (excluding gold),
- the value of merchandise exports (excluding gold and agriculture),
- the ratio of output prices to unit labour costs in manufacturing,
- the London gold price in rand,
- company profits after tax,
- the net number of new companies registered,
- the number of new motor vehicles sold,
- net gold and other foreign exchange reserves, and
- consumer credit at constant prices.

The time series measuring the number of real-estate transactions has not been published since November 2000 and was accordingly omitted. The series depicting overtime hours as a percentage of ordinary hours worked in manufacturing was omitted because of the non-comparability of the series over time. This indicator was replaced by the results of an opinion survey of the average hours worked per factory worker in the manufacturing sector[4].

4 All the opinion survey data included in the composite leading business cycle indicator are published by the Bureau for Economic Research, University of Stellenbosch.

Some of the time series previously included in the composite leading business cycle indicator were replaced by related or comparable series that received higher ratings during the evaluation process. These include the following:

- The international business cycle indicator, comprising the industrial production indices of South Africa's main trading-partner countries, was replaced by the percentage change over twelve months in the new composite leading business cycle indicator of major trading-partner countries. This indicator comprises the composite leading business cycle indicators of eight of South Africa's main trading-partner countries, weighted according to the value of South Africa's exports to each country[5].

5 The source of the composite leading business cycle indicator of each trading-partner country is the Foundation for International Business and Economic Research in New York.

- The percentage change over twelve months in commodity prices, measured in US dollars, for a basket of South Africa's export commodities, was replaced by the six-month smoothed growth rate in this commodity price index.

- The percentage change over twelve months in the real M1 money supply, deflated by the consumer price index, was replaced by the six-month smoothed growth rate in the real M1 money supply.

- The index of the prices of all classes of shares traded on the JSE Securities Exchange SA (JSE) was replaced by the six-month smoothed growth rate in the prices of all classes of shares traded on the JSE.

- The total number of residential building plans passed was replaced by the number of residential building plans passed for flats, townhouses and houses larger than $80m^2$.

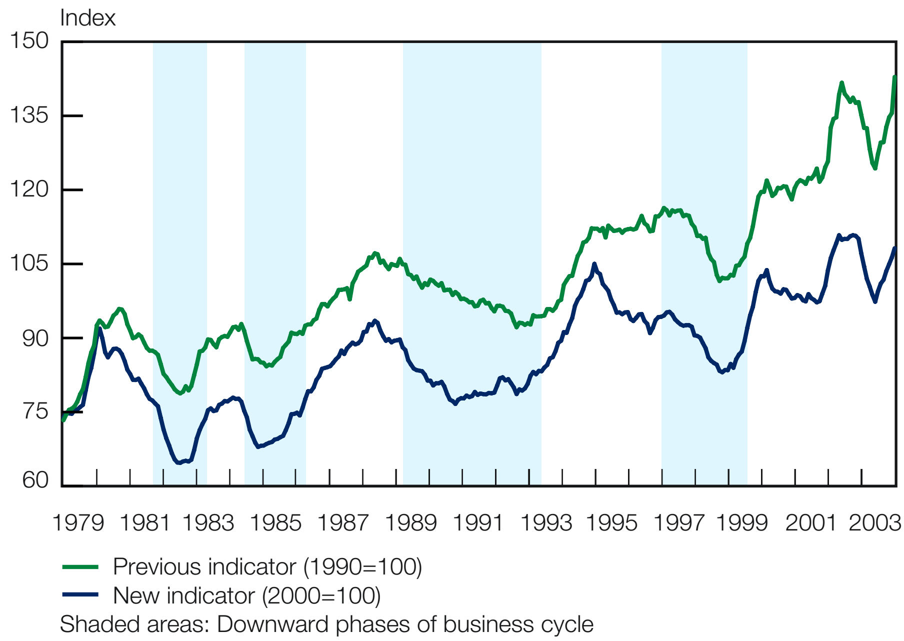
- The tender Treasury bill discount rate was substituted for an interest rate spread indicator, representing the difference between the yield on government bonds with a maturity of ten years and longer, and the interest rate on 91-day Treasury bills.

Three of the previous component time series were retained unaltered in the revised composite leading business cycle indicator. These were:
- an opinion survey of volume of orders in manufacturing,
- an opinion survey of stocks in relation to demand in manufacturing and trade, and
- an opinion survey of business confidence in the manufacturing, construction and trade sectors.

Three component time series were included in the revised composite leading business cycle indicator for the first time, namely the six-month smoothed growth rate in the number of square centimeters devoted to job advertisements in the *Sunday Times* newspaper, the six-month smoothed growth rate in labour productivity of the manufacturing sector, and gross operating surplus as a percentage of gross domestic product.

