Quarterly Bulletin
Kwartaalblad

September 2001

South African Reserve Bank
Suid-Afrikaanse Reserwebank

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Quarterly Economic Review

List of tables

List of graphs

Article
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A note on the business cycle in South Africa during the period to 1997 to 1999

by J C Venter and W S Pretorius

Contents

List of graphs

Quarterly Economic Review

Introduction

The slowdown in the pace of economic activity in the United States of America has had a more pronounced spillover into growth in the euro area and other parts of the global economy than was earlier envisaged. This implies that growth in world trade slowed down too, affecting trade and economic conditions in virtually all developing countries.

The US Federal Reserve System has lowered official short-term interest rates on seven occasions over the past eight months – one of the most aggressive easings in monetary policy in history. Yet the latest releases of economic statistics still paint a mixed picture. The US economy may still avoid moving into a period of declining output, but hopes of a quick rebound have faded. Simultaneously, a weaker American economy, together with declines in international crude oil prices from earlier peaks, have reduced the risk of inflationary pressures worldwide.

Growth prospects weakened in several emerging-market economies and some of them experienced serious financial crises in the first half of 2001. Turkey, Argentina and Brazil had to take stern measures to stabilise their financial systems and to limit the spread of their problems to other economies. Argentina implemented an austerity fiscal package in order to balance the national budget. In all three countries the International Monetary Fund played a role by offering policy advice and by making additional resources available under the existing standby facilities.

The weakening of the international economy contributed to a slowdown in output growth in South Africa during the first quarter of 2001. But unlike the slowdown in global economic activity which apparently intensified in the second quarter of 2001, growth in the domestic economy picked up from an annualised rate of 2 per cent in the first quarter of 2001 to 2½ per cent in the second quarter. The resilience of the South African economy in the first half of 2001 could be attributed, among other things, to the flexibility of the exchange rate of the rand and the fact that the potential benefits of the recent depreciation of the rand were not eroded by higher inflation as so often happened in the past.

Domestic real final demand remained relatively buoyant in the second quarter of 2001, even though growth in final consumption expenditure and fixed capital formation slowed down somewhat. By contrast, inventory investment fell sharply, forcing real gross domestic expenditure in the second quarter of 2001 to fall too. The decline in inventory levels might well be an indication that domestic producers feel less confident about the strength of future growth in aggregate income and demand.

The domestic saving ratio declined in the second quarter of 2001, mainly because of weaker saving by the corporate sector. Despite an appreciable increase in the share of operating surpluses in total factor income, companies preferred to step up their dividend payments rather than retaining profits in the firm. To a certain extent, this corporate behaviour could have been a reflection of available excess capacity in the domestic economy.

The long-term decline in employment in the non-agricultural formal sectors of the economy continued in the first quarter of 2001. Partly reflecting this pattern of utilisation of available labour resources, wages in the private sector continued to increase at modest rates in the first quarter of 2001. Moderate wage increases, combined with strong productivity growth which is also partly related to the reduction in employment, resulted in a further slowdown in the growth of nominal unit labour cost. In the medium to longer term this may contribute to an improvement in the international competitiveness of domestic producers, and consequently to stronger growth in exports, employment and the economy in general.

The slower growth in nominal unit labour cost together with lower international oil prices were reflected in lower year-on-year price inflation in the first half of 2001. Price pressures at the production level have started easing in recent months and consumer price inflation has also started declining. However, there were signs of an acceleration in endogenously generated inflation from the first quarter of 2001 to the second quarter. For example, production prices of domestically produced goods and the prices of non-food consumer goods rose more rapidly in the second quarter of 2001 than in the first quarter. The growth in overall inflation indicators was curbed mainly by smaller increases in the prices of imported goods and a decisive slowdown in the prices of consumer services.

The current account of the balance of payments, which moved into a surplus in the fourth quarter of 2000, fared reasonably well in the second quarter of 2001, despite the slowdown in the international economy. Merchandise export volumes recovered somewhat from the slight weakness of the first quarter of 2001 and, bolstered by the domestic price-raising effect of the depreciation of the rand, overall nominal export earnings increased quite impressively.

The increase in import prices that followed the depreciation of the rand over the past two years, helped by a decline in inventory investment, discouraged the importation of goods into the country and reinforced the trade surplus in the second quarter of 2001. This healthier trade balance was offset by a considerably higher deficit on the services and income account, essentially reflecting the steady accumulation over the past eight years of non-residents' ownership of shares in domestic companies. As a consequence, the surplus on the current account of the balance of payments fell back slightly in the second quarter of 2001.

The restructuring of the corporate relationship between De Beers and the Anglo American Corporation contributed materially to a surplus on the external financial account of the country. The international reserves of the country strengthened further, but despite these favourable conditions the rand remained under persistent downward pressure, largely owing to non-economic factors originating outside the country. Nonetheless, the flexibility of the exchange rate has contributed appreciably to the recent strengthening of the current-account balance at a time when the international economy has been losing its growth momentum.

Confident that inflation prospects would not be jeopardised by an upturn in the growth of aggregate demand in the second half of 2001 and in 2002, the Reserve Bank lowered its interest rate on repurchase transactions by 100 basis points in June 2001. This step brought the repurchase rate down to 11 per cent and the prime lending rate of the private banks to 13,50 per cent – the lowest rate since March 1986. A one-off administrative adjustment to the margin between the Reserve Bank's repurchase rate and the interbank call rate was made by lowering the rate on repurchase transactions further by 100 basis points. This adjustment was made purely for operational purposes and was not meant as a change in monetary policy.

All of these rate adjustments were consistent with the policy objective of lowering inflation to within the upper region of the 3 to 6 per cent target range in 2002.

Since the introduction of inflation targeting, the growth in M3 has no longer been used as an intermediate target for monetary policy purposes. Nevertheless, money supply and credit continue to provide useful information about prospective spending plans and inflationary pressures. Recent trends have been encouraging. M3 growth has accelerated noticeably, but this was largely a result of strong growth in longer-term deposits. This might have been influenced more by fears of losses on equity investments than by intentions to spend in the future.

Bank credit extension to the private sector also continued to rise briskly. The greater part of this credit expansion was extended to the corporate sector where fixed capital formation, which lays the foundation for future economic growth, has been growing at a solid pace over the past year. The smaller part of credit extension to the private sector reflected a reasonably buoyant consumer demand. The net claims of the banking sector on the government sector declined quite sharply in the first half of 2001, slowing down the growth in total bank credit extension to a very low rate.

The secondary bond market has continued to perform well in 2001 and yields have fallen by about 220 basis points from December 2000 to August 2001. Unlike previous rallies in the bond market, the declines in bond yields during 2000 and 2001 were mainly driven by domestic institutional and other investors. Non-residents have continued to sell bonds on a net basis in the domestic market in the first eight months of 2001.

Sound macroeconomic fundamentals, coupled with the well-regulated environment in which the domestic markets operate, probably contributed most to a substantial decline in the sovereign risk premium on South African government debt. Furthermore, the inflation-adjusted yield on long-term bonds has declined to its lowest level since 1994. Short-term interest rates broadly followed the repurchase rate of the Reserve Bank downwards in June 2001, but when the repurchase rate was lowered as part of the changes made to the functioning of the money-market refinancing system, other short-term rates remained unaffected.

The repurchase-based refinancing system in the money market was introduced in March 1998 when it replaced the old system which allowed for overnight borrowing by private-sector banks from the Reserve Bank at a pre-announced fixed Bank rate. Under the repurchase system, the Reserve Bank announced the maximum amount of funds available each day and banks had to bid for those funds, effectively determining the cost of central bank borrowing at the auction.

Although the system worked reasonably well, a number of shortcomings became apparent. To eliminate these inefficiencies, some modifications to the system were proposed after in-depth research and widespread consultation with domestic money-market participants and experts at other central banks and multilateral agencies. Among these changes was the partial closing of the margin between the repurchase rate and the interbank call rate. As indicated above, money-market interest rates were left unaffected by this adjustment.

The decline in yields in the bond market was influenced by steadily waning inflation expectations and also by a decline in the supply of public-sector fixed-interest securities. As the overall public-sector borrowing requirement was under control and government gave preference to funding in the international capital markets, and in addition more funds were expected to be released by the scheduled restructuring of government assets, there were excess funds available in the domestic debt market. Bond prices were bid higher and so the cost of funds declined below banks' lending rates, causing activity in the primary corporate bond market to pick up. Cash holdings of non-bank financial intermediaries also increased appreciably.

The uncertainty about growth prospects together with the recent volatility in share price movements dampened the demand for new capital in the market for equity issues. In the secondary share market, activity was bolstered by the De Beers/Anglo American transaction. Share prices generally rose by about 8 per cent in the first eight months of 2001, underpinned by the strong performance of gold-mining shares, but they were simultaneously held back by a decline of 64 per cent in the prices of information-technology shares.

The increase in real-estate prices started to slow down in the first half of 2001. This may weigh down on future household final consumption expenditure, potentially dampening the business mood in coming months. By contrast, share prices may be bolstered when part of the cash overhang of non-bank financial intermediaries finds its way to the share market, counteracting the negative sentiment that may follow the rather lacklustre price movements in the property market.

The government's fiscal strategy of broadening the tax base and rationalising public spending is being implemented successfully. The budget deficit in fiscal 2000/01 undershot the initial target for the year and a healthy primary surplus was achieved on the accounts of national government. Especially among provincial governments the principles of good governance were firmly established – the aggregated net indebtedness of provincial governments to private-sector banks declined noticeably over the past year or so.

Emphasis on foreign borrowing for financing the budget deficit of national government contributed substantially to the decline in the overall cost of capital in the economy. The consolidation of public finances has now reached a stage where it is providing scope for infrastructural spending in areas such as roads, education and water supplies. The government has also reduced corporate tax rates to make South Africa a more internationally competitive investment destination.

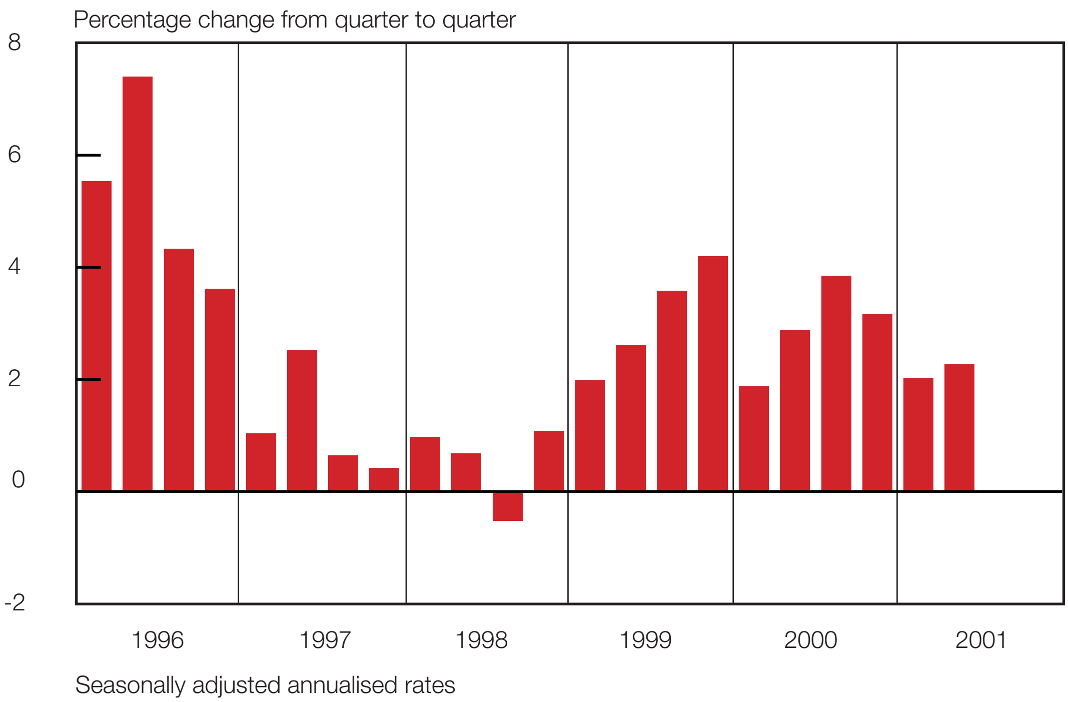
Domestic economic developments

Domestic output

The weakening of the international economy was reflected in economic growth in South Africa slowing down from an annualised rate of 3 per cent in the fourth quarter of 2000 to 2 per cent in the first quarter of 2001. Although a further slowdown in global economic activity was reported recently, slight improvements in the growth performance of the mining, manufacturing, construction and trade sectors helped to lift South Africa's economic growth rate to an annualised level of 2½ per cent in the second quarter of 2001. Somewhat paradoxically, two of the leading sectors in the mild growth pick-up in the second quarter of 2001 are quite significantly exposed to international economic conditions.

When the level of real gross domestic product in the first half of 2001 is compared with the first half of 2000, year-on-year economic growth amounted to about 2½ per cent. However, output in the remainder of the year will have to strengthen appreciably if growth for the calendar year as a whole is to match that for 2000. In 2000 the growth in gross domestic product accelerated to 3 per cent from 2 per cent in the previous year.

Real gross domestic product



Agricultural production fell by an annualised 6 per cent in the first quarter of 2001. In the second quarter of 2001 real agricultural production declined further, but at a much lower rate of 1½ per cent. Fairly wet climatic conditions and a temporary short-

Real gross domestic product
Percentage change at seasonally adjusted annualised rates

	2000					2001	
Sectors	1st qr	2nd qr	3rd qr	4th qr	Year	1st qr	2nd qr
Agriculture	-8½	7½	24	1	4	-6	-1½
Mining	-3	-3½	-2½	½	-2	1	2
Manufacturing	2½	2½	4	4½	3½	1	1½
Electricity, gas and water	½	2½	2	2½	4½	2	1
Construction	-1	1½	3	3½	-1	1½	2½
Commerce	5½	6	5½	4½	5	3	3½
Transport and communication	4½	7	6	6½	6½	4½	4½
Financial services	3	3½	4½	3½	5	4½	4
Total	2	3	4	3	3	2	2½

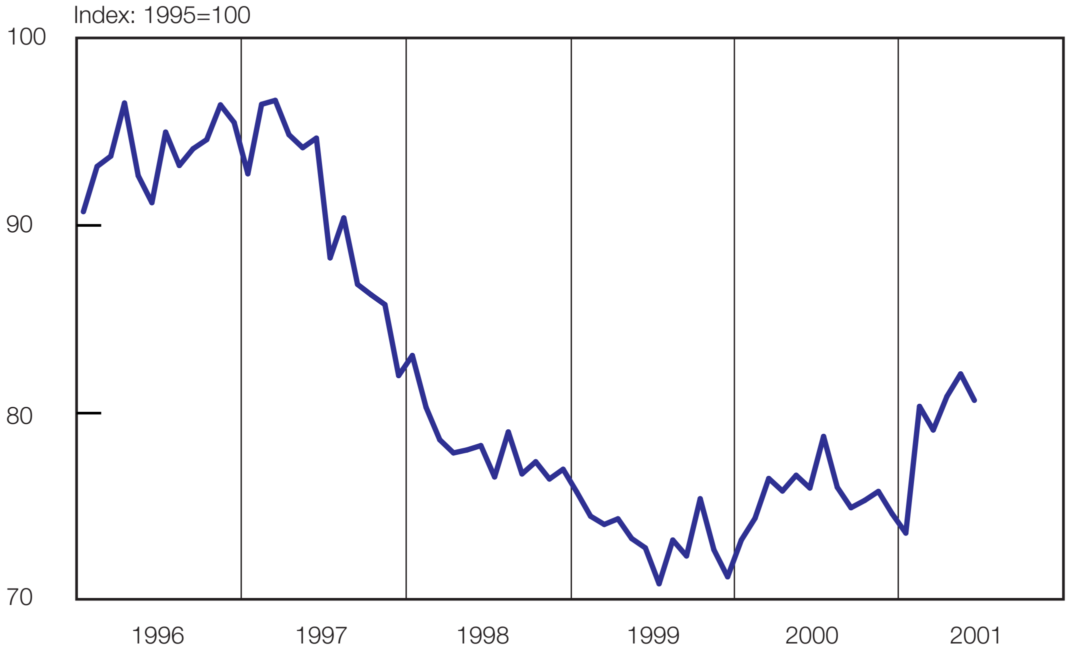
age of diesel fuel delayed the harvesting of the maize crop. Maize production may therefore be bunched in the third quarter of 2001, but year-on-year growth in agricultural output in the remainder of the year will also be strongly influenced by an expected decline in the size of the maize crop from 10,6 million tons in 2000 to 7,5 million tons in 2001.

The growth in real value added by the *mining sector* picked up from an annualised rate of ½ per cent in the fourth quarter of 2000 to 1 per cent in the first quarter of 2001 and 2 per cent in the second quarter. This acceleration occurred despite the progressive weakening in global economic conditions and was most prominent in the diamond industry and in the platinum-group metals industry. The long-term downward trend in the gold mining industry was also brought to a halt, perhaps only temporarily, when gold production remained almost unchanged from the first quarter of 2001.

The growth in the real value added of the *manufacturing sector* which is supposed to benefit most from a more competitive real exchange rate of the rand, accelerated modestly from an annualised rate of 1 per cent in the first quarter of 2001 to 1½ per cent in the second quarter. Real manufacturing production also benefited from strong demand in the export market for South African produced motor vehicles. Other sectors where output growth strengthened were food processing, clothing manufacturing and basic metal products. Output of wood and wood products, chemicals and electric machinery weakened slightly.

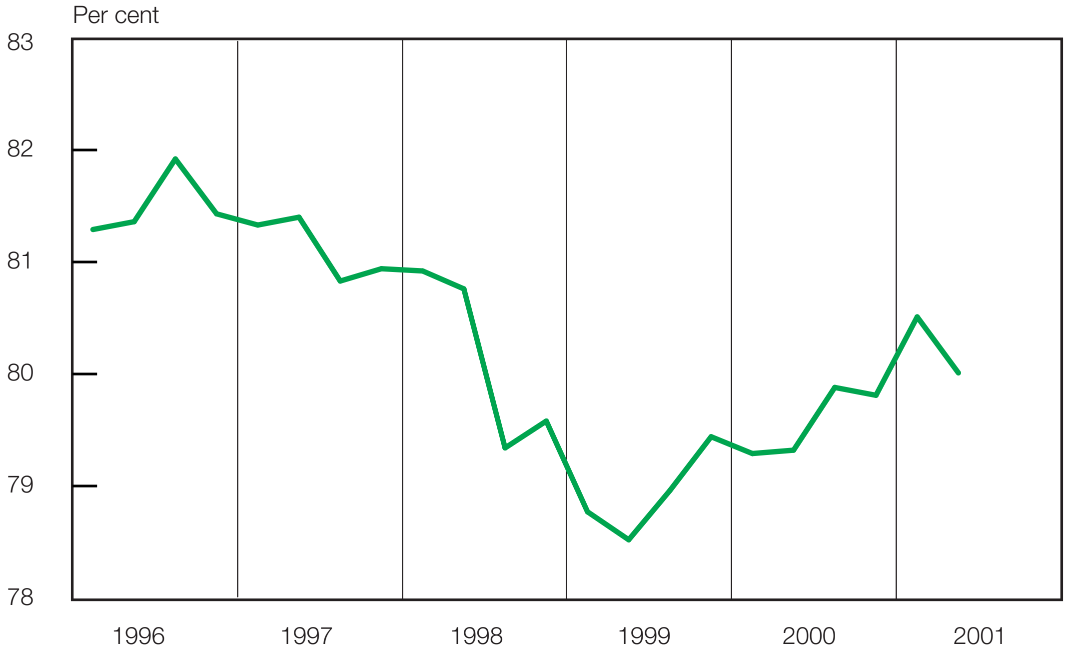
Overall demand for manufactures remains strong relative to supply and there was a further increase in the value of unfilled orders. This probably indicates that manufacturing production volumes could increase further in the second half of 2001. Ample production capacity for meeting higher demand is still available in the industry. The rate of capacity utilisation in manufacturing in the second quarter of 2001 fell back to 80,0 per cent from 80,5 per cent in the first quarter, partly because of the concentration of public holidays in the second quarter. When the business cycle was in a recovery phase in 1995, the capacity utilisation rate was at 83,7 per cent. If this rate is seen as full utilisation, there is potential for manufacturing output to expand further without putting undue pressure on available resources. In the meantime, fixed capital formation is continuing in the manufacturing sector, thus adding capacity to the already existing production facilities.

Total unfilled orders in manufacturing



Seasonally adjusted at constant prices

Utilisation of production capacity in manufacturing



Seasonally adjusted

Growth in real value added by the sector supplying *electricity, gas and water* slowed down to an annualised 1 per cent in the second quarter of 2001. Electricity supply fell because of modest demand for household consumption during a relatively mild winter and the stepping up of supply from Mozambique. By contrast, activity in the *construction industry* strengthened, essentially in the development of construction works such as roads and non-residential buildings.

Reflecting the relatively solid expansion of final aggregate domestic demand, real output in the *commercial sector* increased at an annualised 3½ per cent in the second quarter of 2001, slightly up from growth of 3 per cent in the first quarter. The wholesale trade and the retail trade sectors participated in the relatively buoyant trading conditions and the hospitality sector (i.e. catering and accommodation) as well. Real value added by the motor trade, which grew to reach a very high level in the first quarter of 2001, could not improve further in the second quarter.

Growth in the *transport, storage and communication sector* maintained a sturdy annualised pace of 4½ per cent in the second quarter of 2001, reflecting the ongoing expansion of telecommunication services in the country. Real value added by the transportation subsector, however, showed almost no growth in the second quarter of 2001, mostly because of the negative impact on long-haulage transport business of the high fuel prices and the unstable situation in Zimbabwe. Growth in real value added by the *financial intermediation, insurance, real estate and business services sector* fell back somewhat from an annualised 4½ per cent in the first quarter of 2001 to 4 per cent in the second quarter as activity in the securities and real-estate markets started to expand at a less vigorous pace.

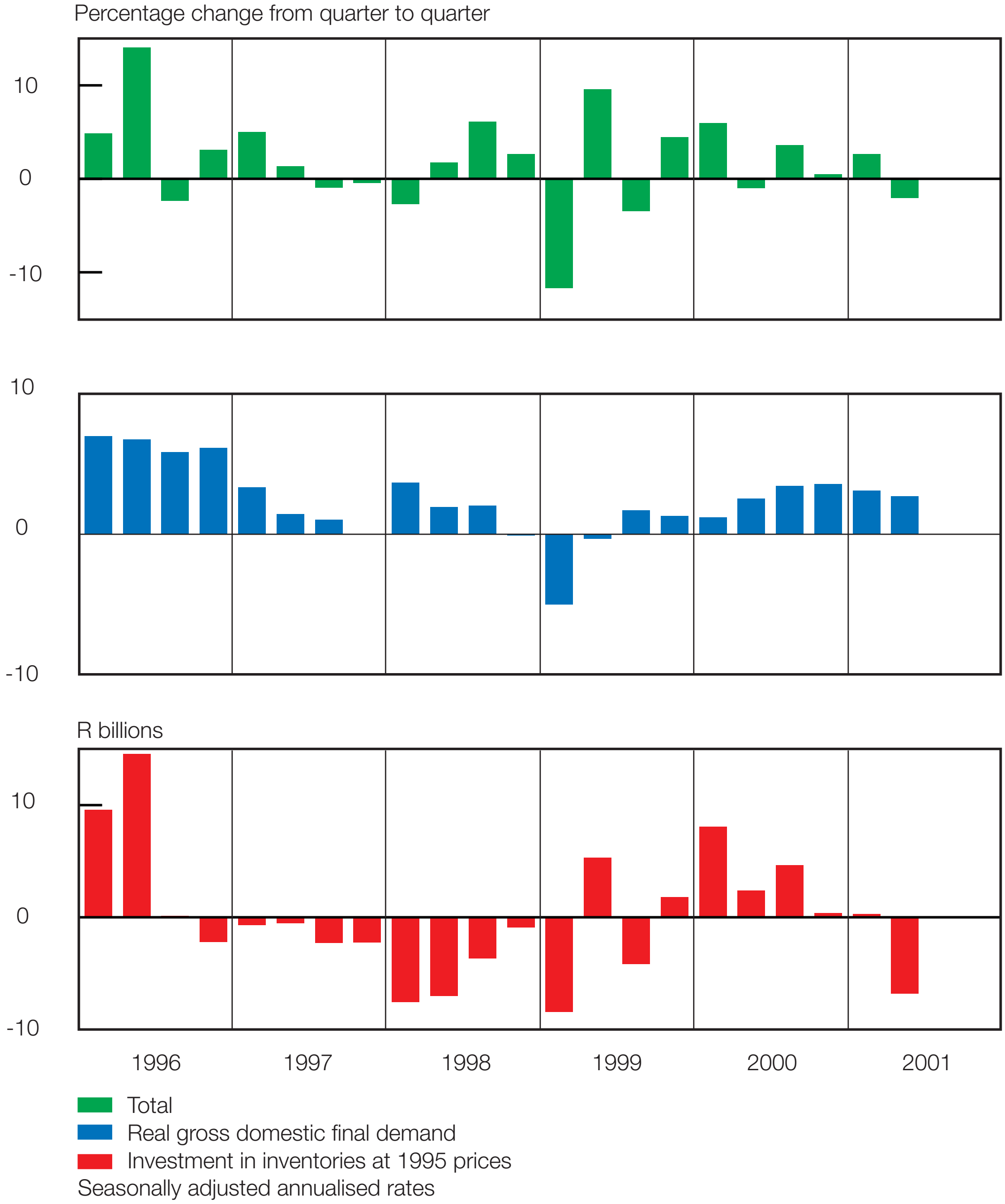
Domestic expenditure

In contrast to domestic production which maintained its upward thrust despite the weakening international economy, real gross domestic expenditure declined in the second quarter of 2001. Overall real gross domestic expenditure fell at an annualised 2 per cent in the second quarter of 2001, following an increase of 2½ per cent in the first quarter. The decline in total domestic spending was caused by a sharp cutback in inventories. Aggregate final demand (i.e. the total of final consumption expenditure and gross fixed capital formation) still increased quite strongly, albeit at a mildly slower pace than in the first quarter of 2001.

Real gross domestic expenditure
Percentage change at seasonally adjusted annualised rates

	2000					2001	
Components	1st qr	2nd qr	3rd qr	4th qr	Year	1st qr	2nd qr
Final consumption expenditure by households.....	3½	3	3½	3½	3	3	2½
Final consumption expenditure by general government	-7½	1	1	1½	-2½	1½	1½
Gross fixed capital formation	2½	3	6	6½	1½	6	5
Change in inventories (R billions)	8,1	2,4	4,7	0,4	3,9	0,3	-6,8
Gross domestic expenditure........................	6	-1	3½	½	2½	2½	-2

Real gross domestic expenditure



Growth in real *final consumption expenditure by households* slowed on an annualised basis to 2½ per cent in the second quarter of 2001 from 3 per cent in the first quarter. This partly reflected slower growth in the real disposable income of households and a weakening in consumer confidence which curbed households' willingness to incur debt.

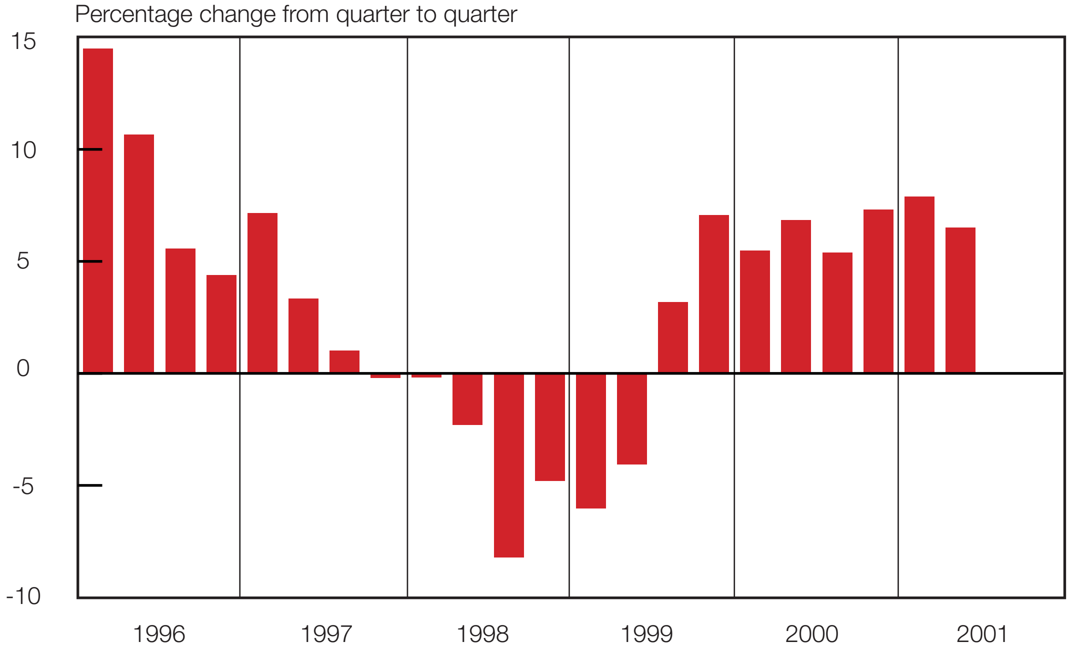
Expenditure on *durable goods* declined in the second quarter of 2001, mainly because of a decline in the buying of new motorcars. As these expenditures are mostly financed through debt contracts, the decline in motorcar purchases also led to a decline in households' debt-to-income ratio from 56½ per cent in the fourth quarter of 2000 to 55½ per cent in the second quarter of 2001.

