Quarterly Bulletin

December 2002

South African Reserve Bank

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Quarterly Economic Review

Introduction

When the attacks on the World Trade Center in New York and the Pentagon Building in Washington, D.C. were launched, global economic activity had already lost considerable momentum. A major cause of this slowdown was the sudden slump in the demand for communications, information and computing technology products and the accompanying fall in share prices, which caused a sizeable loss of financial wealth. Furthermore, the earlier tightening of monetary policy to curb inflationary pressures and the rising oil prices also weighed on economic activity. This developed into a worldwide loss of confidence which caused delays in decisions on expenditure and investment. Aggregate demand was depressed not only in the United States, but also in the rest of the world.

Economic policies in the industrial countries reacted to the weakness in aggregate demand. Monetary and fiscal policies were relaxed in response to the weaker outlook for the global economy. Fairly soon, there were clearer signs that the global economy had reached a lower turning point, but so far the recovery has been somewhat tepid and not evenly distributed among the major industrial countries.

Amid these concerns about global economic developments, financial markets became more uncertain and volatile, signifying that the recovery would not be as strong as had been anticipated earlier in 2002. Still, economic activity is expected to gather momentum as the effects of the monetary easing and fiscal incentives permeate through the global economy. Even so, inflation is not likely to impede the spread of the recovery.

Apparently unperturbed by the uncertainties in the global economy, the South African economy continued to expand during 2002. The pace of overall economic growth was firm at an annualised rate of 3 per cent in the third quarter of 2002, following exceptionally strong growth of 4 per cent in the second quarter.

Growth was fairly evenly distributed over all the major production sectors of the economy. The pace-setters were the transport and communication sector, manufacturing and agriculture. Output originating in the mining sector languished somewhat, but nominal value added in this sector benefited substantially from the depreciation in the exchange value of the rand in the closing months of 2001.

In the first two quarters of 2002 economic growth was driven by rising domestic demand and growing export volumes. This benign situation of balanced growth suffered a setback in the third quarter of 2002 when the international demand for South African produced goods faltered unexpectedly. Domestic demand was still robust and aggregate gross domestic expenditure grew at a faster pace in the third quarter of 2002 than in the second quarter.

There was a large accumulation of inventories in the third quarter of 2002, but fixed capital formation also increased quite rapidly. Growth in final consumption expenditure by households, however, slowed down from the second to the third quarter of 2002. However, households' real outlays on durable goods, such as motorcars, strengthened in the third quarter of 2002 – purchases of durable goods were apparently advanced in order to avoid paying higher prices later.

Operating surpluses of export-oriented industries were boosted by the depreciation in the exchange rate of the rand in the last quarter of 2001. This shifted the distribution of domestic income in favour of employers – the share of operating surpluses in aggregate production-factor rewards is now at its highest level since the Second World War. The strong growth in operating surpluses also helped to improve corporate saving and the national gross saving ratio.

The high level of economic activity in the second quarter of 2002 was accompanied by an increase in employment in the formal non-agricultural sectors of the economy. Of even greater significance was that this increase in the supply of jobs occurred primarily in private-sector business enterprises. This was the first time since early 1999 that measured formal-sector employment actually increased in any calendar quarter. The latest increase in employment levels may signal that the strategies aimed at containing cost and raising efficiencies in the production process have been successful and that future output expansions may perhaps be accompanied by the creation of new jobs.

The increase in employment in the second quarter of 2002 had little impact on the overall excess supply of labour in the economy. Against the background of substantial excess supply in the labour market, the rate of increase in nominal wages and salaries remained downwardly inflexible. In fact, nominal wage growth began to accelerate in the second half of 2001 and remained at a high level in the first half of 2002. At the same time, productivity growth slowed down as employers became less aggressive about paring their staff complements. This meant that the cost implications of higher nominal wage growth were not fully absorbed by higher output per worker, eventually leading to fairly strong increases in economy-wide unit labour cost in the first half of 2002.

The acceleration in growth in unit labour cost, together with the depreciation in the exchange value of the rand in 2001 and rapid increases in food and oil prices, propelled production and consumer price inflation to considerably higher levels in the first half of 2002. Measured over periods of one year, these price increases remained well above the inflation-target ranges set by government. However, there were indications that the incremental growth in prices, when measured from one quarter to the next, was actually slowing down at the production price level. But even this lower quarter-to-quarter price growth exceeded by some margin the upper limit of the inflation target range set at 6 per cent for 2002, 2003 and 2004.

Weaker global economic conditions caught up with the South African economy in the third quarter of 2002. While export volumes were still at a high level and growing in the first half of 2002, they declined quite sharply as the world demand for South African exports declined in the third quarter. Import volumes, by contrast, declined only slightly and remained at a high level, responding to fairly strong domestic demand. Interest and dividend payments to non-resident investors shrank on a net basis, but this could not prevent the current account of the balance of payments changing from surpluses in the first half of 2002 to a deficit in the third quarter. A deficit on the current account of the balance of payments usually signals that expenditure in the economy exceeds aggregate disposable income.

There was a sudden reversal of portfolio capital movements from strong net inflows in the second quarter of 2002 to net outflows of almost equal size in the third quarter. Market participants linked this sudden flow-reversal to the leaking of a draft empowerment charter for the mining industry which raised concerns about the riskiness of investment throughout the South African economy. The overall positive imbalance on the financial account of the country with the rest of the world declined to a level in the third quarter which fell far short of the financing requirements of the current account. By necessity, the country's holdings of net gold and other international reserves subsequently declined in the third quarter of 2002.

The deficit on the current account in the third quarter of 2002 and the small inflow of capital into the economy weighed on the exchange rate of the rand, pushing the weighted exchange value lower by some 1,3 per cent from the end of June 2002 to the end of September. The exchange rate strengthened in the early part of the fourth quarter, creating the impression that the overall balance-of-payments position was improving.

As regularly happens shortly after an increase in bank lending rates, overall monetary growth and the growth in bank credit extension accelerated in the first quarter of 2002. This coincided with the expansion of aggregate income and expenditure and also provided the monetary accommodation for rapidly rising prices, inevitably following in the wake of the depreciation in the exchange value of the rand in the second half of 2001. In the long run, and in the absence of velocity changes, an increase in the overall money supply in excess of real output must be associated with inflation.

Later, in the second and third quarters of 2002, growth in M3 and in bank credit extension were reined in by, among other things, the progressive tightening of the Reserve Bank's monetary policy stance. From January to September 2002 the Reserve Bank increased its interest rate on short-term repurchase transactions on four occasions by 100 basis points at a time. Quarter-to-quarter growth in M3 and bank credit extension slowed down to relatively low rates in the third quarter of 2002, signalling a reduction in the inflationary pressures in the economy.

Short-term money-market interest rates generally moved higher in the first ten months of 2002, either following increases in the Reserve Bank's repurchase rate or in anticipation of future increases in this rate. By contrast, the yield on long-term government bonds generally declined from about the end of March 2002, reflecting falling inflation expectations and a limited supply of investable paper in the market.

The downward movement in bond yields was interrupted by a fairly short interlude of rising yields from about the end of July 2002 to the beginning of October. This temporary reversal of the downward drift in bond yields was caused, alongside other factors such as higher inflation expectations, by the leaking of the draft empowerment charter for the mining industry.

The divergent movements of short- and long-term interest rates caused a flattening of the yield curve and later inverted the slope of the curve over the entire maturity spectrum. Some analysts interpret such a downward sloping yield curve as a reflection of a tight monetary policy stance, leading eventually to enduringly lower inflation.

Following the lead given by the major international markets, share prices on the JSE Securities Exchange SA fell by almost a quarter from the end of May 2002 to the beginning of August. In the ensuing months some of these losses in capital value were recovered, mostly in the resources sector of the market. The real-estate market also revealed a softer undertone in the middle quarters of 2002.

The financial position of the national government remained sound in the first half of fiscal 2002/03. Judging by information released through the *Medium Term Budget Policy Statement* the prospects are that this situation will continue in the second half of the year. Overall national government expenditure increased slightly faster than the usual growth in the months from April to September, but the small excess over budgeted expenditure is unlikely to widen in the second half of the fiscal year. Incoming information indicates that growth in spending is broadly on target for the fiscal year as a whole.

Simultaneously, improving economic conditions, higher inflation and efficient tax administration assured that growth in national government revenue by far exceeded the budget projections for the full fiscal year. As a consequence, and allowing for the usual seasonal pattern of revenue and expenditure flows, the budget deficit of the national government as a ratio of gross domestic product is expected to fall to 1,6 per cent – well below the originally projected deficit ratio of 2,1 per cent for fiscal 2002/03.

A capital transfer of R7 billion was made by the national government to the Reserve Bank during the third quarter to compensate the Bank for losses incurred on forward foreign-exchange transactions. Also, the financial position of the provincial governments deteriorated and the surpluses of the non-financial public-sector businesses narrowed. All these contributed to an increase in the borrowing requirement of the overall non-financial public sector from 0,8 per cent of gross domestic product in the first half of fiscal 2001/02 to 3,0 per cent in the first half of the current fiscal year, still well within the limits of sustainable public-debt growth.

When presenting the *Medium Term Budget Policy Statement* to Parliament, the Minister of Finance announced that an agreement had been reached between the National Treasury and the Reserve Bank to raise the upper limit of the inflation target range for 2004 from 5 per cent to 6 per cent.

Domestic economic developments

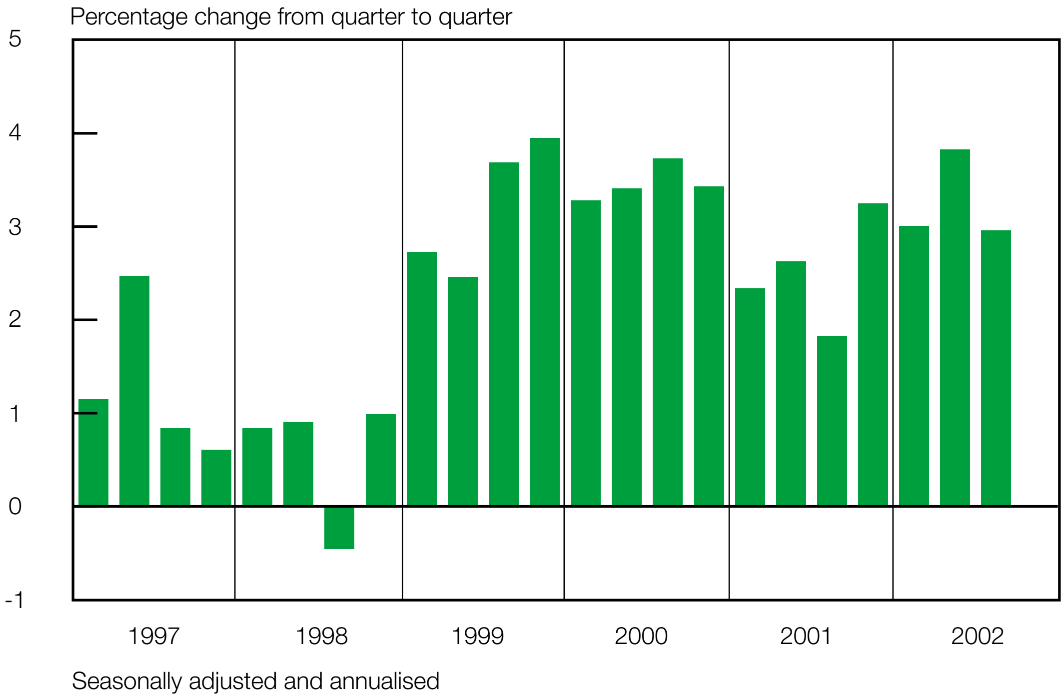
Domestic output[1]

The South African economy continued to grow in the third quarter of 2002, albeit at a slightly slower pace than in the second quarter. Current estimates indicate that growth in *real gross domestic product* was firm at a seasonally adjusted and annualised rate of about 3 per cent in the third quarter of 2002, following even stronger growth of 4 per cent in the second quarter. As was the case in the second quarter of 2002, the growth in output was again well distributed throughout the various sectors of the economy in the third quarter.

Overall, the level of real gross domestic product was about 3 per cent higher in the first three quarters of 2002 than in the corresponding quarters of 2001, signalling that economic growth of some 2½ to 3 per cent may be forecast with a fair degree of certainty for 2002 as a whole. This growth rate is roughly on a par with the year-to-year growth rate recorded in 2001.

1 In accordance with normal practice during the third quarter of every year, revisions have been made to national accounts data and are incorporated in this issue of the Quarterly Bulletin. *These revisions are based on more detailed or more appropriate data that have become available. In addition, seasonal factors have been updated.*

Real gross domestic product



Real output expanded robustly in the *agricultural sector* during the middle quarters of 2002. Following growth at a seasonally adjusted and annualised rate of 9 per cent in the second quarter of 2002, the real value added by the agricultural sector increased at 5 per cent in the third quarter. Agricultural output benefited from increased activity in field crop production and livestock farming. Field crop production was boosted by an increase in the size of the maize crop from 7,5 million tons in the 2001 harvesting season to an estimated crop of 9,1 million tons in the 2002 harvesting season.

Real gross domestic product
Percentage change at seasonally adjusted annualised rates

	2001					2002		
Sectors	1st qr	2nd qr	3rd qr	4th qr	Year	1st qr	2nd qr	3rd qr
Primary sectors	-4	-1	-2	-2	-1½	3½	4½	2½
Agriculture	-7	-2	-1	½	-1½	7½	9	5
Mining	-1½	0	-3	-4½	-1½	½	1½	1
Secondary sectors	2	2	0	5½	3½	3½	5	3
Manufacturing	1½	2	0	7	3½	4	6	3½
Tertiary sectors	4	3½	3½	3½	3½	2½	3½	3
Non-agricultural sectors	3	3	2	3½	3	2½	3½	3
Total	2½	2½	2	3	3	3	4	3

Two quarters of rather lacklustre growth in the *mining sector* were followed by an output expansion of just 1 per cent in the third quarter of 2002. Coal, diamond and some other mines were successful in expanding real value added. Gold production declined as gold producers responded to the higher rand price of gold by cutting output volumes and allowing margins to widen.

Real value added by the *manufacturing sector* grew at a seasonally adjusted and annualised rate of 3½ per cent in the third quarter of 2002, following exceptionally strong growth of 6 per cent in the second quarter. Strong demand in export markets, brought about by efficiency-enhancing investments in recent years and the real depreciation in the value of the rand in 2001, spurred activity in the manufacturing sector as a whole. The subsectors of manufacturing that benefited the most were producers of transport equipment, chemical products, metal products as well as machinery and equipment. Easier entry of South African producers into the United States market in terms of US legislation, namely the African Growth and Opportunity Act, is also having a positive effect on manufacturing production, especially in the textile industry.