The previous and the new composite leading business cycle indicator are shown in Graph 1. The new composite leading business cycle indicator exhibits a longer lead time than the previous indicator at three of the four business cycle peaks and at two of the four business cycle troughs. The difference in the lead times of two of these turning points is quite noticeable. The new composite leading business cycle indicator reached a trough in October 1990, almost two years prior to the corresponding trough indicated by the previous leading indicator. The new indicator reached a peak in December 1994, preceding the subsequent reference peak in the business cycle by almost two years. This reference peak in the business cycle was not as clearly predicted by the previous composite leading business cycle indicator as by the new composite leading indicator.

Graph 1: Composite leading business cycle indicator



The composite coincident business cycle indicator

The seven time series previously included in the composite coincident business cycle indicator and the five components now included in the revised composite coincident business cycle indicator are shown in Table 2.

Table 2 Component time series of the composite coincident business cycle indicator

Previous components	New components
Gross value added at constant prices, excluding agriculture, forestry and fishing	Gross value added at constant prices, excluding agriculture, forestry and fishing
Value of wholesale, retail and new vehicle sales at constant prices	Value of wholesale, retail and new vehicle sales at constant prices
Utilisation of production capacity in manufacturing	Utilisation of production capacity in manufacturing
Employment in the manufacturing, mining and construction sectors	Total formal non-agricultural employment
Physical volume of manufacturing production: durable goods	Industrial production index
Physical volume of manufacturing production: non-durable goods	
Value of imports at constant prices, excluding minerals	

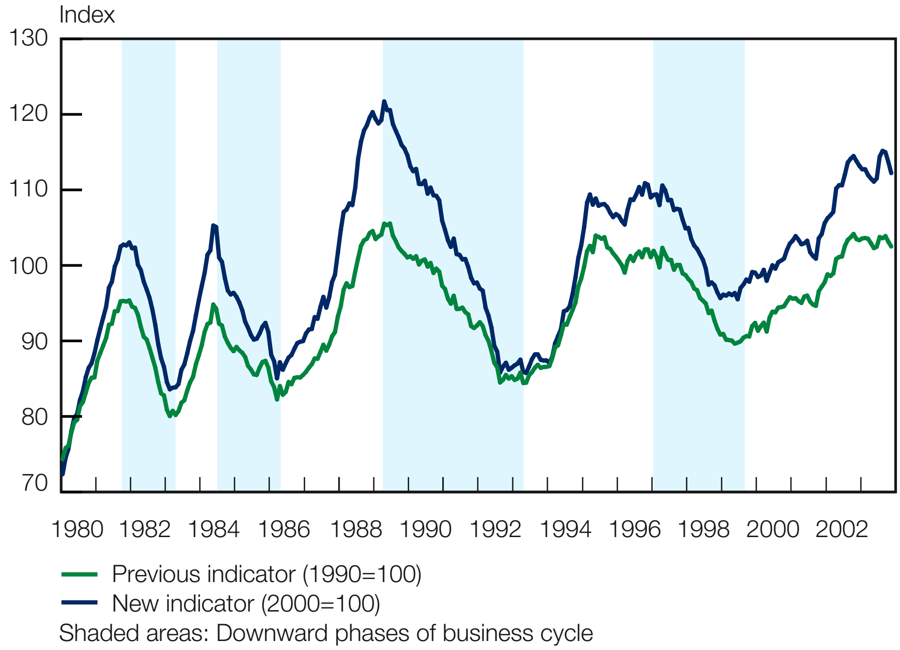
The time series representing the value of imports at constant prices excluding mineral products was omitted from the new composite coincident business cycle indicator because it displayed an inconsistent timing relationship with the reference turning points of the business cycle. Three of the previous component time series of the coincident indicator were retained unaltered, namely:

- the aggregate gross value added at constant prices, excluding agriculture, forestry and fishing,
- the value of wholesale, retail and new vehicle sales at constant prices, and
- the utilisation of production capacity in the manufacturing sector.

The time series reflecting the number of people employed in the manufacturing, mining and construction sectors was expanded to encompass total formal non-agricultural employment. The new industrial production series replaces the two series measuring the physical volume of manufacturing production separately for durable and non-durable goods. This industrial production series comprises the physical volume of total manufacturing production, the physical volume of mining production and the quantity of electricity generated in South Africa. The series are weighted according to the relevant sectors' contributions to the aggregate gross domestic product.

The previous and the new composite coincident business cycle indicator are shown in Graph 2. It is clear from this graph that the specific turning points of the previous and the new coincident indicator are closely correlated. One notable exception, however, occurs during the period 1995 – 1996. Both the previous and the new coincident indicator show a double peak during this period but, unlike in the previous indicator, the second peak of the new indicator is higher than the first one. The revised coincident indicator therefore also correlates closer with the November 1996 reference peak in the business cycle.

