PART TWO
MACROECONOMIC DEVELOPMENTS IN SOUTH AFRICA DURING 2001*

INTRODUCTION

46 An imbalance between the total disposable income and total spending of a country is reflected in the net flow of goods and services into or out of that country. These cross-border movements of goods and services, together with the net movement of international capital to and from the country, significantly influences the demand and supply for foreign exchange in the domestic foreign exchange market.

47 In a market where the exchange rate should be free to find its own level, the supply of and the demand for foreign exchange are the main factors deciding the eventual level of the exchange rate. An excess supply of foreign exchange should usually be associated with an appreciation in the exchange value of the domestic currency. Conversely, a shortage of foreign exchange could be expected to cause a depreciation in the exchange rate of the domestic currency.

48 After a prolonged period of rapid expansion during the 1990s, the United States economy slowed down rather abruptly from about the beginning of 2001. The attacks on September 11 which destroyed the World Trade Centre in New York and damaged the Pentagon building in Washington, D.C. finally pushed the United States economy into recession.

49 As the United States economy faltered, it dragged other economies into its slump. The South African economy reacted in varying ways to the changing global economic conditions. Until the middle of 2001 total

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* Part Two of this statement was prepared at a time when the estimates of the national income and expenditure accounts and the estimates of cross-border trade and financial flows were in an early stage of finalisation, and are therefore still fairly tentative. Survey returns are still being awaited by the Bank from prominent firms

domestic income growth held up well in the face of the global slowdown and actually accelerated from the first to the second quarter.

50 Gross domestic expenditure in the South African economy in the first half of 2001 was less than national disposable income (i.e. the net income available to residents of South Africa which can either be spent or saved). Therefore the country had a surplus of exports over imports, i.e. a surplus on the current account of the balance of payments. At the same time there was an inflow of capital into the economy. Given an ample supply of foreign exchange during this period, the exchange rate of the rand showed limited variation and by the end of June 2001 was roughly at the same level as at the end of December 2000.

51 In the second half of the year, domestic spending exceeded total national disposable income. The excess of total domestic spending over total national disposable income was expressed in a deficit on the current account of the balance of payments which was not matched by any inflows of international capital into the economy.

52 When a deficit on the current account of the balance of payments is not accompanied by an inflow of capital, the deficit is widely perceived as a major source of exchange rate instability. Under circumstances such as these, where the demand for foreign exchange exceeds the supply of foreign exchange, a depreciation in the exchange rate of the rand could be expected as a normal market reaction. The size and speed of the depreciation in the closing months of 2001 are obviously far more difficult to explain. I suppose that is why we are sitting here in this Commission.

53 Imbalances on the current account have to be financed (or funded) by international capital movements, e.g. in the case of a deficit on the

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participating in the South African economy. Financial flows obtained from these survey returns may later result in substantial revisions to some of the statistical information contained in this document.

current account by borrowing from the rest of the world or by investments into South Africa by non-residents.

DOMESTIC INCOME

54 Domestic income is the total value of income generated in the South African economy over a given period of time. When total disposable income falls short of total domestic spending, it causes an excess of imports over exports which could adversely affect the exchange rate of the rand.

55 During the first half of 2001 the growth in total domestic income (adjusted for inflation and generally referred to as economic growth or growth in gross domestic product) had apparently been left unscathed by the downturn in the global economy. But by the third quarter of 2001 the domestic economic situation became more closely aligned with the world economy. Consequently the quarter-to-quarter economic growth, at an annualised rate, fell from 2 per cent in the second quarter of 2001 to about 1 per cent in the third quarter.

56 In the fourth quarter of 2001 the economy regained some of its earlier vigour and quarter-to-quarter growth in domestic income accelerated to about 2½ per cent. This acceleration was partly spurred on by a further improvement in the international competitiveness of domestic producers and by the buoyancy in domestic spending, as discussed later in this document.

57 The stronger growth in domestic income was concentrated in robust output expansions in the manufacturing sector and the continuation of solid growth in the services sectors (i.e. commerce, transport, communication and financial services). By contrast, the income generated by agriculture and mining declined.

58 The net result of these developments was that the growth in total domestic income (adjusted for inflation) slowed down from 3½ per cent in 2000 to 2 per cent in 2001.

DOMESTIC SPENDING

59 Total spending in the economy consists of spending by households and government on goods and services, capital spending by the public and private sectors, and investment in inventories.

60 Growth in aggregate domestic spending (adjusted for inflation) held up fairly well during 2001, reflecting steady growth in spending by households, a slight acceleration in spending by government and a pick-up in capital spending. Growth in gross domestic final demand (i.e. total domestic spending excluding inventory investment) strengthened appreciably in the second half of 2001. The rate of inventory accumulation slowed down quite noticeably in the last quarter of that year.