The real value added by the *construction sector* increased at a seasonally adjusted and annualised rate of 2½ per cent in both the second and third quarters of 2002. Roads construction and the improvement of economic and social infrastructure provided the basis for increased activity in the civil engineering subsector. Residential construction and alterations to existing buildings also made some contribution to the faster pace of construction activity, but on a far less impressive scale than civil engineering.

Growth in the real value added by the *commerce sector* (seasonally adjusted and annualised) slowed down from 2½ per cent in the second quarter of 2002 to 2 per cent in the third quarter. The retail trade sector, which is an important component of commerce, sets the pace in this sector, followed by catering and accommodation. Households' disposable income grew steadily, and the catering and accommodation sector received a fillip from South Africa's hosting of the United Nations World Summit on Sustainable Development in August 2002 which attracted a large number of delegates and other visitors to the country.

The real value added by the *transport, storage and communication sector* grew at a fast clip in the middle quarters of 2002. Growth at an annualised rate of approximately 6 per cent was helped along by the ever-expanding cellular telephone industry and increased road and air travel.

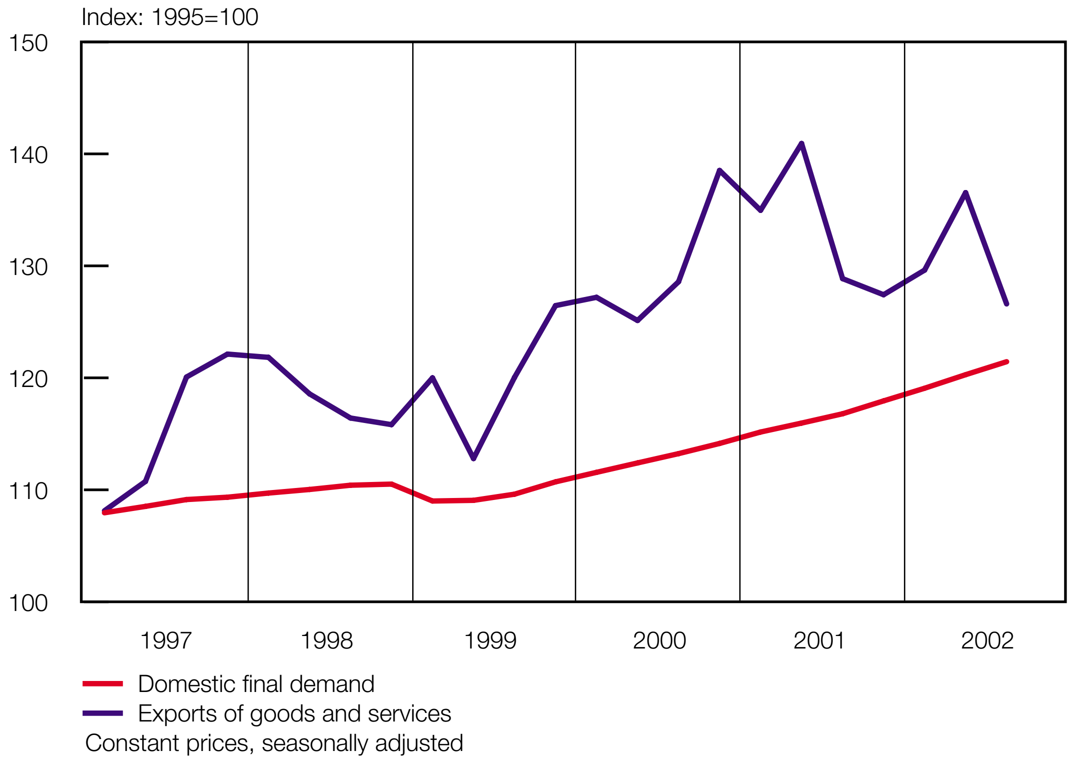
Growth in the real value added by the *financial intermediation, insurance, real-estate and business services sector* slowed down from an annualised rate of 4 per cent in the second quarter of 2002 to about 3 per cent in the third quarter. Slowdowns in real activity in the banking sector and lower trading volumes in the securities and derivatives markets were the main factors responsible for the lower growth in the financial intermediation sector. Growth in real value added in the *real-estate sector* remained lively, despite the higher cost of mortgage financing, but this could not counter the slight deterioration in activity in the rest of the sector.

Growth in output originating in the general-government sector has been fairly subdued in recent years. The paring of employment in the public sector was widely seen as a mechanism to improve productivity in public-service delivery, holding back the growth in real value added by general government. This process has now largely accomplished its objectives. Helped along by a gentle rise in employment, real value added by general government increased at annualised rates of 2½ per cent in both the second and third quarters of 2002.

Domestic expenditure

The expansion of the South African economy in the first half of 2002 was fairly well balanced in the sense that it was driven by increases in both domestic expenditure and in export demand. This benign situation came to an end in the third quarter of 2002 when the expansion became more dependent on growth in domestic expenditure. The physical quantity of exports declined in the third quarter of 2002, as is discussed later in this review.

Aggregate domestic final demand and exports



To a large extent due to the replenishment of inventories, the rate of growth in real *gross domestic expenditure* picked up from zero in the second quarter of 2002 to a seasonally adjusted annualised increase of 8 per cent in the third quarter. Firmer growth in real fixed capital formation and in final consumption expenditure by general government added momentum to the growth in real gross domestic expenditure, but growth in final consumption expenditure by households slowed down from the second to the third quarter.

Real gross domestic expenditure

Percentage change at seasonally adjusted annualised rates

	2001					2002		
Components	1st qr	2nd qr	3rd qr	4th qr	Year	1st qr	2nd qr	3rd qr
Final consumption expenditure by households	3½	2½	3	3½	3	3½	3½	3
Final consumption expenditure by general government	3½	3½	3½	4	3½	3½	3½	3½
Gross fixed capital formation	5	3	2½	6½	3½	7	7½	8½
Change in inventories (R billions)*	0,4	-2,3	4,0	4,7	1,7	8,1	1,2	5,5
Gross domestic expenditure	3½	1	7	4	2½	7	0	8

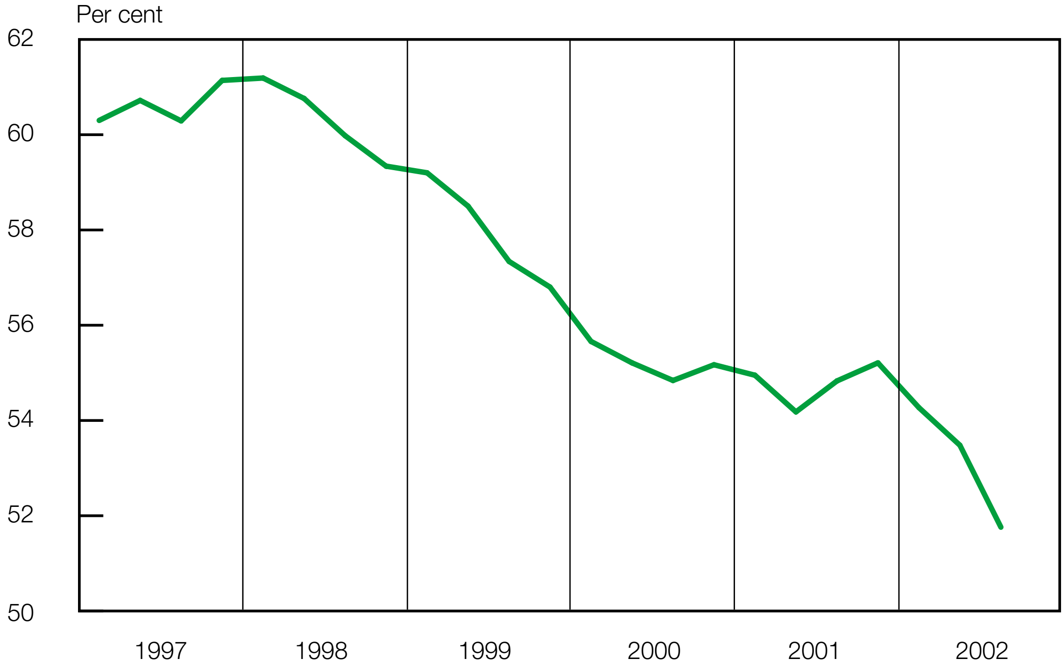
* At 1995 prices

Growth in *real final consumption expenditure by households* decelerated from a seasonally adjusted and annualised rate of 3½ per cent in the second quarter of 2002 to about 3 per cent in the third quarter. Households' real disposable income increased steadily, partly because of some tax relief to taxpayers and an increase in farm income. Household savings accordingly strengthened somewhat and recourse to debt financing diminished in the third quarter of 2002. Although household debt relative to disposable income declined to 52 per cent in the third quarter of 2002 – it was 55 per cent in 2001 – rising bank lending rates and other finance charges lifted households' debt-servicing costs as a percentage of their disposable income from an average of 7½ per cent in 2001 to more than 8 per cent in the third quarter of 2002.

The slowdown in final consumption expenditure by households in the third quarter of 2002 was clearly evident in spending on semi-durable goods, particularly in real outlays on clothing and footwear and motor vehicle parts and accessories. Increases in the prices of semi-durable goods relative to the prices of other consumer goods, and the relatively high elasticity of spending on these items with respect to price changes, probably contributed to households' economising on spending in this area.

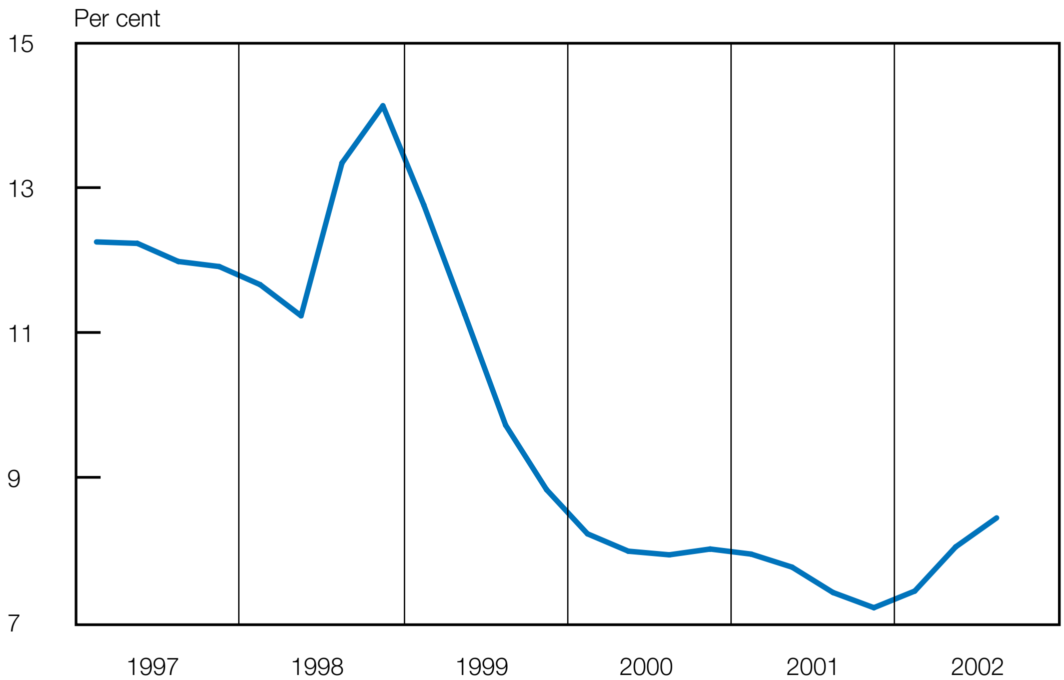
Households' real outlays on *non-durable goods* increased in the third quarter of 2002 at a rate approximately similar to that attained in the second quarter. Increases in nominal spending on non-durable goods roughly matched the acceleration in prices, implying that growth in inflation-adjusted or real spending on non-durable goods sustained the growth rates of previous quarters. Somewhat perversely, total real outlays on *durable goods* increased quite strongly in the third quarter of 2002. Some preemptive buying ahead of anticipated price rises in the fourth quarter of 2002 inspired higher spending on new motorcars, especially those in the expensive segment of the market. Growth in households' real outlays on *services* accelerated from the second to the third quarter of 2002. Higher spending in the medical services category and on transport and communication services contributed to the increase in overall spending on services.