Graph 2: Composite coincident business cycle indicator



Timing relationship of the revised indicators

The timing relationship of the composite coincident and leading business cycle indicators is shown in Table 3 along with the reference turning points of the business cycle for the period since August 1981. As is the case in other countries, there is a fairly large dispersion in the number of months by which the leading indicator leads the reference turning points of various cycles.

Table 3 Timing relationship between the composite indicators and reference turning points of the business cycle*

Reference turning points		Timing relationship in months			
		Coincident indicator		Leading indicator	
Peak	Trough	Previous	New	Previous	New
August 1981		+4	+4	-11	-18
	March 1983	-1	-1	-8	-8
June 1984		-1	-1	-1	-4
	March 1986	0	0	-13	-16
February 1989		+4	+2	-9	-9
	May 1993	-1	0	-9	-31
November 1996		0	-1	+2	-23
	August 1999	-3	-2	-11	-10
Average:		0	0	-7½	-15
Median:		-½	-½	-9	-13

* A plus (minus) sign indicates that the relevant indicator lags (leads) the reference turning point

Note on flows of funds in South Africa's national financial accounts for the year 2002

by Z Nhleko and D H Meyer[1]

Introduction

The national financial accounts on pages S-44 to S-53 of this issue of the *Quarterly Bulletin* present the flow-of-funds accounts for 2002. The national financial account, as part of an integrated system of economic accounts, provides a summary data set on total economic activity for the period under review and presents a means, among other things, to:
- identify surplus and deficit economic sectors;
- analyse the linkages between borrowers and lenders of funds;
- analyse the linkages between financial transactions and real economic activity; and
- guide authorities and market participants in monitoring monetary and other macroeconomic developments.

This note focuses on the first three objectives and is merely illustrative[2]. An analysis of economic developments is made by summarising real and financial activity for 2002 as a whole through the national financial accounts, thus showing interrelationships among the key groups of economic agents.

Financing balance

Saving is the ultimate source of domestic finance, and consequently also of capital formation. Individual economic sectors may experience a surplus or a deficit, depending

1 The Reserve Bank wishes to express its sincere appreciation to all the reporting organisations – government departments, financial market and other public and private-sector institutions – for furnishing the data used for the compilation of South Africa's financial accounts. The views expressed are those of the authors and do not necessarily reflect the views of the South African Reserve Bank.

2 For a more comprehensive discussion of the technical aspects of South Africa's national financial accounts, consult "A note on flows of funds in South Africa's national financial accounts for the year 1999" by M A Kock and D H Meyer. Quarterly Bulletin, No 219, March 2001.

Table 1 Financing balances[1,2], 2001 and 2002
R millions (Surplus units (+)/Deficit units (-)

	2001			2002		
	Gross saving	Gross capital formation	Net lending (+)/net borrowing (-)	Gross saving	Gross capital formation	Net lending (+)/net borrowing (-)
Foreign sector[3]	-64	-	-64	-6498	-	-6 498
Financial intermediaries	15 625	3 097	12 528	24 970	10 384	14 586
Central and provincial governments	1 492	9 205	-7 713	-1 282	11 120	-12 402
Local authorities	7 589	12 396	-4 807	4 434	13 226	-8 792
Non-financial business enterprises						
Public	23 433	14 450	8 983	32 878	15 851	17 027
Private	63 481	84 994	-24 649	85 372	103 614	-18 242
Households[4]	32 078	19 492	12 586	38 176	23 855	14 321
Total	143 634	143 634	-	178 050	178 050	-

1 Gross saving plus net capital transfers less gross capital formation. Gross capital formation consists of total fixed-capital formation and total changes in inventories, before providing for consumption (depreciation) of fixed capital.
2 A positive amount reflects a net lending position and by implication a net acquisition of financial assets, whereas a negative amount reflects a net borrowing position and by implication a net incurrence of financial liabilities.
3 A positive amount reflects a surplus for the rest of the world and therefore a deficit on South Africa's balance on current account of the balance of payments. A negative amount represents a deficit for the rest of the world and a surplus on South Africa's balance on current account of the balance of payments.
4 Including unincorporated business enterprises and non-profit institutions serving households.

on the extent to which their saving covers their investment in fixed assets and inventories. Individual sectors may therefore be either net lenders or net borrowers in the economy. Table 1 summarises the saving and investment activity in South Africa.

Although individual sectors may experience saving deficits, for the economy as a whole investment may not exceed saving, unless supplemented by transactions with the rest of the world. In 2001 domestic net saving only marginally exceeded the financing of gross capital formation. In 2002 the situation improved and a substantial surplus was recorded on the current account of the balance of payments. This means that the net saving of the domestic surplus sectors was more than sufficient to finance the deficits of the central and provincial governments, local authorities and non-financial private business enterprises.