60.1 **Spending by households**

Growth in spending by households accelerated from a quarter-to-quarter annualised rate of 2½ per cent in the third quarter of 2001 to 3½ per cent in the fourth quarter. This can mainly be attributed to a general increase in spending on new cars and other durable and semi-durable goods.

60.2 **Spending by government**

Recurrent spending by government picked up in the course of 2001, following several years of fiscal consolidation. In the third and fourth quarters of 2001, spending by government rose at annualised rates of 2½ per cent and 3 per cent, reflecting increased spending on goods and services of a non-capital nature.

60.3 **Capital spending**

60.3.1 Capital spending, which started to recover in 2000 following a sharp decline in 1999, strengthened during 2001, mainly in the private sector. In addition, increased spending by government on infrastructural development gave further impetus to total capital spending. Parastatals, by contrast, scaled down their capital spending, probably as part of their preparations for future restructuring.

60.3.2 On account of these developments, total capital spending is estimated to have increased at a quarter-to-quarter and annualised rate of about 5½ per cent in the fourth quarter of 2001, compared with 3 per cent in the third quarter.

60.4 **Excess spending over income**

60.4.1 Excess spending over income in the second half of 2001 lifted total spending to a level 1,1 per cent higher than national disposable income in the third quarter and 0,3 per cent higher in the fourth quarter (see Graph 1).

60.4.2 This imbalance created a need in the foreign exchange market for an inflow of international capital in order to limit downward pressure on the exchange value of the rand.

CURRENT ACCOUNT OF THE BALANCE OF PAYMENTS

61 The balance on the current account of the balance of payments is defined as the sum of exports and imports of goods and services out of and into South Africa. The current account consists of two sub-accounts, namely the trade account and the services account. The trade account records transactions in merchandise imports and exports, including gold, whereas the services account records income payments and receipts, such as dividends, interest and employee compensation, transportation fees for goods and passengers, travel services and other services.

62 The excess of total spending over total disposable income declined somewhat in the fourth quarter of 2001 (see Graph 2). This meant that the deficit on the current account of the balance of payments (seasonally adjusted and annualised) also narrowed from R10,9 billion in the third quarter of 2001 to R2,7 billion in the fourth quarter (see Graph 3). As a ratio of gross domestic product, the deficit on the current account declined to 0,3 per cent in the fourth quarter of 2001 from roughly 1 per cent in the third quarter. For the calendar year 2001 as a whole, the deficit on the current account amounted to just R1,7 billion, mainly on account of the surpluses realised in the first half of the year. (See Table 1 : Current Account of the Balance of Payments.)

62.1 Merchandise exports

The shrinking deficit on the current account of the balance of payments in the fourth quarter of 2001 was almost entirely due to a rally in export earnings. Exports of mining products, agricultural products and manufactured goods contributed to the higher value of the goods exported in the fourth quarter. In real terms (i.e. adjusted for the effect of price increases) merchandise export earnings fell in the fourth quarter, implying that the rise in export earnings was entirely a consequence of steep increases in the prices of exports.

62.2 **Gold exports**

The rand value of South Africa's net gold exports increased substantially in the fourth quarter of 2001. The average realised price of gold per fine ounce rose from R2351 in the third quarter to R2856 in the fourth quarter, but the volume of gold exports declined in the fourth quarter.

62.3 **Merchandise imports**

62.3.1 Reflecting in part the robustness of growth in total domestic spending, the value of merchandise imports rose significantly in the fourth quarter of 2001, partly offsetting the increase in export earnings. A sharp increase in the value of imported manufactured goods, especially of machinery and electrical equipment and of vehicles and transport equipment, contributed most to the steep increase in the value of merchandise imports. Imports in these types of goods are usually consistent with growth in capital spending.

62.3.2 The increased value of merchandise imports in the fourth quarter of 2001 was also largely due to higher prices. After adjusting for price increases, the real value of merchandise imports fell by about 1 per cent from the third quarter of 2001 to the fourth quarter.

62.4 **Net payments for services**

62.4.1 Preliminary estimates indicate that net service, income and current transfer payments to non-residents (i.e. people and organisations residing outside South Africa) for services rendered declined from R48,6 billion in the third quarter to R41,7 billion in the fourth quarter of 2001, helping to reduce the deficit on the current account of the balance of payments slightly.

62.4.2 The shortfall on the country's services account with the rest of the world widened considerably from the first to the second quarter of 2001. This higher deficit on the services account was related to inward movements of foreign direct equity investment into the economy in recent years, giving rise to dividend payments on non-resident shareholdings.

62.4.3 Investment income received from offshore equity investments made by South African companies also increased, but to a far smaller extent than the increase in dividend payments. The overall deficit on the services and income account widened from a seasonally adjusted and annualised value of R37,2 billion in the first quarter of 2001 to R47,1 billion in the second quarter, R48,6 billion in the third quarter and R41,7 billion in the fourth quarter.