Household debt as percentage of disposable income



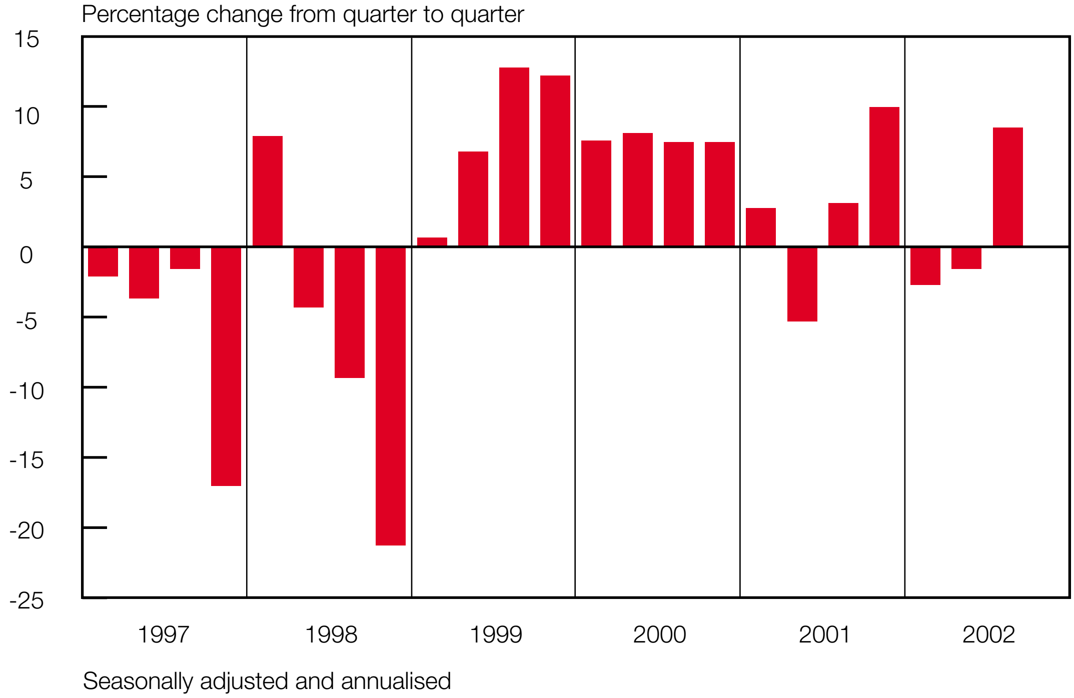
Seasonally adjusted

Debt-servicing cost of households as percentage of disposable income

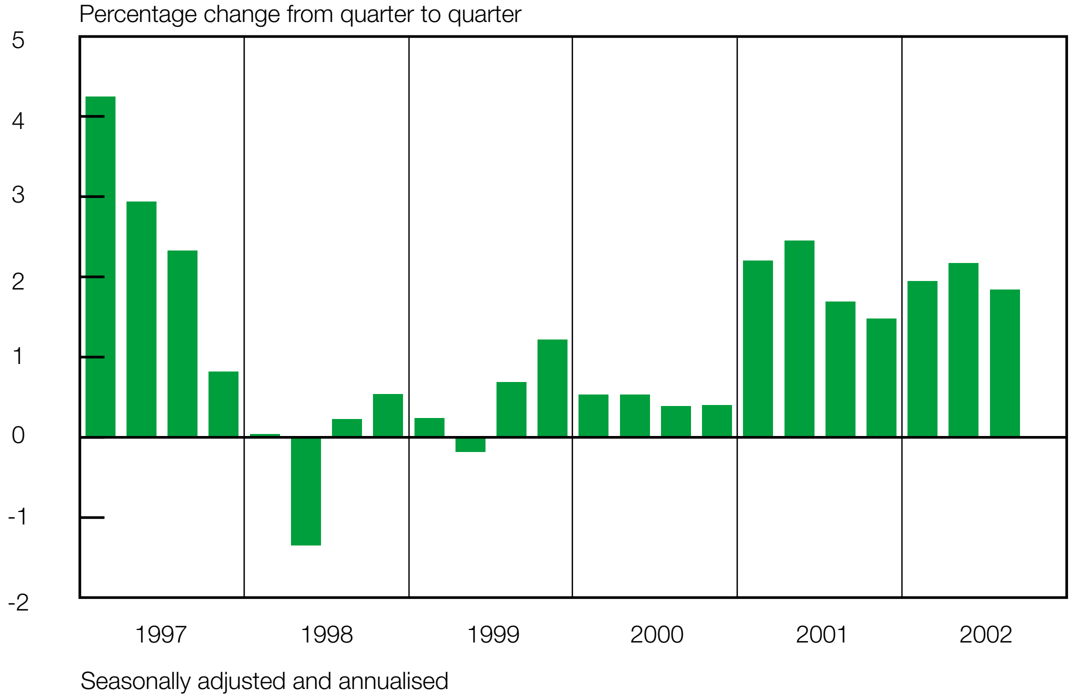


Seasonally adjusted

Real final consumption expenditure by households on durable goods

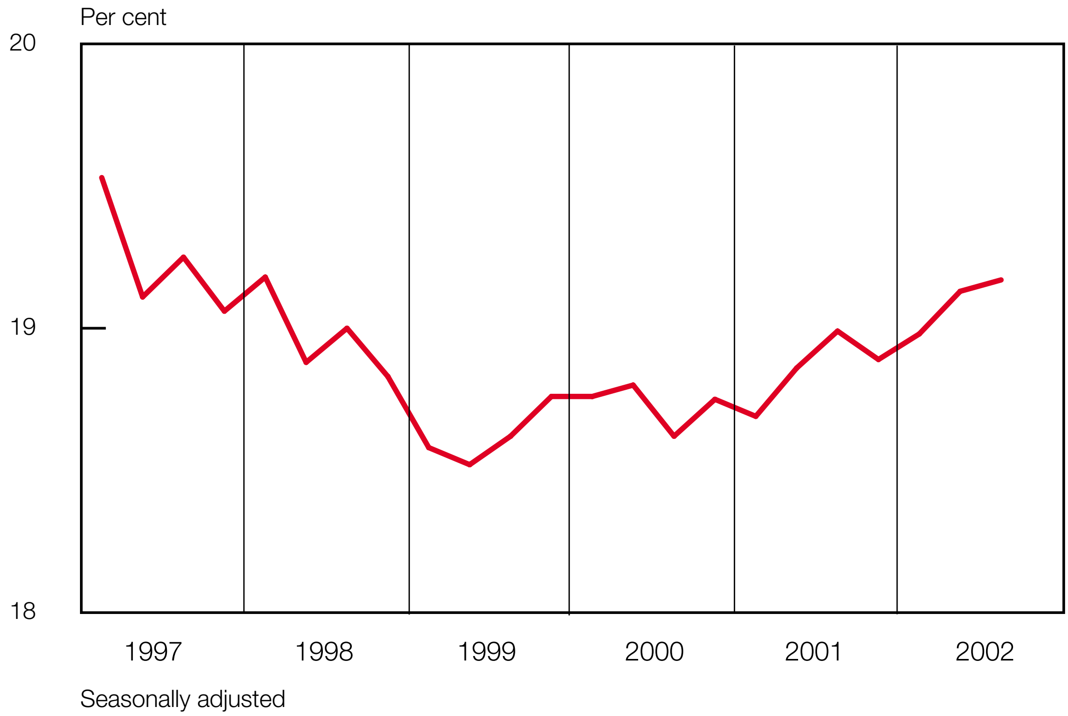


Real final consumption expenditure by households on non-durable goods



Real final consumption expenditure by general government increased at a seasonally adjusted and annualised rate of 3½ per cent in the third quarter of 2002, similar to the growth registered in the second quarter. Spending on non-wage goods and services increased quite noticeably in the third quarter of 2002; real spending on compensation of employees increased too, but at a lower rate than spending on non-wage goods and services. Despite the fairly strong growth in the latest two quarters, final consumption expenditure by general government as a percentage of gross domestic product has now remained at a level of around 19 per cent for six quarters in succession.

Final consumption expenditure by general government as percentage of gross domestic product

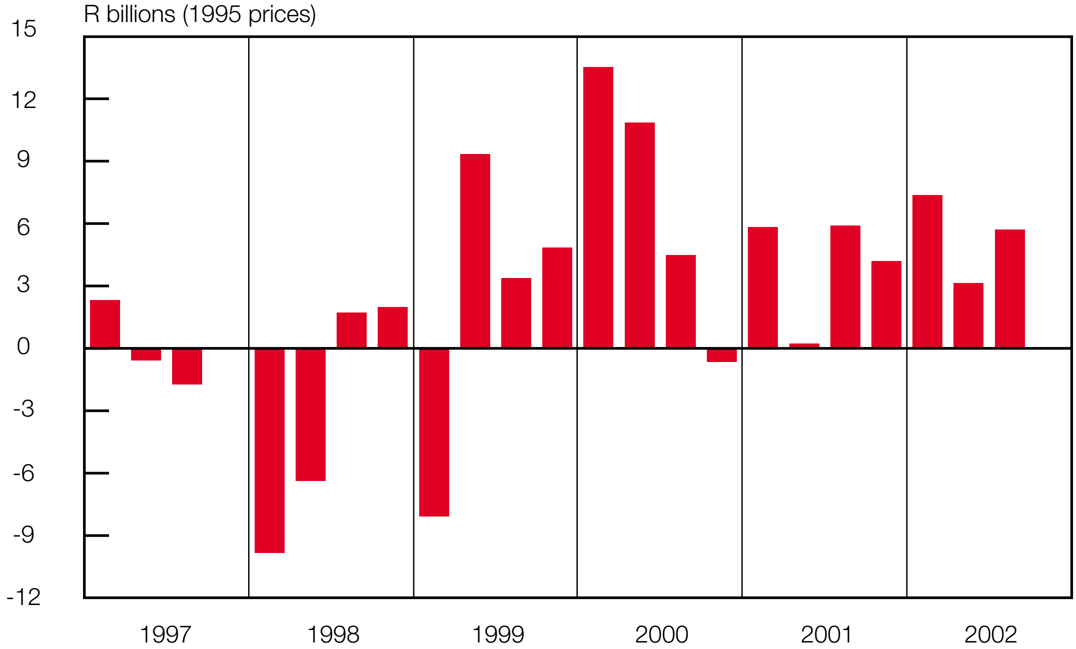


Real gross fixed capital formation increased at seasonally adjusted and annualised rates of 7½ per cent in the second quarter of 2002 and 8½ per cent in the third quarter. All three institutional sectors, namely private business enterprises, public corporations and general government, participated in this expansion of productive capacity. Real fixed capital formation was taken to a level in the first three quarters of 2002 that was about 6 per cent higher than in the corresponding period of 2001, up from growth of about 3½ per cent in 2001 as a whole.

The growth in real gross fixed capital formation by *private-sector businesses* accelerated from 8 per cent in the second quarter of 2002 to about 9 per cent in the third quarter. Production capacity in all the main sectors of the economic activity benefited from the heightened investment activity in the private sector. In the manufacturing sector, motorcar manufacturers stepped up fixed capital formation to meet growing export demand. In the agricultural sector, capital formation responded to better-than-expected field crops and the need to replace obsolete equipment. The cellular telephone industry faced an ever-increasing demand for service delivery and the platinum industry experienced boom conditions as export demand grew.

The development of the Coega harbour and industrial complex in the Eastern Cape pushed real gross fixed capital formation by *public corporations* higher at seasonally adjusted and annualised rates of 6 per cent in the second quarter of 2002 and 7 per cent in the third quarter. Eskom, the electricity utility company, also stepped up its real capital expenditure in the third quarter of 2002, whereas that of the *general government sector* has been accelerating from an annualised rate of ½ per cent in the first quarter to 9 per cent in the third quarter.

Changes in industrial and commercial inventories



Seasonally adjusted and annualised

The slump in inventory investment in the second quarter of 2002 was followed by fairly strong inventory replenishment in the third quarter, probably signalling the realignment of inventory levels with expectations of continued growth in aggregate demand. The inflation-adjusted value of net investment in inventories (seasonally adjusted and annualised) rose from R1,2 billion in the second quarter of 2002 to R5,5 billion in the third quarter. Inventory accumulation was reported in the mining, manufacturing and commercial sectors. Overall, the increase in industrial and commercial inventories only kept pace with the growth in gross domestic product, leaving the level of these inventories relative to aggregate production unchanged at about 16 per cent in the third quarter of 2002.

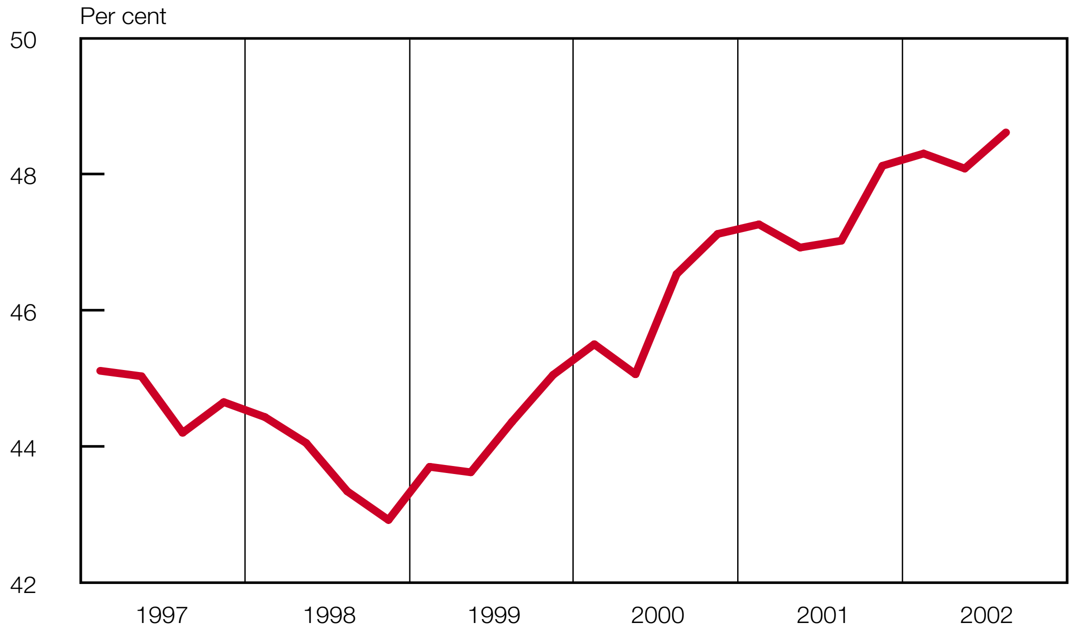
Factor income and saving

The year-on-year growth in aggregate *nominal factor income* accelerated from 10½ per cent in the second quarter of 2002 to 11½ per cent in the third quarter. This pick-up was due to faster growth in both the operating surpluses of businesses and the compensation of employees.

Measured over one year, gross operating surpluses increased by 15½ per cent in the third quarter of 2002, following an increase of 13½ per cent in the second quarter. Growth in total compensation of employees, also measured over four quarters, picked up from 8 per cent in the second quarter of 2002 to 8½ per cent in the third.

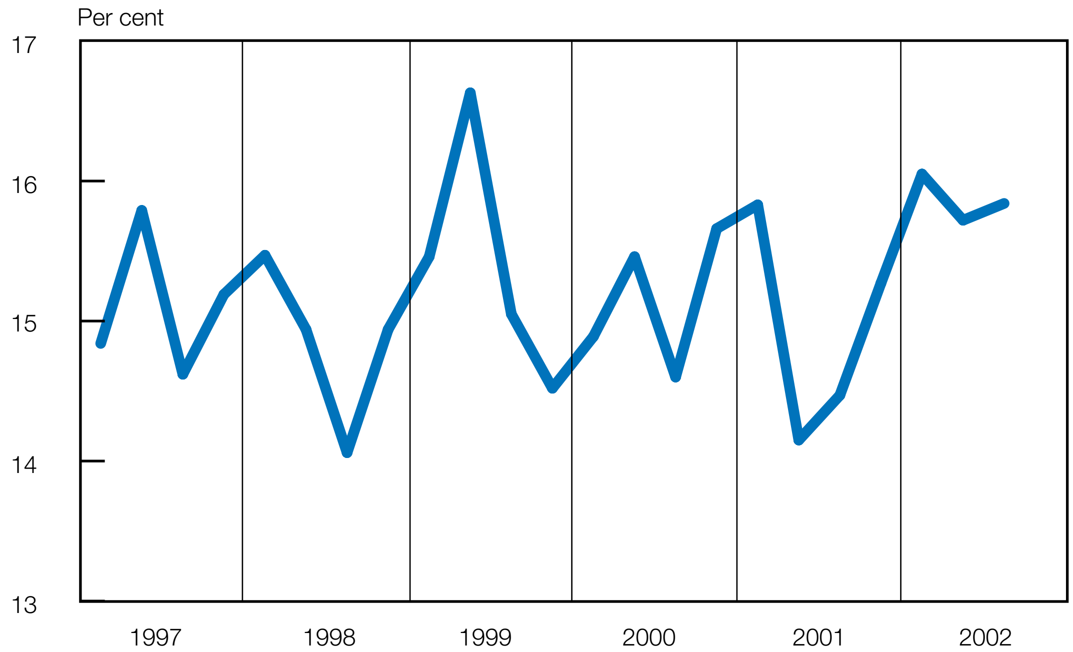
With operating surpluses growing faster than the compensation of employees, the share of capital (i.e. operating surpluses) in the overall value of output increased from 48 per cent in the second quarter of 2002 to 48½ per cent in the third quarter – the highest ratio recorded in the period after the Second World War.