Unlike spending on durable goods, households' spending on *semi-durables* and on *non-durable goods and services* not only increased in the second quarter of 2001 but increased at a faster rate than in the first quarter. Spending on clothing and footwear was quite strong and increased by an annualised 5½ per cent in the second quarter of 2001 compared with 4 per cent in the first quarter. Growth in real spending on non-durable goods and services picked up from an annualised 2½ per cent in the first quarter of 2001 to 3 per cent in the second quarter, despite cuts having been made in spending on petroleum products.

Growth in real *final consumption expenditure by general government* remained generally weak, reflecting ongoing efforts by government to curb current expenditure and contain the growth in the public-sector wage bill. Public consumption in real terms increased at a seasonally adjusted annualised rate of 1½ per cent in the first and second quarters of 2001. The containment of spending growth was more pronounced in the area of employee remuneration where the rationalisation of personnel numbers caused a decline in real outlays on salaries and wages. Real expenditure on intermediate goods and services increased further in the second quarter of 2001.

Growth in real *gross fixed capital formation* continued at a brisk pace of 5 per cent in the second quarter of 2001 and was only slightly lower than growth at 6 per cent in the first quarter. The major part of the new capital formation is taking place in the *private business sector.* There was a slight slowdown in private-sector fixed investment growth from an annualised 8 per cent in the first quarter of 2001 to 6½ per cent in the second quarter, but investment activity remained fairly buoyant in most sectors of the economy. Notable exceptions were the agricultural sector and private residential buildings where declines occurred in the second quarter of 2001. Manufacturing, the telecommunications industry and platinum mines were among the sectors where the capital formation continued briskly.

Real gross fixed capital formation by the private sector



Seasonally adjusted annualised rates

Real fixed capital formation by corporations in the *public sector* declined sharply in the second quarter but infrastructural investment spending by general government departments increased strongly. Overall real fixed capital formation in the public sector increased at an annualised 1 per cent in the second quarter of 2001, following a slightly stronger increase of 2 per cent in the first quarter.

The level of *inventories* declined substantially in the second quarter of 2001, signalling that previous build-ups of inventories were mostly involuntary and that producers and traders were concerned about the prospects for continued growth in aggregate demand. The cutbacks in inventories occurred across the full spectrum of production sectors of the economy. This was aggravated by the delay in the harvesting of the maize crop. The decline in inventory investment is estimated to have compressed the growth in real gross domestic product by an annualised 4½ percentage points in the second quarter of 2001.

Factor income

The growth over four quarters in total nominal factor income declined from about 11 per cent in the first quarter of 2001 to 10 per cent in the second quarter, broadly consistent with the general slowdown in price inflation. Compensation of employees, reflecting the moderation in nominal wage growth, and operating surpluses, consistent with the slowdown in inflation in product prices, grew at lower rates than before.

Declining employment numbers in the formal sectors of the economy together with moderate nominal wage growth compressed the growth over four quarters in total compensation of employees from 7 per cent in the first quarter of 2001 to 6½ per cent in the second quarter. With aggregate output in nominal terms rising at a faster pace, the percentage share of employee compensation in total factor income fell from 53½ per cent in the first quarter of 2001 to 53 per cent in the second quarter.

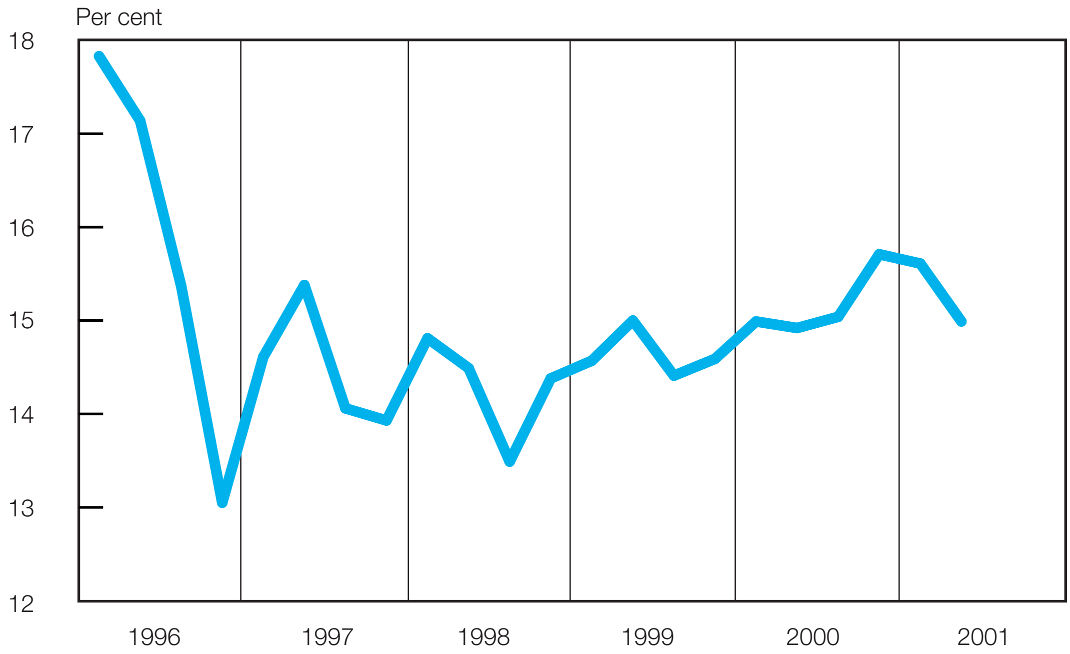
The growth over four quarters in nominal gross operating surpluses exceeded by a fair margin the growth in employee compensation, pushing higher the share of operating surpluses in the total value of factor income. At the aggregate level, the year-on-year growth in nominal gross operating surpluses slowed down from 15½ per cent in the first quarter of 2001, to 14½ per cent in the second quarter. However, at the sectoral level, the growth in nominal gross operating surpluses accelerated in agriculture, manufacturing and commerce.

Gross saving

South Africa’s saving ratio (i.e. gross saving as a percentage of gross domestic product) weakened from 15½ per cent in the first quarter of 2001 to 15 per cent in the second quarter. Usually this relatively low saving ratio imposes a constraint on capital formation but in the second quarter of 2001 the economy had a substantial excess of saving over gross capital formation, mainly because of the steep decline in inventory investment.

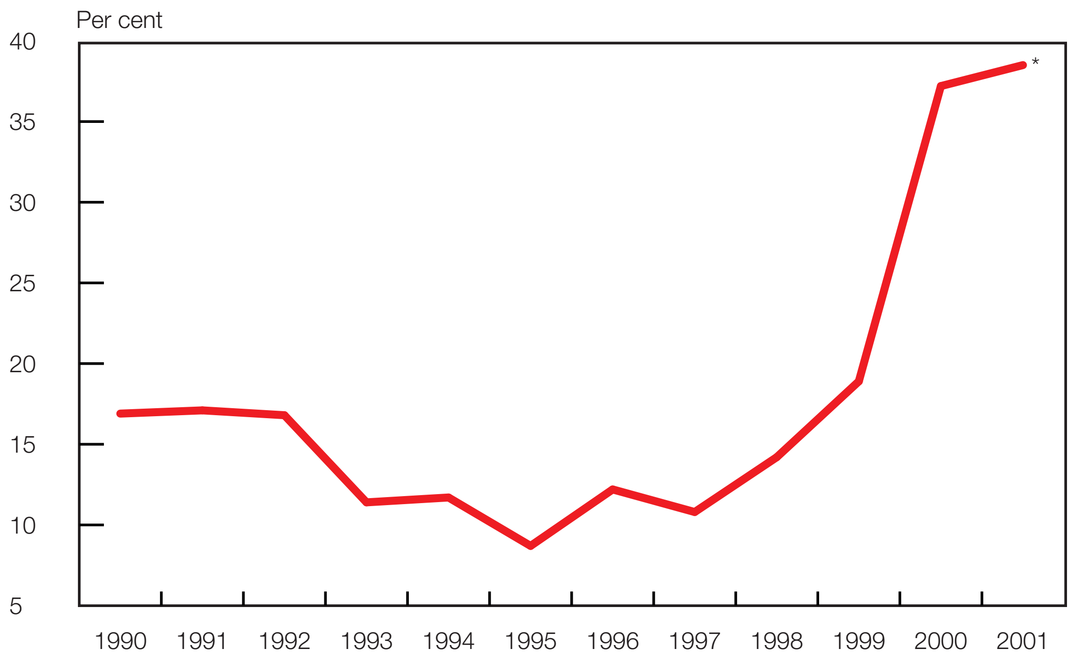
The decline in the saving ratio in the second quarter of 2001 was largely caused by lower corporate saving. As a percentage of gross domestic product, gross corporate saving declined from 12 per cent in the first quarter of 2001 to 11½ per cent in the second quarter. Companies generally preferred to make dividend payments instead of retaining profits in the firm. This may in part reflect a lack of lucrative investment opportunities. Especially dividend payments to non-resident shareholders rose very strongly. As a percentage of total dividend payments by companies, payments to non-resident shareholders have now increased from 10½ per cent in 1997 to 37 per cent in 2000 and 38½ per cent in the first half of 2001.

Gross saving as percentage of gross domestic product



Seasonally adjusted

Dividends paid to non-resident shareholders as percentage of total dividends paid



* First half of 2001

Gross saving by households remained weak against the backdrop of continued relatively strong final consumption expenditure. Relative to gross domestic product, households' gross saving remained at a level of about 3 per cent in the second quarter of 2001. Reflecting the overall improvement in public finances, gross saving by general government strengthened further in the second quarter of 2001.

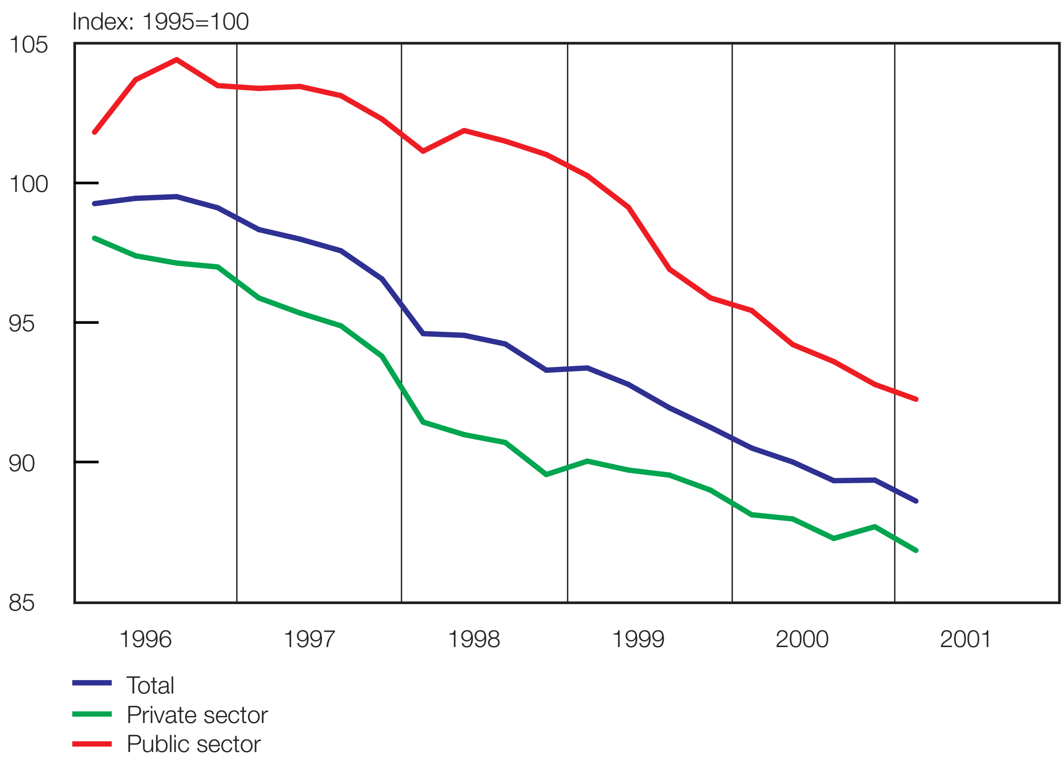
Employment

A brief respite in the longer-term decline in regularly surveyed *formal-sector non-agricultural employment* in the fourth quarter of 2000 was followed by a renewed spate of job losses in the opening months of 2001. The most pronounced of these were lay-offs at gold mines and some state-owned enterprises and lost employment opportunities in the construction and manufacturing sectors. According to the *Survey of Employment and Earnings in Selected Industries* (SEE) by Statistics South Africa, formal-sector employment declined by 2,1 per cent or about 100 000 employees in the year to March 2001.

Despite the continued decline in employment numbers, the incidence of strikes and work stoppages rose markedly from a very low level in the first quarter of 2001. According to NMG-Levy Consultants and Actuaries, the number of workdays lost to strikes and other forms of work stoppages rose from about 85 000 in the first quarter of 2001 to around 235 000 in the second quarter. Further increases in strike activity occurred in the third quarter of 2001, organised by high-profile unions with large memberships in prominent sectors of the economy, notably the motor manufacturing industry.

The average number of jobs in the non-agricultural private sector declined at a year-on-year rate of 1,5 per cent in the first quarter of 2001 or by about 45 000 workers. This compares with an average decline in private-sector employment of 2,0 per cent

Non-agricultural employment



in 2000. In contrast to the decline in overall private-sector employment in the first quarter of 2001, small employment gains were made in certain sectors of the economy, namely in the electricity-generating and financial intermediation and insurance sectors.

The contraction in *public sector* employment in the early months of 2001 was more severe than in the private sector. Public-sector employment had fallen by 4,1 per cent in 2000 and decreased by 3,3 per cent in the year to the first quarter of 2001. Declines in employment were recorded at all levels of the public sector, ranging from a year-on-year rate of 1,0 per cent in local government departments to 6,3 per cent in certain state-owned enterprises. A spate of resignations and early retirements aggravated the decline in public-sector employment, as did the termination of part-time employment contracts by universities, technikons and provincial departments.

Results from the household-based *Labour Force Survey* (LFS) for September 2000, as published by Statistics South Africa, indicate an unemployment level equal to 25,8 per cent of the economically active population. When discouraged workers who are no longer searching for a job are also counted as unemployed, the unemployment rate rises to 35,9 per cent.

According to the International Labour Organisation's *World Employment Report* for 2001, world employment has improved appreciably since the Asian financial crisis in 1998. However, the report warns that in the longer term, economic growth alone is unlikely to ensure the creation of a sufficient number of jobs needed to accommodate new entrants to the workforce and to reduce the current unemployment levels. Addressing the unemployment problem requires greater attention to core labour issues such as investment in human capital, as well as making employment a more central goal of economic policy. The report also indicates that nearly one-third of the world's labour force of about 3 billion is either unemployed, underemployed and seeking more work, or earns less than needed to keep their families out of poverty.

Labour cost and productivity

Inflationary pressures originating in the labour market have remained relatively subdued in the past year or so. The year-to-year rate of growth in nominal remuneration per worker in the formal non-agricultural sectors of the economy was 8,8 per cent in 2000, significantly below that of previous years. When measured over periods of four quarters, nominal wage growth per worker in the formal non-agricultural sectors of the economy has moderated from 10,3 per cent in the fourth quarter of 2000 to 9,4 per cent in the first quarter of 2001.

The slowdown in nominal wage growth is corroborated by information obtained from the Automated Clearing Bureau on the salaries, wages and pensions deposited into the accounts of almost 5 million salaried and retired workers. This measure indicates that the growth in average nominal wages declined from 8,3 per cent in 1999 to 6,1 per cent in 2000. These statistics furthermore indicate that nominal remuneration growth had picked up in the first quarter of 2001, but slowed down again in the second quarter. According to the Steel and Engineering Industries Federation of South Africa, growth in labour cost in the steel and engineering industry slowed down from 5,3 per cent in 2000 to 4,2 per cent in the first half of 2001. NMG-Levy Consultants and Actuaries reported that the average level of wage settlements in collective bargaining agreements amounted to 7,5 per cent in the first half of 2001, about the same as in 2000 but well down from the 8,3 per cent increase in 1999.

Surveys by PE Corporate Services among some 800 companies employing more than 1,5 million people, indicate that the labour market is at present characterised by differentiated rates of wage increase. In industries and staff categories where shortages are particularly acute and trading conditions relatively buoyant, wage increases may be expected to exceed inflation by a margin of about 3 percentage points. By contrast, in sectors such as manufacturing, global competition and depressed local demand kept salary and wage increases generally below 7 per cent. Significantly, it was also found that companies were increasingly linking their pay rises to the CPIX measure of consumer price inflation.

Surveys conducted by Statistics South Africa indicate that nominal wage growth in the *private sector* slowed down from a year-on-year rate of 8,2 per cent in the fourth quarter of 2000 to 5,1 per cent in the first quarter of 2001. Increases ranged from a low of 1,2 per cent in the construction sector to 13,7 per cent in the electricity-generating sector. In fact, the electricity-generating sector was the only sector in which nominal remuneration grew faster in the first quarter of 2001 than in the closing months of 2000. Overall, average nominal wages in the private sector increased by 8,7 per cent in 2000 – the lowest rate of increase in the past three decades.

Pay increases in the *public sector,* at an average rate of 9,4 per cent in 2000, were somewhat more generous than in the private sector. In the various structures of the public sector, the growth in compensation per worker varied considerably in 2000. In the transport, storage and communication sector pay increases exceeded 10 per cent, but in the local government sector increases of around 4 per cent were generally granted.

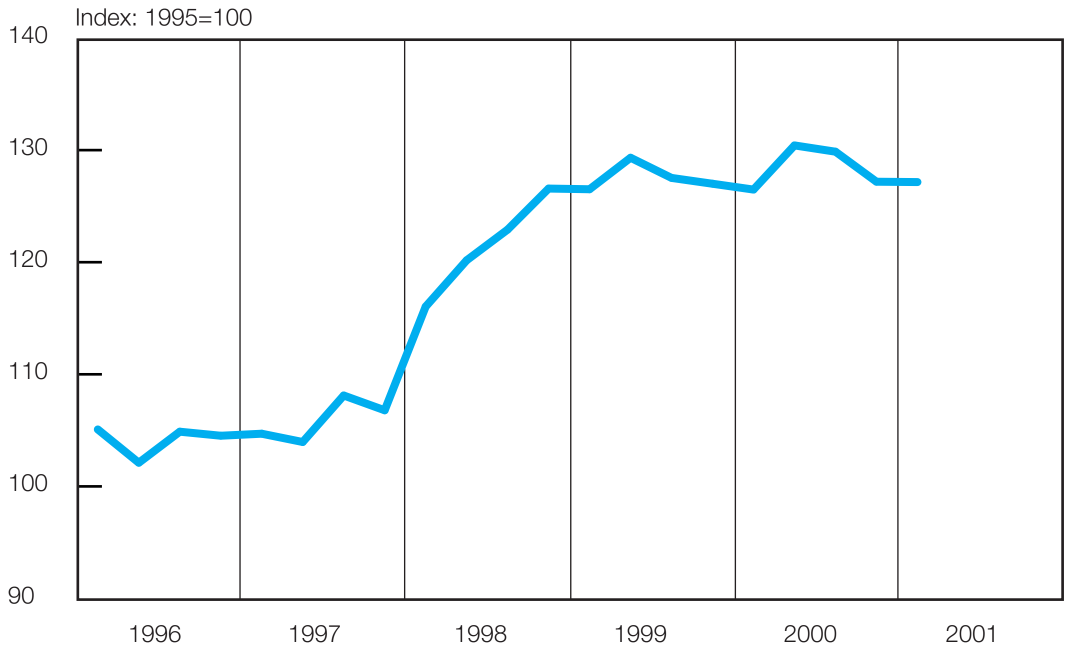
In the non-agricultural sectors of the economy, nominal remuneration per worker rose faster than output prices (as reflected by the increase in the price deflator for value added in the economy) during 2000. This resulted in an increase of some 2 per cent in the inflation-adjusted compensation per worker or *real product wage*. When measured over periods of one year, real remuneration per worker slowed down to a rate of 1,4 per cent in the first quarter of 2001.

Mainly because a smaller number of workers were in gainful employment, output per worker in the formal non-agricultural sectors of the economy increased at a rate of 6,0 per cent in 2000 – the highest rate of increase in the past three decades. When measured over periods of four quarters, the growth in labour productivity slowed down from 6,1 per cent in the third quarter of 2000 to 5,0 per cent in the fourth quarter and remained at this level in the first quarter of 2001.

Despite slower growth in labour productivity, the decline in the growth in nominal remuneration per worker in the opening months of 2001 was still sufficient to curb the growth in nominal unit labour cost (i.e. the cost of labour per unit of output, or the ratio between nominal remuneration per worker and output per worker). The year-on-year growth in nominal unit labour cost slowed down from 5,1 per cent in the fourth quarter of 2000 to 4,2 per cent in the first quarter of 2001. In the manufacturing sector, the growth in nominal unit labour cost amounted to only 0,7 per cent in 2000 and to 0,5 per cent in the year to the first quarter of 2001.

Continued moderate rates of increase in nominal unit labour cost will depend on the outcome of this year's round of wage negotiations and whether the increases in labour productivity can be sustained. From a growth and export perspective, a continuation of slower increases in nominal unit labour cost coupled with the recent decline in the exchange rate might improve the international competitiveness of domestic producers and therefore lead to stronger growth in export volumes and real income levels, provided increases in domestic prices can be contained.

Nominal unit labour cost in manufacturing



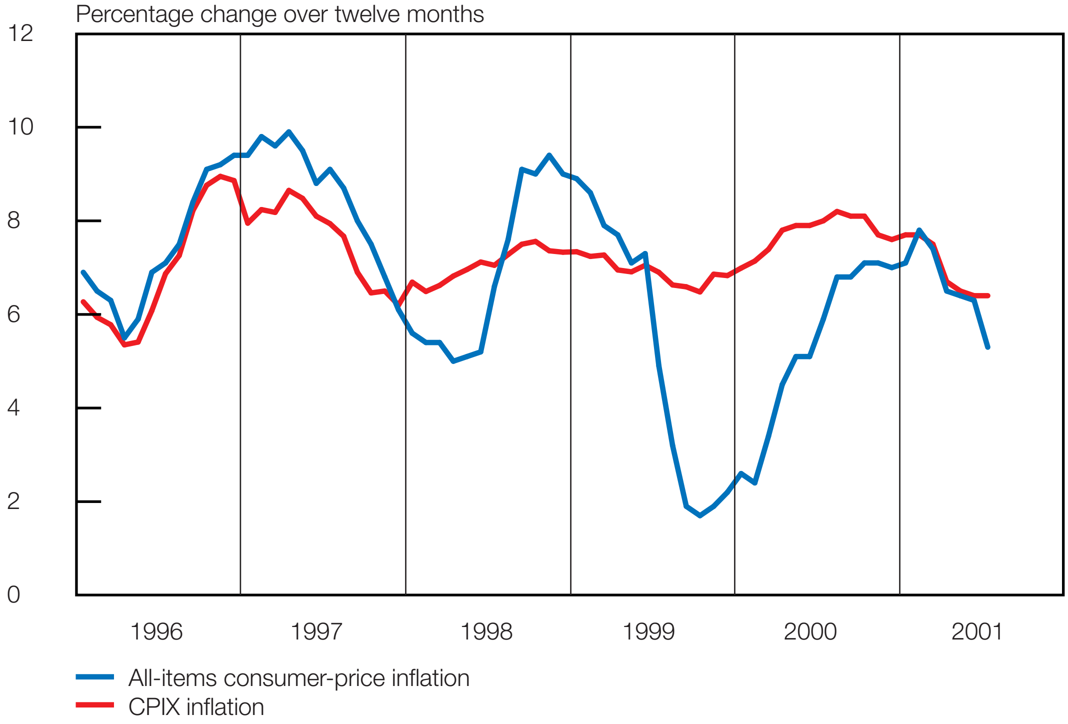
Over the medium to longer term, HIV/AIDS could add to upward pressures on unit labour cost because the impact of HIV/AIDS on productivity is expected to increase as AIDS sickness among HIV infected employees sets in. Also, employee insurance, medical aid and death benefits, as well as costs associated with staff replacement and training are likely to exert upward pressure on unit labour cost. Currently, there is a dearth of information for determining the extent of these costs. More rigorous research and systematic surveillance are required to come to any precise quantification of the potential cost burden imposed by HIV/AIDS.

Prices

Inflation in the prices of consumer goods and services moderated meaningfully in the first half of 2001. The year-on-year rate of increase in the *consumer price index* for metropolitan and other urban areas excluding mortgage cost (CPIX) – the benchmark indicator for inflation-targeting purposes – has declined from 8,2 per cent in August 2000 to 6,4 per cent in July 2001. This rate of increase is only 0,4 percentage points above the upper limit of the inflation target range of between 3 and 6 per cent set for 2002. When measured from quarter to quarter and expressed at an annualised rate, the short-term pace of CPIX inflation has almost halved from 7,8 per cent in the first quarter of 2001 to 4,5 per cent in the second quarter.

In contrast to the moderation in consumer price inflation, production price inflation has advanced at a firmer pace in recent months. Measured over periods of twelve months, the rate of increase in the *all-goods production price index* rose from 8,1 per cent in April 2001 to 8,6 per cent in May, June and July. When omitting the moderating effect of relatively low rises in food prices, inflation in production prices would

CPIX and headline inflation

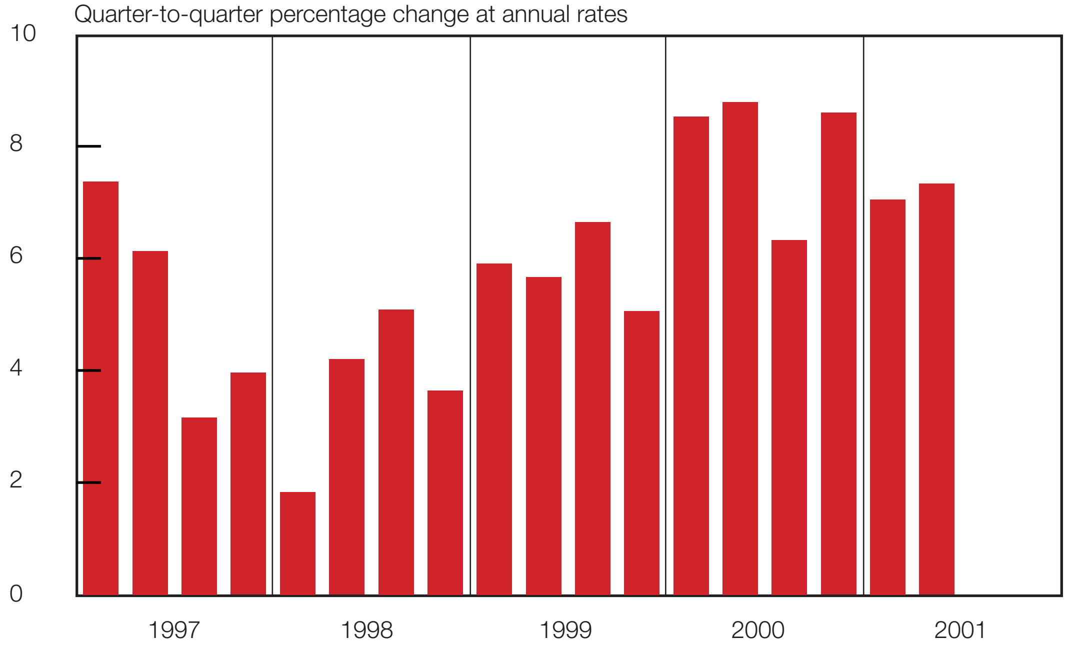


have amounted to an even higher rate of 9,6 per cent in the year to June 2001 and 8,9 per cent in the year to July. The recent rise in production price inflation resulted mainly from higher rates of increase in the prices of domestically produced goods.