62.4.4 The greater discrepancy between dividends paid to non-resident investors and received from offshore companies is the inevitable result of the growing interest in South Africa displayed by non-resident investors in recent years. A reasonable return on investment is required to attract inward foreign investment into the economy. Unless such profitable investments are matched by equally profitable offshore investments by South African companies, the negative dividend gap will continue to widen.

FINANCIAL ACCOUNT OF THE BALANCE OF PAYMENTS

63 The financial account summarises international capital flows and covers all transactions associated with changes of ownership in the foreign assets and liabilities of an economy. Three broad categories of investment are distinguished, namely direct investment, portfolio

investment and other investment. (See Table 2 : Net Financial Transactions Not Related To Reserves)

64 The imbalance on the financial account of South Africa's accounts with the rest of the world changed from a surplus (or an inflow of capital) of R4,7 billion in the third quarter of 2001 to a deficit (or outflow of capital) of R1,5 billion in the fourth quarter. Along with the surplus of R8,7 billion in the first three quarters of 2001, the outflow in the fourth quarter of the year brought the total inflow of international capital to R7,2 billion in 2001, down from R9,1 billion in 2000.

64.1 **Direct investment**

64.1.1 Foreign direct investment flows into South Africa are reflected in an increase in the country's direct foreign liabilities. Direct investment is that category of international investment which reflects the objective of an investor in one country to obtain a lasting interest in an enterprise in another country.

64.1.2 Non-residents invested direct investment capital into the South African economy during the first three quarters of 2001, but this changed to an outflow of R1,9 billion in the fourth quarter. The outflow of direct investment capital in the fourth quarter of 2001 resulted mainly from the delayed payment of the dividends declared during the third quarter of 2001. (See explanatory note at page 327 of the Bundle.)

64.1.3 South African companies increased their holdings of foreign direct investment assets by R5,4 billion during the fourth quarter of 2001, mainly by acquiring a dominant interest in the equity capital of foreign companies. These transactions are recorded as an outward movement of capital from the economy. However, for the whole of 2001, South African companies reduced their foreign assets to the value of R28,7 billion, i.e. an inflow of international capital.

64.1.4 On a net basis (i.e. offsetting changes in direct foreign assets against changes in direct foreign liabilities), foreign direct investment changed from an inflow of R3,6 billion in the third quarter of 2001 to an outflow of R7,3 billion in the fourth quarter, thus contributing to the weakness of the rand.

64.1.5 Owing mainly to the restructuring of the corporate relationship between the Anglo American Corporation and the De Beers Mining Company and the accompanying net inflow of direct investment capital in the second quarter of 2001, a net inflow of R85,9 billion in foreign direct investment capital was recorded in 2001 as a whole (see Graph 4).

64.2 **Portfolio investment**

64.2.1 Portfolio investment includes investment in equity and debt securities not classified as direct investment.

64.2.2 Inflows of foreign portfolio investment capital through the JSE Securities Exchange SA during the fourth quarter of 2001 were fully offset by non-residents' net sales of fixed-interest securities on the Bond Exchange of South Africa. Non-resident investors increased their holdings of domestic equity securities by R7,9 billion during the fourth quarter but simultaneously reduced their holdings of domestic bonds by R10,1 billion.

64.2.3 South African institutional investors and individuals increased their foreign portfolio assets by R3,3 billion in the fourth quarter of 2001 (i.e. an outflow of capital), following outward investments in the three preceding quarters.

64.2.4 The net outward movement of portfolio capital totalled R3,4 billion in the fourth quarter. This raised the total net value of international portfolio capital outflows to R67,6 billion for the calendar year 2001 as a whole, compared with net outflows of R13,8 billion in 2000.

64.2.5 Portfolio capital outflows in the second quarter of 2001 reached unprecedentedly high levels that were also a direct consequence of the restructuring of the corporate relationship between the Anglo American Corporation and the De Beers mining company.

64.3 **Other investment**

64.3.1 Other investment is the category of international capital that includes all transactions not covered by direct investment and portfolio investment. It consists of trade credits, short-term and long-term loans and cross-border bank deposits.

64.3.2 Other foreign investment moved out of South Africa (i.e. there was a decline in foreign liabilities) to the value of R1,5 billion in the fourth quarter of 2001. The bulk of this outflow was a consequence of the repayment of foreign loans by parastatal companies and the withdrawal of foreign-currency denominated deposits at domestic banks by non-resident deposit holders.

64.3.3 In this investment category, South Africans increased their foreign assets by R0,3 billion, i.e. they exported capital to this amount. In particular, trade financing extended by South African businesses to non-resident clients was stepped up in the fourth quarter of 2001, possibly in some instances to benefit from the depreciation of the rand.