Gross operating surplus as percentage of total factor income



Seasonally adjusted

Gross saving as percentage of gross domestic product



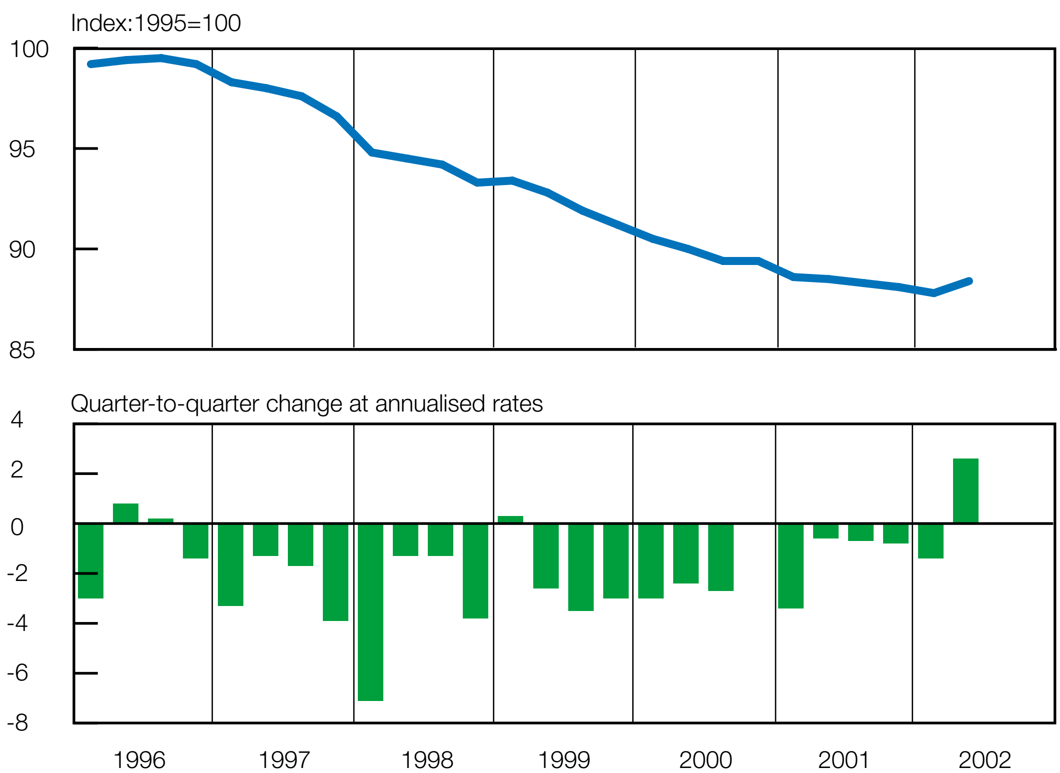
Seasonally adjusted

Operating surpluses increased strongly in the agricultural sector where farm income was boosted by the increase in the size of the maize crop and high product prices, and the export-oriented mining and manufacturing sectors reaping windfalls from the depreciation in the exchange value of the rand. The rise in operating surpluses allowed companies to retain a larger portion of profits in the business, lifting saving by the corporate sector relative to gross domestic product from just below 11 per cent in the second quarter of 2002 to 11 per cent in the third quarter. Household saving improved too, but remained unchanged as a percentage of gross domestic product from the first to the third quarter of 2002. With general government also contributing to the national saving effort, gross saving as a percentage of gross domestic product rose from 15½ per cent in the second quarter of 2002 to 16 per cent in the third. Against the backdrop of the development needs of the South African population, this low saving ratio is generally perceived as inadequate for the financing of strong investment-driven growth in the economy.

Employment

According to the *Survey of Employment and Earnings in Selected Industries* (SEE) by Statistics South Africa, employment in the *regularly surveyed formal non-agricultural sectors of the economy* increased at an annualised rate of 2,6 per cent in the second quarter of 2002. This was the strongest quarterly increase in the past six and a half years and resulted entirely from employment gains in the private sector. Public-sector employment contracted further, albeit at a slower pace than in preceding quarters.

Formal-sector non-agricultural employment



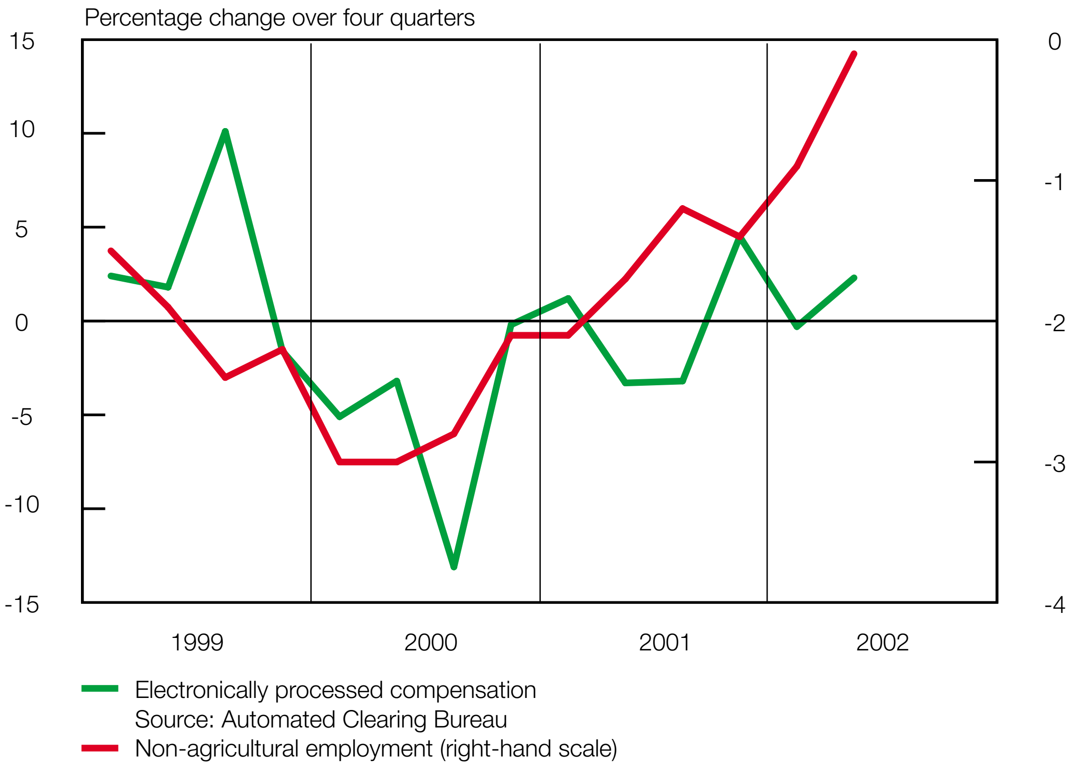
Seasonally adjusted

Several factors contributed to the increase in overall employment in the second quarter of 2002. These were
- an improvement in the international price competitiveness of domestic industries caused by the depreciation in the value of the rand during 2001;
- incentives provided by United States legislation (i.e. the African Growth and Opportunity Act) which generated an estimated R10 billion worth of exports in 2001 by companies employing about 20 000 workers;
- an increase in international commodity prices, which improved the job-creating potential of particularly the mining industry;
- the increase in the number of foreign visitors to the country (later boosted by the large number of delegates to the United Nations World Summit on Sustainable Development that was held in the third quarter of 2002) which created additional job opportunities in the trade, catering and accommodation services sector; and
- relatively strong economic growth that was fairly evenly distributed among the major production sectors of the economy.

Employment in the *private sector* increased at an annualised rate of 4,1 per cent in the second quarter of 2002, driven higher by employment gains in all the major subsectors of the economy, except for the financial intermediation and insurance sectors. The largest personnel increase was recorded in the construction sector, followed by washing and laundering services, transport, storage and communication, and the mining sector. Employment in the manufacturing sector increased at an annualised rate of almost 3 per cent in the second quarter of 2002.

Evidence of the rise in employment is corroborated by an increase in the number of electronically paid salaries, wages and pensions processed by the Automated Clearing Bureau of South Africa (see accompanying graph).

Number of electronically processed compensation payments
and non-agricultural employment



The total number of monthly electronic payments approached the 5 million mark in the second quarter of 2002. Since about the middle of 2000, the growth in the number of electronic remuneration payments accelerated noticeably to reach a year-on-year rate of increase of 2,3 per cent in the second quarter of 2002.

Contrary to the rise in private-sector employment, *public-sector* employment declined at an annualised rate of 0,3 per cent in the second quarter of 2002. But there was a slowdown in the pace of employment losses in most subsectors of the public service. The only exception was in the transport, storage and communication sector, where the pace of decline accelerated. Some of these job losses were absorbed by private-sector firms active in the transportation and communication industry where personnel numbers were increased by almost 6 per cent between the first half of 2001 and the first half of 2002.

In an effort to further improve the collective bargaining processes in the labour market and tighten procedures in the event of dismissals and retrenchments, and to address problems in the case of insolvencies, the Labour Relations Act and the Basic Conditions of Employment Act were amended on 1 August 2002. The terms and conditions of employment of domestic workers were also defined more precisely. From 1 November 2002 employers will be compelled to pay a minimum wage ranging between R418 per month for employees who work 27 hours or less per week and R800 per month for employees who work 45 hours per week.

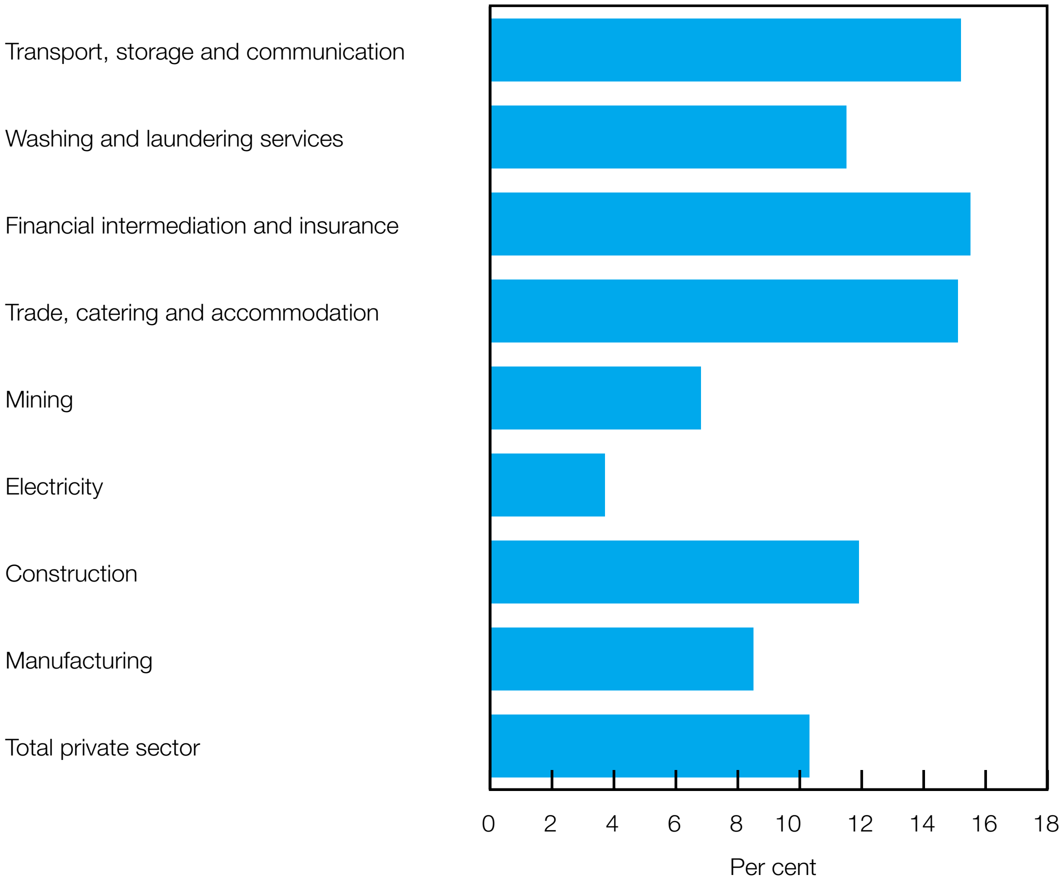
Labour cost and productivity

Although the year-on-year growth in the *average nominal remuneration per worker* in the formal non-agricultural sectors of the economy slowed down from 9,4 per cent in the first quarter of 2002 to 8,7 per cent in the second quarter, annual wage growth still averaged 9,1 per cent in the first half of 2002 – one of the highest growth rates in the past four years. With overall year-on-year consumer price inflation averaging 7,2 per cent in the first half of 2002, employed workers therefore enjoyed an improvement of almost 2 per cent in their “real consumption wage”, i.e. in the real buying power of their remuneration.

Furthermore, information obtained from the Automated Clearing Bureau signals that the slowdown in nominal wage growth in the second quarter of 2002 could have been reversed in the third quarter. Also, survey results obtained from Andrew Levy Employment Publications show that the average rate of wage settlements in collective bargaining agreements concluded at the enterprise level rose from 7,5 per cent in the first nine months of 2001 to 7,7 per cent in the first nine months of 2002. At the centralised level, the settlement rate was even higher at 8,7 per cent in the first three quarters of 2002.

Despite the deceleration in nominal remuneration growth in the *private sector* from the first to the second quarter of 2002, wage growth accelerated from an annual average of 9,1 per cent in 2001 to 10,3 per cent in the first half of 2002. High rates of nominal wage growth were especially noticeable in the financial intermediation and insurance industry, where average pay was roughly 16 per cent more in the first half of 2002 than in the first half of 2001. Fairly sizeable remuneration increases, i.e. in excess of 15 per cent, were recorded in the transport, storage and communication sector, as well as in the trade, catering and accommodation services sector. Remuneration growth in the mining, electricity generating and manufacturing sectors was less pronounced than in the other sectors of the economy.