The year-on-year rate of increase in the prices of *domestically produced goods* which had receded from 8,0 per cent in November 2000 to 6,9 per cent in April 2001, accelerated to 8,2 per cent in July. Rising food price inflation, though still at a modest level, contributed most to the pick-up in inflation in the prices of domestically produced goods. Measured over periods of twelve months, inflation in the prices of manufactured food products accelerated from 3,8 per cent in March 2001 to 7,2 per cent in July. Additional inflationary pressure came from a 25 per cent rise in the prices of petrol and diesel in the year to June 2001. Furthermore, the rising prices of non-food agricultural products, printing and paper products, transport equipment, chemicals and chemical products and electricity added to upward price pressures. Still, the quarter-to-quarter pace of inflation in the prices of domestically produced goods picked up only marginally from an annualised rate of 7,1 per cent in the first quarter of 2001 to 7,3 per cent in the second quarter.

The higher inflation in the prices of domestically produced goods has been partly offset by a deceleration in the rates of increase in the prices of *imported goods* in recent months. Imported inflation, when measured over periods of twelve months, declined from 15,0 per cent in December 2000 to 9,2 per cent in July 2001. The decline in imported inflation over this period was primarily due to lower international oil prices and the stronger exchange rate of the rand in May and June 2001. Coupled with declining inflation in trading-partner countries, this contributed meaningfully to the slowdown in imported inflation.

Inflation in prices of domestically produced goods



Production prices

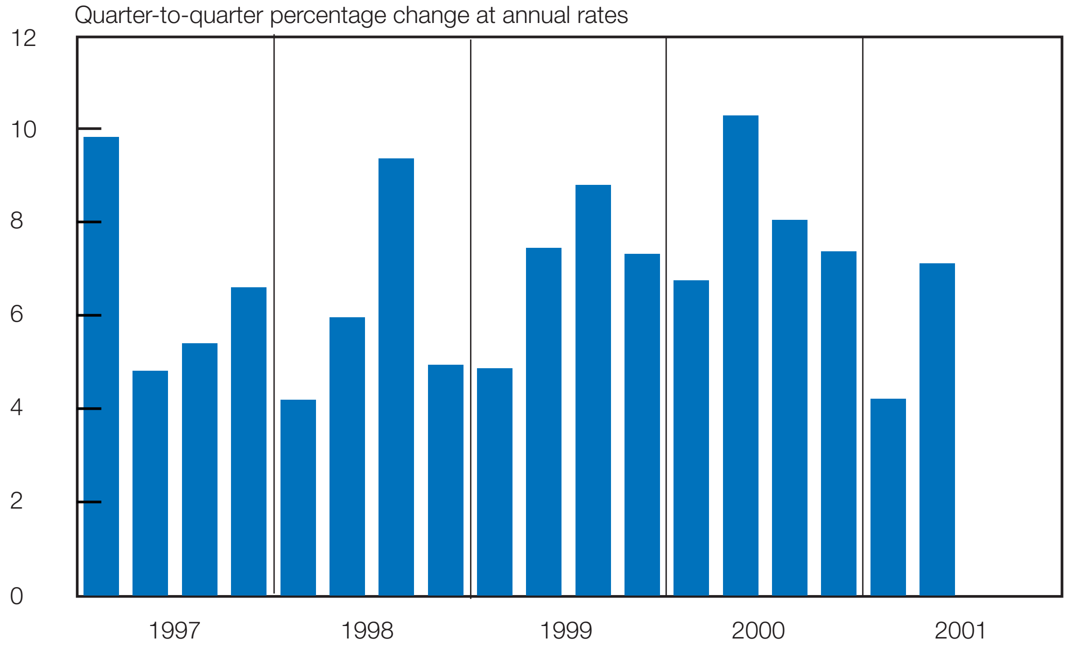
Quarter-to-quarter percentage change at annual rates

Period		Domestically produced goods	Imported goods	Overall production prices
2000:	1st qr	8,5	21,9	11,8
	2nd qr	8,8	14,4	10,0
	3rd qr	6,3	8,3	7,3
	4th qr	8,6	14,0	10,6
	Year	7,3	14,4	9,2
2001:	1st qr	7,1	14,1	8,5
	2nd qr	7,3	6,6	6,7

"Headline" inflation or the year-on-year rate of increase in the *overall consumer price index* for metropolitan areas slowed down from 7,8 per cent in February 2001 to 5,3 per cent in July. Increases in the prices of consumer services decelerated quite significantly. In the case of housing-related services, price increases moderated from a year-on-year rate of 8,1 per cent in February 2001 to 3,4 per cent in July. Housing-related services include mortgage rates, house rent and domestic workers' wages. Expressed at a seasonally adjusted and annualised rate, the rate of increase in the prices of all consumer services fell from 13,4 per cent in the first quarter of 2001 to just 4,2 per cent in the second quarter. Smaller increases in the prices of other services, apart from housing-related services, also contributed to the decline in inflation in the prices of all consumer services.

The year-on-year rate of increase in the prices of *consumer goods* fell back from 8,7 per cent in August 2000 to 5,2 per cent in July 2001. Declines in the price of food,

Prices of consumer goods excluding food



which had risen steeply in 2000, helped to bring down the inflation rate. When omitting food prices from the overall consumer price index for *goods*, the year-on-year rate of increase in the prices of non-food items rose from 6,4 per cent in April 2001 to 7,1 per cent in June but slowed down to 5,9 per cent in July. Higher increases were reported in the prices of furniture and equipment, clothing and footwear, beverages and tobacco and the running cost of transport. Measured from quarter to quarter and calculated at an annualised rate, the increase in the prices of consumer goods picked up from 4,1 per cent in the first quarter of 2001 to 7,0 per cent in the second quarter.

Consumer prices

Quarter-to-quarter percentage change at annual rates

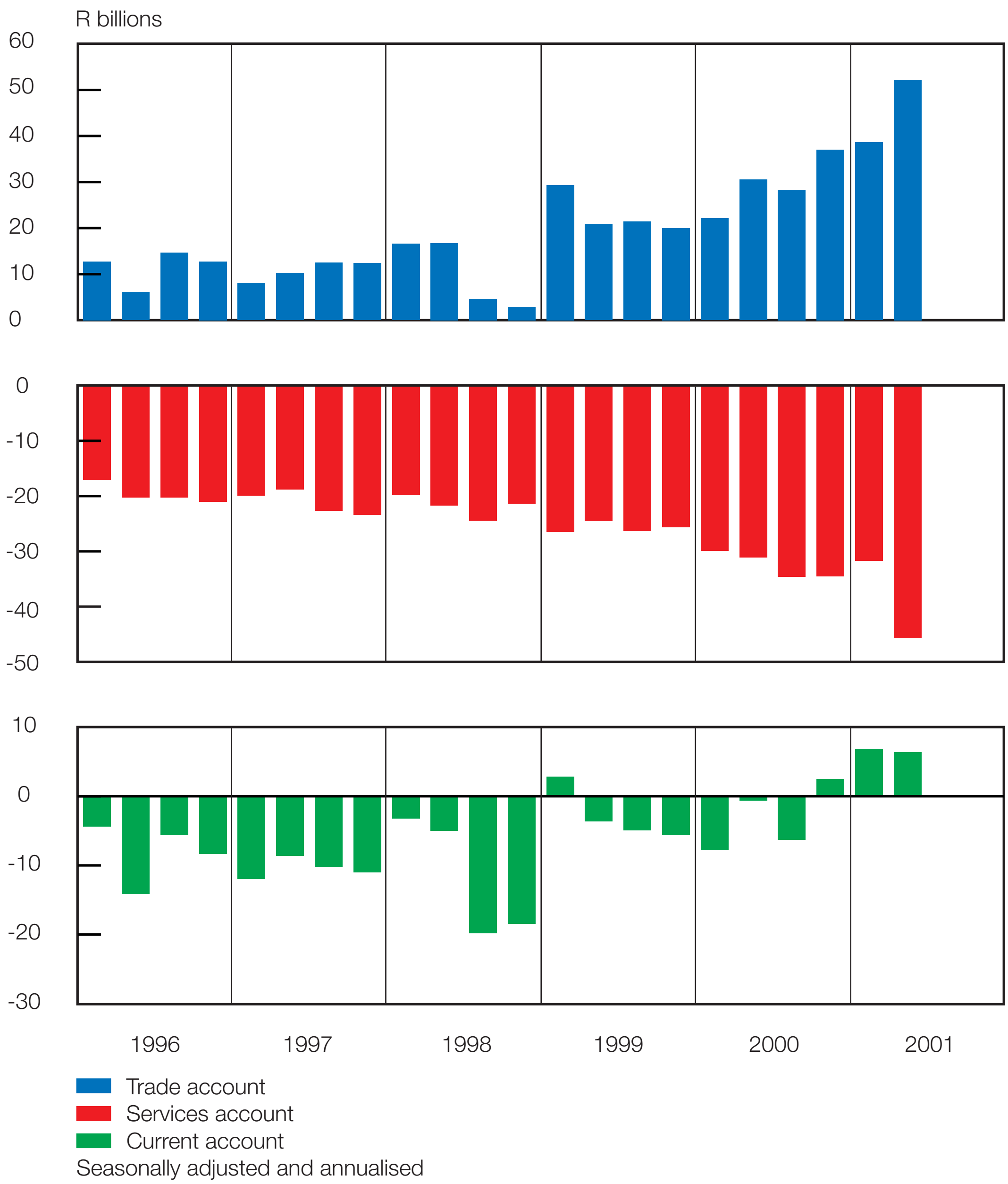
Period		Goods	Services	Overall CPI	CPIX inflation
2000:	1st qr	8,5	5,5	6,6	8,7
	2nd qr	10,6	9,3	10,7	8,8
	3rd qr	7,6	4,1	6,0	7,6
	4th qr	4,1	6,5	5,0	6,1
	Year	7,9	2,4	5,3	7,8
2001:	1st qr	4,1	13,4	7,5	7,8
	2nd qr	7,0	4,2	6,3	4,5

Foreign trade and payments

Current account

The current account of the balance of payments, which moved into a surplus in the fourth quarter of 2000, continued to perform reasonably well in the first half of 2001. Usually the balance on the trade account shrinks during economic recoveries and on occasion even falls into deficit. Although the economy is almost two years into the current recovery, the positive balance on the trade account still improved from R38,6 billion (at a seasonally adjusted and annualised rate) in the first quarter of 2001 to R52,1 billion in the second quarter.

Current account



Balance of payments on current account
Seasonally adjusted and annualised
R billions

	2000					2001	
	1st qr	2nd qr	3rd qr	4th qr	Year	1st qr	2nd qr
Merchandise exports........................	172,7	183,1	190,5	219,1	191,3	225,1	230,7
Net gold exports	27,0	26,0	28,4	27,2	27,2	26,6	29,9
Merchandise imports........................	-177,6	-178,6	-190,6	-209,3	-189,0	-213,1	-208,5
Net service, income and current transfer payments	-29,9	-31,1	-34,6	-34,5	-32,6	-31,7	-45,8
Balance on current account	**-7,8**	**-0,6**	**-6,3**	**2,5**	**-3,1**	**6,9**	**6,3**

Changing relative prices, following the depreciation of the rand since the beginning of 2000, dampened the demand for imports while stimulating exports and production in import-competing industries. This, alongside falling domestic inventories and a decline in the price of imported crude oil, contributed to the increase in the trade balance, but the deficit on the services and income account widened. Largely because of increased net dividend payments to the rest of the world, the deficit on the services and income account widened by so much that the surplus on the current account of the balance of payments shrank from a seasonally adjusted annualised value of R6,9 billion in the first quarter of 2001 to R6,3 billion in the second quarter.

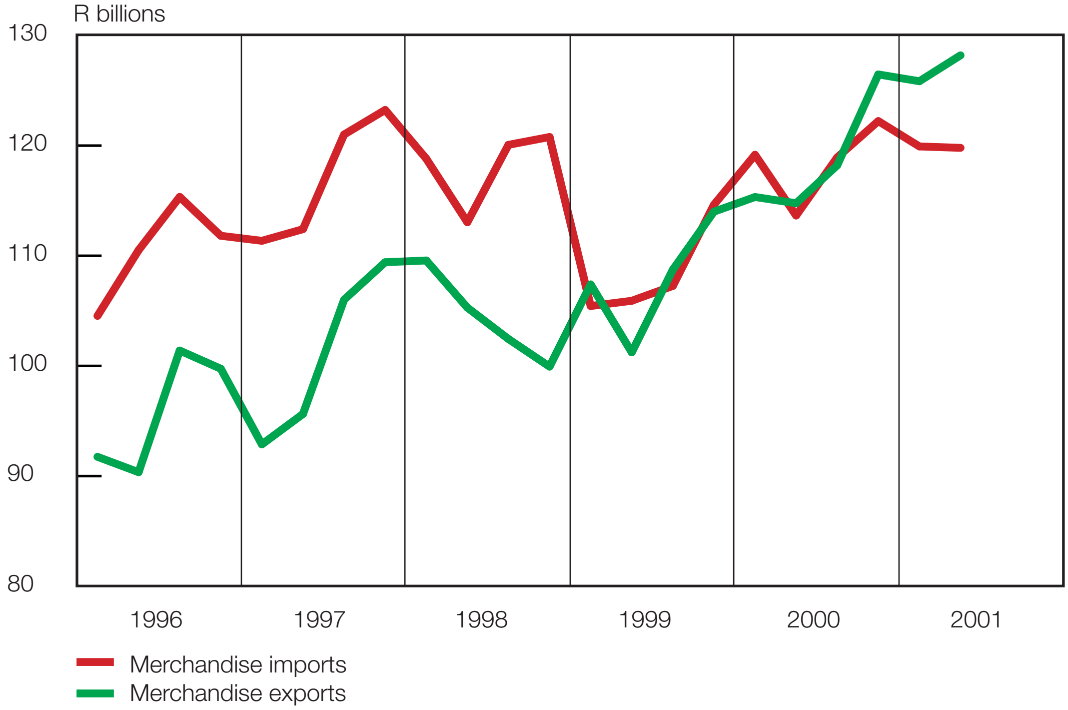
In the face of a slowing global economy, merchandise export earnings (seasonally adjusted) rose by 2½ per cent in the second quarter of 2001. Mining and mineral exports, particularly exports of platinum-group metals, contributed most to this increase. Exports of motorcars, other transport equipment, and textiles and textile articles also increased noticeably. However, exports from other subsectors of manufacturing could not escape the effects of the slowdown in the global economy, leading to a small decline in the overall value of manufactured exports from the first quarter of 2001 to the second quarter.

The international prices of commodities exported from South Africa changed minimally from the first quarter of 2001 to the second quarter. Exporters nevertheless benefited, on average, from higher prices in rands as the exchange rate has declined markedly since the beginning of 2000. Overall, the price index of merchandise exports rose by ½ per cent from the first to the second quarter of 2001, implying that the volume of merchandise exports grew by some 2 per cent in the second quarter. At an annualised rate, this is equivalent to real growth in excess of 8 per cent, demonstrating clearly that the potential benefits from the recent exchange rate depreciation were not eroded by high inflation as in the past, but that the competitiveness of South African exporters became greatly enhanced.

Large volumes of oil were imported in the second quarter of 2001. When oil is excluded from merchandise imports, the value of non-oil imports measured at constant prices fell by about 1 per cent from the first quarter of 2001 to the second quarter. This was broadly consistent with the inventory-led decline in real gross domestic expenditure. The volume of total merchandise imports including oil, declined only marginally.

Import prices fell in the second quarter of 2001, reflecting low inflation in the production prices of countries exporting to South Africa and a drop in the price of crude oil. This price decline caused the value of merchandise imports to decline by 2 per cent from R213,1 billion (seasonally adjusted and annualised) in the first quarter of 2001 to R208,5 billion in the second quarter.

Exports and imports at constant 1995 prices



The net value of gold exports improved from R26,6 billion in the first quarter of 2001 to R29,9 billion in the second quarter. Export volumes increased by 6,2 per cent in the second quarter of 2001 and the average realised rand price strengthened by 5,9 per cent. In dollar terms, the fixing price of gold per fine ounce on the London market rose by 1,5 per cent from US$264 in the first quarter of 2001 to US$268 in the second quarter.

The shortfall on the country's services and income account with the rest of the world widened considerably from the first to the second quarter of 2001. This higher deficit on the services and income 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. Investment income received from non-resident 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 annualised value of R31,7 billion in the first quarter of 2001 to R45,8 billion in the second quarter.

Financial account

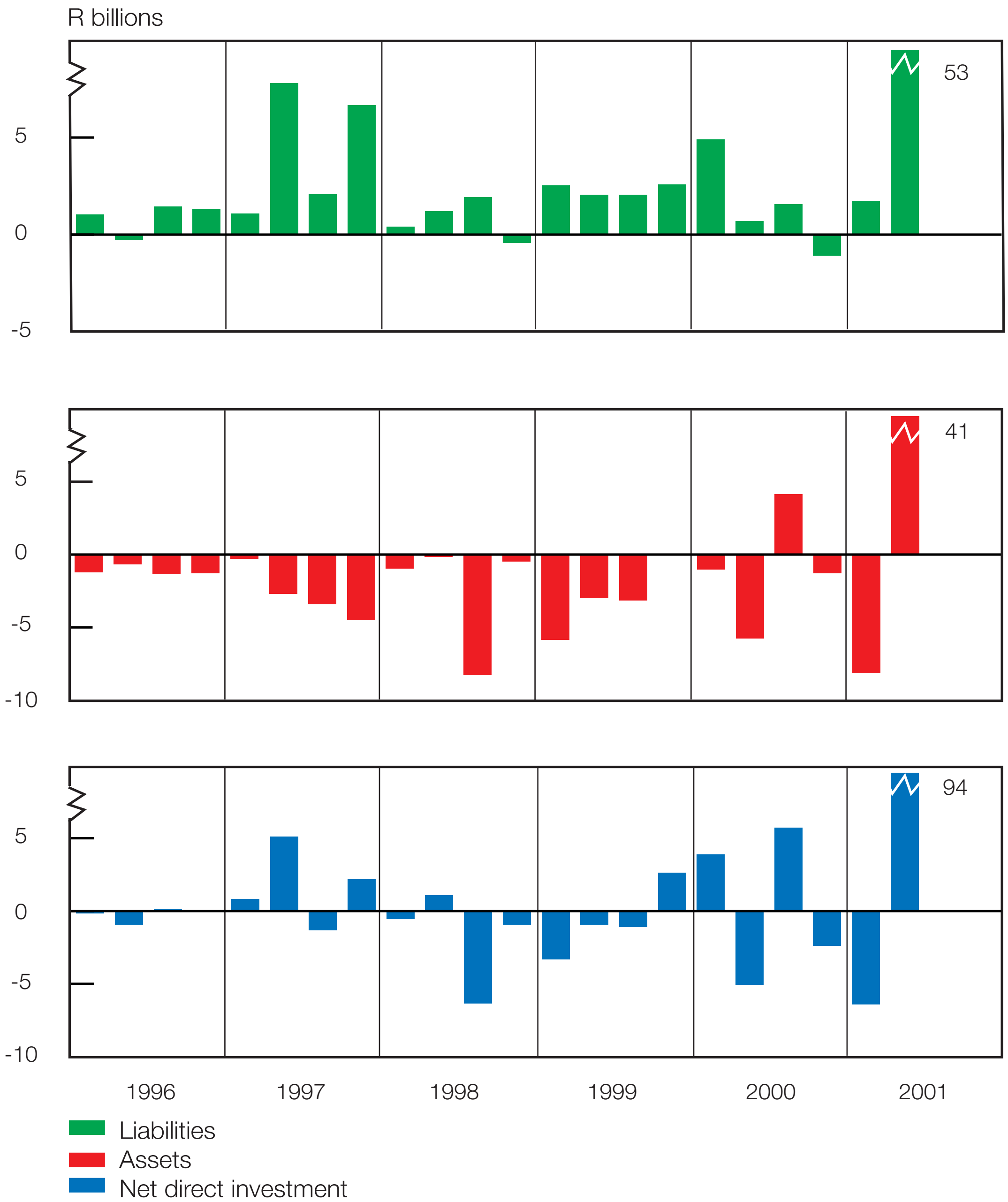
Investor sentiment towards emerging markets deteriorated once again in the second quarter of 2001, after signs of financial instability in Argentina, Brazil and Turkey. Investors apparently differentiated between emerging markets and rewarded those with sound macroeconomic fundamentals, as is evident in the case of South Africa where equity capital continued to flow into the economy via the share market. A deficit of R3,8 billion on the external financial account in the first quarter of 2001 was turned into a surplus of R5,6 billion in the second quarter. Transaction flows on the financial account were nevertheless largely dominated by the restructuring of the shareholding in the De Beers mining company.

Foreign direct investment flows into South Africa rose from just R1,7 billion in the first quarter of 2001 to R52,9 billion in the second quarter. By far the greatest share of these inflows were triggered by the buy-out of minority shareholders in the De Beers mining company as part of the restructuring of the corporate relationship between the Anglo American Corporation and De Beers.

Outward foreign direct investment changed almost equally impressively: an outflow (i.e. an accumulation of foreign assets) of R8,1 billion in the first quarter of 2001 changed to an inflow (i.e. a decline in foreign assets) of R40,9 billion in the second quarter. These inflows were largely a consequence of the cancellation of the cross-shareholding between the Anglo American Corporation, which is a non-resident company, and the De Beers mining company.

On a net basis, foreign direct investment capital to the value of R93,8 billion was recorded as flowing into South Africa in the second quarter of 2001, compared with an outflow of R6,4 billion in the previous quarter.

Direct investment



Net financial transactions not related to reserves
R billions

	2000					2001	
	1st qr	2nd qr	3rd qr	4th qr	Year	1st qr	2nd qr
Change in liabilities							
Direct investment	4,9	0,7	1,6	-1,1	6,1	1,7	52,9
Portfolio investment	6,8	-1,3	8,1	-1,8	11,8	3,5	-27,2
Other investment	1,8	7,1	5,7	-4,6	10,0	0,3	-11,3
Change in assets							
Direct investment	-1,0	-5,7	4,1	-1,3	-3,9	-8,1	40,9
Portfolio investment	-11,2	-4,3	-7,0	-3,1	-25,6	-0,2	-36,9
Other investment	-2,7	0,9	-2,7	-3,4	-7,9	-6,0	-8,0
Total financial transactions *	**4,2**	**-5,6**	**10,9**	**-1,0**	**8,5**	**-3,8**	**5,6**

* Including unrecorded transactions

A sizeable outflow of *portfolio investment capital* was recorded on account of the delisting of the De Beers mining company from the JSE Securities Exchange. In addition, foreign loans of ¥35 billion, equivalent to R2,3 billion, were redeemed by public corporations and non-resident investors reduced their holdings of fixed-interest securities listed on the Bond Exchange of South Africa. These capital outflows were partly offset by new bond issues by the national government in the European and Japanese capital markets, mobilising some R5,6 billion in capital. Throughout the second quarter, non-resident investors also remained net buyers of listed equity. The end result of these flows was that portfolio investment into South Africa changed from an inflow of R3,5 billion in the first quarter of 2001 to an outflow of R27,2 billion in the second quarter.

Outward foreign portfolio investment increased substantially in the second quarter of 2001 because of the allocation of Anglo American shares to South African residents who had previously had an equity interest in the De Beers mining company. Essentially because of these transactions, outward portfolio investment rose to R36,9 billion in the second quarter of 2001, compared with R0,2 billion in the first quarter.

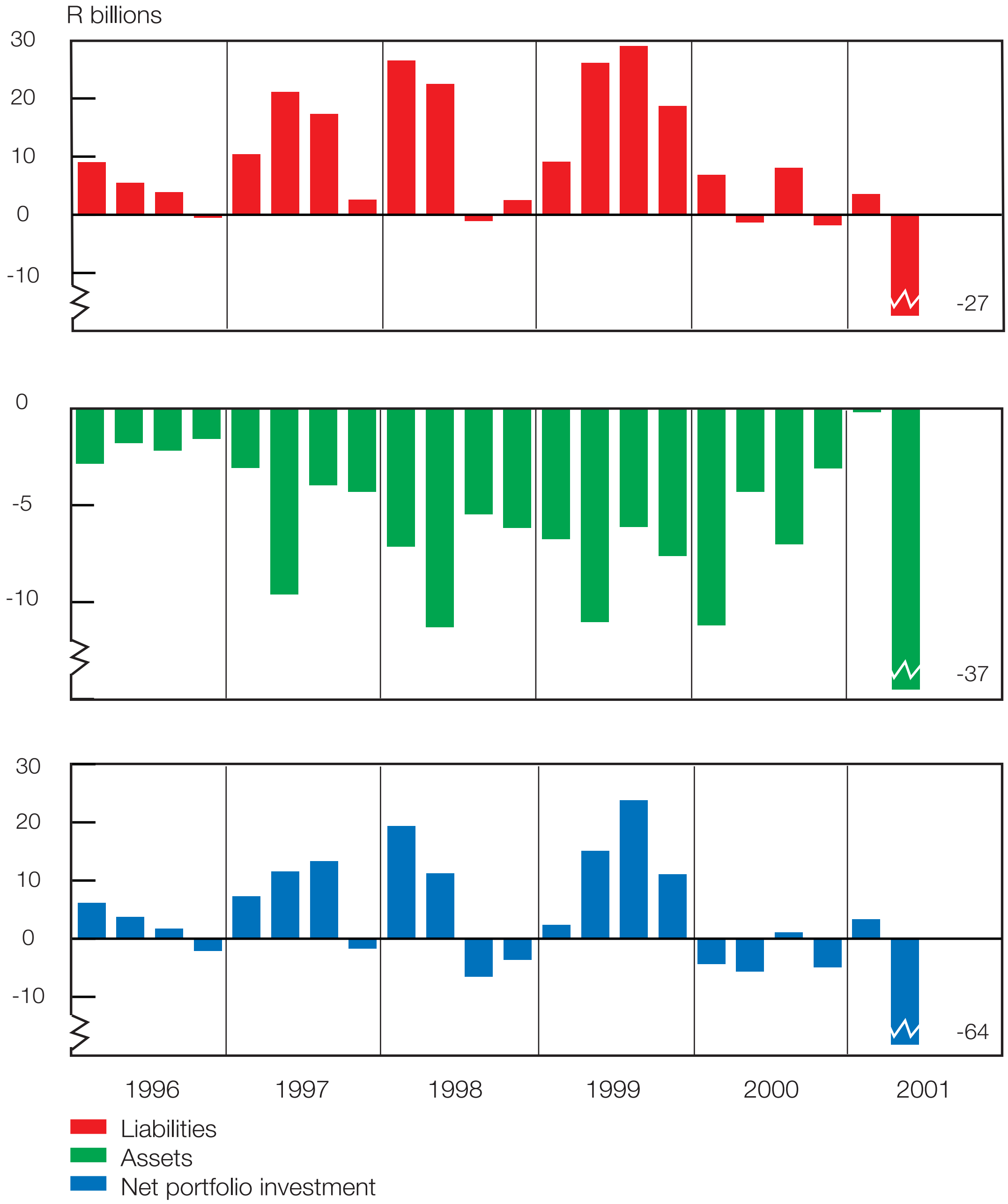
On a net basis, i.e. when inflows are offset against outflows, cross-border portfolio investment flows changed from an inflow of R3,3 billion in the first quarter of 2001 to an outflow of R64,1 billion in the second quarter.

Other foreign investment into South Africa switched from an inflow of R0,3 billion in the first quarter of 2001 to an outflow of R11,3 billion in the second quarter. Short-term loans were repaid in the second quarter of 2001, probably in response to expectations at the time of further declines in the exchange value of the rand and the decline in domestic interest rates. There was also some withdrawal of non-residents' foreign-currency deposits with South African banks.

Other investment from South Africa in the rest of the world (i.e. an outflow of capital from the economy) increased from R6,0 billion in the first quarter of 2001 to R8,0 billion in the second quarter. A contributing factor to the outflow in the second quarter of 2001 was some delay in the repatriation of export proceeds by South African exporters.

On a net basis, *other investment* in the rest of the world by South African economic agents was stepped up from R5,7 billion in the first quarter of 2001 to R19,3 billion in the second quarter.