For 2002 gross saving by non-financial private business enterprises amounted to 8 per cent of gross domestic product. Non-financial public business enterprises and households each contributed 3 per cent of gross domestic product and financial intermediaries another 2 per cent. All these sectors raised their gross saving in 2002, while the gross saving of the sectors which usually contribute little to the national saving effort – central, provincial and local government, and the foreign sector – fell back in 2002.

Sectoral analysis

Economic units with financial surpluses are always in search of appropriate investment outlets while deficit units require additional means to finance their operations. The inter-sectoral linkages between borrowers and lenders of funds and the impact of such linkages on the system as a whole are analysed in this section, briefly reviewing each of the main institutional sectors.

Foreign sector

The foreign sector refers to all non-resident units that enter into transactions with residents and therefore represents a mirror image of South Africa's balance of payments.

For the domestic economy as a whole, as noted in Table 2, the total net acquisition of financial assets equals the total net accumulation of liabilities, with the rest of the world as the balancing item. The foreign sector balances the domestic saving-investment gap through the balance on current account of the balance of payments. In 2002 South Africa experienced a surplus of R6,5 billion on the current account – i.e. an outflow of funds or by definition net lending to the rest of the world.

Table 2 Flow of funds: Foreign sector and combined domestic sectors, 2002

R millions

	Domestic institutional sectors	Rest of the world	Total
Net incurrence of financial liabilities............................	296 749	5 708	302 457
Net lending (+)/net borrowing (-)	6 498	-6 498	-
Net acquisition of financial assets..............................	303 247	-790	302 457

The net outflow of funds was the result of increases in foreign assets held by the domestic sectors which exceeded inward non-resident financial investment. The domestic sectors increased their holdings of foreign shares and other financial assets. Gold and foreign exchange reserves held by monetary institutions excluding the Reserve Bank also increased significantly. Investment by non-residents into South Africa was mainly through an increase in their holdings of government bonds.

Concurrently, non-residents decreased their extension of trade credit and short-term loans to the domestic sectors somewhat.

Financial intermediaries

Financial intermediaries transform the bulk of funds received from surplus entities (lenders) into a variety of financial instruments structured to suit the requirements of deficit entities (borrowers). The financial intermediaries identified in South Africa include both monetary and non-bank financial institutions. The financial intermediaries sector consists of five subsectors, namely the monetary authority, other monetary institutions, Public Investment Commissioners, insurers and retirement funds, and other financial institutions. Each of these are discussed separately.

Monetary authority

The monetary authority sector consists of the South African Reserve Bank and the Corporation for Public Deposits. The main function of this sector is to implement monetary policy, issue cash, implement foreign exchange policy and act as custodian of the international reserves.

The monetary authority interacts mostly with other monetary institutions as reflected by the increase in the level of bank loans and advances made to and received between the two sectors. Further tightening of the cash reserve requirement during 2002 contributed to the increased level of banks' deposits with the South African Reserve Bank. A significant reduction in foreign liabilities occurred when the National Treasury assumed responsibility for repaying some of the Reserve Bank's foreign liabilities early in 2002.

Other monetary institutions

The other monetary institutions sector is a consolidation of the accounts of banks, mutual banks, the Land Bank and Postbank. This sector engages in financial intermediation mainly through accepting deposits and extending loans. The abbreviated flow of funds presented in Table 3 shows that the sector was a net lender of funds in 2002.

Other monetary institutions recorded gross saving of R15,1 billion and gross capital formation of R9,6 billion in 2002. Monetary deposits with them rose by R90,5 billion during the year.

Financing of deficit sectors was effected through bank loans and advances amounting to R35,1 billion, mortgage loans to the value of R26,8 billion and gold and foreign reserves to the value of R21,1 billion. The decrease in other assets and other liabilities of this sector was, among other things, due to a decline in its exposure to derivative instruments. In 2002, other monetary institutions invested 90 per cent of their total resources in financial assets and this sector's asset flows accounted for close to half of financial intermediary asset flows and 19 per cent of total asset flows.

Table 3 Flow of funds: Other monetary institutions, 2002

Transaction items	Sources/ liabilities R millions	Uses/ assets R millions
Gross saving	15 072	
Gross capital formation		9 597
Net lending (+)/net borrowing (-)	5 475	
Net financial investment (+/-)		5 475
Net incurrence of financial liabilities	77 907	
Net acquisition of financial assets		83 382
Gold and other foreign reserves	-	21 066
Monetary deposits	90 508	3 432
Bank loans and advances	9 977	35 141
Bills, bonds and loan stock	-8 275	3 510
Mortgage loans	-	26 810
Other assets/liabilities	-14 303	-6 577
Total sources/liabilities and uses/assets	92 979	92 979
	Per cent	
Percentage of total sources used for gross capital formation	10,3	
Percentage of total sources used to acquire financial assets	89,7	
Percentage of total asset flows	18,6	
Percentage of total financial intermediary asset flows	46,6	

Public Investment Commissioners

Fulfilling a role similar to that of an asset manager, the Public Investment Commissioners received inflows of R29,3 billion in 2002. The bulk of funds was received from the government's official pension and provident funds and, to a lesser extent, social security funds, other government funds and trust accounts of households. Of the total funds received, more than 45 per cent were in turn invested in long-term government securities, 19 per cent directly in shares and 15 per cent allocated to other external asset managers. The Public Investment Commissioners accounted for 15 per cent of the total financial intermediary asset flows.