Nominal remuneration per worker in non-agricultural private sector:
Year-on-year change in first half of 2002



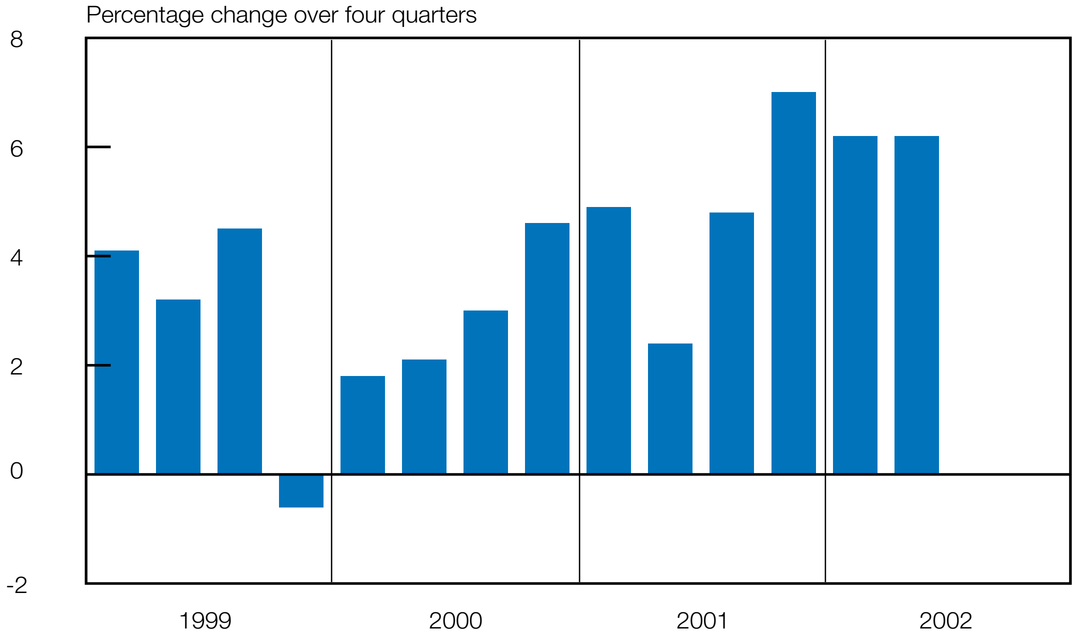
Growth in the nominal remuneration per worker in the *public sector* accelerated from a year-on-year rate of 6,5 per cent in the first quarter of 2002 to 8,4 per cent in the second quarter. Increased wage pressures were fairly pervasive throughout the public sector in the second quarter of 2002. While high year-on-year remuneration increases were granted to employees in national government departments, nominal remuneration growth in the transport, storage and communication sector and at local government level was lower than at the national government level.

Partly as a consequence of the heightened international competitiveness of domestic producers following the sharp depreciation in the rand in the closing months of 2001, growth in *manufacturing production* picked up strongly to a year-on-year rate of 5,2 per cent in the first half of 2002. So, year-on-year growth in labour productivity in this sector (measured as real output per worker) rose from 3,1 per cent in the third quarter of 2001 to 6,5 per cent in the second quarter of 2002. Economy-wide labour productivity growth was considerably lower than in the manufacturing sector, amounting to a year-on-year rate of 2,4 per cent in the second quarter of 2002.

The brisk pace of increase in manufacturing labour productivity, coupled with a slowdown in nominal remuneration growth, compressed the rate of increase in nominal unit labour cost in the manufacturing sector. Measured over periods of four quarters, the growth in the cost of labour per unit of output in the manufacturing sector fell back from 5,8 per cent in the first quarter of 2002 to virtually zero in the second quarter, averaging just 2,8 per cent in the first half of the year. This slowdown in the growth in nominal unit labour cost in the manufacturing sector contributed to the containment of production price increases in the middle quarters of 2002.

Nominal unit labour cost in most of the other sectors of the economy rose considerably faster than nominal unit labour cost in the manufacturing sector. Although slightly down from the fourth quarter of 2001, the growth in nominal unit labour cost in the overall formal non-agricultural sector of the economy was still at a high year-on-year rate of 6,2 per cent in the first two quarters of 2002. These increases were almost twice as high as in the first half of 2001 and were at levels hardly consistent with the inflation target set by government.

Nominal unit labour cost in formal non-agricultural sectors

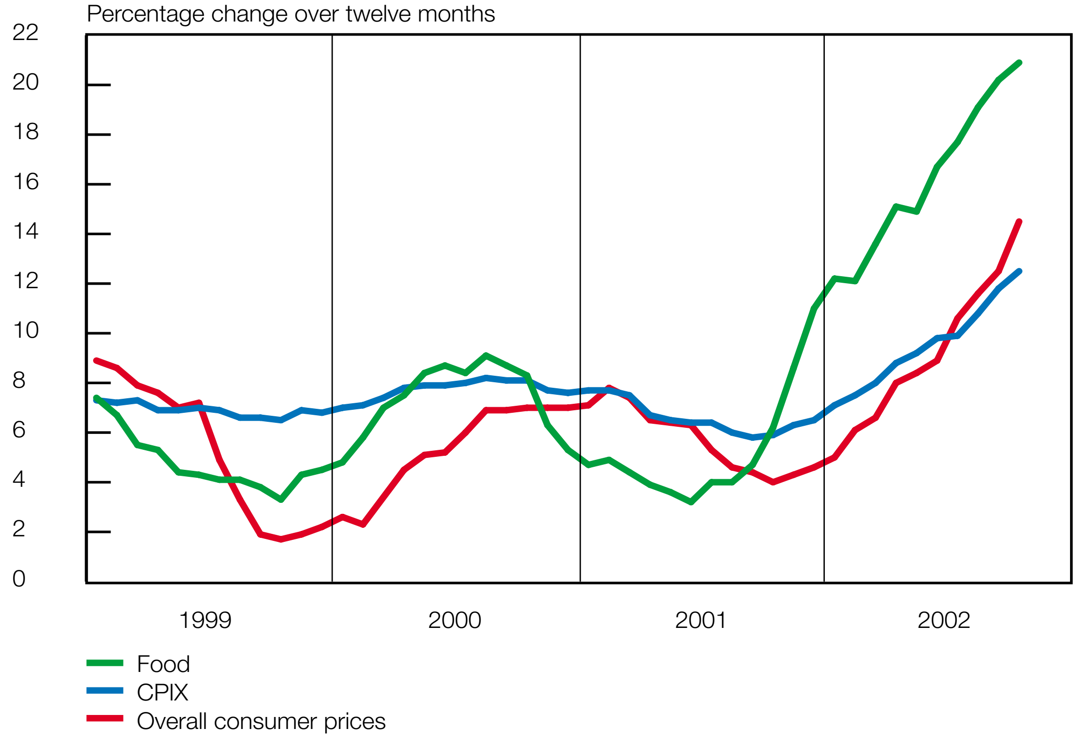


Prices

Price increases continued to be dominated by the after-effects of the depreciation in the exchange rate of the rand towards the end of 2001. Inflationary pressures were further intensified by increases in the prices of food and imported petroleum. Over and above these price-raising forces, a severe drought in the southern African region aggravated circumstances further and helped to push the year-on-year increase in food prices to 20,9 per cent in October 2002. This motivated the government to announce various relief measures to provide short-term assistance to the poor.

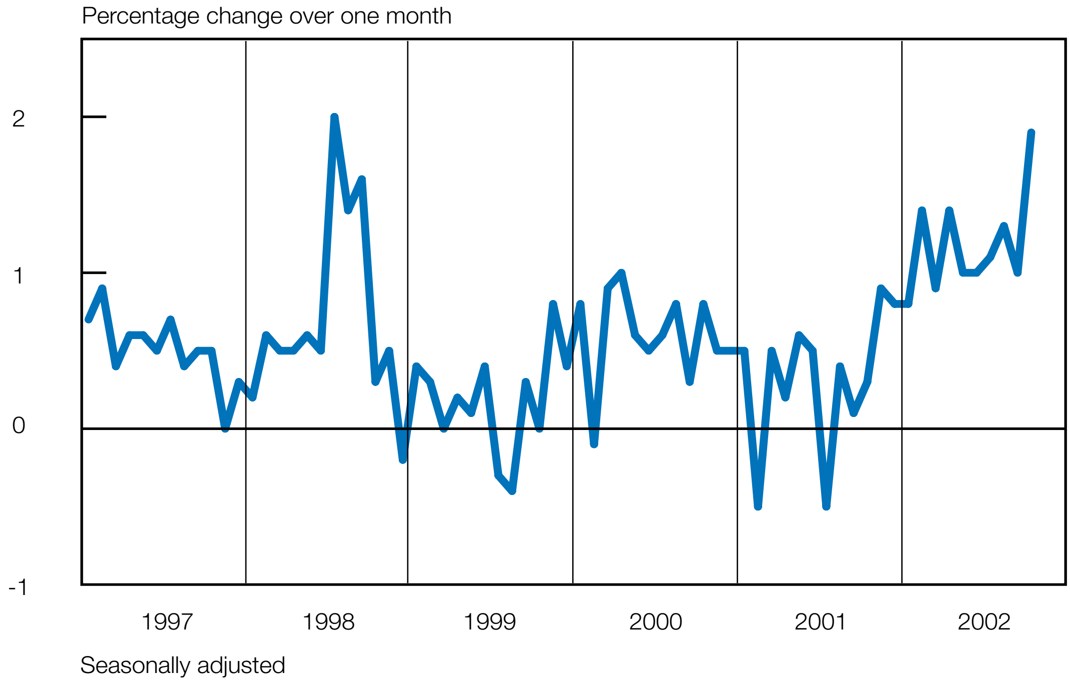
Essentially driven higher by the increase in food prices, CPIX inflation (i.e. changes in the overall consumer price index for metropolitan and other urban areas, excluding the interest cost of mortgage bonds) accelerated from a year-on-year rate of 5,8 per cent in September 2001 to 12,5 per cent in October 2002. Of significance is the fact that the changes in food prices contributed as much as 42,4 per cent to the increase in CPIX in the year to September 2002, compared with only 17,2 per cent in the year to September 2001. The quarter-to-quarter pace of CPIX inflation accelerated from an annualised rate of 7,6 per cent in the fourth quarter of 2001 to 12,7 per cent in the third quarter of 2002.

Consumer prices



Despite the fact that higher CPIX inflation was first and foremost a result of steep increases in food prices in recent months, non-food CPIX inflation accelerated from a year-on-year rate of 5,4 per cent in December 2001 to 10,2 per cent in October 2002. The quarter-to-quarter increases in the prices of non-food items rose from 4,9 per cent in the fourth quarter of 2001 to 9,2 per cent in the third quarter of 2002,

Consumer prices

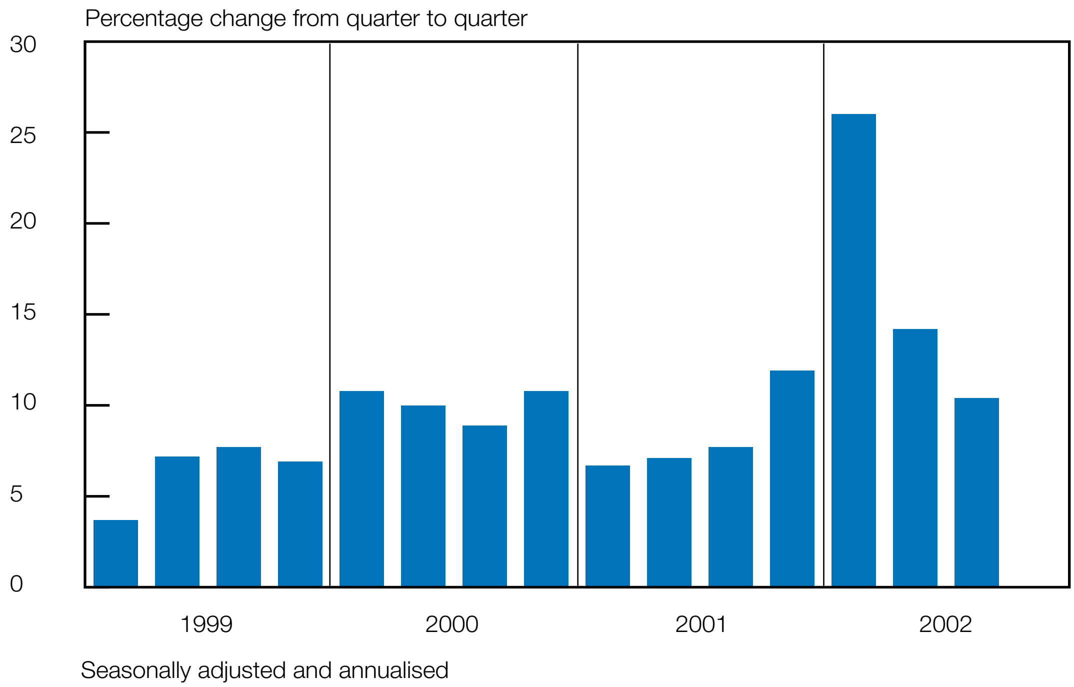


but there were signs that this rate was levelling off at around the 9 per cent mark. The rise in non-food CPIX inflation in the past nine months or so resulted from higher rates of increase in the prices of housing services, furniture and equipment, medical care and health expenses, new and used vehicles, and transport running cost.

Increases in production prices, usually seen as foreshadowing rising consumer prices, picked up to a level significantly higher than the increase in consumer prices during 2002. Measured over periods of twelve months, the rate of increase in the *all-goods production price index* rose almost twofold from 7,8 per cent in September 2001 to 15,4 per cent in both August and September 2002. By contrast, the *quarter-to-quarter* rate of increase in the production prices of goods, which had been as high as 26,0 per cent in the first quarter of 2002, slowed down appreciably to 10,4 per cent in the third quarter. This slowdown occurred in the prices of both domestically produced and imported goods.

The year-on-year rate of increase in the prices of *domestically produced goods* rose from 8,4 per cent in December 2001 to a thirteen-year high of 15,3 per cent in August 2002. During this period strong increases in food prices at both the agricultural and manufactured level contributed considerably to the overall increase in production prices, but the prices of mining products, paper and paper products, products of petroleum and coal, basic metal products, and electrical machinery also increased faster than before. Following a substantial month-on-month *decline* of 27,5 per cent in the price of electricity – reflecting a new pricing strategy of Eskom – the year-on-year increase in the prices of domestically produced goods tapered off to 14,9 per cent in September 2002.