Portfolio investment

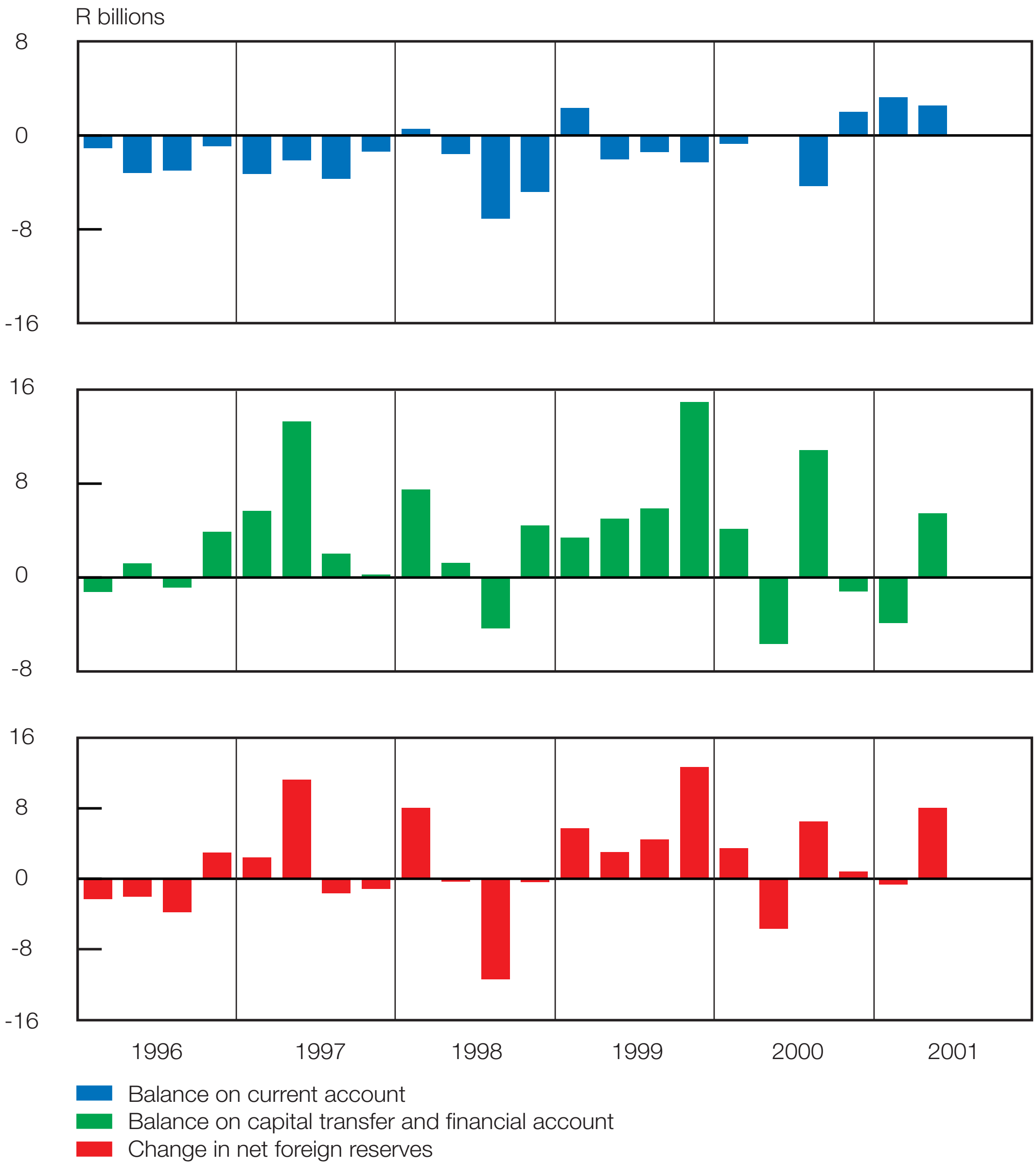


Foreign reserves

The joint effect of the surpluses on the current and financial accounts of the balance of payments was an increase in the net international reserves of the country of R8,0 billion in the second quarter of 2001. This followed an increase of only R0,6 billion in the first quarter of the year.

South Africa's gross gold and foreign-exchange reserves (i.e. international reserves before reserve-related borrowing is netted off) amounted to R96,6 billion or US$12,0 billion at the end of June 2001. Although the international reserves increased appreciably in the second quarter of 2001, the sharp rise in dividend payments to the rest of the world prevented the country's import cover from rising further. Import cover remained unchanged at about 16 weeks' worth of imports of goods and services.

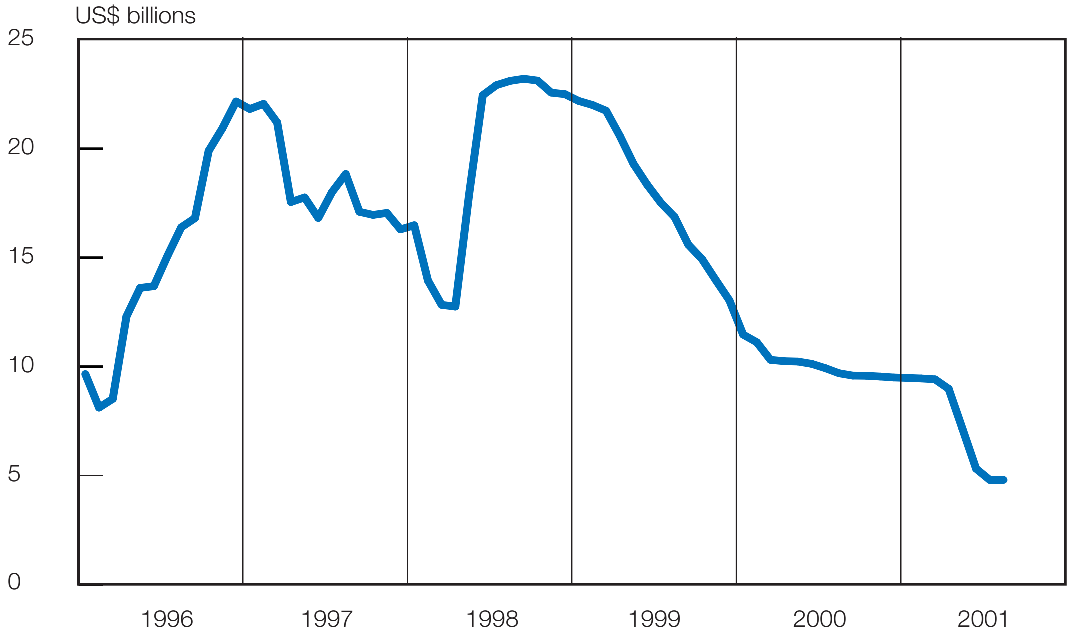
Overall balance of payments



The international reserve holdings of the Reserve Bank rose by only R0,1 billion in the second quarter of 2001 to R60,4 billion at the end of June. Mainly because of the depreciation of the exchange value of the rand, the Bank's international reserves increased to R62,8 billion at the end of August 2001. Expressed in dollars, the gross international reserves of the Bank have remained unchanged at US$7,5 billion since the end of March 2001.

Short-term credit facilities utilised by the Reserve Bank declined marginally from R20,8 billion at the end of March 2001 to R20,7 billion at the end of July. In July 2001, the Reserve Bank and the National Treasury announced the successful conclusion of a three-year syndicated loan facility to the value of US$1,5 billion. The National Treasury participated as a potential co-borrower for the credit facility. The Reserve Bank was the initial borrower, but the National Treasury reserved the right to assume the role of borrower for all or part of the loan at a later stage. The involvement of the National Treasury helped to secure the participation of investment banks, normally not seen in transactions of this nature.

Net open position in foreign currency



Oversold position of the Reserve Bank

The strong inflows of capital in the second quarter of 2001 afforded the Reserve Bank the opportunity to reduce its net oversold position in foreign currency (i.e. the Bank's oversold forward position in foreign currency reduced by its net holdings of spot international reserves) from US$9,4 billion at the end of March 2001 to US$5,3 billion at the end of June. In July 2001, when the Reserve Bank purchased the proceeds of government's bond issue in the Samurai market, the net oversold position in foreign currency declined further to US$4,8 billion. If the National Treasury does assume the role of borrower of the newly arranged syndicated loan facility, the Bank's net oversold position in foreign currency could improve further.

Exchange rates

The strong improvement in the overall balance of payments brought to an end a prolonged declining trend in the nominal effective exchange rate of the rand in the second quarter of 2001. The nominal effective exchange rate of the rand strengthened by 1,2 per cent from the end of March 2001 to the end of June, following a decline of 13,6 per cent from the end of December 1999 to the end of March 2001.

The rand again came under strong pressure in July and August, falling against the US dollar from R7,89 on 21 May 2001 to R8,41 on 28 August. Against a basket of fourteen currencies, the rand depreciated by 8,2 per cent from 29 June 2001 to 31 August. This was partly due to the crisis in Zimbabwe which resulted in fears among some participants in the foreign-exchange and securities markets that the problems of that country might spill over into South Africa. In addition, investor sentiment towards emerging markets generally deteriorated during July and August 2001 following concern about Argentina's ability to meet its foreign debt obligations. Developments elsewhere in emerging-market economies, such as Turkey and Brazil, contributed to the deterioration in investor sentiment. Domestically, rumours about the possible delay of the restructuring of shareholdings in Telkom and the protracted strike in the car manufacturing industry also added to the downward pressure on the rand.

Exchange rates of the rand
Percentage change

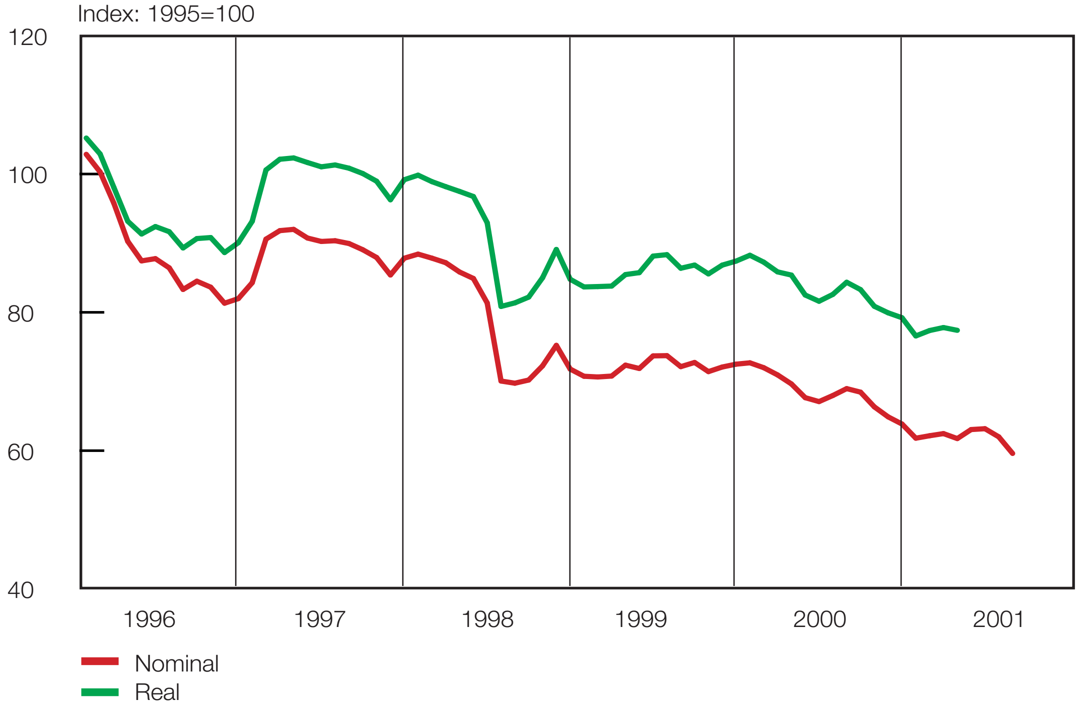
	29 Dec 2000 to 30 March 2001	30 March 2001 to 29 Jun 2001	29 Jun 2001 to 31 Aug 2001
Weighted average*	-1,3	1,2	-8,2
Euro	-0,6	3,6	-11,3
US dollar	-5,6	-0,6	-3,9
British pound	-1,4	1,0	-7,4
Japanese yen	3,1	-1,3	-8,4

* The weighted exchange-rate index consists of a basket of 14 currencies

The net average daily turnover in the domestic market for foreign currency rose from US$9,9 billion in the first quarter of 2001 to US$10,3 billion in the second quarter. The value of transactions in which non-residents participated, declined marginally from US$6,4 billion in the first quarter of 2001 to US$6,3 billion in the second quarter, lowering the level of non-resident participation from 64½ per cent in the first quarter of 2001 to 61 per cent in the second quarter.

As inflation is higher in South Africa than in its major trading-partner countries, the real effective exchange rate declined by 9½ per cent from December 1999 to December 2000, although on average it was only 3 per cent lower in 2000 than in 1999. In 2001, the weighted value of the rand declined further by 2,1 per cent from December 2000 to April 2001, reducing the average value of the real effective exchange rate of the rand by 10,9 per cent in the first four months of 2001 compared with the corresponding period in 2000. This decrease in the value of the currency strengthened the competitiveness of domestic producers in export markets and helped to sustain economic growth during a phase of global economic weakening.

Effective exchange rates of the rand



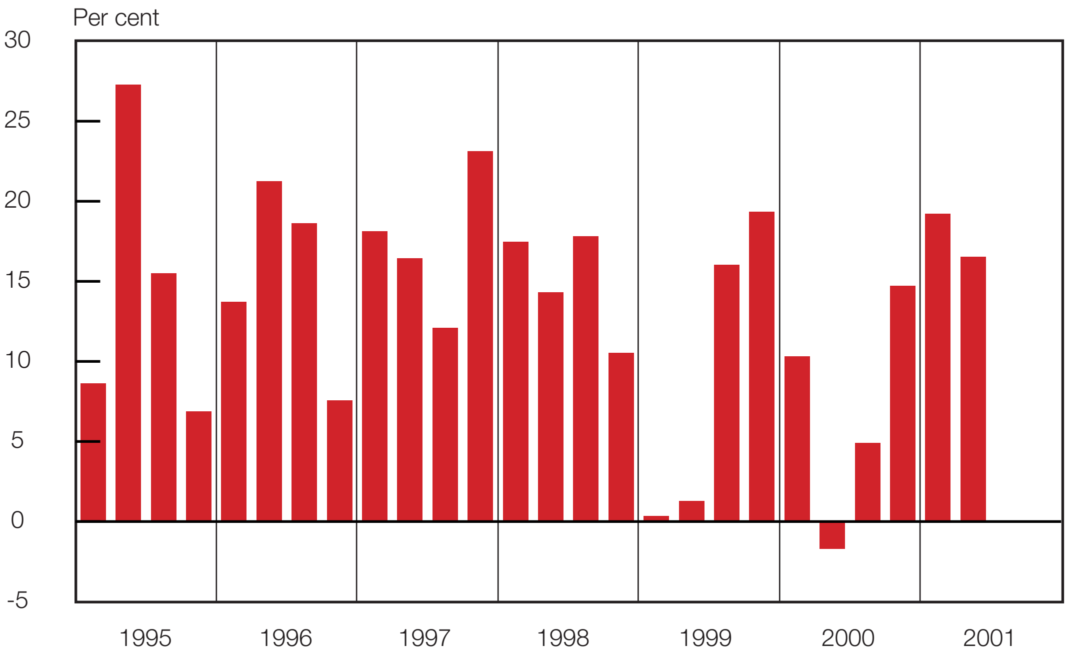
Monetary developments, interest rates and financial markets

Money supply

Growth in the broadly defined money supply (M3) has accelerated noticeably in the first half of 2001, rising from 9,2 per cent in the year to January 2001 to 13,9 per cent in June. The year-on-year growth in M3 accelerated further to 17,8 per cent in July 2001 but this was off the exceptionally low base that had been established a year earlier, and strongly influenced by an exceptional build-up of deposits with the banking system following the De Beers restructuring.

The seasonally adjusted and annualised quarter-to-quarter growth in M3 accelerated from 14,7 per cent in the fourth quarter of 2000 to 19,2 per cent in the first quarter of 2001 before slowing down to a still fairly high rate of 16,5 per cent in the second quarter.

Quarter-to-quarter growth in M3



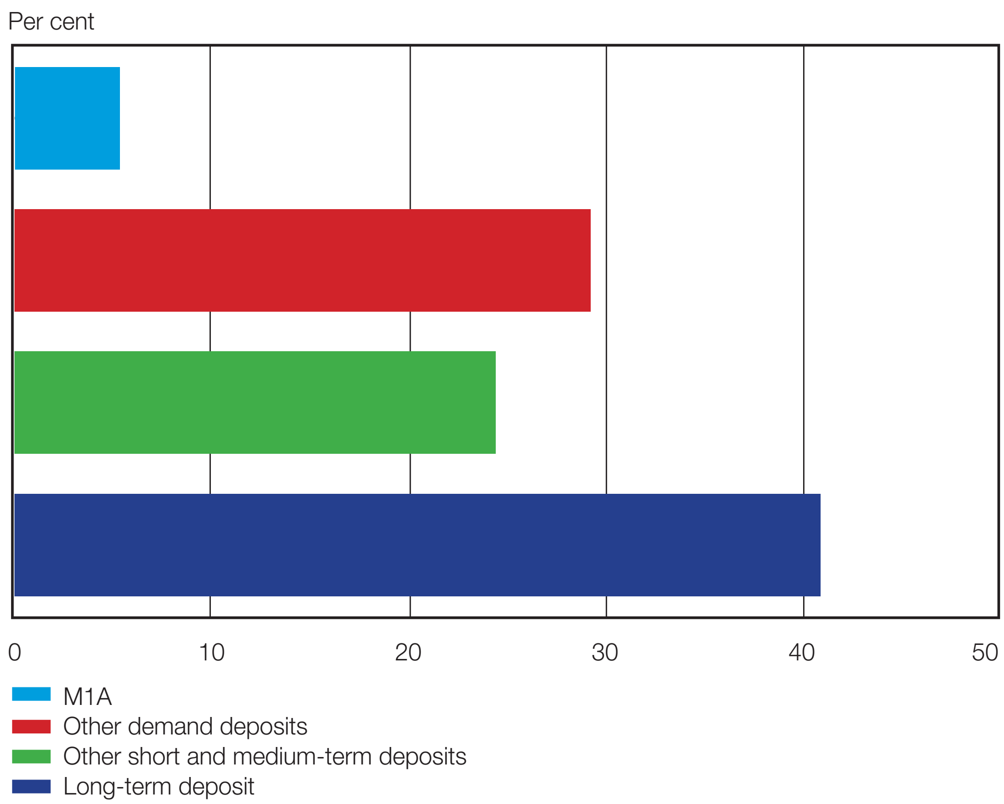
Seasonally adjusted and annualised

The rapid growth in M3 since the middle of 2000 has been prompted by a steady rise in the relative return on M3 deposits. The somewhat slower growth in the demand for money in the second quarter of 2001 was not a consequence of a decline in the return on M3 deposits but was broadly consistent with a bias towards slower growth in most output and spending aggregates in that quarter.

Since the introduction of inflation targeting as a framework for conducting monetary policy, the growth in M3 has no longer been used as an intermediate target for policy-making purposes. Nevertheless, data on money supply and credit extension continue to signal important information on potential expenditure and inflationary pressures.

The recent rapid growth in M3 is evidently not consistent with any future acceleration in domestic spending. About 41 per cent of the overall increase in M3 in the first seven months of 2001 is accounted for by increases in deposits with a maturity of six months or longer. This kind of deposit is seldom used as a temporary cache for spending power, but is more often viewed as a safe-haven asset with a fair interest yield. Since the middle of 2001 the strong demand for long-term deposits may also have arisen because of the risk of losses on equity investments in a relatively volatile share market.

Composition of growth in M3 in the first seven months of 2001



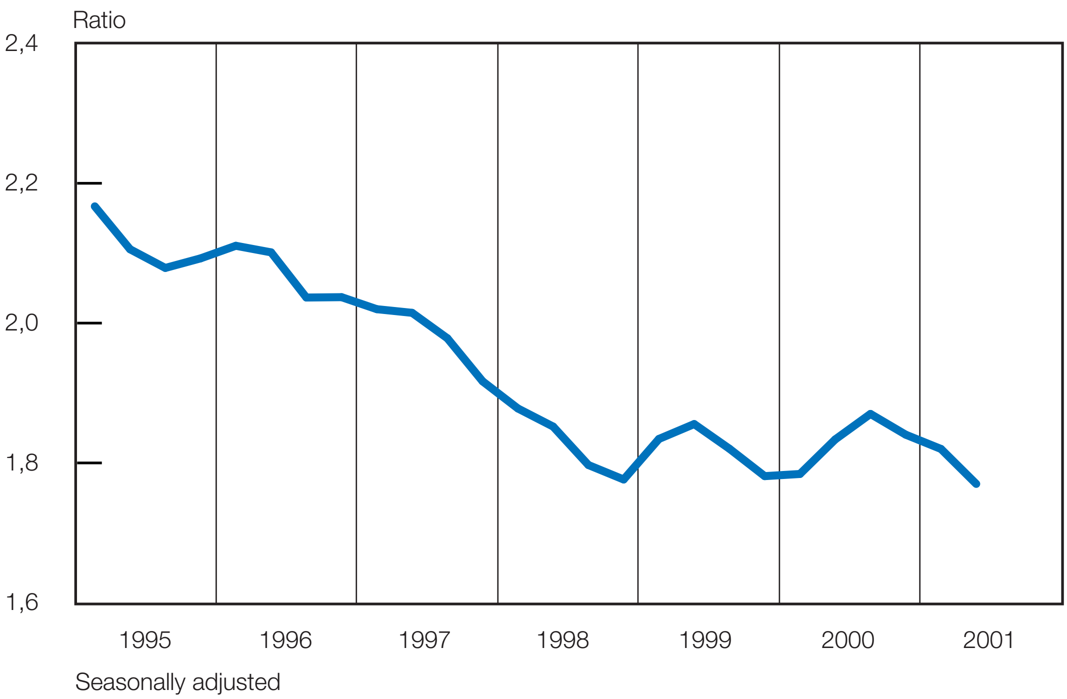
The growth over twelve months in the narrow M1A monetary aggregate (consisting of notes, coin, cheque and transmission deposits) accelerated to 15,9 per cent in July 2001. From November 2000 to May 2001 the year-on-year growth in M1A fluctuated between a negative growth rate of 1,2 per cent in November 2000 and positive growth of 3,2 per cent in April 2001. Inflation was relatively low over this period, and expectations of high inflation gradually waned, creating conditions in which the demand for cash holdings is generally low. Largely because of the high base value in December 2000 and slow growth in M1A in the first five months of 2001, this aggregate contributed only 5,3 per cent to the overall increase in M3 in the first seven months of 2001.

Twelve-month growth rates in monetary aggregates
Per cent

Period		M1A	M1	M2	M3
2000:	Aug	2,0	8,4	7,1	8,6
	Sep	7,0	14,0	7,2	8,9
	Oct	5,2	8,3	5,9	7,8
	Nov	-1,2	1,4	5,2	6,5
	Dec	1,7	3,3	6,2	7,5
2001:	Jan	0,2	7,1	7,5	9,2
	Feb	0,3	3,3	7,9	9,4
	Mar	-1,1	6,4	11,8	12,8
	Apr	3,2	7,3	11,1	12,3
	May	2,9	9,0	11,7	13,5
	Jun	6,7	8,6	11,1	13,9
	Jul	15,9	14,6	14,7	17,8

The quarter-to-quarter annualised growth in M3 exceeded the growth in nominal gross domestic product by 7,1 percentage points in the fourth quarter of 2000 and by 5,4 percentage points in the first quarter of 2001. The differential between the growth rates of these two aggregates widened to 11,5 percentage points in the second quarter of 2001. The income velocity of circulation of M3 accordingly declined from 1,84 in the fourth quarter of 2000 to 1,77 in the second quarter of 2001.

Income velocity of M3



The main counterparts of the increase of R9,7 billion in M3 in the second quarter of 2001 were increases of R12,0 billion in claims on the private sector and R11,0 billion in net foreign assets. These were partly offset by a contraction of R11,1 billion in net claims by the banking sector on the government sector and a decline of R2,2 billion in the net other assets of the monetary sector.

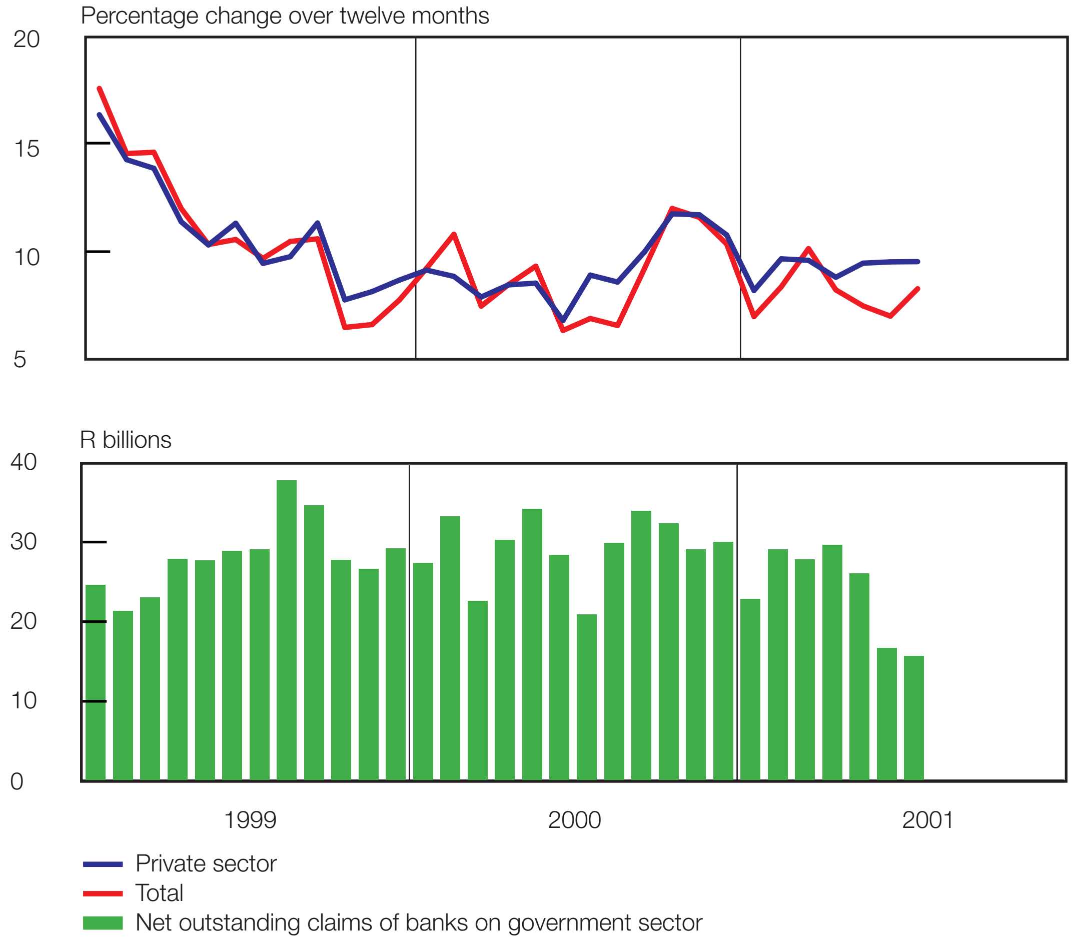
Credit extension

The quarter-to-quarter annualised growth in the total indebtedness of the non-bank private business sector, households and the government sector to the monetary sector fell from its recent peak of 18,9 per cent in the fourth quarter of 2000 to 2,7 per cent in the first quarter of 2001 and 2,5 per cent in the second quarter. Similarly, the growth in credit extension over twelve months slowed down from 10,1 per cent in March 2001 to 7,0 per cent in June and 8,3 per cent in July.

The rapid slowdown in bank credit extension in the first half of 2001 was essentially caused by a steep decline in the use of bank credit by the government sector. Net credit extended to the government sector declined by R2,2 billion in the first quarter of 2001 and by R11,1 billion in the second quarter – the latter being the largest quarterly decline ever recorded. Government deposits to the amount of R11,7 billion were accumulated in anticipation of large interest payments to be made during the third quarter, but banks increased their holdings of government securities by only R0,6 billion in the second quarter of 2001.

Credit extension to the private sector grew at a fairly even year-on-year rate in the first seven months of 2001, fluctuating in a relatively narrow range of between 8,2 per cent

Credit extension



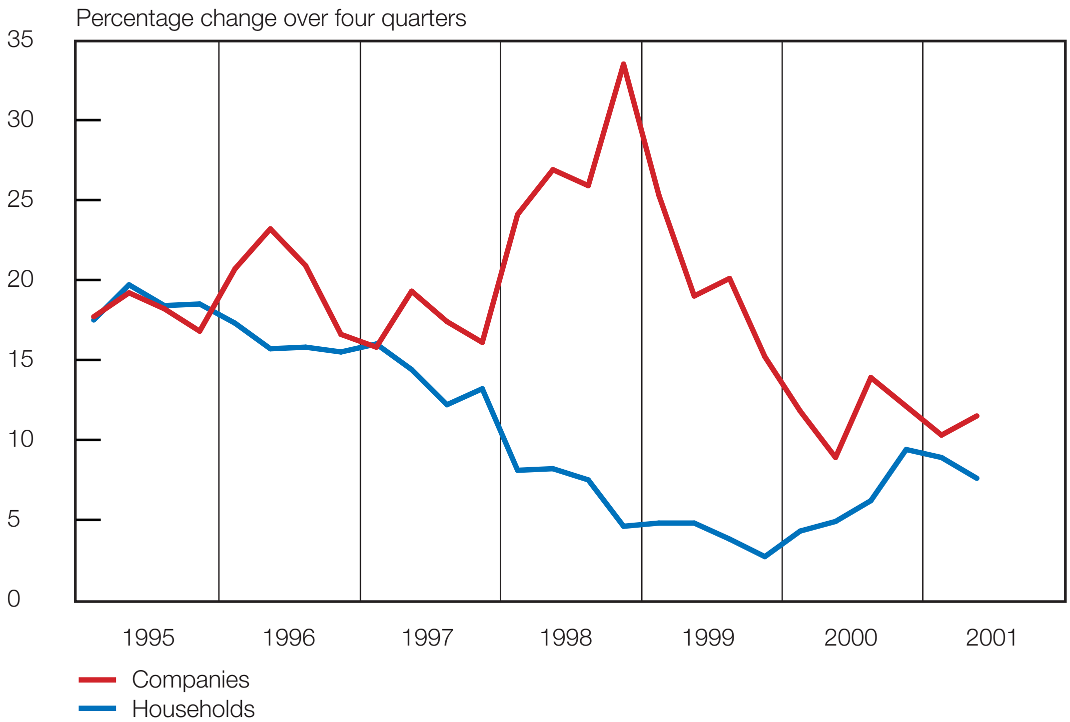
in January 2001 and 9,7 per cent in February. In each of the three months to July 2001, bank credit extended to the private sector grew at a year-on-year rate of 9,5 per cent.