64.3.4 On a net basis, other foreign investment amounted to an outflow of R29,3 billion in 2001.

OVERALL BALANCE OF PAYMENTS

65 The overall balance of payments is defined as the change in the country's gold and other foreign exchange reserves owing to transactions on the current and financial accounts of the balance of payments. Gross gold and other foreign exchange reserves consist of external assets that are readily available to and controlled by the Bank for the direct financing of payment imbalances.

66 The deficit on the current account of the balance of payments and the net outflow of capital through the financial account resulted in a deficit of R2,1 billion on South Africa's overall balance of payments in the fourth quarter of 2001. (This change is equivalent to the change in the country's international reserves owing to balance of payments transactions over that quarter see Graph 5).

67 The value of South Africa's gross gold and other foreign exchange reserves (i.e. international reserves before foreign loans, expressly concluded by the Reserve Bank to bolster total reserves, are netted off) accordingly declined in dollar terms from USD13,3 billion at the end of September 2001 to USD12,4 billion at the end of December. But because of the depreciation in the exchange rate of the rand, the country's total international reserves rose in rand terms from R118,9 billion to R150,7 billion over the same period. The result was an improvement in the import cover (i.e. the value of gross gold and other foreign exchange reserves relative to the value of imported goods and services) from 20 weeks' worth of imports at the end of September 2001 to 24 weeks' worth of imports at the end of December.

68 The gross gold and foreign exchange reserve holdings of the Bank remained unchanged at USD7,5 billion from the end of 2000 to the end of 2001 (see Graph 6). Converted into rands, these holdings rose by R33,6 billion to R90,6 billion at the end of December 2001.

69 The short-term credit facilities utilised by the Bank (which are related to reserves and therefore do not contribute to changes in the imbalance on the country's external accounts), rose from USD2,6 billion at the end of December 2000 to USD4,0 billion at the end of September 2001 but then remained unchanged until the end of December (see Graph 7). This signalled that the Bank had not drawn on foreign credit lines to strengthen gross reserves in the last quarter of 2001.

70 The Bank's net open forward position (NOFP)*, widely seen as a serious source of exchange-rate vulnerability, remained unchanged at USD4,8 billion in the fourth quarter of 2001. As a matter of record, as of today, the NOFP is at USD2,9 billion.

EXCHANGE RATE MOVEMENTS

(See Table 3: Exchange Rates of the Rand)

71 A weighted index of the exchange rate of the rand against a basket of fourteen other currencies remained broadly unchanged over the first six months of 2001. Then it declined by 13,5 per cent from the end of June 2001 to the end of September and fell further by 24,0 per cent from the end of September to the end of December (see Graph 8).

72 Under a regime of freely floating exchange rates, a deficit on the current account of the balance of payments, coupled with a net outward movement of investment capital, would technically exert downward pressure on the exchange rate.

73 These downward pressures were probably exacerbated in the fourth quarter of 2001 by the delayed repatriation of foreign-currency export

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* NOFP is expressed in US dollar terms and is defined as the sum of the net reserves (gross gold and foreign currency reserves minus foreign loans) of the Reserve Bank and its oversold forward book, i.e. the extent to which the Reserve Bank's future

proceeds and heightened risk aversion towards investment in emerging-market economies. A widely held view in market circles is that the unsettled political situation in Zimbabwe also weighed down on the exchange value of the rand.

74 A depreciation in the exchange value of the rand is not without its benefits. The competitiveness of domestic producers in international markets as measured by the inflation-adjusted effective exchange rate of the rand improved significantly from December 2000 to September 2001 (the latest available estimate). The monthly average inflation-adjusted effective exchange rate of the rand declined by 11,9 per cent over this period.

CONCLUDING OBSERVATIONS

75 I conclude this part of my statement by observing that the macroeconomic scene in South Africa in the fourth quarter of 2001 was characterised by total domestic expenditure exceeding total disposable income. The excess of total domestic expenditure over total disposable income was expressed in a deficit on the current account of the balance of payments which was not matched by an inflow of foreign investment capital into the economy. In fact, capital left the country during the fourth quarter of 2001. This is a very significant factor for the exchange rate's behaviour during that period.

76 Under circumstances such as these, a depreciation in the exchange value of the rand could be expected as a normal market reaction. The magnitude of the depreciation would, however, always be difficult to predict with a high degree of accuracy.

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obligations to deliver US dollars are not covered by the Reserve Bank's net reserves.

77 Other factors which could have contributed to the steep decline in the exchange rate of the rand in the second half of 2001 include the heightened awareness of risk associated with investing in emerging markets and the perceived political instability in the Southern African subregion, particularly in Zimbabwe. These and other potential explanatory factors are discussed in part three of this statement.