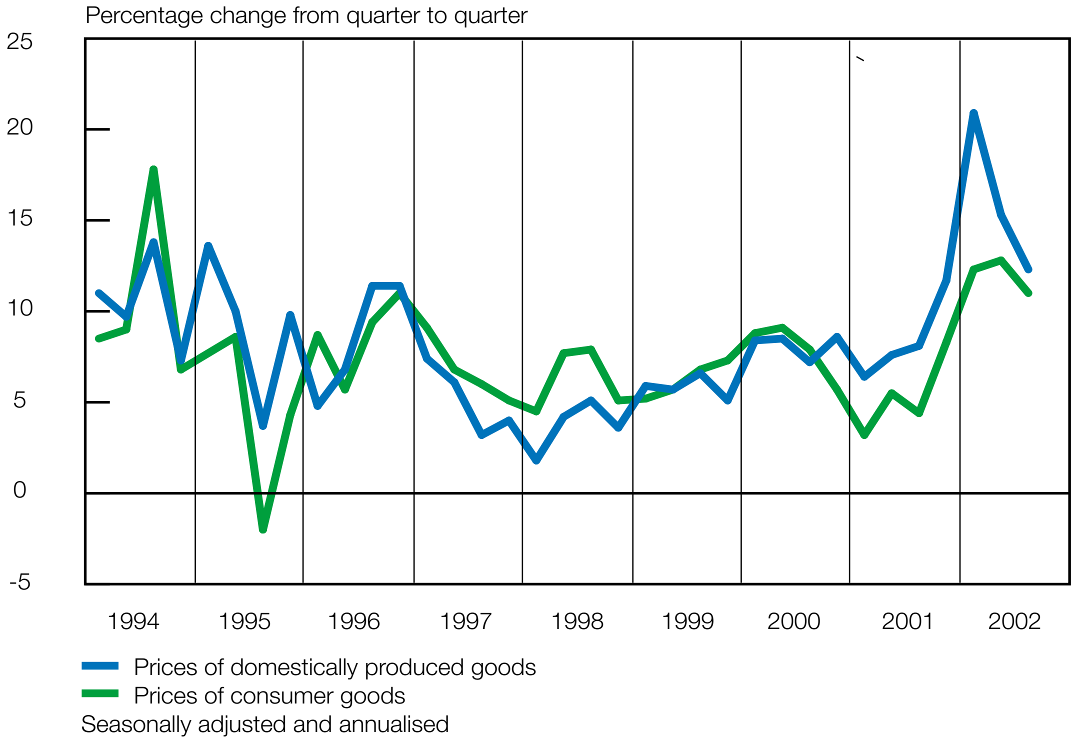
Production price index



When omitting food prices from the price index of domestically produced goods, the prices of the remaining goods increased by just 8,1 per cent in the year to September 2002 – some 6,8 percentage points below the actual increase in the price index of all domestically produced goods. Also, the year-on-year pace of increase in the production prices of non-food items has slowed down somewhat since May 2002.

The quarter-to-quarter increase in the prices of domestically produced goods fell back from 20,9 per cent in the first quarter of 2002 to 15,3 per cent in the second quarter and 12,3 per cent in the third quarter. This slowdown resulted mainly from lower rates of increase in the prices of textiles, clothing and footwear, basic metals, machinery and transport equipment and actual declines in the prices of electricity, gas, water and mining products.

Production and consumer prices of goods



Growth in the prices of *imported goods*, which fuelled the acceleration in the price increases of domestically produced goods late in 2001 and early in 2002, levelled off appreciably from an annualised rate of 40,0 per cent in the first quarter of 2002 to 3,8 per cent in the third quarter. When measured over periods of twelve months, the increase in the prices of imported goods slowed down from 17,4 per cent in April 2002 to around the 16 per cent mark in the ensuing months to September 2002.

Production prices

Quarter-to-quarter percentage changes at annualised rates

Period		Domestically produced goods	Imported goods	Overall production prices
2000:	**Year**	**7,3**	**14,4**	**9,2**
2001:	1st qr	6,4	8,1	6,7
	2nd qr	7,6	7,4	7,1
	3rd qr	8,1	4,7	7,7
	4th qr	11,7	12,4	11,9
	Year	**7,8**	**10,0**	**8,4**
2002:	1st qr	20,9	40,0	26,0
	2nd qr	15,3	12,9	14,2
	3rd qr	12,3	3,8	10,4

The recent strengthening in the exchange rate of the rand and lower international crude oil prices contributed to this slowdown in production price inflation.

As price pressures moved from the production level to end-product prices and home mortgage interest rates climbed, *headline inflation* (i.e. the year-on-year changes in the overall consumer price index for metropolitan areas) jumped from 4,0 per cent in October 2001 to 14,5 per cent in September 2002, outpacing CPIX inflation from July 2002. Quarter-to-quarter increases in the overall consumer price index, however, stabilised at an annualised rate of 14,6 per cent in the second and the third quarters of 2002.

Historically, changes in the production prices of domestically produced goods usually preceded changes in the prices of *consumer goods*. This sequence of price changes was repeated during the current inflationary episode. Following the slowdown in the quarter-to-quarter pace of increase in the prices of domestically produced goods in the second quarter of 2002, increases in the prices of consumer goods slowed down from an annualised rate of 12,8 per cent in the second quarter of 2002 to 11,0 per cent in the third quarter. This slowdown occurred despite the further acceleration in the quarter-to-quarter pace of growth in food prices.

Increases in the prices of *consumer services* often change independently of the changes in the prices of traded goods. During the current wave of rising prices, the year-on-year rate of increase in the prices of consumer services was around the 7 per cent level as recently as June 2002. Only during the third quarter of 2002 did the prices of consumer services begin to catch up with the pace of increase in the prices of consumer goods; in October the prices of consumer services were rising at a year-on-year rate of 16,4 per cent. This acceleration not only resulted from increases in home mortgage interest rates, but also from stronger increases in the prices of other non-housing-related services. When measured from quarter to quarter and expressed at an annualised rate, services price increases amounted to 19,8 per cent in the third quarter of 2002 compared with 15,8 per cent in the second quarter.

Consumer prices

Quarter-to-quarter percentage changes at annualised rates

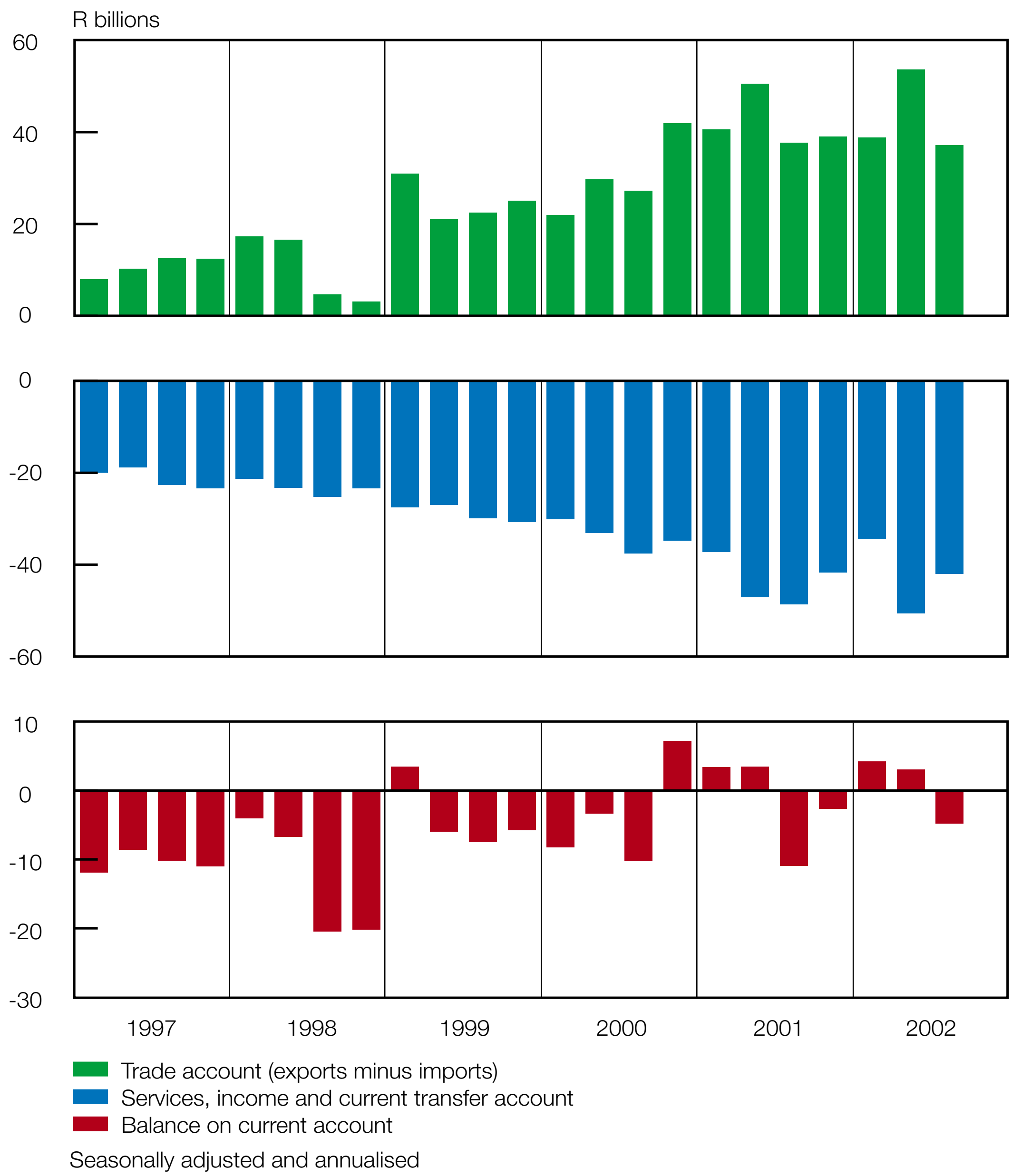
Period		Goods	Services	Headline inflation	CPIX inflation
2000:	**Year**	**7,9**	**2,4**	**5,4**	**7,8**
2001:	1st qr	3,2	4,3	3,3	5,2
	2nd qr	5,5	0,0	3,4	3,2
	3rd qr	4,4	1,5	1,7	6,5
	4th qr	8,3	2,2	5,0	7,6
	Year	**5,6**	**5,5**	**5,7**	**6,6**
2002:	1st qr	12,3	12,1	12,2	11,7
	2nd qr	12,8	15,8	14,6	11,1
	3rd qr	11,0	19,8	14,6	12,7

Foreign trade and payments

Current account

The relatively slow recovery in global economic activity and the consequent weaker international demand for domestically produced goods caused the physical quantity of merchandise exports to contract steeply in the third quarter of 2002. Over the same period, the volume of non-oil merchandise imports, underpinned by a modest increase in gross domestic expenditure, declined too, but only marginally. In nominal terms, and also considering the relative price movements, the surplus on the trade account after adjustment for seasonal factors narrowed from R53,7 billion in the second quarter of 2002 to R37,2 billion in the third quarter.

Balance of payments: Current account



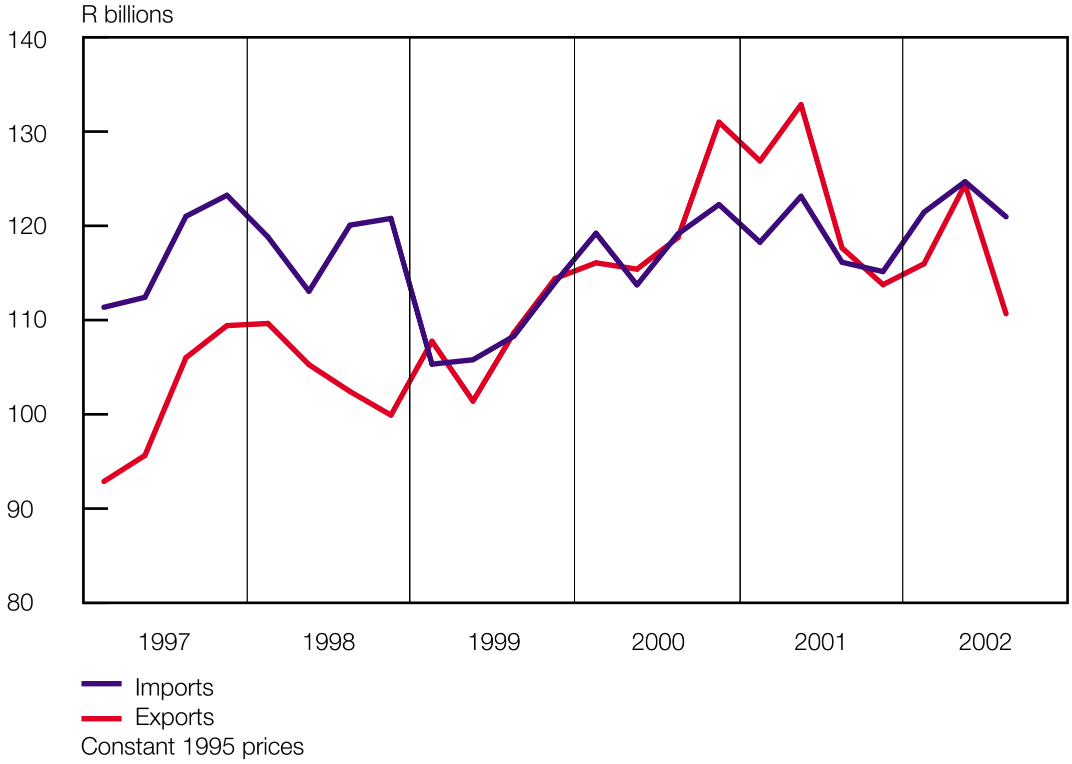
The deficit on the services and income account of the balance of payments contracted in the third quarter of 2002, largely due to a decline in net investment income paid to the rest of the world. The size of the shrinking of the deficit on the services and income account could not fully counteract the weakening in the country's trade balance. The current-account balance (seasonally adjusted and annualised) consequently changed from a surplus of R3,1 billion in the second quarter of 2002 to a deficit of R4,8 billion in the third quarter. Relative to gross domestic product, the current-account balance changed from a surplus of 0,3 per cent in the second quarter to a deficit of 0,4 per cent in the third quarter.