Insurers and retirement funds

In 2002 the sector insurers and retirement funds registered a net financing surplus and accounted for 23 per cent of financial intermediary asset flows. As indicated in Table 4, this sector was therefore able to supply funds to the value of R7,6 billion, on a net basis, to the deficit sectors. As expected, member contributions accounted for the bulk of the funds available for investment in financial assets by insurers and retirement funds.

The official pension and provident funds increased their investment portfolios with the Public Investment Commissioners by R26,5 billion.

Table 4 Flow of funds: Insurers and retirement funds, 2002

	R millions
Financing balance	7 623
Net incurrence of financial liabilities	37 404
Members' interest in the reserves of retirement and insurance funds	53 447
Other liabilities	-16 043
Net acquisition of financial assets	45 027
Monetary deposits	5 501
Other deposits	27 151
Public Investment Commissioners	26 470
Foreign deposits	-304
Other	985
Bills and bonds	-12 958
Short-term government bonds	-13 834
Long-term government bonds	-3 326
Other	4 202
Other loan stock and preference shares	-188
Domestic	6 687
Foreign	-6 875
Shares	3 615
Domestic	5 792
Foreign	-2 177
Other assets	21 906
	Per cent
Percentage of total asset flows	9,1
Percentage of total financial intermediary asset flows	22,7

The insurers and retirement funds industry generally decreased investment in bills, other loan stock and preference shares. The redemption by government of short-term fixed interest securities in the fourth quarter of 2002 contributed to a decline in the short-term bonds held by insurers and retirement funds. Foreign investment declined noticeably in the wake of global uncertainties and a stronger exchange rate of the rand.

Other financial institutions

The other financial institutions sector reflects the consolidated accounts of all non-bank financial intermediaries that acquire funds and carry out investments through sales of units in unit trusts, lending and similar activities. This sector consists of, among other things, unit trusts, participation mortgage bond schemes, finance companies and financial public enterprises. Financial activity in this sector during 2002 resulted mainly from inflows to unit trusts.

As can be seen in Table 5, the sector received funds from investors amounting to R15,8 billion. Other financial institutions focused their activity on extending trade credit and short-term loans to other institutions amounting to R11,7 billion. The rest of the funds were held in monetary deposits and invested in bills and shares. This sector accounted for 13 per cent of the total financial intermediary asset flows in 2002.

Table 5 Flow of funds: Other financial institutions, 2002

	R millions
Financing balance	697
Net incurrence of financial liabilities	**25 958**
Deposits received	15 801
Trade credit and short-term loans	1 290
Other loan-stock and preference shares	780
Long-term loans	-1 969
Other liabilities	10 056
Net acquisition of financial assets	**26 655**
Monetary deposits	**18 378**
Other deposits	**-4 077**
Foreign deposits	-4 113
Other	36
Bills and bonds	**-5 654**
Short-term government bonds	-1 285
Long-term government bonds	-9 368
Other	4 999
Trade credit and short-term loans	**11 684**
Other loan stock and preference shares	**123**
Domestic	816
Foreign	-693
Shares	**3 559**
Domestic	4 371
Foreign	-812
Other assets	**2 642**
	Per cent
Percentage of total asset flows	5,3
Percentage of total financial intermediary asset flows	13,4

General government: Central government and provincial governments

Increased gross capital formation and capital transfers to other sectors resulted in an increase in the central and provincial governments' financing deficit from R7,7 billion in the calendar year 2001 to R12,4 billion in the calendar year 2002. As depicted in Table 6, an amount of R11,9 billion was raised in the financial markets through the net incurrence of financial liabilities to finance this deficit.

In 2002 the foreign sector contributed substantially to the financing needs of the central and provincial governments, especially through their holding of government bonds. Capital raised in the foreign sector amounted to R35,3 billion. The Public Investment Commissioners contributed a further R10,2 billion to the financing needs of central and provincial governments.

A substantial portion of the financing requirements for 2002 was funded through the issuance of non-marketable government bonds to the value of R21,1 billion, of which R15,7 billion were foreign issues. This partly offset the large redemptions of short-term government bonds and low domestic issuance of long-term government bonds during 2002. The redemption of short-term government bonds in the last quarter of 2002 led to a reduction in the level of such instruments held by institutional investors.