Reflecting the consistently robust growth in real private-sector fixed capital formation, some R8,5 billion of the overall R12,0 billion increase in bank lending to the private sector went to the corporate sector in the second quarter of 2001. Measured over periods of twelve months, the growth in credit extended to the corporate sector accelerated from 12,1 per cent in December 2000 to 12,7 per cent in June 2001.

Some two-thirds of the overall increase in bank credit to the private sector in the second quarter of 2001 were earmarked for asset-backed lending which includes mortgage advances, leasing finance and instalment sale credit.

The rate of growth in *mortgage advances* has picked up considerably in recent months: its twelve-month growth rate accelerated from 11,3 per cent in December 2000 to 16,1 per cent in May 2001 before declining slightly to 15,5 per cent in June and 14,7 per cent in July. In addition to the strong rise in corporate fixed capital formation, the buoyancy of mortgage financing also reflected the recovery of the real-estate market. About half of the total increase in banks' claims on the private sector in the second quarter of 2001 can be attributed to mortgage advances. This solid growth lifted the share of mortgage advances in the overall stock of outstanding private-sector credit from 40,1 per cent in January 2001 to 40,4 per cent in July.

Credit extended to households and companies



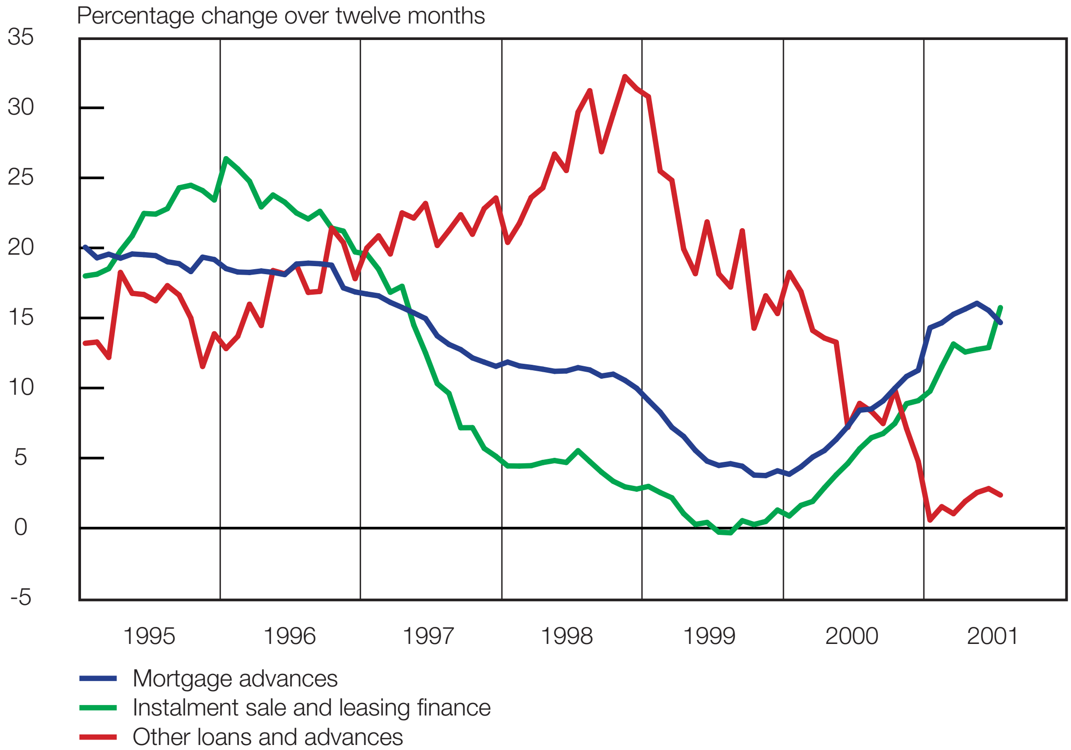
The growth over twelve months in *instalment sale credit* increased steadily from the beginning of 2000 to peak at 13,4 per cent in April 2001 before declining slightly to 12,0 per cent in June, it amounted to 13,1 per cent in July. This probably reflected reasonably strong consumer demand, but the recent signs of weaker growth were related to the slowdown in new vehicle sales during the past couple of months.

The twelve-month rate of increase in *leasing finance* accelerated from 4,2 per cent in June 2000 to 14,8 per cent in June 2001 and 22,0 per cent in July. This type of credit is mainly utilised to purchase vehicles and other capital and durable goods. The firm growth of the past year or so was probably also related to the expansion of fixed capital formation in the business sector.

Increase in credit extension to the private sector by type of credit
Year-on-year percentage change

	2000		2001	
	Dec	Mar	Jun	Jul
Mortgage advances	11,3	15,3	15,5	14,7
Instalment sale	9,0	12,9	12,1	13,1
Leasing finance	9,4	13,7	14,8	22,0
Other loans and advances	4,8	1,0	2,8	2,4
Investments	63,2	29,5	5,3	0,3
Bills discounted	36,7	18,3	25,4	80,6
Total	**10,8**	**9,6**	**9,5**	**9,5**

Credit extension to private sector by type of credit



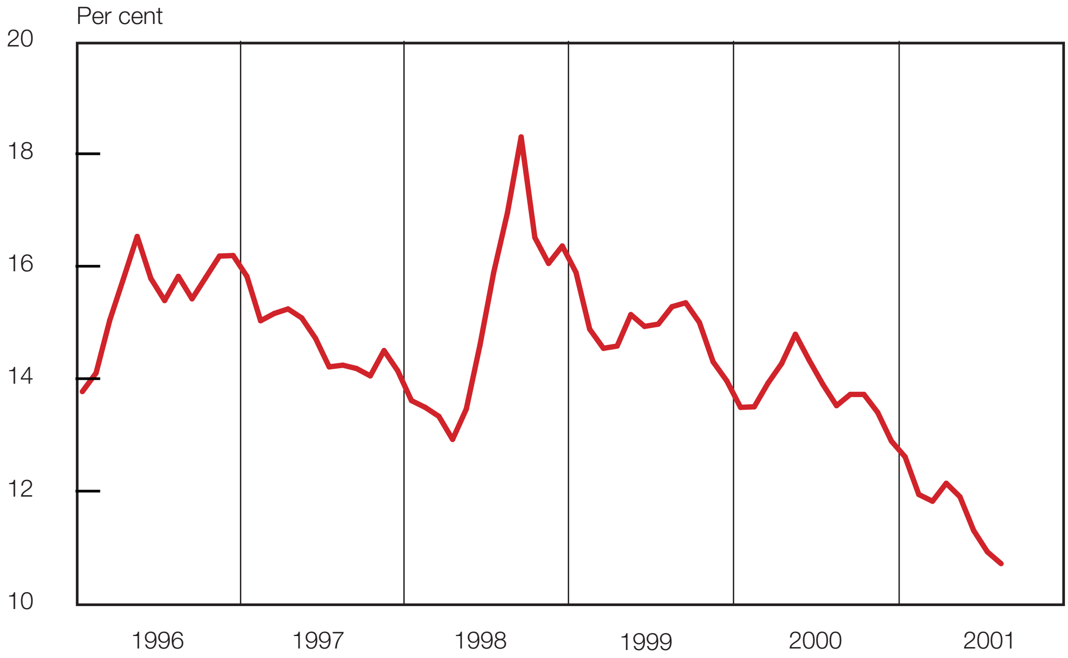
In contrast to growth in mortgage advances, twelve-month growth in *other loans and advances* fell back from rates of more than 10 per cent at the beginning of 2000 to a low of 0,6 per cent in January 2001. Since the beginning of 2001, this growth rate has increased gradually to 2,8 per cent in June and 2,4 per cent in July. The relatively weak demand for this type of credit is explained by the corporate sector's demand for funding shifting gradually away from credit intermediated through the banking system towards other forms of financing, such as the issuance of fixed-interest securities. This tendency was reinforced by the steady fall in long-term interest rates, the demand for fixed-interest securities by institutional investors and the rather lacklustre performance of the equity market. In addition, the lowering of income tax rates in 2000 strengthened households' cash flow and reduced the intensity of their distress borrowing. Because of these shifts, "other loans and advances" as a percentage of total credit extended to the private sector declined from 39,9 per cent in January 2001 to 38,6 per cent in July.

Prudent behaviour in the extension of bank credit is set to be structurally enhanced from October 2001 when new regulations requiring a 10 per cent instead of an 8 per cent capital ratio is planned to come into effect. Virtually all South African banks already observe this new requirement.

Interest rates and yields

The yields on long-term government bonds declined sharply in the first half of 2001, extending the declining trend of the past two and a half years. The fall in the level of bond yields was mainly brought about by the shrinking supply of public-sector fixed-interest securities, strong domestic investor demand for fixed-interest securities as bonds outperformed equity investments, lower short-term interest rates and lower measured and expected inflation.

Nominal yield on long-term government bonds



Bond yields increased in April 2001 when the weakening of the rand against the US dollar and high international petroleum prices fuelled concerns about inflation. The *monthly average yield on long-term government bonds* increased from 11,8 per cent in March 2001 to 12,1 per cent in April. Perceptions improved somewhat during May and then turned strongly positive when the Reserve Bank lowered its repurchase rate by 100 basis points in mid-June 2001, resulting in the monthly average yield on government bonds falling to 11,3 per cent in June and 10,9 per cent in July – its lowest level since 1983.

In July 2001 fear of spill-over effects from events in Argentina, Brazil and Turkey, together with renewed weakness in the value of the rand against the dollar, caused the daily average bond yield to rise to 11,24 per cent on 13 July. These concerns dissipated in the second half of the month and as confidence returned to the market, the daily average of bond yields declined to 10,48 per cent on 13 August. In the second half of August 2001 sentiment deteriorated again when the exchange value of the rand depreciated to new record lows and bond yields rose to 10,90 per cent on 23 August. Sentiment in the market was also negatively affected by news of the breakdown of law and order in parts of sub-Saharan Africa and wage negotiations in the South African labour market.

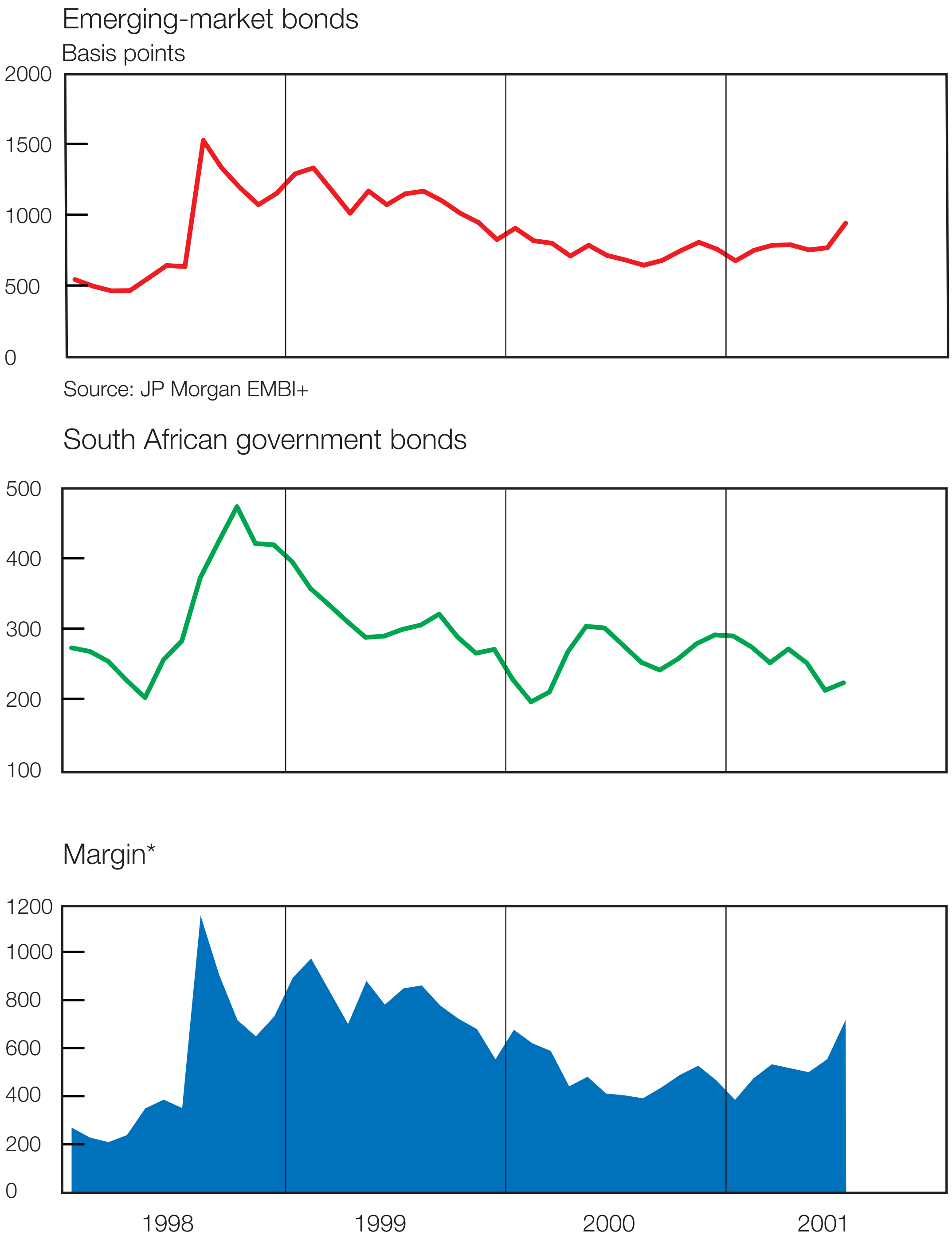
The *currency risk premium* embedded in South African bond yields (measured as the spread between the nominal yield on government bonds with an outstanding maturity of five years in the domestic market and in the United States market) declined quite impressively from an average level of 420 basis points in 2000 to 344 basis points in the first seven months of 2001, reaching its lowest level since the 1997/98 crises in emerging markets. This improvement was due to lower measured and expected inflation and to growing recognition of the certainty of medium-term financial stability in the country.

The upward movement in South Africa's *sovereign risk premium* (measured as the *spread* between long-dated South African bonds listed in the United States securities market and comparable bonds issued by the US Federal Government) from February to December 2000 changed to a downward movement in the first seven months of 2001. Most other emerging markets experienced quite a noticeable widening of their yield spreads in the first seven months of 2001. In July 2001, the yield spread of South African debt over US Treasury debt widened too, but not by nearly as much as that of other emerging markets. As a consequence, the yield margin between emerging-market debt and South African foreign-currency denominated debt widened appreciably. Relative to other emerging markets, South Africa's sovereign credit standing remained largely intact, essentially on account of sound domestic economic fundamentals which gave rise to positive perceptions by international investors.

The *inflation-adjusted yield* on long-term government bonds increased from 4,0 per cent in February and March 2001, when it was at its lowest level since 1994, to an average rate of 5,1 per cent in April and May. From June 2001, the sharp decline in nominal yields lowered the real bond yield to 4,6 per cent in June and 4,2 per cent in July.

The slope of the *yield curve* has flattened significantly since bond yields peaked for 2000 on 10 May. More recently, the upward-sloping yield curve has shifted downwards over its entire maturity spectrum since 23 April 2001 when concerns about inflation abated and the Reserve Bank lowered its rate on short-term repurchase transactions. During the period from late April 2001 to the end of August the downward drift in the yield curve was interrupted by short-lived reversals in yields at the long end, partly because of exogenous factors such as developments in other emerging markets and changes in the exchange rate of the rand. Still, the *yield-differential* between short- and long-dated bonds of 143 basis points at the end of August 2001 was slightly less than the differential of 153 basis points on 23 April 2001.

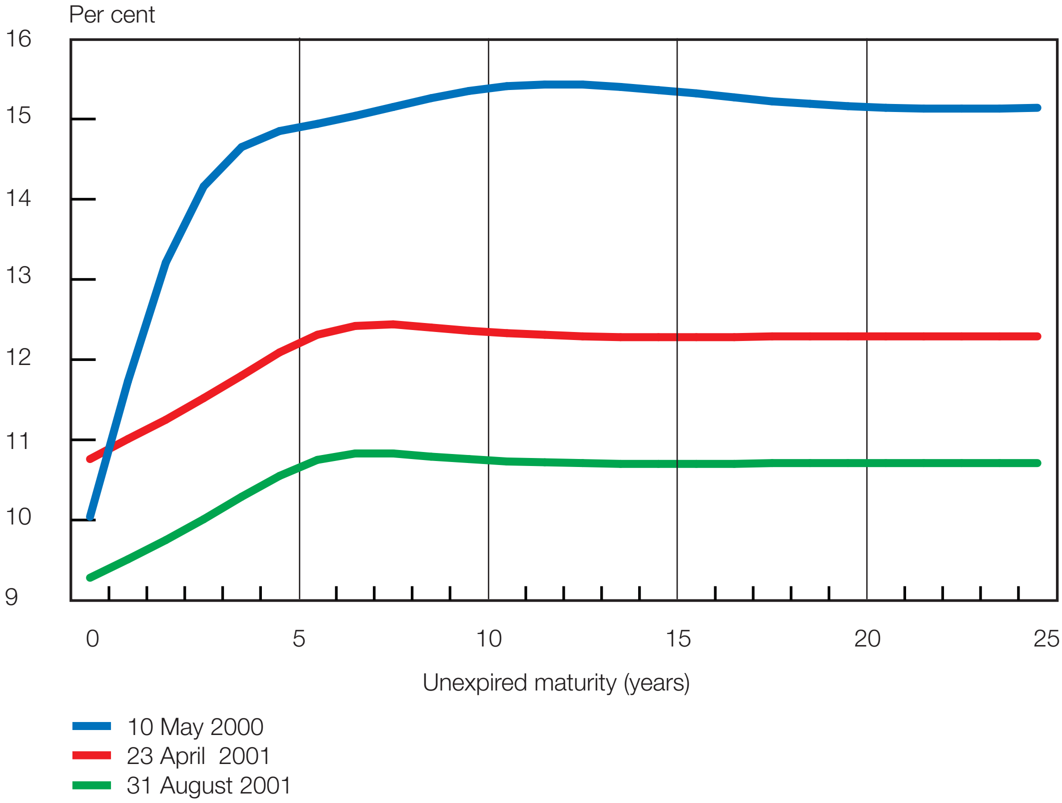
Sovereign risk premiums



* Margin between emerging market bonds and South African government bonds

The Reserve Bank's official rate on repurchase transactions has been kept fairly stable over the past twenty months. Two rate adjustments in 2000 – a downward adjustment of 25 basis points in January 2000 that was reversed in October – were followed by a reduction of 100 basis points in June 2001. The one-percentage-point decline in the repurchase rate in June 2001 was preceded by a small temporary increase in the repurchase rate to above 12 per cent. This temporary increase was a result of some banks tendering at rates slightly higher than 12 per cent because they were uncertain about the timing of money flows following the De Beers/Anglo

Yield curves



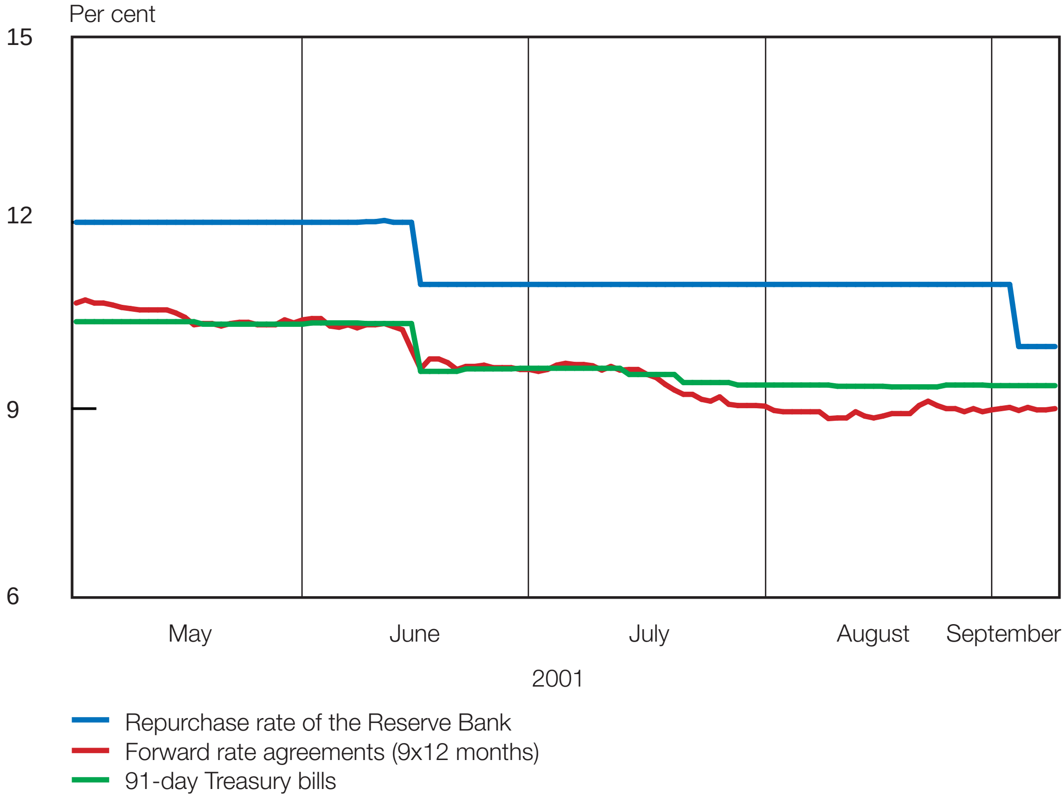
American transaction. The Reserve Bank assisted the return of the repurchase rate to 12 per cent by overproviding in the banks' liquidity needs by R20 million on 11 June 2001 and R100 million on 12 June.

Other money-market rates broadly followed the movements in the repurchase rate and declined by about 75 basis points in the wake of the June reduction. For instance, the rate on 91-day Treasury bills declined by 77 basis points to 9,60 per cent on 15 June 2001. Private banks reduced their call rate on interbank funds by 75 basis points to 8,75 per cent and a little later by a further 25 basis points to 8,50 per cent. These second-round rate reductions were echoed in the tender rate on 91-day Treasury bills which receded further from 9,65 per cent on 6 July 2001 to 9,42 per cent on 20 July 2001.

The expectations-sensitive rate on 9x12 month forward rate agreements (FRAs) declined by 31 basis points to 9,64 per cent on 15 June 2001, signalling expectations of lower inflation and greater certainty that the inflation target of 3 to 6 per cent would be achieved in 2002. Turbulence in the foreign-exchange market caused the FRA rate to edge higher by 10 basis points from 9,63 per cent on 3 July 2001 to 9,73 per cent on 5 July. When the turbulence in the foreign-exchange market calmed down and fears of spill-over effects from other emerging markets subsided, the FRA rate fell back again and was trading at 8,95 per cent at the end of August 2001.

Other *lending and deposit rates* broadly followed the reduction in the Reserve Bank's repurchase rate in June 2001. Private-sector banks lowered their prime overdraft rate at first by only 75 basis points in June and later by a further 25 basis points in July. They similarly lowered the *predominant rate on mortgage loans* in two steps from 14,5 per cent, where it had been since February 2000, to 13,75 per cent in June 2001 and 13,50 per cent in July – its lowest level since February 1988. The

Money-market interest rates



predominant rate on twelve-month fixed deposits was lowered from 9,5 per cent in May 2001 to 8,5 per cent in June.

Money market

Money-market conditions eased somewhat during the first two months of 2001 but tightened in the following months. The average daily liquidity requirement of the private-sector banks increased to R11 billion in April but then decreased marginally to R10,7 billion in May and hovered around the R10,4 billion mark in June, July and August.

The relatively high liquidity requirement of the private-sector banks was influenced strongly by Reserve Bank interventions in the money market. These interventions ensured an appropriate level of dependence on central bank funding which enabled the Reserve Bank to influence market interest rate movements. The Bank's interventions also neutralised liquidity injections stemming from losses on forward foreign-exchange transactions and, at times, increases in the Bank's net foreign assets.

In order to drain liquidity from the market, the Bank relied quite heavily on currency swaps, which involve the selling of foreign exchange in the spot market and simultaneously buying in the forward market, coupled with a foreign currency deposit at the Bank. The outstanding amount of these swap transactions was raised from R21,9 billion at the end of March 2001 to R25,6 billion at the end of July. During August 2001, the outstanding amount of these deposit-linked swap transactions was reduced to R13,2 billion at the end of the month. This neutralised the potential liquidity injection of offshore borrowing by the Bank and the delivery of foreign currency under forward contracts against payment in rands. In the process the Bank's net open position in foreign currency was also left unaffected, but the net foreign assets of the Bank were reduced.

Other measures applied by the Bank to keep the money market in a relatively tight situation included an increase in the outstanding amount of reverse repurchase transactions in government securities with private-sector parties from R5,4 billion at the end of March 2001 to R5,9 billion at the end of August. These transactions were reinforced by an increase in the outstanding amount of Reserve Bank debentures from R3,7 billion at the end of March 2001 to R5,0 billion at the end of July and R4,9 billion at the end of August. Liquidity conditions also became tighter during June and July 2001 due to an increase in the amount of notes and coin in circulation outside the Reserve Bank.

The repurchase-based refinancing system in the money market which was introduced in March 1998 has worked reasonably well over the past three and a half years, but a number of shortcomings have become apparent. Participation in the daily repo auction has been limited to a few banks, money-market rates have been relatively unresponsive to changes in liquidity conditions, and the development of the interbank market was not promoted by the system.

The Reserve Bank has conducted comprehensive research on ways to overcome these shortcomings. After extensive consultations with the South African banking sector, experts from a number of other central banks, the Bank for International Settlements and the International Monetary Fund it was decided that some modifications would be made to the current system. The changes to the Bank's operational procedures were announced by the Governor of the South African Reserve Bank on 28 August 2001 for implementation on 5 September and include the following:

- A one-off adjustment to the margin between the repurchase rate of the Reserve Bank and the interbank call rate was made by lowering the repurchase rate by 100 basis points to 10 per cent.
- The Reserve Bank now calculates a South African Overnight Index Average (SAONIA) on a daily basis to serve as a benchmark for money-market interest rates.
- The rate on repurchase transactions is now fixed by the Reserve Bank.
- The Reserve Bank no longer announces the estimated liquidity requirement prior to auctions for repurchase transactions. This change was intended to create an incentive for banks to square off in the interbank market.
- The daily repurchase auction was replaced by a weekly auction with a seven-day maturity.
- To enable banks to square off their positions, the Reserve Bank, at its discretion, now conducts daily final or supplementary repurchase auctions. Supplementary auctions at the prevailing repurchase rate are conducted when the Bank is satisfied with the changes in interbank rates. Final auctions at rates of 1,50 percentage points below or above the prevailing repurchase rate will be conducted when the Bank wants to influence the interbank rates.
- For purposes of calculating the minimum reserve balance to be held in an account with the Reserve Bank, the amount of vault cash that qualifies as a reduction of this balance is now limited to 75 per cent of the total amount of vault cash held. This reduction will be reduced further by 25 percentage points per year over a three-year period.