Balance of payments on current account

Seasonally adjusted and annualised
R billions

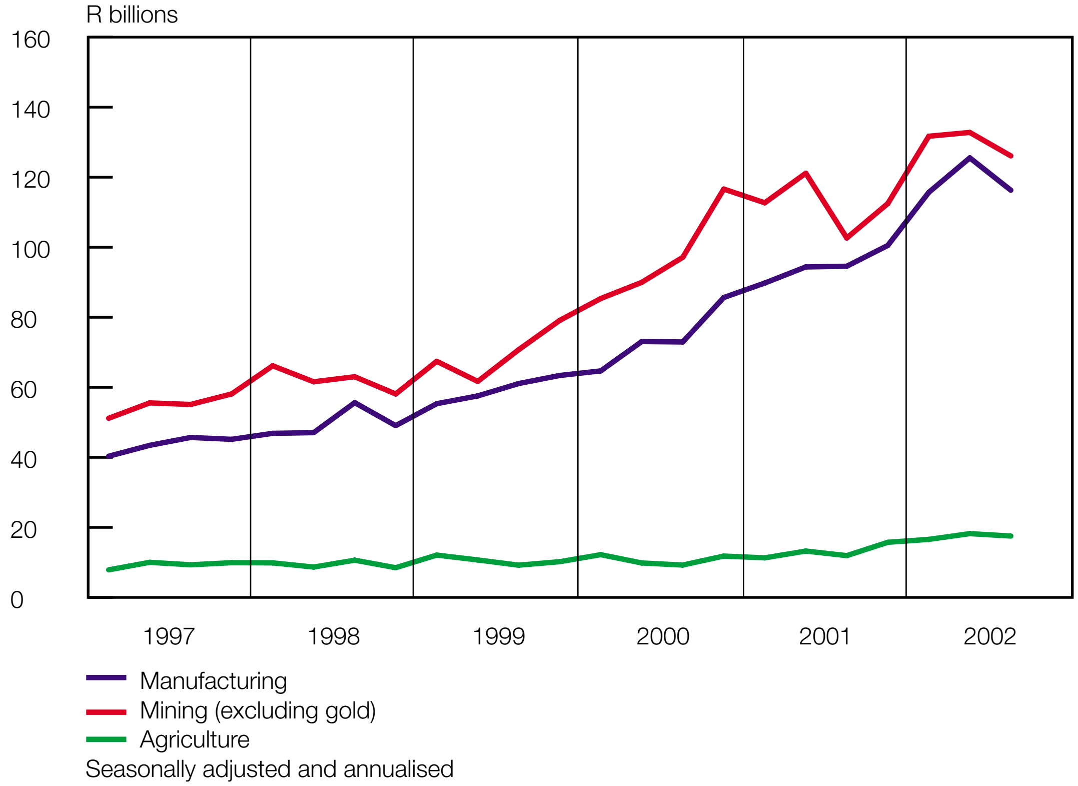
	2001					2002		
	1st qr	2nd qr	3rd qr	4th qr	Year	1st qr	2nd qr	3rd qr
Merchandise exports................	226,0	241,4	221,5	240,9	232,5	275,3	288,0	271,6
Net gold exports	25,3	27,4	30,1	34,9	29,4	39,6	44,2	45,0
Merchandise imports................	-210,7	-218,2	-214,0	-236,8	-219,9	-276,0	-278,5	-279,4
Trade account	**40,6**	**50,6**	**37,6**	**39,0**	**42,0**	**38,9**	**53,7**	**37,2**
Net services, income and current transfer payments	-37,2	-47,1	-48,5	-41,7	-43,7	-34,7	-50,6	-42,0
Balance on current account	**3,4**	**3,5**	**-10,9**	**-2,7**	**-1,7**	**4,2**	**3,1**	**-4,8**

Real merchandise imports and exports



Having increased robustly from the second half of 2001 to the first two quarters of 2002, the physical quantity of merchandise exports fell by 11 per cent in the third quarter. Export volumes of mining products and manufactured goods contracted sharply in the third quarter of 2002. Especially the subcategories mineral products and vehicles and other transport equipment suffered from the weaker international demand for domestically produced goods.

Composition of merchandise exports



The unit price of South Africa's merchandise exports, which had declined by 2½ per cent in the second quarter of 2002, recovered by 6 per cent in the third quarter. Over and above the normal supply and demand conditions, the rand price of exports benefited from higher international commodity prices and the lower external value of the rand. Although the effect of the sharp decline in the volume of merchandise exports was partly neutralised by the increase in the rand prices of exports, the overall value of merchandise exports (seasonally adjusted and annualised) nonetheless declined from R288,0 billion in the second quarter of 2002 to R271,6 billion in the third quarter.

Seasonally adjusted and annualised, the value of net gold exports increased marginally from R44,2 billion in the second quarter of 2002 to R45,0 billion in the third quarter. Gold price changes were fairly muted in the third quarter of 2002. On the London market the average fixing price of gold rose from US$313 per fine ounce in the second quarter of 2002 to US$314 per fine ounce in the third quarter, and the average realised price in rands remained broadly unchanged over the same period. The physical volume of gold exported also showed little change from the second to the third quarter of 2002.

The physical quantity of merchandise imports increased somewhat from the first to the second quarter of 2002, but declined by 3 per cent in the third quarter. The volume of non-oil merchandise imports declined by only 1½ per cent from the second quarter of 2002 to the third quarter, but the volume of imported oil declined steeply. The value of imports of manufactured goods, especially in the subcategories chemical products, machinery and electrical equipment, and vehicles and transport equipment rose somewhat.

The rand price of imported goods increased by some 3,5 per cent in the third quarter of 2002, mainly as a result of the depreciation in the exchange value of the rand. The unit price of imported goods in the first nine months of 2002 was on average 26,3 per cent higher than in the corresponding period of 2001. Essentially caused by these price increases, the value of merchandise imports (seasonally adjusted and annualised) increased from R278,5 billion in the second quarter of 2002 to R279,4 billion in the third quarter.

Net service, income and current transfer payments to non-residents declined from a seasonally adjusted and annualised value of R50,6 billion in the second quarter of 2002 to R42,0 billion in the third quarter. Included in these net payments and receipts is net investment income paid to the rest of the world. Net investment income is the difference between the amount that South African residents earn on their direct, portfolio and other investments abroad and the amount that non-residents earn on their direct, portfolio and other investments in South Africa. These payments and receipts are determined by the size of investments held and the rates of return on these investments.

Non-residents' investments in South Africa generally exceed South Africans' investments in the rest of the world by a substantial margin and payments to the rest of the world generally exceed receipts. There was a sizeable withdrawal of portfolio capital from South Africa in the third quarter of 2002, leading to lower interest and dividend payments to non-resident investors. This decline in net investment income paid to the rest of the world made a noticeable contribution to the shrinking of the deficit on the services and income account of the balance of payments.

South Africa's hosting of the United Nations World Summit on Sustainable Development in August 2002 made a sizeable contribution to the smaller deficit on the services and income account by increasing foreign tourist expenditure in the country.

Financial account

Contrasting developments in the first two quarters of 2002 when strong net financial flows into South Africa were recorded, the positive imbalance on the financial account of the balance of payments contracted substantially in the third quarter. Net capital inflows of R12,1 billion and R21,5 billion in the first and second quarters of 2002, respectively, declined to R0,7 billion in the third quarter. However, the R34,3 billion cumulative surplus on the financial account in the first three quarters of 2002 was still considerably more than the R7,2 billion surplus in 2001 as a whole. The abrupt decline in the positive imbalance on the financial account in the third quarter of 2002 could be attributed to the volatile behaviour of portfolio investment flows which changed from net inflows of R14,1 billion in the second quarter to net outflows of broadly the same magnitude in the ensuing quarter.

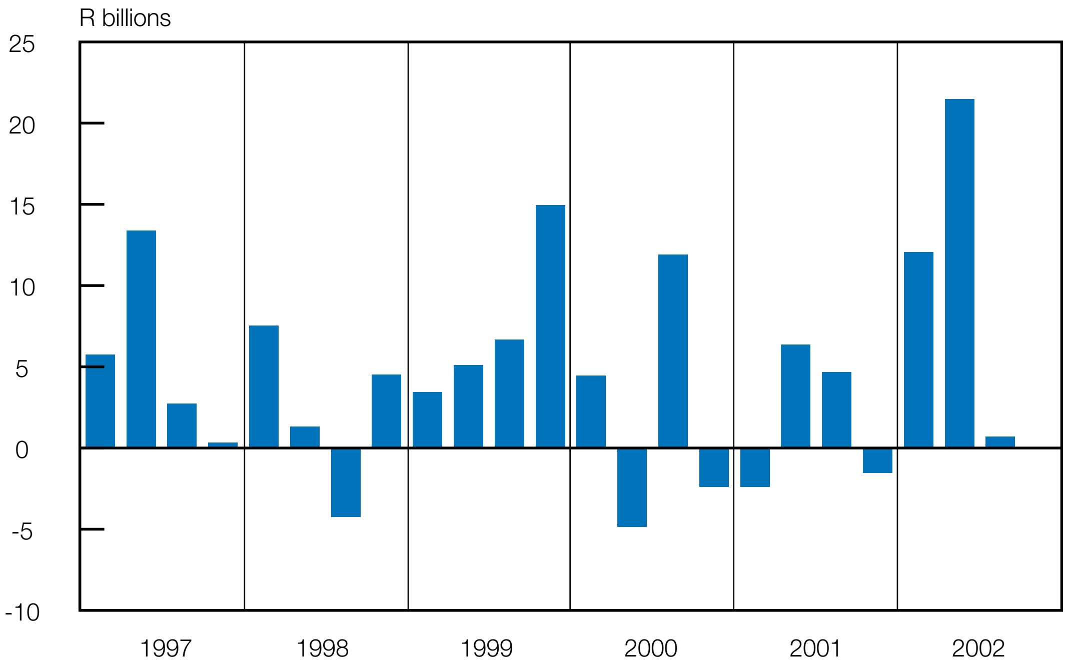
Net financial transactions not related to reserves

R billions

	2001					2002		
	1st qr	2nd qr	3rd qr	4th qr	Year	1st qr	2nd qr	3rd qr
Change in liabilities								
Direct investment	2,4	53,1	3,6	-1,9	57,2	1,6	2,3	1,9
Portfolio investment	3,5	-27,2	-0,2	-0,1	-24,0	4,4	15,7	-12,9
Other investment	-2,5	-9,0	-5,1	-1,5	-18,1	13,7	-4,8	-4,1
Change in assets								
Direct investment	-8,1	42,2	0,0	-5,4	28,7	-1,0	5,4	2,6
Portfolio investment	-0,7	-37,1	-2,5	-3,3	-43,6	-5,7	-1,6	-0,9
Other investment	-6,0	-10,8	5,9	-0,3	-11,2	0,7	-0,9	5,0
Total financial transactions*	-2,4	6,4	4,7	-1,5	7,2	12,1	21,5	0,7

* Including unrecorded transactions

Balance of payments: Financial account



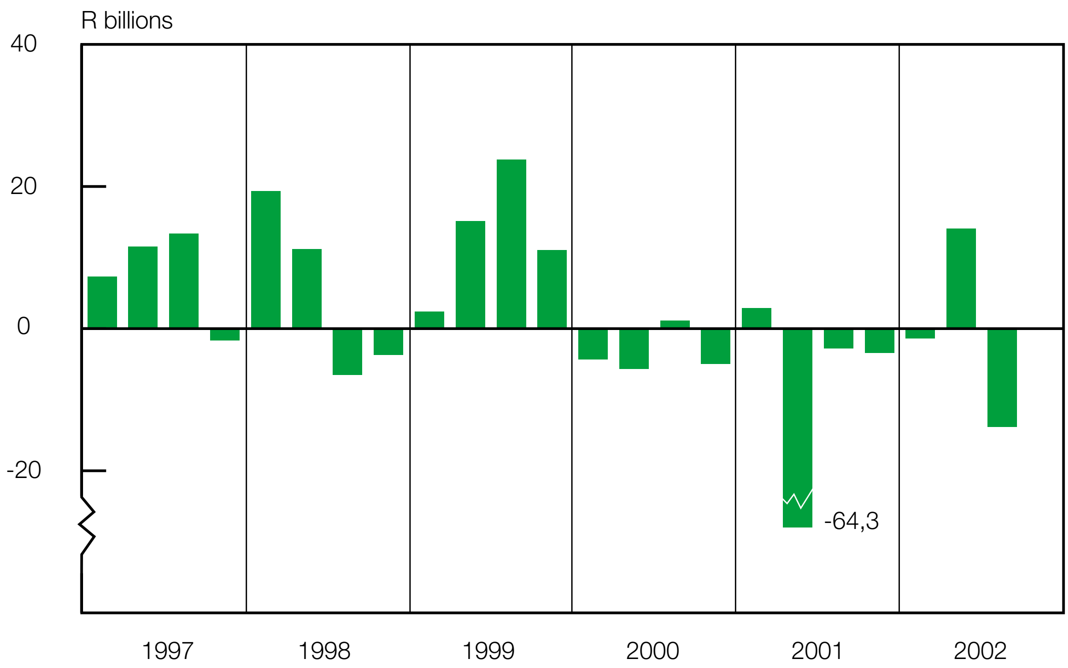
Foreign direct investment into South Africa contracted from R2,3 billion in the second quarter of 2002 to R1,9 billion in the third quarter. The increase in foreign direct investment liabilities during the third quarter of 2002 originated mainly from dividends which were declared by South African subsidiary companies but not yet distributed by the end of September 2002. New long-term loan financing was also obtained from non-resident parent or holding companies in the third quarter of 2002. These inflows were partly counteracted by a reduction in outstanding foreign liabilities when short-term loans were repaid.

Outward direct investment changed from outflows of R1,0 billion in the first quarter of 2002 to inflows (i.e. a reduction in foreign direct investment assets) of R5,4 billion in the second quarter and R2,6 billion in the third quarter. Resident companies reduced their capital holdings in offshore subsidiary companies and there was a decline in the amount of offshore open account balances during the third quarter of 2002. Some South African companies acquired foreign direct investment assets (i.e. an outflow of direct investment capital) but the amount of these outflows fell short of the amount of the foreign direct investment inflows. On a net basis, foreign direct investment inflows slowed down from R7,7 billion in the second quarter of 2002 to R4,5 billion in the third quarter.

Following the leaking of the draft empowerment charter for the mining industry, foreign portfolio investors reduced their holdings of domestic shares during the third quarter of 2002. Heightened risk aversion towards emerging markets might also have influenced international investors in their decision to disinvest from South Africa. On a quarterly basis, non-resident investors became net sellers of domestic equity for the first time since the fourth quarter of 1996. Simultaneously, foreign investors' holdings of South African fixed-interest securities declined. Portfolio investment into South Africa consequently changed from an inflow of R15,7 billion in the second quarter of 2002 to an outflow of R12,9 billion in the third quarter.

Portfolio investment abroad by South African investors declined from R5,7 billion in the first quarter of 2002 to R1,6 billion in the second quarter and R0,9 billion in the third quarter. This slowdown could be attributed to, among other things, the lacklustre performance of international equity markets. On a net basis, portfolio investment into South Africa changed to an outflow of R13,8 billion in the third quarter of 2002, compared with an inflow of R14,1 billion in the second quarter.

Net foreign portfolio investment



Other foreign investment into South Africa changed from inflows of R13,7 billion in the first quarter of 2002 to outflows of R4,8 billion in the second quarter and R4,1 billion in the third quarter. These outflows had their origin mainly in the withdrawal by non-resident deposit holders of foreign-currency and rand-denominated non-resident deposits from South African banks.