Table 6 Flow of funds: Central government and provincial governments, 2002

	R millions
Financing balance	**-12 402**
Net acquisition of financial assets	-524
Net incurrence of financial liabilities	11 878
Net incurrence of financial liabilities by financial instrument	**11 878**
Treasury bills	-3 453
Short-term government bonds	-12 677
Long-term government bonds	3 041
Non-marketable government bonds	21 130
Other	3 837
Financing by sector	**11 878**
Foreign sector	35 347
Public Investment Commissioners	10 240
Insurers and retirement funds	-17 950
Other financial institutions	-11 083
Other domestic sectors	-4 676

General government: Local authorities

Local governments recorded an overall financing deficit of R8,8 billion in 2002. The financing of the deficit occurred through both foreign and domestic borrowing, mostly in the form of trade credit and short-term loans.

Non-financial public corporate business enterprises

The non-financial public corporate business enterprises sector recorded a net financing surplus of R17,0 billion in 2002. The surplus was not only utilised to finance deficit sectors, but also to reduce this sector's own financial liabilities. This was done through the net redemption of their securities and by reducing long-term and mortgage loans and other financial liabilities. Investment in real assets, amounting to R15,9 billion, exceeded investment in financial assets by a wide margin.

Non-financial private corporate business enterprises

Non-financial private corporate business enterprises experienced a financing deficit in 2002. As indicated in Table 7, the financing deficit of R18,2 billion was funded in the financial markets through trade credit and short-term loans and bills, bonds and loan stock. Excess funds were deposited with monetary institutions, invested in foreign shares and channelled to the extension of trade credit and short-term loans. This sector's gross capital formation of R103,6 billion represented 58 per cent of total gross domestic capital formation in 2002, highlighting its importance in the real economy.

Households

Households were net providers of funds to deficit sectors in 2002. They recorded a financing surplus and also had access to additional funding such as mortgage loans, short-term loans and trade credit. Households were able to maintain their interest in retirement and life funds and succeeded in increasing their deposits with banks and other financial institutions.

Table 7 Flow of funds: Non-financial private corporate business enterprises, 2002

Transaction items	Sources/ liabilities R millions	Uses/ assets R millions
Gross saving	84 034	
Capital transfers	1 338	
Gross capital formation		103 614
Net lending (+)/net borrowing (-)	-18 242	
Net financial investment (+/-)		-18 242
Net incurrence of financial liabilities	56 602	
Net acquisition of financial assets		38 360
Monetary deposits	-	46 708
Other deposits	-4 939	-21 741
Bank loans and advances	7 610	-
Trade credit and short-term loans	15 121	18 444
Bills, bonds and loan stock	27 195	-18 383
Shares	*7 823*	*7 676*
Domestic	*5 440*	*-3 120*
Foreign	2 383	10 796
Long-term and mortgage loans	1 033	-15 033
Other assets/liabilities	2 759	20 689
Total sources/liabilities and uses/assets	141 974	141 974
	Per cent	
Percentage of total sources used for gross capital formation	73,0	
Percentage of total sources used to acquire financial assets	27,0	
Percentage of total asset flows	28,4	

Summary and conclusion

The analysis of South Africa's national financial accounts for 2002 reveals the following:

- Increased outward foreign investment by domestic sectors was evidenced by a net outflow of funds to the rest of the world;
- tightening of reserve requirements by the South African Reserve Bank occasioned an increase in deposits by private banks at the Reserve Bank;
- increased issuance of securities by banks expanded the scope of available investment opportunities;
- central government's net borrowing requirement increased and was largely satisfied by foreign borrowing and bond issues abroad;
- the continued strong financial position of non-financial public corporate business enterprises was accompanied by a fairly high level of capital formation by this sector; and
- households continued to be net providers of funds to deficit sectors.

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Note on the revision of monetary aggregates

by Money and Banking Division[1]

1 The Reserve Bank wishes to express its sincere appreciation to all the reporting banks for their co-operation in furnishing the data used for the revisions.

2 Removal of duty on negotiable certificates of deposit was only announced in the 2004/05 Budget and will be effected on 1 April 2004.

With the release of this *Quarterly Bulletin* the South African Reserve Bank introduces revised values of the broader monetary aggregates. This note discusses the background to, reasons for and the impact of the revision of the monetary aggregates released by the Bank.

In the 2003/04 Budget the removal of stamp duty on fixed deposits was announced. In practice promissory notes were exempted from stamp duty, while negotiable certificates of deposit remained subject to such duty[2]. In taking advantage of the cost implications of this announcement, banks have increased their issues of negotiable promissory notes (NPNs) at the expense of negotiable certificates of deposit (NCDs). These instruments, although not absolutely identical, are extremely close substitutes.

Prior to the removal of stamp duty on promissory notes, the amount of such notes issued in South Africa was fairly limited. Both the amount in issue and the secondary market trading in NPNs rose sharply following removal of the stamp duty.