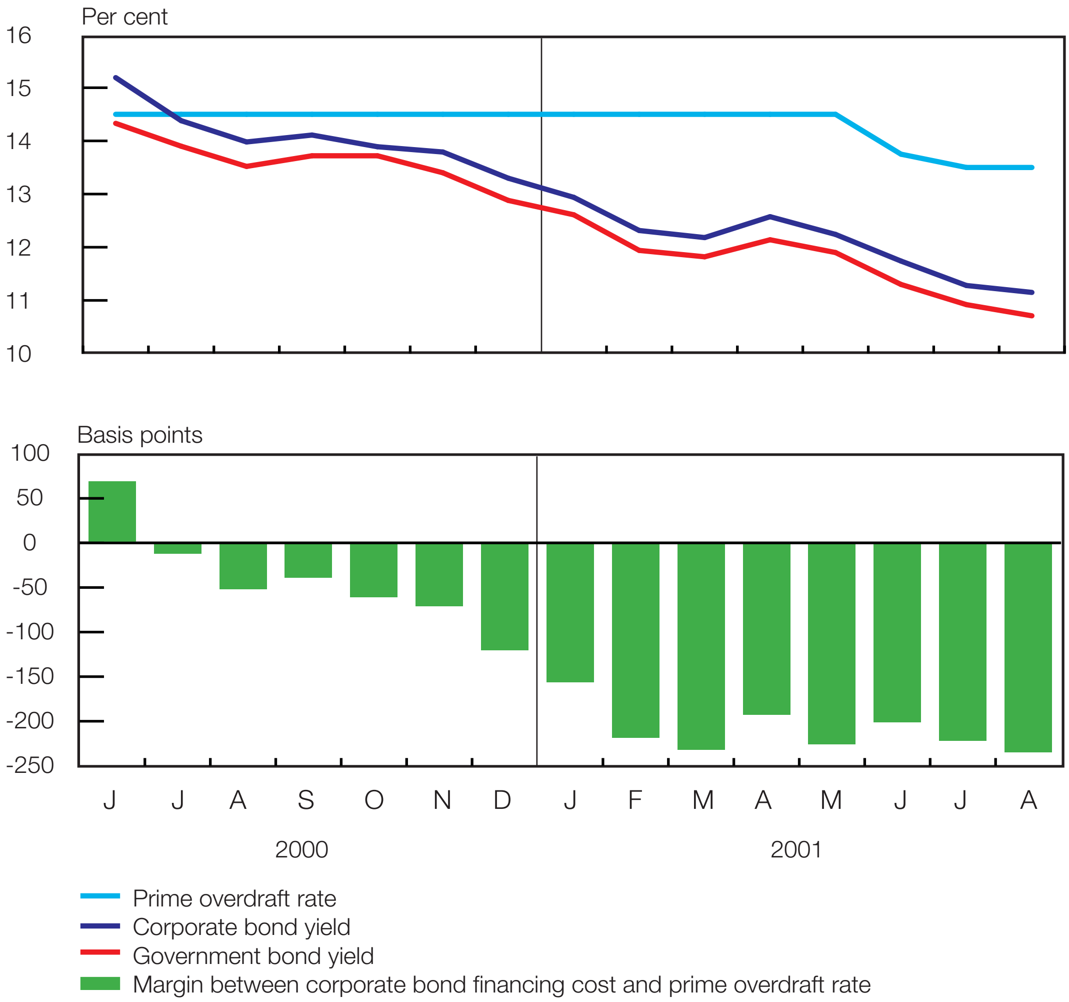
Bond market

Funding in the *primary corporate bond market* is gaining in popularity as a viable alternative to both bank lending and the issuance of share capital. The fledgling market in corporate securitised debt offers opportunities for investors who are searching for attractive yields at a time when the supply of public-sector debt is dwindling, and for borrowers who can mobilise funds at increasingly competitive rates.

Along with the decline in yields on public-sector debt securities, the cost of finance in the corporate bond market (measured as the average yield on seven private-sector issues listed on the Bond Exchange of South Africa) declined to well below the prime overdraft rate of banks (the benchmark cost of bank lending). The growing liquidity of the traded corporate bond market also influenced *corporate credit risk*. The outstanding nominal value of private-sector loan stock listed on the Bond Exchange of South Africa (excluding "stripped" bonds) increased almost fourfold from R3,8 billion in December 1999 to R13,7 billion in July 2001.

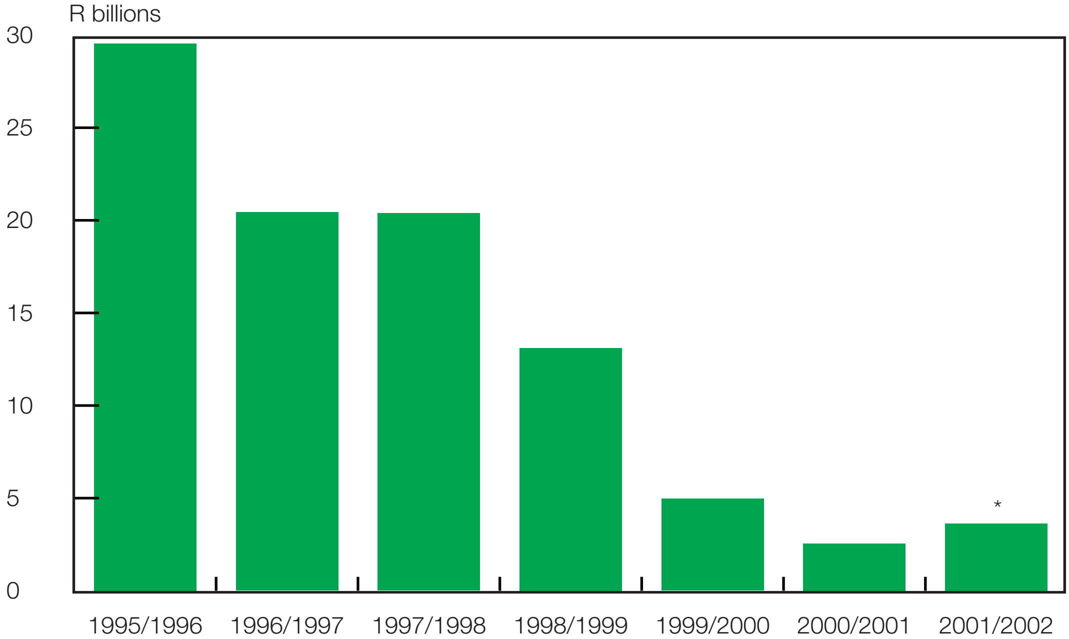
Though activity in the corporate bond market is picking up, the *supply of new debt* in the domestic primary market for public-sector fixed-interest securities is declining. The net issue of bonds by public-sector borrowers fell to R2,5 billion in fiscal

Financing cost



2000/01 and amounted to only R1,2 billion in the first half of 2001 compared with R3,9 billion in the first half of 2000.

Net borrowing by the public sector in the domestic bond market



* April to June 2001

In financing public-sector borrowing needs, funding in the domestic market was to a greater extent replaced by borrowing in the *international markets.* The national government capitalised on the country's favourable credit standing and raised some R9,5 billion in the international markets from April to July 2001, compared with R1,9 billion in the whole of fiscal 2000/01. Other domestic public-sector borrowers, however, have steered clear of the international bond market since their last issue at the end of fiscal 1999/2000, probably because of uncertainties about future movements in the exchange rate of the rand.

In contrast to the interest shown by foreign investors in the market for South African foreign-currency denominated debt, the weakening of the exchange rate of the rand tainted the market for *rand-denominated fixed-interest investments.* Redemptions of rand-denominated bonds in the *eurorand market* by non-resident borrowers in 2000 exceeded new borrowing by R3,0 billion and by R0,4 billion in the first eight months of 2001. South African public-sector borrowers have made no new issues of rand-denominated bonds in the eurobond market since the last issue in March 1999.

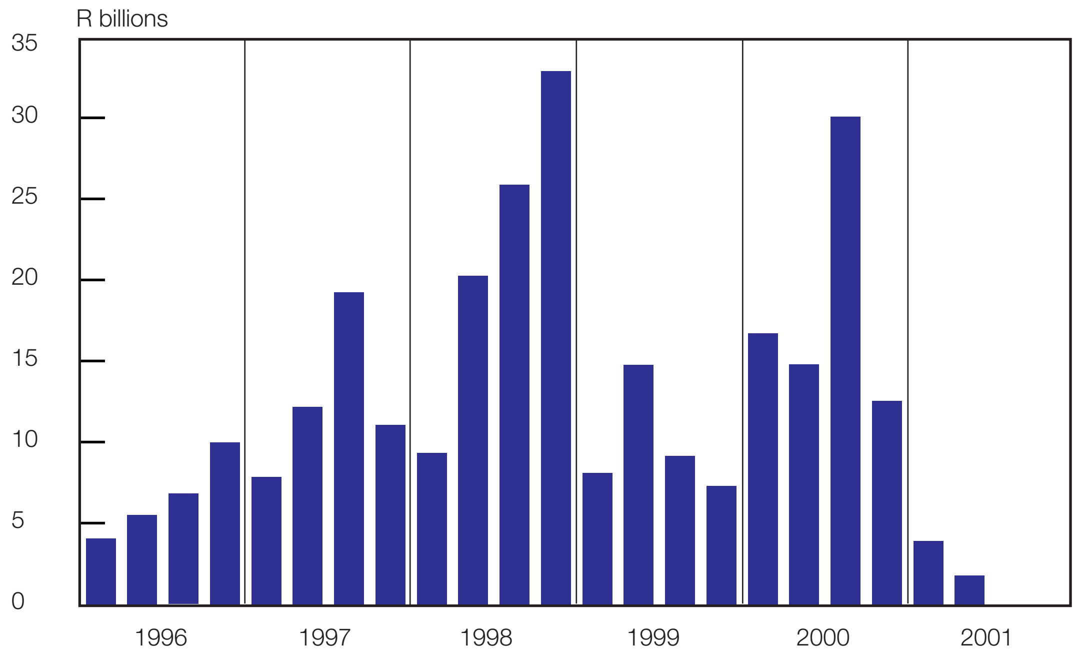
Participation by non-resident investors in the domestic secondary bond market was strongly influenced by concerns that crises in other emerging markets might spill over into South Africa and by the perennial weakness of the rand. These two factors were probably the main deterrents that prompted non-resident investors to sell bonds, on a net basis, during the current bull market and to forfeit the opportunity for significant capital gains. Net sales of bonds by non-residents, which have been prevalent since the beginning of 2000, continued into 2001 but tapered off from net sales worth R5,8 billion in the first quarter of the year to R2,1 billion in the second quarter. In July and August 2001 bonds to the net value of R0,5 billion were sold by non-residents.

The strong rally in the *secondary bond market* was driven mainly by domestic institutions which showed a clear preference for investing in bonds rather than under-performing equities. An unprecedentedly high turnover of R10,5 trillion was recorded in 2000, followed by R7,9 trillion in the first eight months of 2001 – 10 per cent more than in the first eight months of 2000. A quarterly record turnover of R2,9 trillion was reached in the second quarter of 2001 and a monthly record of R1,2 trillion in July 2001. Bonds to the value of R1,1 trillion were traded in August 2001.

Share market

Capital raised in the *primary share market* by companies listed on the JSE Securities Exchange fell from R30,0 billion in the third quarter of 2000 to just R1,8 billion in the second quarter of 2001. In the first seven months of 2001 capital worth R7,7 billion was raised, compared with R45,9 billion in the corresponding period in 2000. Uncertainties created by the volatility of share prices and the prospect of weaker global economic growth probably featured prominently in the decision making of companies.

Capital raised in the primary share market



Trading in the *secondary share market* nevertheless remained lively. Volatile price movements presented many opportunities for speculative trading which were supplemented by increases in trading ahead of major corporate restructurings. The quarterly value of shares traded increased from R147 billion in the first quarter of 2001 to R154 billion in the second quarter, fractionally below the quarterly record turnover of R155 billion set in the first quarter of 2000. Monthly turnover peaked at R57 billion in May 2001 when the cross-shareholding between De Beers and Anglo American was terminated and De Beers was delisted from the JSE Securities Exchange. Shares to a monthly average value of R48 billion were traded in July and August 2001.

The share market was underpinned in 2001 by stronger demand from non-resident investors than in 2000. In the first eight months of 2001, non-residents were net buyers of shares worth R20,3 billion on the JSE Securities Exchange. This compares with a total of R17,4 billion in the whole of 2000, but is still far below the net purchases of shares worth R40,6 billion in 1999. During 2000 investor sentiment towards the JSE Securities Exchange had been seriously impaired by problems in Zimbabwe and other conflicts in sub-Saharan Africa.

Share prices

The *monthly average price level of all classes of shares* rose by 7,7 per cent from December 2000 to August 2001. Although weakness in stock markets around the world has generally dampened sentiment, lower inflation, declining interest rates and the easing of monetary policy have underpinned the market, with the exception of information technology companies. Nevertheless, sentiment shifted quite frequently during the first eight months of 2001. For example, the monthly average of the all-share price index rose by 8,5 per cent from a low in April 2001 to a record high in June but fell back by 5,0 per cent in the two months to August. On a daily basis the closing level of the all-share price index fell by 6,1 per cent between 21 May 2001 and the end of August when it was still about 26,1 per cent higher than the low point recorded in May 2000.

The prices of *information technology companies* fell by 64,3 per cent from December 2000 to August 2001, reflecting broadly similar price movements in share markets around the world. By contrast, the gold sector, which fell 23 per cent in 2000, regained all its lost ground by rising, on balance, by 51,3 per cent from November 2000 to August 2001. Despite a decline of 10,3 per cent from May to August 2001, resource-based counters climbed by 21,6 per cent from December 2000 to August 2001.

Judged in terms of *price-earnings ratio,* share prices are fairly low by historical standards. The price-earnings ratio in the first eight months of 2001 approached lows last encountered during the emerging-markets crises of 1998 and after the end of the Gulf War in 1991. The price-earnings ratio of shares listed on the JSE Securities Exchange fell from 14,2 in February 2001 to 11,5 in August. Mirroring the movement in the price-earnings ratio, the monthly average dividend yield on all classes of shares increased from 2,5 per cent in January 2001 to 3,0 per cent in August. The relatively low level of share prices and the improvement in dividend yields may encourage investors to adjust their portfolios by increasing the equity content relative to the fixed-interest component.

Market for derivatives

Price movements and buoyant trading activity in the underlying securities markets continued to underpin lively trading in the *formal market for derivative products* in the first eight months of 2001.

Trading in the Financial Derivatives Division of the JSE Securities Exchange, formerly the SAFEX, was concentrated in *equity-related derivative products* such as *index and individual equity futures and options on such futures contracts.* These products accounted for an average of about 99 per cent of the overall *value* and *number* of trades in financial derivative instruments in the first eight months of 2001. The combined *number* of equity-related derivative contracts traded, reached a record high of 8,3 million contracts in the first quarter of 2001 before receding to 7,6 million in the second quarter. Trading in these contracts subsequently increased from a monthly average of 2,5 million in the second quarter of 2001 to 2,7 million in July and 2,8 million in August. The *number of option contracts* exceeded the number of futures contracts from the second quarter of 2000.

Growth on the JSE Securities Exchange in the *warrants market,* a complementary product to equity options, was even more substantial. The number of warrants traded increased from 5,0 billion in the first quarter of 2001 to a new record of 5,8 billion in the second quarter. Trading subsequently increased from a monthly average of 1,9 billion contracts in the second quarter of 2001 to 2,5 billion in July and 2,6 billion in August.

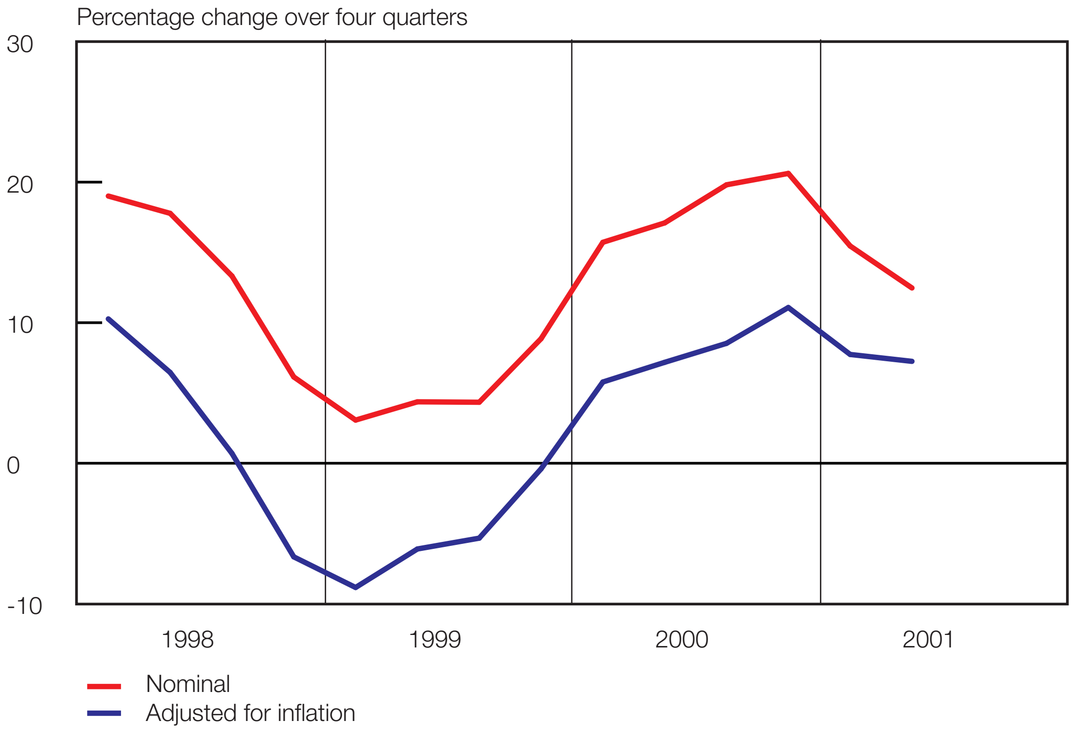
The *number of commodity futures contracts and options on such contracts* traded in the Agricultural Products Division of the JSE Securities Exchange decreased from a record high of 209 400 in the first quarter of 2001 to 188 200 in the second quarter. However, the monthly average number of about 62 700 contracts in the second quarter of 2001 increased to a record of 95 100 contracts in August.

Real-estate market

Trading activity in the real-estate market and gains in residential property prices slowed down somewhat in the first half of 2001. The stimulatory effect of the decline in the cost of mortgage finance on the recovery in residential property prices from 1999 and the growth in the home loan market from 2000 is apparently petering out.

The *real-estate market* calmed down somewhat in the first seven months of 2001. The rate of change over four quarters in the *average nominal price of houses* as measured by Absa, a private bank, increased from 3,0 per cent in the first quarter of 1999 to 20,6 per cent in the fourth quarter of 2000, before slowing to a still high 15,4 per cent in the first quarter of 2001 and 12,5 per cent in the second quarter. The year-on-year increase in the *inflation-adjusted price of houses* turned positive in the first quarter of 2000 and accelerated to 11 per cent in the fourth quarter before falling back to 7,7 per cent in the first quarter of 2001 and 7,2 per cent in the second quarter.

Real-estate prices



Source: Absa

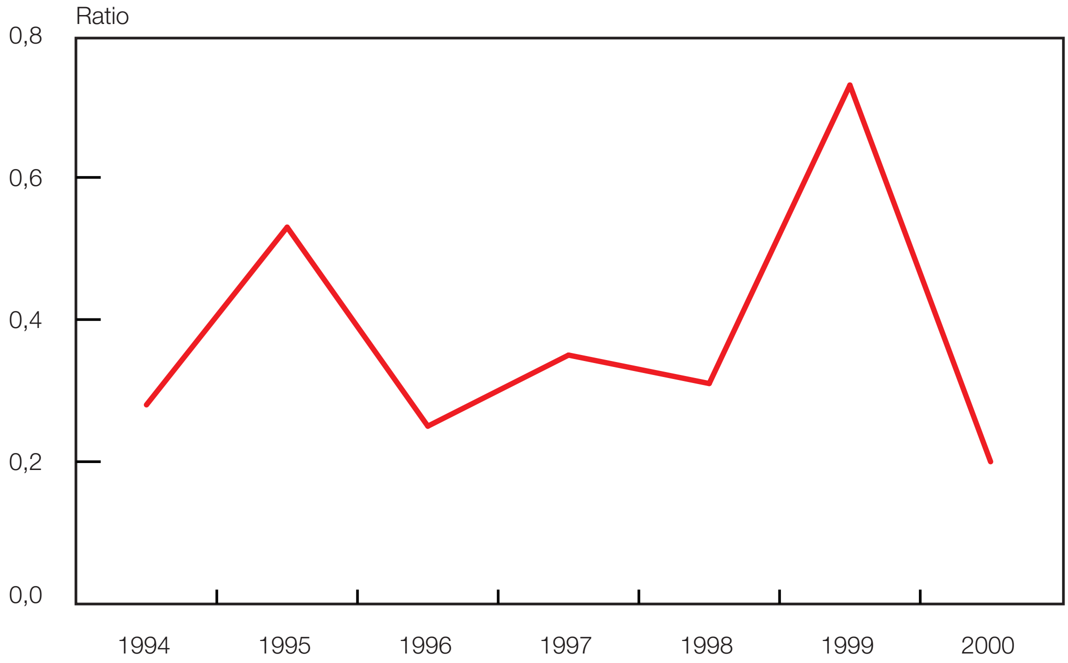
Non-bank financial intermediaries

The *demand for money in asset portfolios* as reflected by the increase over the past number of years in the holdings of *cash and deposits by non-bank financial intermediaries* (i.e. insurers, pension funds, the Public Investment Commissioners and unit trusts) was mirrored by the growth in the broadly defined money supply (M3). This development was related to heightened uncertainty about price movements in the financial markets and fears of losses on equity and bond investments, leading to shifts in portfolios in favour of cash and money-market instruments. During the past four years there was also a marked shift towards increased investments placed with money-market unit trusts and money-market instruments held by unit trusts.

The *ratio* of the change in the holdings of cash and deposits by non-bank financial intermediaries to the change in M3 peaked at 0,7 in 1999 when a sizeable portion of the growth in M3 was explained by strong demand for deposit-type investments by investors in unit trusts and institutional investors. This ratio fell sharply to 0,2 in 2000 when the holdings of cash and deposits by non-bank financial institutions levelled off while the monetary aggregate M3 continued to grow. The decline in this ratio may partly reflect a shift by the *investing public* towards deposits held directly at banking institutions, rather than through non-bank financial intermediaries.

The *overhang of cash balances* held by the investing public and institutional investors could in time impart some upward bias to the general level of asset prices. This may be countered by relatively weak future institutional cash flows which are expected to remain broadly the same as in 2000.

Change in holdings of cash and deposits by non-bank financial intermediaries as a ratio of change in M3

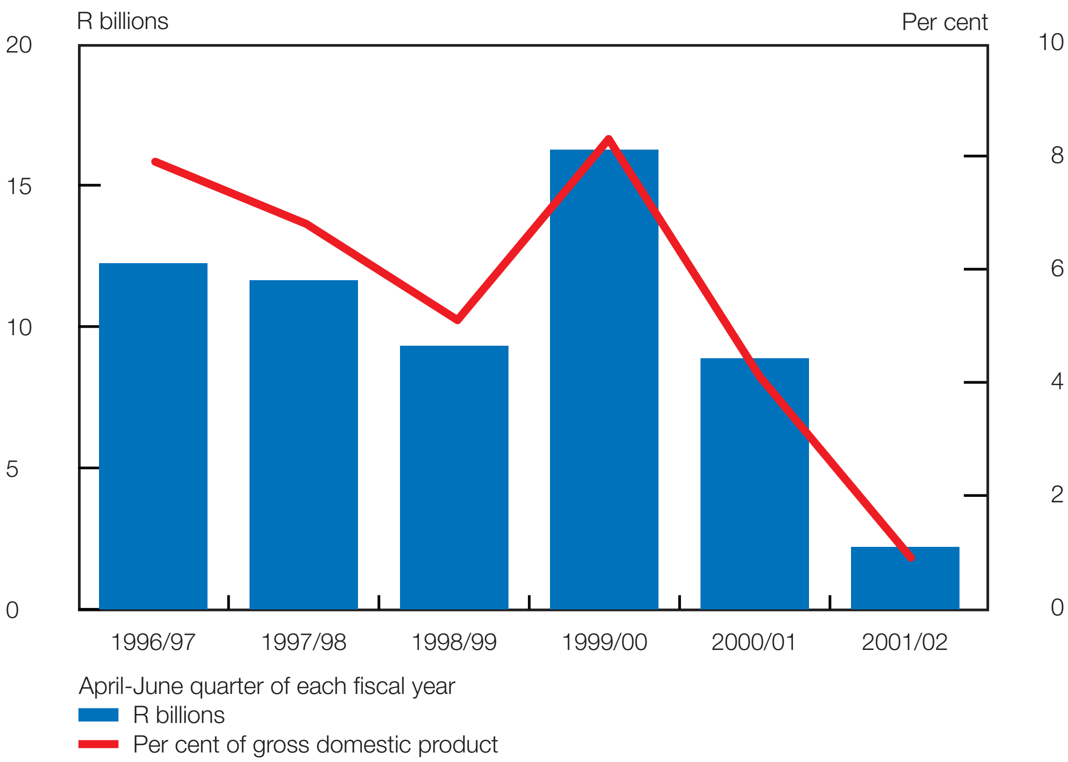


Public finance

Non-financial public-sector borrowing requirement

The *non-financial public-sector borrowing requirement* (i.e. the deficit before borrowing and debt repayment of the consolidated central government, provincial governments, local authorities and non-financial public enterprises and corporations) amounted to R2,2 billion in the April-June quarter of 2001 – R6,7 billion less than in the corresponding quarter of 2000. As a ratio of gross domestic product, the non-financial public-sector borrowing requirement in the April-June quarter of 2001 amounted to 0,9 per cent which was well below the 4,1 per cent recorded in the same quarter of the previous year. The *Budget Review 2001* projected an outcome of 1,3 per cent for fiscal 2001/02 as a whole. Viewed against the background of the average ratio of 6,4 per cent recorded in the same quarter of the previous five fiscal years, the ratio for the April-June quarter of 2001 was quite small. This improvement in the public finances can mainly be attributed to declines in the borrowing requirement of national and provincial governments. The borrowing requirement of the non-financial business enterprises placed virtually no additional pressure on capital market activity in the April-June quarter of 2001.

Non-financial public-sector borrowing requirement

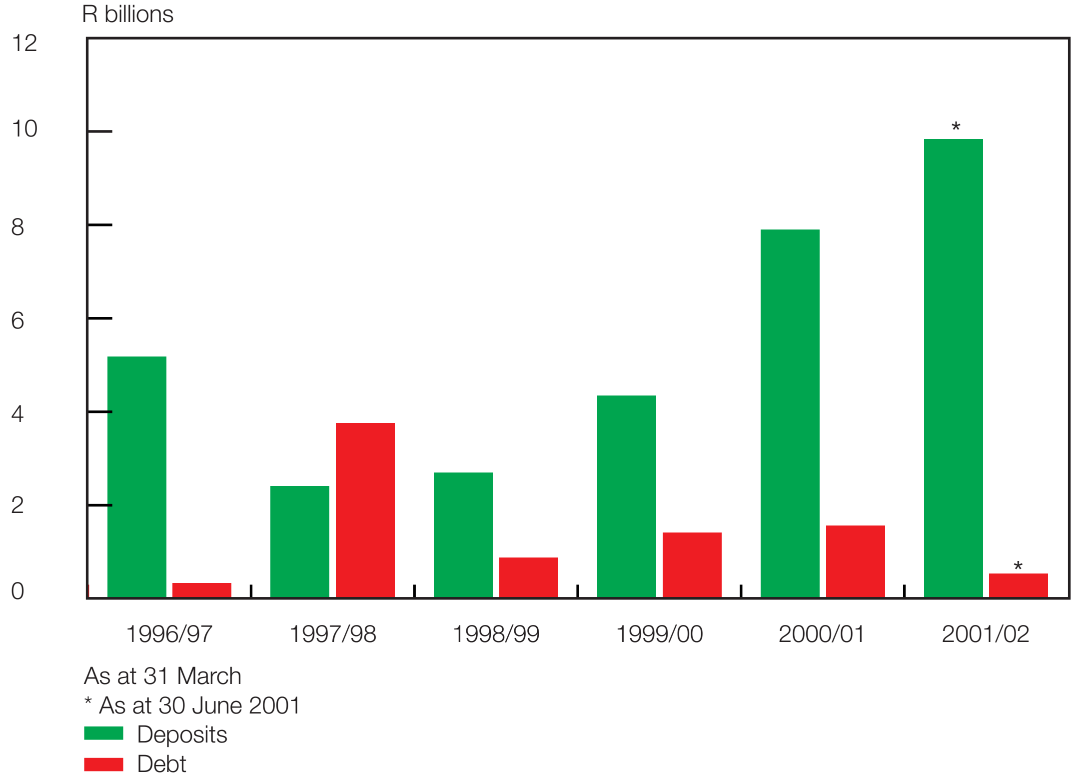


The borrowing requirement of the *consolidated general government* amounted to R2,0 billion in the April-June quarter of 2001, which was R6,8 billion less than in the corresponding period of 2000. As a ratio of gross domestic product, the consolidated general government borrowing requirement amounted to 0,9 per cent compared with the 4,1 per cent recorded in the same quarter of the previous year. Total revenue and grants received by the general government sector increased at a year-on-year rate of 20,1 per cent in the April-June quarter of 2001, whereas total expenditure and net lending grew at a year-on-year rate of only 7,0 per cent.