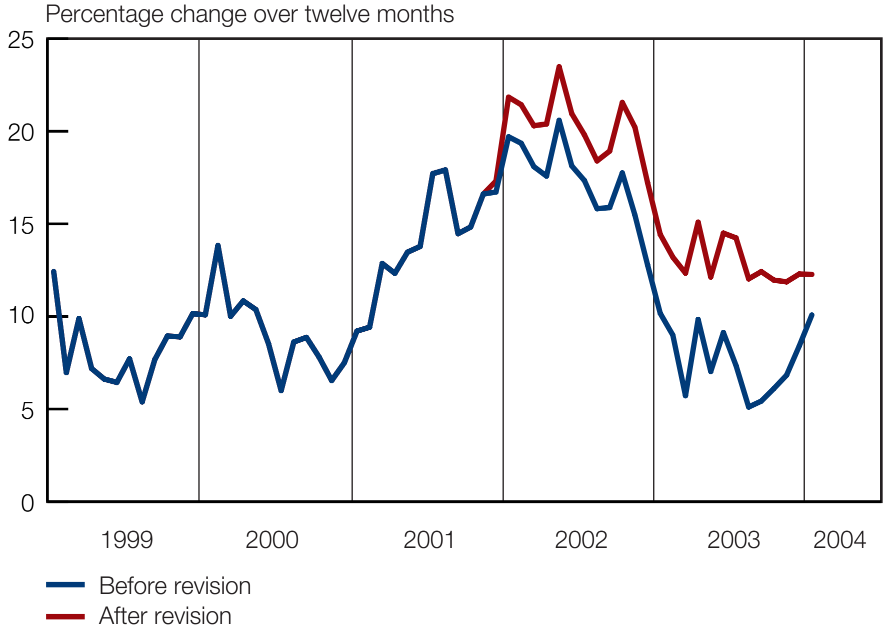
South Africa's current definition of broad money (M3) includes NCDs issued by banks and held by non-bank domestic private-sector parties, but does not include NPNs, since the focus is on *deposits*. Consequently, the increased substitution between the two instruments in favour of NPNs led to the level of deposits at banks as measured by M3, reduced by the magnitude of this substitution effect. After careful observation of this trend and consideration of the extreme closeness of the two instruments, it was concluded that in substance the shift to NPNs does not signal a true reduction in the public's underlying holdings of monetary deposits. Although not technically deposits in a narrow legal sense, NPNs were deemed close enough substitutes to deposits to warrant inclusion in the monetary aggregates.

To obtain the building block data necessary to include NPNs held by non-bank private-sector domestic parties in M3, banks were requested to revise their balance sheet data in order to correctly identify the holding sectors of NPNs in South Africa's financial statistics. The revisions were made from December 2001 up to January 2004.

The NPNs that were reclassified have all along formed part of *other liabilities* in the monetary analysis. Focusing on data at the end of December 2003 to illustrate the magnitude of the revision, it may be noted that a total amount of around R74 billion in NPNs was taken out of *other liabilities* and reclassified as part of deposits with banks. Of the total amount of NPNs reclassified, around 70 per cent was issued to non-bank domestic private-sector parties; around 20 per cent was issued to other banks; and around 10 per cent was in the books of the Public Investment Commissioners and are classified as part of the government sector.

Following the revisions, the average twelve-month growth rate in M3 for 2002 amounted to 20,4 per cent against 17,4 per cent previously. For 2003 this rate was similarly raised from 7,5 per cent to 13,0 per cent. A graphical representation of the divergence between the revised and the original growth rates in M3 is provided in Graph 1. It is evident from the graph that twelve-month growth in M3 accelerated during 2002 and reached an upper turning point of 23,5 per cent in May as opposed to 20,6 per cent as previously reported. Also clear from the graph is that growth in M3 remained above the 10 per cent mark throughout 2003. For the latest data point – January 2004 – the revised twelve-month growth rate is 12,3 per cent against an original rate of 10,1 per cent.

Graph 1: Growth in M3



Most of the NPNs issued were in the three-to-six-month maturity area. M1A and M1 were not affected by the revision, but M2 and M3 were both revised upward to a significant extent. The divergence between the revised and the original numbers for the average twelve-month growth in M2 amounted to 2 percentage points for 2002 and 5,1 percentage points for 2003, broadly similar to the divergence relating to M3.

The impact of the revisions on the statistical counterparts of change in M3 during 2003 is presented in the table below.

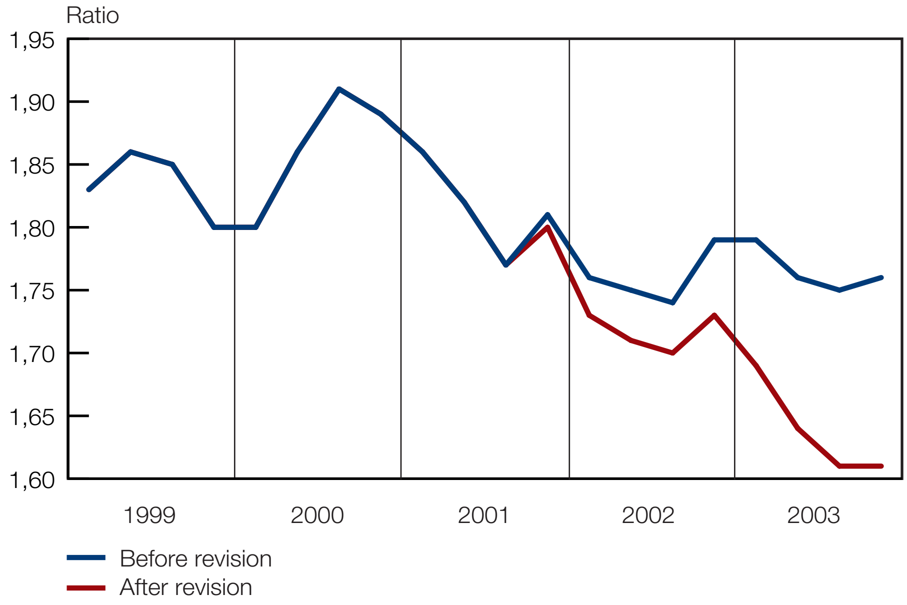
Counterparts of change in M3

R billions

Counterparts	2003			
	Before revision		After revision	
Net foreign assets		61,7		61,7
Net claims on the government sector		-19,2		-19,2
Gross claims	19,3		19,3	
Government deposits (+ decrease; - increase)	-38,5		-38,5	
Claims on the private sector		130,8		130,8
Net other assets and liabilities		-117,1		-87,5
Total change in M3		56,2		85,8

The revisions to the level of deposits of the non-bank domestic private-sector parties also affected the income velocity of circulation of M2 and M3. The impact of the revision on the income velocity of circulation of M3 is presented in Graph 2. From the graph it is clear that the revised income velocity of M3 declined significantly below the original data and reached low values of 1,61 in both the third and the fourth quarters of 2003, suggesting the availability of ample liquidity in the economy.

Graph 2: Income velocity of circulation of M3



For ease of comparison, an addendum is provided on the following page showing the original and revised data for M2 and M3.

Addendum

Original and revised data for M2 and M3
R billions

Period		M2		M3	
		Before revision	After revision	Before revision	After revision
2001:	Jan	459,6	459,6	505,9	505,9
	Feb	467,3	467,3	515,1	515,1
	Mar	479,6	479,6	529,3	529,3
	Apr	479,3	479,3	529,7	529,7
	May	479,3	479,3	533,0	533,0
	Jun	478,8	478,8	538,2	538,2
	Jul	485,7	485,7	546,8	546,8
	Aug	498,2	498,2	559,2	559,2
	Sep	496,9	496,9	561,7	561,7
	Oct	497,9	497,9	560,6	560,6
	Nov	510,9	510,9	576,3	576,3
	Dec	532,7	535,1	592,5	595,5
2002:	Jan	545,0	551,2	605,6	616,4
	Feb	552,7	558,8	614,8	625,5
	Mar	564,9	571,6	625,0	636,8
	Apr	558,7	567,2	622,8	637,7
	May	573,3	581,8	642,7	658,2
	Jun	560,6	568,0	635,8	651,0
	Jul	556,5	563,7	641,6	655,1
	Aug	568,2	577,2	647,7	662,1
	Sep	574,9	585,7	650,9	668,1
	Oct	584,2	597,8	660,1	681,4
	Nov	590,5	610,1	665,5	692,8
	Dec	597,6	618,7	668,2	698,0
2003:	Jan	601,1	626,2	667,2	705,4
	Feb	602,0	628,4	670,0	708,1
	Mar	594,5	632,7	660,8	715,3
	Apr	617,8	654,8	684,1	733,9
	May	624,1	660,8	687,9	738,0
	Jun	627,1	665,6	693,9	745,4
	Jul	621,1	668,8	688,7	748,4
	Aug	617,8	668,7	680,8	741,7
	Sep	624,1	678,9	686,3	751,0
	Oct	639,5	692,2	700,4	762,8
	Nov	646,1	699,5	710,9	775,1
	Dec	662,9	713,2	724,3	783,8
2004:	Jan	672,0	716,7	734,4	791,9

Note to tables

International economic relations and national accounts

Balance of payments data have been revised for the period since 1995 in order to incorporate more accurate information from various sources and to allow for the monetisation and de-monetisation of gold as specified by the *Balance of Payments Manual* (fifth edition). The national accounts tables have been adjusted accordingly.