The *Statement of Revenue, Expenditure and Borrowing for provincial governments* indicated that they recorded a financial surplus of R5,9 billion in the April-June quarter of 2001 compared with the R4,1 billion recorded in the same period of the previous year. This improvement can partly be attributed to conditional grants received by provincial governments, but not yet expended. Conditional grants amounting to R2,2 billion were transferred to provincial governments during the April-June quarter of 2001, but only R0,8 billion of this was actually spent, contributing R1,4 billion to the surplus recorded in the April-June quarter of 2001. Provincial governments now have to indicate separately all amounts received as conditional grants and account for actual spending in the earmarked areas.

The equitable share of provincial governments in the national revenue pool amounted to R29,5 billion in the April-June quarter of 2001 compared with R25,8 billion in the same period of the previous year. This, together with own revenue raised by provincial governments, brought the total revenue and grants of provincial governments to R32,6 billion in the April-June 2001 quarter compared with the R28,7 billion recorded a year earlier. Total spending and net lending by provincial governments increased to R26,8 billion in the April-June 2001 quarter, compared with an amount of R24,6 billion in the corresponding quarter of the previous year. The financial results of the activities of provincial governments have led to a decrease in their use of bank credit from R1,6 billion at the end of March 2000 to R0,5 billion at the end of June 2001. Bank deposits of provincial governments increased from R7,9 billion to R9,8 billion over the same period.

Bank debt and deposits of provincial governments



The borrowing requirement of *local authorities* in the April-June quarter of 2001 was estimated at R0,8 billion, which was slightly more than the R0,7 billion recorded in the previous year. On 8 May 2001, the Minister for Provincial and Local Government informed a joint session of the Portfolio and Select Committees on Provincial and Local Government Affairs that overall management in local government is built on the pillars of good governance. A number of development objectives were outlined, including:

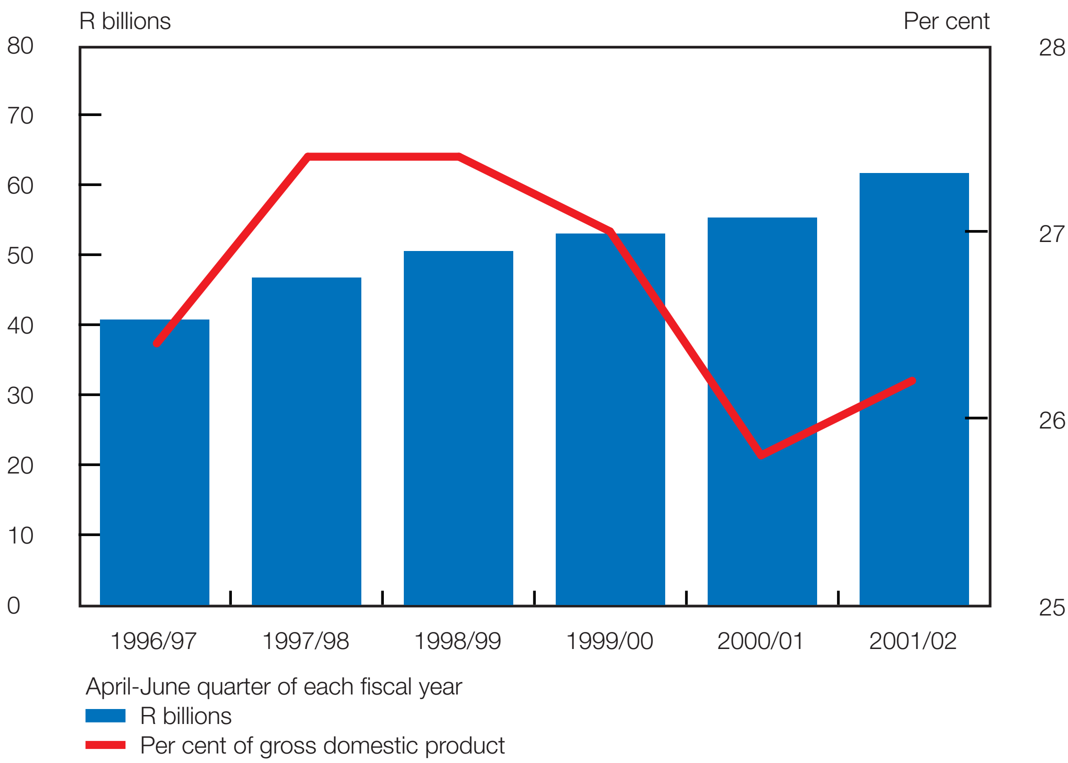
- stabilising and consolidating the system of local government;
- introducing the municipal development planning, financial and performance assessment systems as outlined in the Municipal Systems Act;
- providing support to the newly established local government structures in the form of conditional grants for restructuring, capital grants for infrastructural investment and a range of capacity-building measures;
- strengthening the country's system of intergovernmental relations through government's service delivery and development programme; and
- implementing government's strategies for targeting public-sector expenditure on urban renewal and integrated sustainable development.

The borrowing requirement of the *consolidated central government* decreased mainly because of a decisive narrowing in the borrowing requirement of national government. By contrast, the finances of the extra-budgetary institutions improved only slightly from a deficit of R0,8 billion in the April-June quarter of 2000 to a deficit of R0,5 billion in the same quarter of 2001.

National government finance

National government expenditure in the April-June quarter of 2001 amounted to R61,7 billion which was 11,5 per cent more than in the corresponding quarter of

National government expenditure



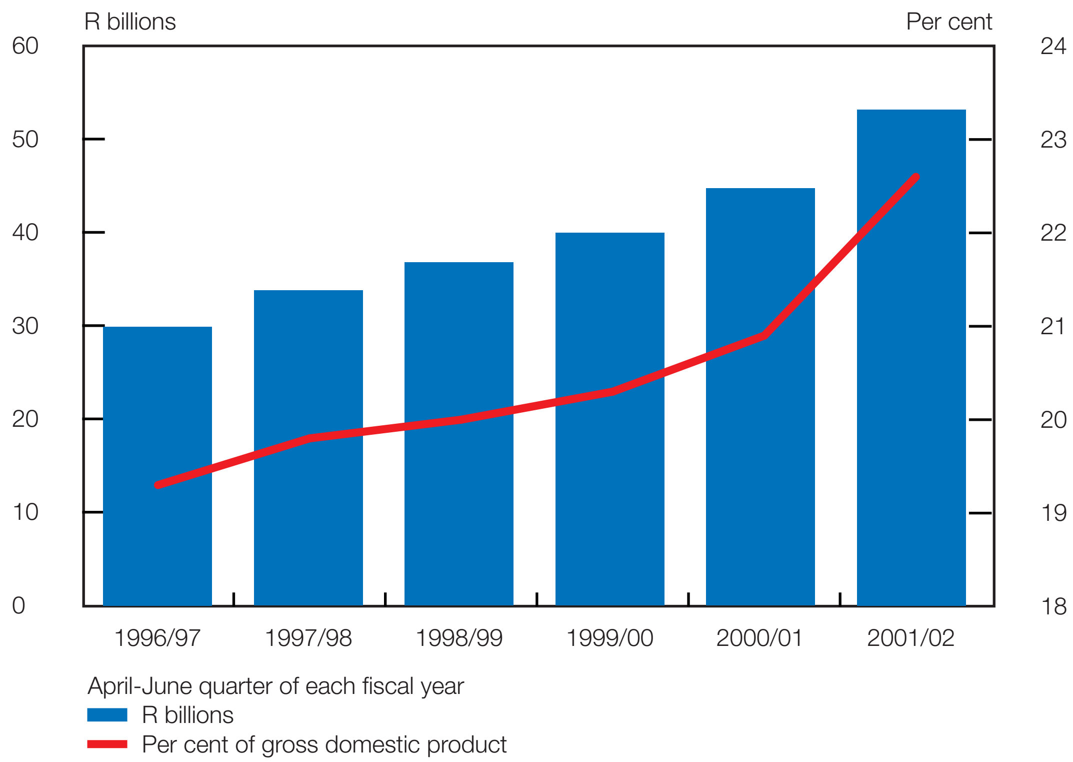
2000. In the Budget proposals for fiscal 2001/02, national government expenditure was estimated to amount to R258,3 billion for the full fiscal year, representing an increase of 10,5 per cent on the actual expenditure in fiscal 2000/01.

An amount of R2,6 billion of national government spending was recorded as capital outlays in the April-June quarter of 2001. This represents 20,1 per cent of the R13,0 billion envisaged in the original Budget for the current fiscal year. Although capital expenditure was expected to grow only modestly, it would be supplemented through investment spending by partnerships formed between government and private sector parties. Interest payments declined by 9,2 per cent from the previous fiscal year, reflecting the shrinking borrowing requirement and falling interest rates. Although these payments recorded a decline in the first quarter of the fiscal year, budget projections allow for an increase of 4,3 per cent for the fiscal year as whole.

National government expenditure as a ratio of gross domestic product amounted to 26,2 per cent in the April-June quarter of 2001 which was slightly more than the ratio of 25,8 per cent recorded in the corresponding quarter of the previous fiscal year. After allowing for cash-flow adjustments (i.e. accounting adjustments for timing differences between the recording of transactions and bank clearances, and late departmental requests for funds), total expenditure increased by 10,8 per cent to amount to R62,7 billion in the April-June quarter of 2001 compared with R56,6 billion in the corresponding period of the previous year.

National government revenue amounted to R53,2 billion in the April-June quarter of 2001, representing a year-on-year rate of growth of 18,9 per cent. This growth rate comfortably exceeded the initial estimated growth rate for fiscal 2001/02 as a whole, which was projected to be 8,0 per cent. Continued improvements in tax collection and the closing of tax loopholes contributed to this improvement. As indicated in the

National government revenue



accompanying table, taxes on income and profits were the main contributors to the revenue of national government. The high rate of increase in revenue from these tax sources can mainly be ascribed to higher corporate profits and greater efficiency in tax administration as reflected in a drop in the number of unassessed income-tax returns.

National government revenue

Revenue source	R billions		
	Fiscal 2001/02 Originally budgeted	April–June 2001 Actual	Percentage change*
Taxes on income and profits	131,6	32,0	28,6
Payroll taxes	2,8	0,6	196,4
Taxes on property	4,7	1,0	2,3
Domestic taxes on goods and services	86,7	18,8	8,9
Taxes on international trade and transactions	9,4	2,1	12,6
Other revenue	6,4	0,8	-53,3
Less: SACU** payments	8,2	2,1	-2,3
Total revenue	233,4	53,2	18,9

* April–June 2000 to April–June 2001
** Southern African Customs Union

National government revenue as a ratio of gross domestic product increased from 20,9 per cent in the April-June quarter of 2000 to 22,6 per cent in the April-June quarter of 2001. After allowing for cash-flow adjustments due to differences in timing between the recording of transactions and bank clearances, national government revenue amounted to R50,5 billion in the April-June quarter of 2001. This represents an increase of 15,3 per cent over the same period in the previous fiscal year.

The net result of the revenue and the expenditure of national government in the April-June quarter of 2001 was a *deficit before borrowing and debt repayment* of R8,5 billion which was markedly lower than the deficit of R10,6 billion recorded in the same period of the previous fiscal year. As a ratio of gross domestic product, the deficit amounted to 3,6 per cent in the April-June quarter of 2001 compared with a deficit ratio of 5,0 per cent in the corresponding quarter of the previous fiscal year. The cash-flow adjusted deficit amounted to R12,2 billion in the April-June quarter of 2001.

Restructuring dividends received from the South African Special Risks Insurance Association (Sasria) amounted to R2,2 billion in the quarter under review. An amount of R18,0 billion was projected to be received from the restructuring of government assets in the whole of fiscal 2001/02.

As indicated in the accompanying table, the net borrowing requirement in the April-June quarter of 2001 was financed mainly through the issuance of foreign loans and short-term Treasury bills. The 7-year Eurobond of €500 million contributed R3,6 billion to the funding in April 2001 and a 20-year marketable Samurai bond to the value of ¥30,0 billion was issued in June 2001, adding R2,0 billion to available resources. An amount of R2,8 billion was also drawn on foreign export credit facilities for the financing of the strategic defence procurement programme. These foreign loans issued in the April-June quarter of 2001 lengthened the average outstanding maturity of foreign government debt from 98 months at the end of March 2001 to 102 months at the end of June 2001.

National government finance
R billions

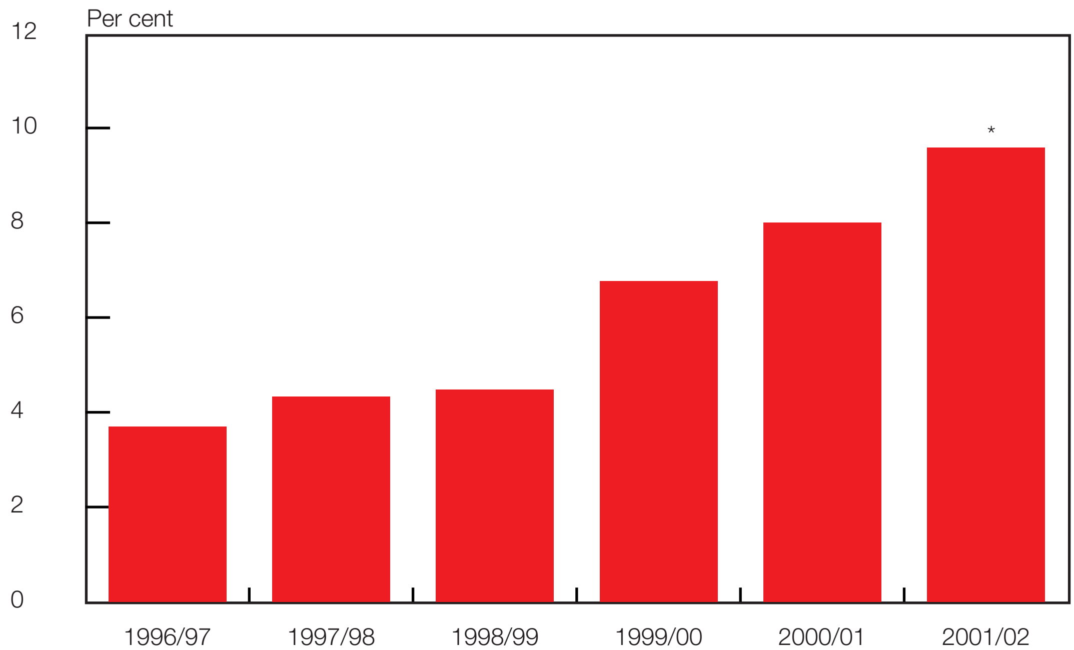
	Fiscal 2001/02 Originally budgeted	April–June 2001 Actual
Deficit	**24,9**	**12,2**
Plus: Extraordinary payments	0,6	0,0
Revaluation of maturing foreign loans	0,0	0,0
Less: Extraordinary receipts	18,0	2,2
Net borrowing requirement	**7,5**	**10,0**
Domestic primary capital market		
Government bonds	...	4,2
Less: Discount on government bonds	...	0,7
Net receipts from domestic government bonds issued	**-7,4**	**3,5**
Treasury bills	3,5	4,8
Foreign loans	11,3	8,3
Change in available cash balances*	–	-6,6
Total net financing	**7,5**	**10,0**

* Increase -, decrease +

Net receipts from domestic government bonds amounting to a nominal value of R4,2 billion were issued during the April-June quarter of fiscal 2001/02. Long-term funding was obtained at an average rate of 10,7 per cent. Treasury bills to an amount of R4,8 billion were issued at an average rate of 9,9 per cent.

The *Budget Review 2001* projects that financing through the issuance of foreign loans will become the principal means of financing government over the medium term whereas net redemption of government bonds was projected for fiscal

Foreign debt as percentage of national government loan debt



As at 31 March
* As at 30 June 2001

2001/02. Limited amounts of government bond issues in the domestic capital market are foreseen for the ensuing years.

Total *national government debt* rose from R417,5 billion at the end of March 2001 to R434,4 billion at the end of June 2001. Apart from the need to finance the deficit of national government, government debt also increased because of the continuing higher rand value of outstanding foreign-currency denominated debt. Total foreign debt amounted to 9,6 per cent of total national government loan debt at the end of June 2001 compared with 8,0 per cent at the end of March 2001. As a ratio of gross domestic product, total national government debt amounted to 47,3 per cent at the end of June 2001 compared with 46,6 per cent at the end of March 2001.

National government finance in July 2001

National government expenditure in July 2001 amounted to R18,4 billion, bringing the cumulative expenditure in the first four months of fiscal 2001/02 to R80,0 billion which was 11,4 per cent more than in the same period of the previous fiscal year. The cash-flow adjusted expenditure amounted to R81,0 billion which was 10,3 per cent more than in the corresponding period of 2000.

National government revenue amounted to R18,7 billion in July 2001 and to R71,9 billion in the first four months of fiscal 2001/02, representing a year-on-year rate of increase of 16,9 per cent. After the usual adjustment for cash flows, revenue amounted to R71,3 billion in the first four months of fiscal 2001/02 which was 15,8 per cent more than in the corresponding period of 2000.

The net result of the national government's revenue and expenditure in the first four months of fiscal 2001/02 was a deficit of R8,2 billion compared with R10,3 billion in the same period of the previous fiscal year. The deficit before borrowing and debt repayment, adjusted for cash flows, amounted to R9,6 billion.

In July 2001 there was another bond issue in the Samurai market to the amount of ¥60,0 billion, with a coupon rate of 2,0 per cent, adding R3,9 billion to the outstanding balance on the marketable foreign loans of national government. Net receipts from the issuance of domestic government bonds in the first four months of fiscal 2001/02 amounted to R4,8 billion, raising the national government debt from R434,4 billion at the end of June 2001 to R437,8 billion at the end of July 2001.

Statement of the Monetary Policy Committee

14 June 2001

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

At a meeting on 13 and 14 June 2001 the Monetary Policy Committee analysed international and domestic economic developments in order to evaluate the monetary policy stance. After lengthy deliberations the Committee decided that the repo rate should decline by 100 basis points to 11,0 per cent with effect from 15 June 2001. The Committee believes that this should lead to downward adjustments in the lending rates of banks. This decision was based primarily on the following considerations:

International economic developments

The economic performance of the United States of America remains weak with first-quarter growth now estimated at a seasonally adjusted annualised rate of 1,3 per cent, i.e. only marginally higher than the 1,0 per cent in the fourth quarter of 2000. Inventory depletion was higher than expected in the first three months of 2001, though private consumption expenditure is still supporting economic growth. Industrial production, particularly durable goods production, declined in April. This brought the capacity utilisation rate of manufacturing enterprises to its lowest level in more than a decade. The manufacturing sector continued to shed jobs and productivity declined in the first quarter for the first time since 1995. This latter development caused a rise in unit labour costs, which may, if sustained over time, put upward pressure on inflation.

The Japanese economy appears to be heading for a recession. In the first quarter of 2001, real gross domestic product declined by 0,8 per cent. Lower industrial production figures in April point to an even weaker second quarter. Growth in the euro area is also starting to show some effects arising from developments in the United States, with growth in total production amounting to an annualised rate of 2,2 per cent in the first quarter of 2001. The global economic slowdown further curbed demand for British exports, leading to a decline in the industrial production of the United Kingdom in February and March 2001. Asian and Latin American economies were also adversely affected by the slower world economic growth. Particularly in non-Japan Asia, the downturn has been more marked than originally expected. The IMF World Economic Outlook nevertheless still forecasts world growth of 3,2 per cent for 2001, compared with 4,8 per cent in 2000.

As a result of the poor short-term outlook for the United States' economy, the Federal Open Market Committee (FOMC) reduced interest rates by a further 50 basis points on 15 May 2001. This has been the fifth cut in interest rates since the beginning of the year, with the benchmark rate moving from 6,50 to 4,00 per cent. The European Central Bank decreased rates by 25 basis points in May 2001. Other countries that have reduced official interest rates since the last meeting of the Monetary Policy Committee, include Denmark, Canada, Israel and New Zealand. None of these countries, however, have decreased rates to the same extent as the United States. By contrast, interest rates in Brazil, where the inflation rate is still above the target range, were raised during May.

Although there are currently no strongly pervasive inflationary trends, higher inflation has been evident in the euro area and some Asian and Latin American countries. The international oil price has moved above the upper end of the OPEC target and, if sustained, could put upward pressure on world inflation. However, OPEC appears to be committed to maintaining oil prices within the target band of US$22 to US$28 per barrel.

Real domestic economic developments

The growth in real gross domestic product in South Africa also slowed down further from an annualised rate of 4 per cent in the third quarter of 2000 to 3 per cent in the fourth quarter and 2 per cent in the first quarter of 2001. At first the lower rate of increase in output could be attributed to a decrease in agricultural production. However, in the first quarter of 2001 output growth slowed down in most sectors, with the exception of financial services and the mining industry.

The general slowdown in economic activity in the first quarter of 2001 once again proves that the fortunes of the South African economy are inextricably interwoven with the global economy. It is almost inevitable that domestic activity will be influenced by changes in international economic conditions. The current global slowdown led to a decline in South African exports and harmed the goods-producing and the trade sectors of the economy. These developments, in turn, affected most of the tertiary sector activities.

Aggregate domestic demand increased by 2½ per cent in the first quarter of 2001. Private household spending on durable goods, gross fixed capital formation by the private sector and inventory accumulation by manufacturers and traders increased during the first quarter.

Households were prepared to incur debt to finance part of their purchases of durable goods, which resulted in some increase in their debt-to-income ratio. At about 56 per cent in the first quarter, this ratio is high but does not seem to have any serious underlying risks. Increases in real private fixed capital formation were reported over the full spectrum of production sectors and were not confined to a few large projects. In addition, businesses added to their stocks of intermediate and finished goods. By contrast, government consumption expenditure at constant prices rose modestly.

In line with the growth in expenditure, there was some indication towards the end of 2000 that employment was improving. The number of people employed in the formal private non-agricultural sectors of the economy increased during the fourth quarter of 2000. However, public-sector employment declined further.

Domestic monetary and fiscal conditions

The seasonally adjusted and annualised quarter-to-quarter growth in the broadly defined money supply (M3) accelerated from 4,9 per cent in the third quarter of 2000 to 14,7 per cent in the fourth quarter and 19,2 per cent in the first quarter of 2001. The year-on-year growth in M3 also increased sharply from 7,5 per cent in December 2000 to 12,3 per cent in April 2001. This acceleration reflected increases in aggregate domestic demand, but M3 growth outpaced the rate of increase in the narrower aggregates because of a comparatively strong rise in longer-term deposits of the public.

Growth in total bank credit extension slowed down from an annualised 18,9 per cent in the fourth quarter of 2000 to 2,8 per cent in the first quarter of 2001. The year-on-year growth in bank credit extension, however, remained below 10 per cent in the first four months of 2001. The largest part of this increased demand for credit came from households.

Public finances were characterised by disciplined spending in the fiscal year ended 31 March 2001. As a result of this, and with national government revenue exceeding earlier expectations, the deficit before borrowing was reduced to a level well below that which had originally been budgeted. The non-financial public-sector borrowing requirement amounted to only 2,2 per cent of gross domestic product in fiscal 2000/01, compared with an average ratio of 4,2 per cent in the preceding five fiscal years.

Domestic financial markets

Activity in the secondary bond and share market generally remained strong in the first five months of 2001. Bond yields, which move inversely to bond prices, declined from a monthly average of 12,9 per cent in December 2000 to 11,9 per cent in May. Share prices rose by 24 per cent from the most recent low in May 2000 to February 2001. The average monthly level of share prices then declined by 8 per cent until April, before increasing again by 9 per cent to an all-time high in May 2001.

Money-market conditions remained relatively stable throughout the first five months of 2001, with the liquidity requirement fluctuating between R8 billion and R11,7 billion. Since the last meeting of the Monetary Policy Committee, overnight rates have increased by approximately ½ percentage point. By contrast, longer-term money-market rates eased, resulting in a substantial flattening of the money-market yield curve.

Balance of payments and foreign exchange market

A small deficit of R0,5 billion was recorded in the overall balance of payments in the first quarter of 2001, which put some downward pressure on the exchange rate of the rand.

Despite the already noted increase in domestic demand, the surplus on the current account of the balance of payments improved in the first quarter of 2001. After adjustment for seasonal factors and annualised, this surplus increased from R2,5 billion in the fourth quarter of 2000 to R6,9 billion in the first quarter of 2001. This was largely the result of a decline in interest and dividend payments to the rest of the world. The volume of merchandise exports declined in the first quarter of 2001, but export earnings were boosted by a general improvement in export prices following the depreciation of the rand. Simultaneously, higher prices for imported goods dampened the demand for imports, holding back growth in the nominal value of imports.

The deficit on the external financial account exceeded the surplus on the current account of the balance of payments. This deficit was mainly the result of direct investments made abroad by South African companies wishing to expand their activities in other parts of the world and a rise in foreign assets related to trade finance. Portfolio capital, on a net basis, continued to flow into the country. The net purchases of domestic shares by non-residents amounted to R15,9 billion in the first five months of 2001. This was offset to some extent by net sales of bonds to the value of R3,6 billion over the same period. In May, however, non-resident investors were net buyers of bonds to the amount of R2,8 billion.

After the exchange rate of the rand had been under considerable pressure during the first four months of 2001, it regained most of its losses in May due in large measure to the restructuring of the De Beers Diamond Corporation which led to a substantial inflow of capital. The trade-weighted value of the rand, which had declined by 3,0 per cent from the end of 2000 to 25 April 2001, was therefore on 14 June 2001 only 0,9 per cent below its level at the end of last year.

Monetary policy

Consumer and production prices clearly indicate that inflation is slowing down. CPIX inflation, targeted to attain an annual average rate of between 3 and 6 per cent in the year 2002, fell from a year-on-year rate of 8,2 per cent in August 2000 to 6,7 per cent in April 2001. Measured from quarter to quarter and at seasonally adjusted and annualised rates, CPIX inflation came down from 8,8 per cent in the second quarter of 2000 to 6,1 per cent in the fourth quarter and remained at that level in the first quarter of 2001. All-goods production price inflation slowed down on a year-on-year basis from 10,0 per cent in December 2000 to 8,1 per cent in April 2001, and on a quarter-to-quarter basis from 11,8 per cent in the first quarter of 2000 to 8,5 per cent in the first quarter of 2001.

This moderation in price increases was mainly the result of more moderate rises in food and energy prices, which had shown exceptionally large increases in 2000. More fundamentally, the slowdown in inflation was related to the moderate rise in unit labour costs over the past two years. This relieved pressure on price increases in an environment that is now relatively open to foreign competition. Although growth in domestic demand has accelerated noticeably, there is still no sign of excessive aggregate demand. Moreover, the current account of the balance of payments has been in surplus during the past two quarters. The rate of capacity utilisation in manufacturing at about 80 per cent is clearly still well below any level that could put pressure on prices, and the private sector has continued to increase investment over the past five quarters. The recent pace of growth of money supply is, however, somewhat disconcerting. Fortunately, it has still been relatively constrained in cheque and transmission deposits, which are usually held mainly for transaction purposes.

With continued fiscal and monetary discipline, the target range of inflation in the year 2002 is achievable. This is supported by the projections made using the Reserve Bank's suite of models. However, the latest quarterly survey of inflation expectations by the Bureau of Economic Research of the University of Stellenbosch indicates a slight increase in average inflation expectations for the year 2001 through 2003. The upside risks for inflation remain primarily developments in the international price of oil, the second-round effects of last year's depreciation of the rand and continued increases in administered prices.

After carefully considering these risks, the Monetary Policy Committee decided that the repo rate should be reduced. Amongst other factors considered by the Committee in reaching this decision were the following changes that have taken place since the beginning of the year:

- A clearly discernible declining trend in inflation in line with the projections of the Committee that the average annual rate of increase in CPIX will be in the target range in 2002.
- A stronger external value of the rand. After the trade-weighted value of the rand had decreased sharply in the first four months of 2001, it started to increase from the end of April to just below the level that it had reached at the end of 2000.
- Only moderate signs of any pressure on inflation arising from the depreciation of the rand during 2000.
- A current account of the balance of payments that changed from a deficit in the third quarter of 2000 to two consecutive quarterly surpluses.
- Greater stability in international oil prices than during 2000.
- A declining trend in long-term bond yields.

Continued moderation in nominal wage increases, no signs of excessive aggregate demand growth and an underutilisation of production capacity were also factors taken into consideration by the Committee.

Statement of the Monetary Policy Committee

26 July 2001

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

The Monetary Policy Committee made a detailed analysis of recent economic developments at its meeting on 26 July 2001 to decide on the most appropriate monetary policy stance. After these deliberations the Committee decided that the repo rate should remain unchanged at 11,0 per cent. This decision was based primarily on the following considerations:

International economic developments

Oil prices, which had declined in June, continued to drift down in July and have traded around a level of US$24 per barrel in the past week. These developments, in conjunction with weaker international demand, have contributed to reduced pressure on inflation rates in many parts of the world. Headline inflation in the United States fell from a year-on-year rate of 3,6 per cent in May 2001 to 3,0 per cent in June. Similar declines were also recorded in the United Kingdom and the euro area. Japan continued to be characterised by deflation, while inflation rates in developing countries tended downwards.

The outlook for world economic growth remains bleak. Forecasts of the Federal Reserve System for economic growth in the United States range from 1,25 to 2 per cent for 2001. After nine months of decline, the industrial production of the United States in June 2001 was 3,6 per cent below its level in the preceding year. Indications are that the euro area slowdown has continued into the second quarter of 2001, and in Germany the growth rate is expected to fall below 1 per cent. Japan is still struggling to move out of a recession, and a decrease in the demand for primary products affected the economic growth of emerging-market economies.

International conditions have been overshadowed recently by events in Argentina and Turkey. Renewed fears that Argentina would default on its external debt and continued problems in the banking sector in Turkey put pressure on emerging-market exchange rates and spreads on foreign currency denominated debt in general. In particular, the currencies of Brazil, Chile, Indonesia and Poland have been affected seriously by the increase in risk aversion and weaker international stock markets. The Brazilian currency, for example, has declined by nearly 27 per cent since the beginning of the year, despite a cumulative increase of 325 basis points in official interest rates. From 3 July 2001 the exchange rate of the rand also depreciated sharply, bringing its value *vis-á-vis* the US dollar on 26 July down to a level that was 8,1 per cent below the level at the end of 2000. On a trade-weighted basis, however, the rand decreased by a more modest 3½ per cent over the same period.

Real domestic economic developments

Most domestic economic indicators suggest that the slowdown in the growth of real economic activity continued in the second quarter of 2001. The physical output of the manufacturing sector declined in the first five months until May 2001. Wholesale trade at constant prices also declined from the high levels at the end of 2000, while the three-months moving average of retail sales in April 2001 was also 0,5 per cent down from its peak in December 2000. Similarly, total new vehicle sales in the second quarter of 2001 were about 8,8 per cent lower than the peak in the first quarter of 2001. Other indicators, such as electricity generated and the real value of buildings completed, confirm a slowing in economic growth in the second quarter of 2001. In contrast to these developments, the physical volume of mining production increased in the first five months of this year.

The positive signs of some recovery in private-sector employment during the fourth quarter of 2000 were not sustained in the first quarter of 2001. According to the latest information, the number of workers in the regularly surveyed formal non-agricultural sectors declined by 2,1 per cent from the first quarter of 2000 to the first quarter of 2001. However, it is encouraging to note that the rate of increase in non-agricultural nominal unit labour cost increased at a slower pace in the first quarter of 2001 than in the fourth quarter of last year. In the manufacturing sector, unit labour cost increased by barely 0,5 per cent in the first quarter of 2001. This important component of the inflation process therefore does not pose any threat to an acceleration in inflation.

Domestic monetary and fiscal conditions

The annual growth in the broadly defined money supply (M3) accelerated from 6,5 per cent in November 2000 to 13,5 per cent in May 2001. The narrowly defined money supply aggregates increased at a much slower pace than M3, indicating that the rise in the broad money supply could partly be attributed to an increase in longer-term deposits by the private sector. Such longer-term deposits are in most cases not used to purchase goods and services and may be less of an inflationary threat than shorter-term deposits.

Bank credit extension to the private sector increased by 10,0 per cent in May 2001 compared with the same month in the preceding year. The growth in instalment sale credit and leasing finance gained momentum in the first five months of 2001, reflecting the firm private households' demand for durable goods. Mortgage advances also accelerated considerably in support of the solid performance of the property market.

Government expenditure in the first two months of fiscal 2001/02 increased by 14,0 per cent compared with the same period in the preceding year. This high increase was recorded despite the fact that the payment of the bonuses of civil servants for the first three months of the calendar year were not paid in April as had been the case in previous years. The increase in government revenue measured over a twelve-month period amounted to 11,7 per cent in the first two months of fiscal 2001/02, with the result that the cumulative budget deficit in this period resembled its usual seasonal pattern.

Domestic financial markets

Lively trading conditions prevailed in the bond market during the second quarter of 2001. The value of turnover in the secondary bond market increased by 4,6 per cent from the first quarter of 2001 to the second quarter. Non-resident transactions in the bond market, however, fell over the same period, with the result that they now account for only about 10 per cent of total turnover.

The long bond yield declined from an average of 12,1 per cent in April 2001 to 11,3 per cent in June 2001. The endorsement of lower inflation expectations by the Reserve Bank when it lowered the repurchase rate by 100 basis points on 15 June 2001 gave further impetus to the decline in bond yields. The yield on the R153 bond declined from 11,49 per cent on 15 June 2001 to 10,63 per cent on 26 July 2001. Turnover in the secondary share market remained high in the first six months of 2001, probably related to volatile share-price movements and corporate restructuring. The all-share index of the JSE Securities Exchange increased, on balance, over this period, performing much better than most other stock exchanges. However, from 14 June this index started to decline, affected primarily by the prices of banking, industrial, platinum-mining and information technology shares.

In the money market, the daily liquidity provided to the market has fluctuated between R9,8 billion and R7,7 billion since the previous meeting of the Monetary Policy Committee. These figures reflect the somewhat easier money-market conditions which prevailed in the period from March to May 2001. As could be expected, the reduction in the repo rate resulted in a much steeper money-market yield curve. At first most of the money-market rates declined by only 75 basis points with the reduction in the repo rate, more or less in line with the decline in the prime lending rates. After the prime rate was brought down by a further 25 basis points with effect from 16 July 2001, money-market rates came down further. Currently most of the money-market rates have declined by more than 1 percentage point since the lowering of the repo rate on 15 June 2001.

Balance of payments

Preliminary estimates indicate that South Africa's overall balance of payments improved significantly in the second quarter of 2001. The larger overall surplus was obtained essentially because of a change from a deficit to a surplus on the financial account, while the current account of the balance of payments probably remained in surplus.

Seasonally adjusted and annualised, the surplus on the trade account increased only marginally from R38,6 billion in the first quarter of 2001 to R39,3 billion in April and May 2001. A moderate contraction in the value of merchandise exports was more than offset by an increase in the value of net gold exports. The value of merchandise exports shrank somewhat over this period in line with the slower growth internationally and a sharp decline in commodity prices, especially in the price of platinum.

The financial account of the balance of payments is expected to have registered a sizeable surplus in the second quarter of 2001. The net inward movement of foreign capital resulted mainly from the restructuring of the stockholding in the De Beers Diamond Corporation and net portfolio inflows into the country. The national government borrowed €500 million on the international capital market in April 2001 and ¥30 billion in June 2001. In addition, non-residents remained net purchasers of domestic shares in the second quarter of 2001. These net purchases to the value of R7,2 billion were to some extent offset, as in previous quarters, by the net sales of bonds by non-residents amounting to R2,1 billion. This brought the net purchases of shares and bonds to R5,1 billion.

These capital inflows made it possible for the Reserve Bank to reduce its net oversold open position in foreign exchange from US$9,4 billion at the end of March 2001 to US$5,3 billion on 30 June 2001. On 18 July 2001, the net open position in foreign exchange declined further to US$4,8 billion when the Reserve Bank purchased the proceeds of government's recent Samurai bond issue of ¥60 billion.

Monetary policy

Recently released consumer and production price statistics indicate that inflationary pressures have abated further in South Africa. The twelve-month rate of increase in the consumer price index for metropolitan and other urban areas excluding mortgage cost (CPIX), which is used as the benchmark for inflation targeting, has continued to decline from 8,2 per cent in August 2000 to 6,4 per cent in June 2001. To a large extent this decline has been due to lower rates of increase in the prices of food and oil products. From February 2001 the prices of consumer services also slowed down from a year-on-year rate of 8,9 per cent to 6,7 per cent in June 2001. Measured from quarter to quarter and adjusted for seasonal influences, the rate of increase in CPIX slowed down from 6,1 per cent in the first quarter of 2001 to 3,8 per cent in the second quarter.

The rate of increase over twelve months in the all-goods production price index declined from 10,0 per cent in December 2000 to 8,6 per cent in June 2001. This decline in the growth of production prices was to a large extent the result of a slowdown in the rate of increase in the prices of imported goods from 15,0 per cent in December 2000 to 10,0 per cent in June 2001. Lower international oil prices and an appreciation of the rand during May and June, together with low inflation levels in trading-partner countries, contributed to the moderation of import prices. The rate of increase in the prices of domestically produced goods also slowed down further in the first half of 2001. The quarter-to-quarter seasonally adjusted and annualised rate of increase in production prices amounted to 6,7 per cent in the second quarter of 2001, compared with 8,5 per cent in the first quarter of the year.

Most of the recent developments, with the notable exception of the depreciation of the rand during July, point to a further decline in domestic inflation. Moderate credit growth, strong productivity growth, low rates of increase in nominal unit labour cost, a surplus on the current account of the balance of payments, a decline in international oil prices and continued fiscal and monetary prudence, are all factors favourable to the containment of inflation. It is, however, important that the secondary effects of the depreciation in the external value of the rand are carefully monitored. A further cause for concern is the fact that administered prices have been rising faster than average consumer prices over the past two years. With continued monetary and fiscal discipline, the projections of the Reserve Bank nevertheless show that the average annual rate of increase in CPIX should fall within the target range of 6 to 3 per cent in 2002.

A note on the business cycle in South Africa during the period 1997 to 1999

by J C Venter and W S Pretorius[1]

Introduction

The South African Reserve Bank has determined reference turning points in the South African business cycle for the period 1946 to 1996. These reference turning points are discussed in various articles published in earlier issues of the South African Reserve Bank's *Quarterly Bulletin.* The most recently identified upper reference turning point in the business cycle occurred in November 1996.[2]

1 The authors wish to thank Mr P J Weideman and Ms S Claassen for valuable contributions during the preparation of this note.

2 Pretorius, W S, Venter, J C and Weideman, P J. 1999. Business cycles in South Africa during the period 1993 to 1997. *Quarterly Bulletin.* Pretoria: South African Reserve Bank, March.

This article discusses the determination and identification of a lower reference turning point following the peak of November 1996. The methods used to determine the reference turning point are described in the next section, then the statistical results yielded by these methods are presented. A brief overview of economic events and developments between 1997 and 1999 follows. Finally, the date of the lower reference turning point is indicated.

Methods used in determining the reference turning point of the business cycle

The lower reference turning point in the business cycle was determined by using several methods. These included the calculation of composite leading and coincident business cycle indicators, the comprehensive historical diffusion index and the current diffusion index. It is important to note, however, that the identification of a reference turning point is never a purely statistical exercise. Economic events and developments occurring near a possible turning point have to be considered in order to pinpoint the turning point to a particular month, especially when the statistical methods employed do not all point to exactly the same turning point date.

The composite business cycle indicators

A composite business cycle indicator is compiled by integrating various economic indicators into a single indicator time series.[3] These composite indicators portray the movement of and turning points in the business cycle. The *composite leading business cycle indicator* comprises individual indicators which tend to shift direction ahead of changes in the business cycle. A change in the direction of the composite leading business cycle indicator is usually an early indication that a turning point in the business cycle may be imminent. The *composite coincident business cycle indicator* combines a number of economic time series which usually move in harmony with the business cycle. A change in the direction of the composite coincident business cycle indicator – generally occurring after the composite leading business cycle indicator has changed direction – indicates that a turning point might have been reached.

3 Van der Walt, B E and Pretorius, W S. 1994. Notes on revision of the composite business cycle indicators. *Quarterly Bulletin.* Pretoria: South African Reserve Bank, September.

The historical diffusion index

The *historical diffusion index* may be defined as a measure of the dispersion of the changes in a number of economic time series in a specific period, mostly a calendar month. The historical diffusion index was constructed from a total of 230 seasonally adjusted economic time series. These time series cover economic processes such as production, sales, employment and income in different sectors of the economy. The specific turning points of the cyclical component of each of the series are determined. A set of specific peak and trough dates is obtained in this way for each time series.

A series is regarded as decreasing for each period subsequent to a peak, up to and including the following trough. Conversely, a series is regarded as increasing for each period subsequent to a trough, up to and including the following peak. The historical diffusion index value for a particular month is then obtained by expressing the number of increasing time series as a percentage of the total number of time series considered. The sectoral contributions are weighed according to each relevant sector's contribution to gross value added. An index value below 50 therefore indicates that more than half of the series considered are decreasing at a particular date, implying that the economy is in a downward phase of the business cycle. Conversely, an index value exceeding 50 indicates that more than half of the series considered are increasing at a particular date, implying that the economy is in an upward phase of the business cycle.

The current diffusion index

The *current diffusion index* is a comprehensive composite index compiled from the actual month-to-month symmetrical percentage changes in each of the 230 seasonally adjusted time series used in constructing the historical diffusion index. A weight is allocated to each series according to the contribution to gross value added of the activity that the time series reflects. The deviation of the current diffusion index from its long-term trend is a quantitative indication of the cyclical movement in general economic activity.

Statistical results

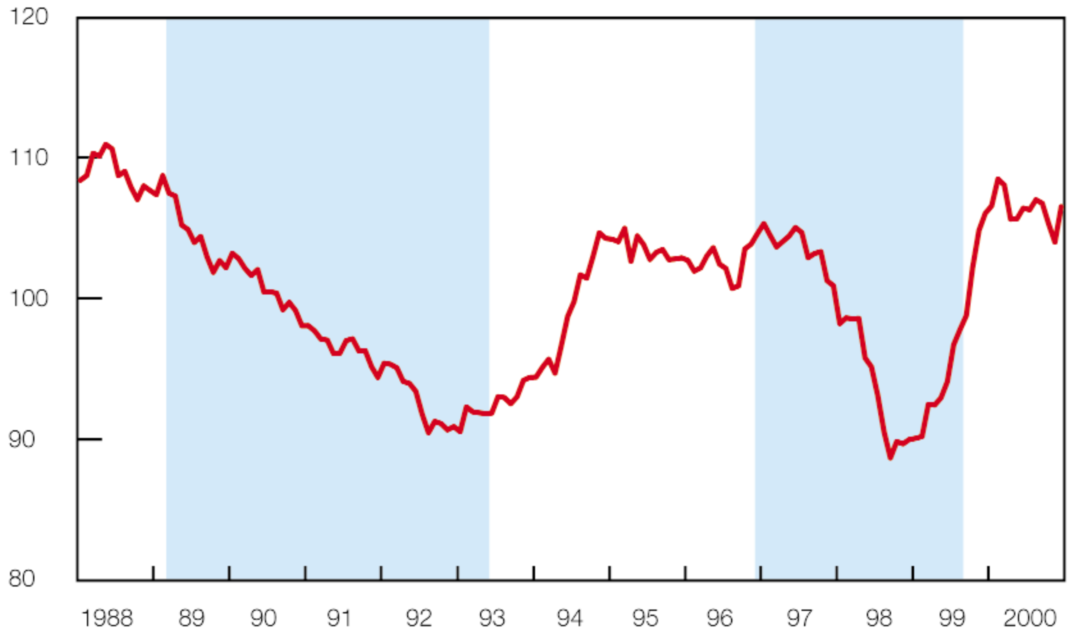
The results obtained from the methods described above, clearly indicate that a downward phase of the business cycle occurred in the South African economy after November 1996 (the latest upper reference turning point). The current results also confirmed the November 1996 upper reference turning point. As the discussion below indicates, the analysis also revealed that a lower reference turning point in the business cycle had already been reached.

The composite business cycle indicators

After declining markedly for almost two years, the composite leading business cycle indicator – expressed as the deviation from its long-term trend – reached a lower turning point in September 1998. After that the indicator increased moderately for a period of five months, followed by more significant increases during the remainder of 1999. The decisive change in the direction of the composite leading business cycle indicator after September 1998 was an early indicator that a reference turning point in the business cycle could soon be reached.

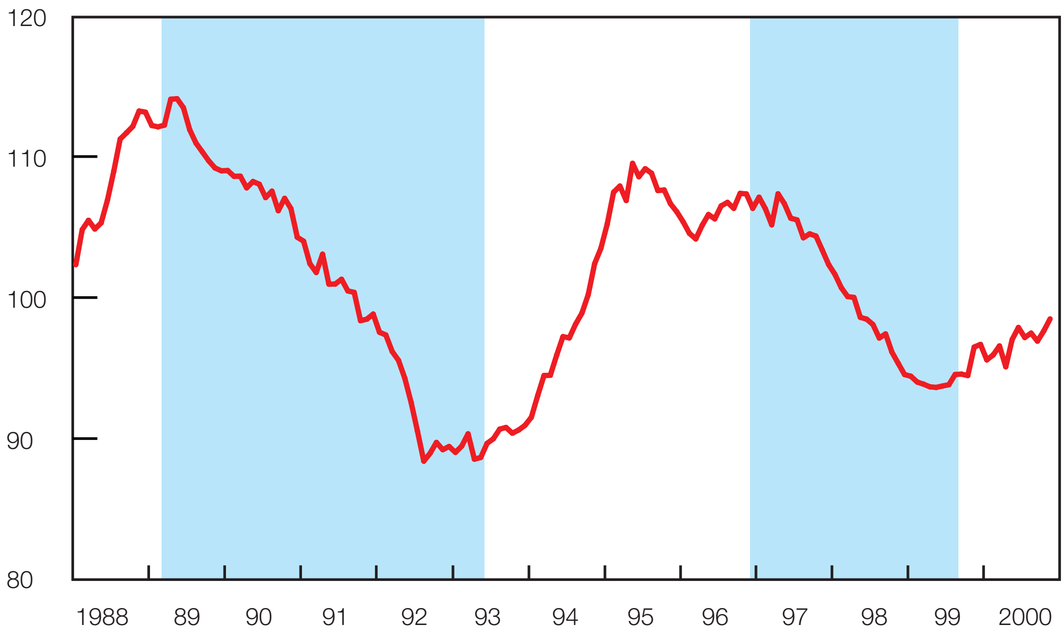
The composite coincident business cycle indicator – expressed as the deviation from its long-term trend – followed a declining time path during the whole of 1997 and 1998. After reaching a trough in May 1999, the indicator increased steadily during the latter half of 1999 and into 2000. This trough in the composite coincident business cycle indicator followed the lower turning point reached eight months earlier in the composite leading business cycle indicator.

Graph 1 Composite leading business cycle indicator
(deviation from long-term trend)



Shaded areas indicate downward phases of the business cycle

Graph 2 Composite coincident business cycle indicator
(deviation from long-term trend)

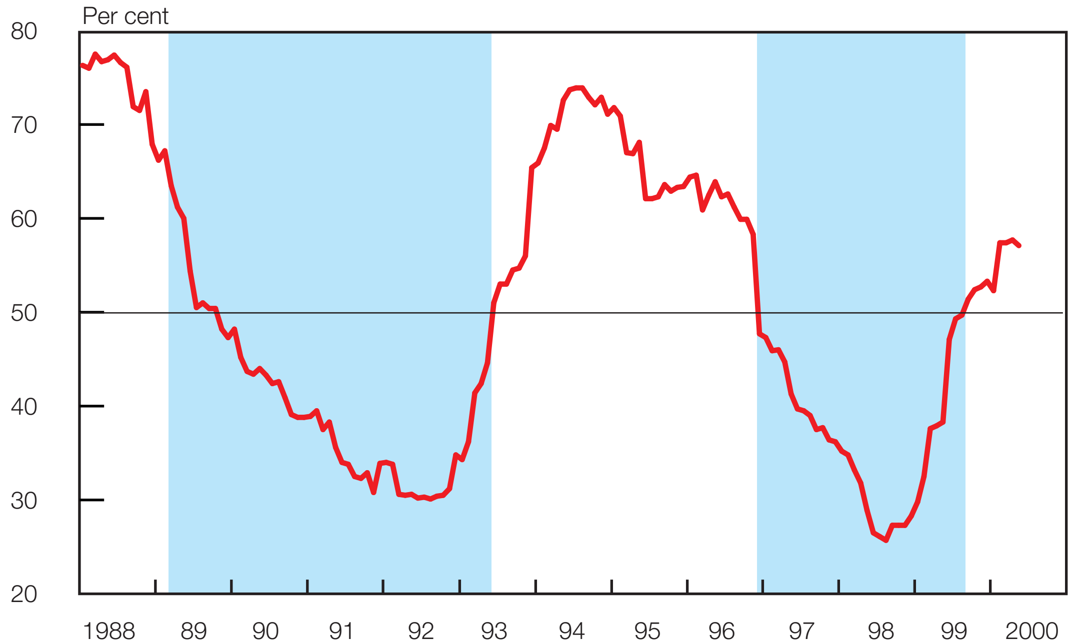


Shaded areas indicate downward phases of the business cycle

The historical diffusion index

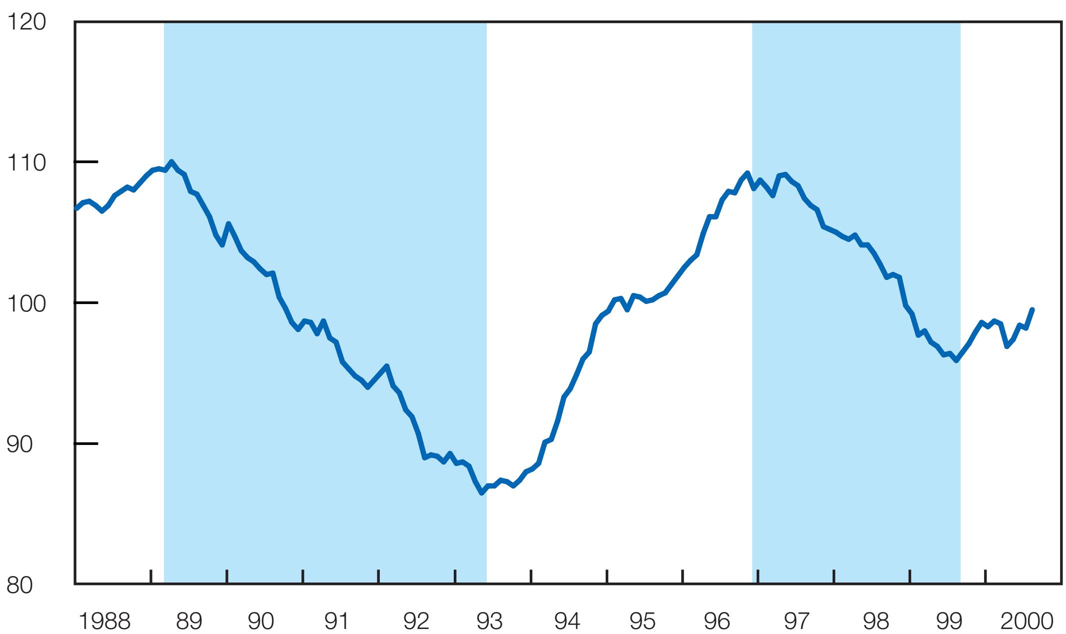
The historical diffusion index fell below 50 per cent in December 1996, confirming that November 1996 had been the date of the previous upper reference turning point. From December 1996 until August 1999, the number of variables moving

Graph 3 Historical diffusion index



Shaded areas indicate downward phases of the business cycle

Graph 4 Current diffusion index (deviation from long-term trend)



Shaded areas indicate downward phases of the business cycle downwards outnumbered those moving upwards. This movement was reversed after August 1999. The historical diffusion index therefore indicates that a lower reference turning point in the business cycle was reached in August 1999.

The current diffusion index

The current diffusion index – expressed as the deviation from its long-term trend – reached an upper turning point in November 1996, corroborating the previously calculated upper reference turning point in the business cycle. Graph 4 shows that the current diffusion index declined steeply after November 1996. This decline continued throughout 1997, 1998 and the first half of 1999. The current diffusion index reached a lower turning point in August 1999 and rose steeply during the latter part of 1999, before moderating somewhat in the first half of 2000.

Macroeconomic events and developments

During the second half of 1996 the recovery in general economic activity was nearing its end and the South African economy subsequently entered a downward phase of the business cycle in December 1996.

The disposable income of households grew progressively slower during 1996 and eventually declined from the fourth quarter of 1997 to the first quarter of 1999. Growth in real gross domestic expenditure also became sluggish during the second half of 1996 and continued its lacklustre performance up to the first quarter of 1999. Growth in household consumption expenditure began to moderate from the second half of 1996 and expenditure actually declined in the fourth quarter of 1998 and the first quarter of 1999. Inventories were also reduced sharply between the second half of 1996 and the first half of 1999.

Real consumption expenditure by general government declined during 1997 and throughout 1998 and 1999. This confirmed government's commitment to reducing the budget deficit and redressing macroeconomic imbalances in the country. Growth in real gross fixed capital formation tapered off towards the second half of 1996 and during 1997. However, growth in gross fixed capital formation accelerated during 1998 as a result of a strong rise in fixed capital formation by public corporations. Gross fixed capital formation by private business enterprises grew only marginally during 1997 and actually declined during 1998 and in the first half of 1999.

The high levels of indebtedness in the country further hampered domestic demand growth. Household debt as a percentage of disposable income reached a level of 60,9 per cent during the first quarter of 1997, then receded slightly before peaking at 61,1 per cent during the first quarter of 1998. Weak wholesale and retail trade sales during 1997, 1998 and the first half of 1999 further emphasised the weakness in domestic demand.

The slowdown in general economic activity was characterised more by a deceleration in aggregate domestic demand than in aggregate production. Nevertheless, production growth also decelerated in 1997 and 1998. Real gross value added in the primary and secondary sectors actually declined during 1997 and 1998, but the growth rate of real gross value added in the much larger tertiary sector only moderated during 1997 and 1998.

During the latter half of 1997, a number of emerging-market economies in Asia came under severe financial pressure. These financial market stresses spread to other emerging-market economies around the world, including South Africa. At first it seemed that the South African economy's growth prospects would not be disrupted by these developments. In fact, monetary policy was relaxed during October 1997 and again in March 1998.

In May 1998 a second round of Asian financial market turmoil erupted, which adversely affected South African financial markets. Net international capital flows into South Africa declined strongly and the nominal effective exchange rate of the rand depreciated considerably. These developments prompted policy makers to act immediately in order to restore financial market stability. Liquidity conditions tightened and interest rates rose sharply from April to August 1998. These events delayed the recovery in general economic activity and prolonged the downward phase of the business cycle.

Real merchandise exports continued to increase moderately throughout most of the economic slowdown. However, the sharp decrease in international commodity prices and reduced demand, especially from Asian markets, led to slower growth in merchandise exports during 1998. The decline in disposable income of households as well as the substantial depreciation of the rand eventually also led to a decline in real merchandise imports during the last quarter of 1998 and early in 1999. However, real merchandise imports improved substantially in the fourth quarter of 1999.

Towards the end of 1998 the worst of the international financial crisis seemed to be over. Output growth in the Asian region gained momentum throughout 1999 and the outlook for demand in the euro area has also improved since 1998. The downward trend in commodity prices was reversed from the first quarter of 1999 and the volume of merchandise exports from South Africa has increased unabatedly since the third quarter of 1999.

Monetary conditions eased from October 1998 when money-market interest rates began decreasing steadily. In this process the private banks lowered their lending rates. By July 1999 the predominant prime overdraft rate was lower than before the financial-market turmoil that had begun in April 1998. Net international capital outflows from South Africa were reversed and turned into strong inflows which strengthened from quarter to quarter in 1999, leading to an improvement in the net international reserves of the country. Business confidence rose again during 1999 from very low levels in 1998.

Real gross domestic final demand started to increase in the third quarter of 1999. This was evident mainly from the acceleration in the growth rate of final consumption expenditure by households and gross fixed capital formation by private business enterprises from the second half of 1999 onwards. Growth in real gross domestic product accelerated significantly in the second half of 1999. This acceleration was most notable in the secondary sectors of the economy. Gross operating surplus as a percentage of total factor income has also increased markedly since the third quarter of 1999.

Conclusion

The sharp reduction in interest rates as well as the fast expansion in world economic activity following the Asian crisis led to an improvement in the South African economy since 1999. Production and aggregate domestic and international demand picked up in the second half of 1999, signalling that the South African economy has moved through a lower turning point in the business cycle and into an upward phase.

The composite leading business cycle indicator reached a lower turning point in September 1998, and since then it has followed a definite upward trend. Eight months later the composite coincident business cycle indicator followed suit, reaching a lower turning point in May 1999. The historical diffusion index indicated a lower turning point three months later in August 1999. The current diffusion index also reached its most recent lower turning point in August 1999.

After due consideration of all the available information, the final reference date for the lower turning point in the business cycle is August 1999.

Note to tables

Maturity structure of foreign-currency denominated debt – S-101

The maturity structure of the South African Reserve Bank's foreign-currency denominated debt outstanding at the end of December 2000 has been amended. Outstanding loans on 31 December 2000 to the value of US$1 095 million were previously classified as having a three-year maturity but are now classified as having a one-year maturity, indicating that they are payable in 2001.