Other investment from South Africa to the rest of the world switched from an outflow of R0,9 billion in the second quarter of 2002 to an inflow of R5,0 billion in the third quarter. South African exporters contributed towards this decline in other foreign assets by repatriating export proceeds to comply with current exchange control regulations and to benefit from the depreciation in the exchange value of the rand in the third quarter of 2002. On a net basis, other investment recorded a positive imbalance of R0,9 billion in the third quarter of 2002 following an outflow of R5,7 billion in the second quarter.

Foreign debt

South Africa's total outstanding foreign debt increased from US$30,8 billion at the end of December 2001 to US$32,3 billion at the end of June 2002 or by US$1,5 billion in the first half of 2002. This increase in the country's interest-bearing foreign liabilities could mainly be attributed to new borrowing by the national government in international capital markets. The dollar value of rand-denominated debt and the euro-denominated debt increased because of the appreciation in the exchange value of the rand and the euro against the US dollar between the end of December 2001 and the end of June 2002.

Foreign debt of South Africa
US$ billions as at end of year

	1997	1998	1999	2000	2001	2002*
Renegotiated debt	**2,5**	**2,3**	**1,5**	**0,8**	**-**	**-**
Other foreign-currency denominated debt	**22,7**	**22,6**	**22,4**	**24,1**	**24,0**	**24,7**
Bearer bonds	4,0	4,3	4,8	5,5	6,0	7,6
Converted long-term loans	1,3	0,8	0,4	0,2	0,1	0,1
Public sector	4,2	3,6	3,2	3,8	3,0	4,7
Monetary sector	7,5	8,8	8,2	8,3	8,9	6,6
Non-monetary private sector	5,7	5,1	5,8	6,3	6,0	5,7
Total foreign-currency denominated debt	**25,2**	**24,9**	**23,9**	**24,9**	**24,0**	**24,7**
Rand-denominated debt	**14,0**	**12,5**	**15,0**	**12,0**	**6,8**	**7,6**
Bonds	10,6	8,3	10,7	8,3	4,3	4,6
Other	3,4	4,2	4,3	3,7	2,5	3,0
Total foreign debt	**39,2**	**37,4**	**38,9**	**36,9**	**30,8**	**32,3**

* End of June 2002

The foreign-currency denominated debt of the public sector increased mainly due to the transfer of liability for a syndicated foreign loan of US$1,5 billion from the Reserve Bank to the National Treasury. Simultaneously, the foreign-currency denominated debt of the monetary sector declined by an equal amount. South African banks repaid on a net basis part of their foreign-currency denominated loans and non-residents reduced their foreign-currency denominated deposits with domestic banks during the first half of 2002.

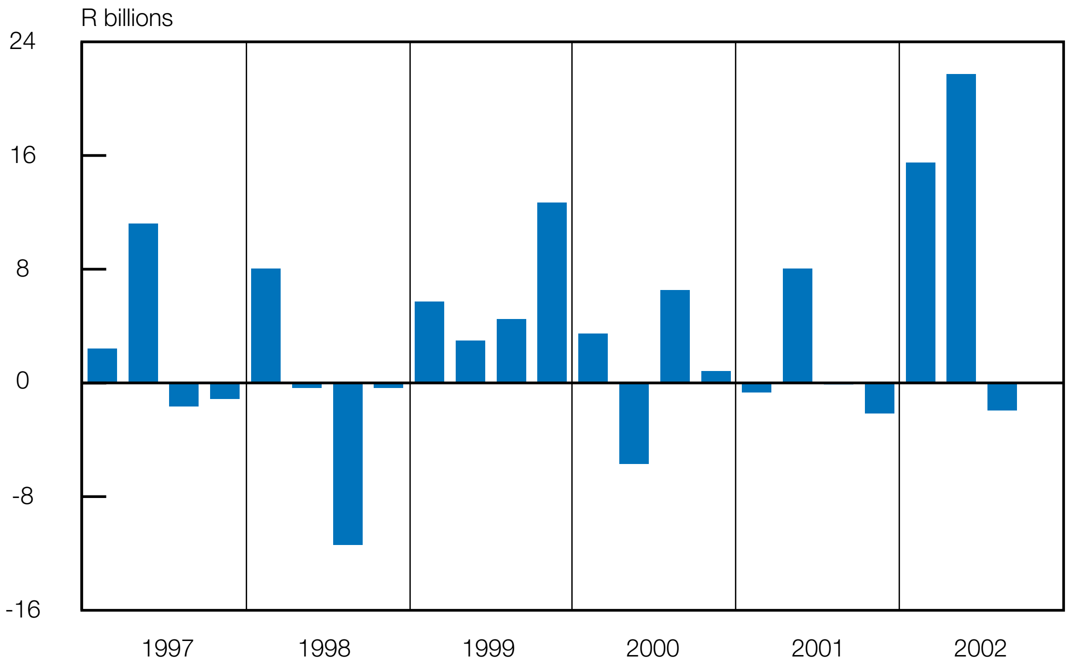
Foreign reserves

The deficit on the current account of the balance of payments in the third quarter of 2002 was financed only to a limited extent by net financial inflows from abroad.

South Africa's net international reserve assets accordingly declined by R1,9 billion in the third quarter of 2002. Cumulatively, the country's net international reserves still rose by R35,6 billion from the end of December 2001 to the end of September 2002, compared with an increase of R7,3 billion in the first three quarters of 2001.

The value of the country's gross gold and other foreign reserves (i.e. international reserves before accounting for reserve-related loans) declined from US$14,6 billion at the end of June 2002 to US$14,4 billion at the end of September 2002. Expressed in rands, these reserves increased from R151,6 billion to R152,4 billion over the same period. The level of import cover (i.e. the value of gross international reserves relative to the value of imports of goods and services) improved somewhat from 20 weeks' worth of imports at the end of the second quarter of 2002 to 20½ weeks' worth at the end of the third quarter.

Change in net international reserves



The gross gold and other foreign reserves of the Reserve Bank increased from R78,3 billion at the end of June 2002 to R80,1 billion at the end of September, but declined to R75,9 billion at the end of October. The value of these reserves in US dollars remained at around US$7,6 billion throughout this period. Short-term credit facilities utilised by the Bank increased from R25,8 billion at the end of June 2002 to R26,3 billion at the end of September, but declined to R25,1 billion at the end of October. These changes were largely brought about by changes in the exchange value of the rand. The Reserve Bank announced the successful conclusion of a foreign loan facility for US$1,0 billion with a syndicate of banks on 9 July 2002.

The net open foreign currency position of the Reserve Bank, determined as the oversold forward position in foreign currency adjusted for net holdings of international reserves, remained around the US$1,8 billion mark from the end of May 2002.

Exchange rates

The exchange rate of the rand weakened during the third quarter of 2002 as uncertainty among non-resident investors about developments in the mature equity markets of the world and in some emerging markets contributed towards a net withdrawal of foreign portfolio capital from South Africa. The weighted exchange rate of the rand, which had increased by 8,4 per cent from the end of December 2001 to the end of June 2002, declined by 1,3 per cent from the end of June to the end of September.

Exchange rates of the rand
Percentage change

	31 Dec 2001 to 28 Mar 2002	28 Mar 2002 to 28 June 2002	28 June 2002 to 30 Sep 2002	30 Sep 2002 to 18 Nov 2002
Weighted average*	6,9	1,4	-1,3	8,6
Euro	7,3	-3,3	-1,0	7,3
US dollar	6,0	9,9	-1,8	10,2
British pound	7,8	2,3	-3,9	9,1
Japanese yen	7,0	-1,2	1,2	9,5

* The weighted exchange rate index is calculated with reference to a basket of 14 currencies

Apart from the problems of some emerging-market economies, a number of other domestic and international developments weighed on the external value of the rand. Among these were concerns about the land reform programme in Zimbabwe and the possible impact it may have on other countries in the southern African region.

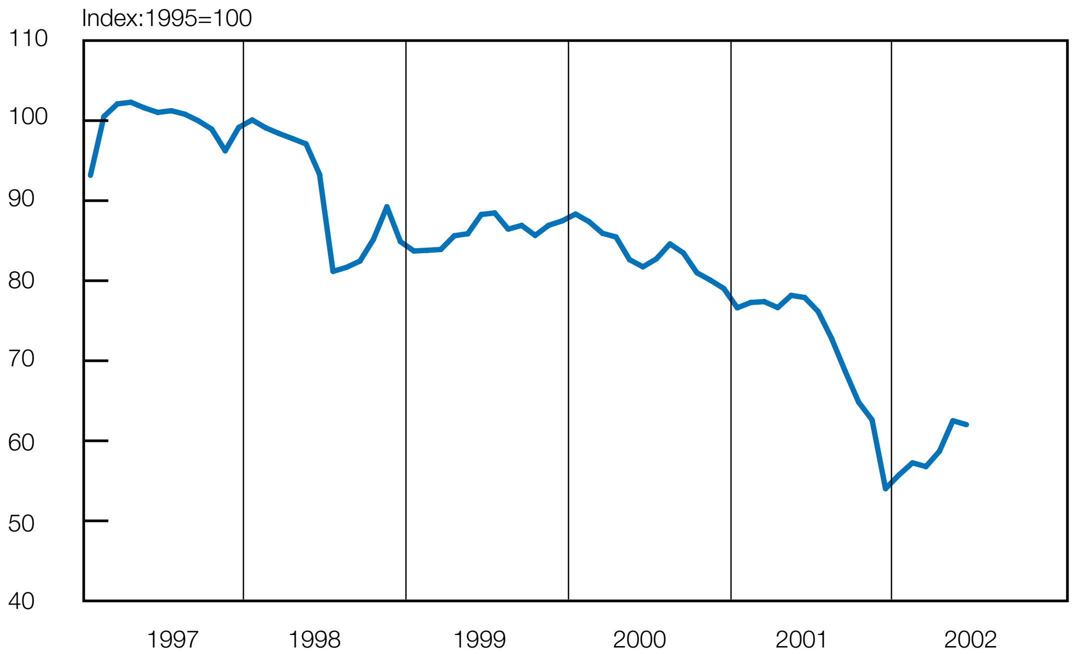
Nominal effective exchange rate of the rand

The leaking of the draft empowerment charter for the mining industry also created uncertainty and contributed towards outflows of mainly portfolio capital in the third quarter of 2002. Assurances given by the government that the proposals contained in the draft charter did not represent official government policy, and the repatriation of foreign currency export proceeds, later provided some support for the exchange rate of the rand. Government's restatement of its commitment to the process of restructuring of state assets and the depreciation of the US dollar against the other major international currencies added momentum to the strengthening of the exchange rate of the rand in October and November 2002. As the rand strengthened, leads and lags in foreign payments and receipts were reversed, lending further support to the recovery of the rand. On balance, the nominal effective exchange rate of the rand increased by 8,6 per cent from the end of September 2002 to 18 November 2002.

The net average daily turnover in the domestic market for foreign exchange, which had declined to US$7,7 billion in the first quarter of 2002 increased to US$8,1 billion in the second quarter but fell back to US$7,3 billion in the third quarter. Transactions concluded between authorised dealers in foreign exchange and resident parties declined by 15 per cent in the third quarter and those with non-resident parties by 6 per cent. Transactions involving non-residents represented about 60 per cent of the total turnover in the foreign-exchange market during the third quarter of 2002, up from 57,6 per cent in the second quarter.

The real effective exchange rate of the rand increased by 14,8 per cent from December 2001 to June 2002. Even so, the average real effective exchange rate of the rand was about 23,3 per cent lower in the first six months of 2002 than in the corresponding period in 2001.

Real effective exchange rate of the rand



Monetary developments, interest rates and financial markets

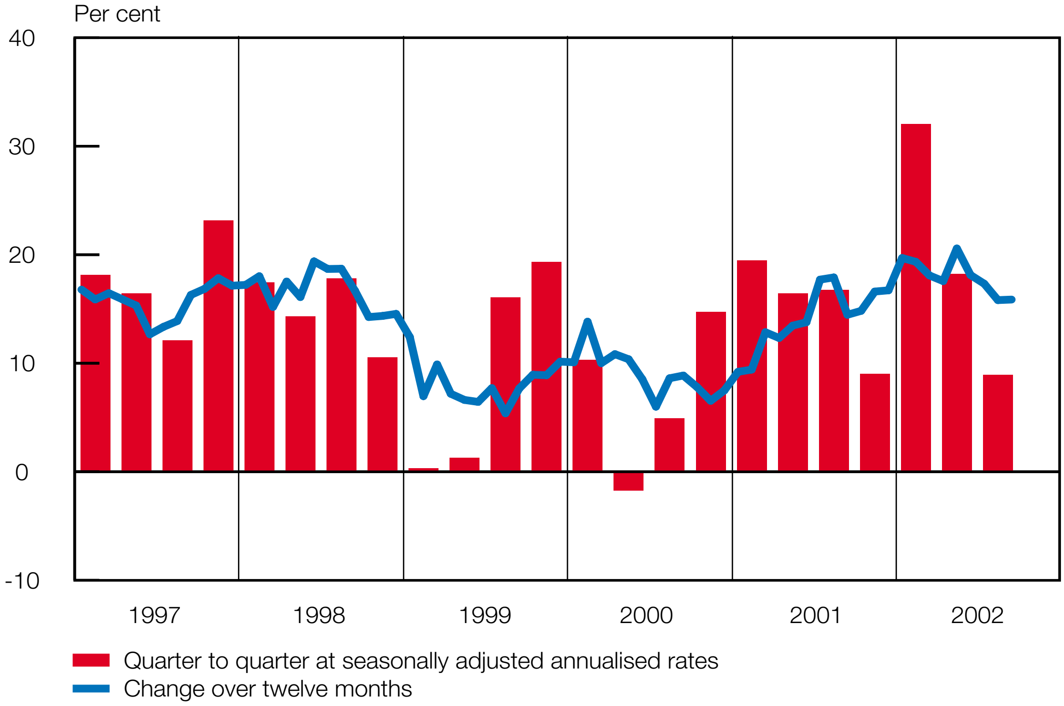
Money supply

The exceptionally rapid acceleration in overall monetary expansion in the first quarter of 2002 appears to have been fairly short-lived as the growth in the aggregate money supply slowed down in the second and third quarters of the year. The quarter-to-quarter annualised growth in the seasonally adjusted *broadly defined money supply* (M3) fell back from 32,0 per cent in the first quarter of 2002 to 18,2 per cent in the second quarter and 8,9 per cent in the third quarter. The pattern of quarter-to-quarter growth in M1 and M2 broadly resembled that of M3 over the past three quarters, as indicated in the accompanying table.

Percentage change in monetary aggregates
Quarterly at seasonally adjusted annualised rates

Period		M1A	M1	M2	M3
2001:	1st qr	9,5	18,8	21,0	19,5
	2nd qr	7,9	18,7	11,3	16,4
	3rd qr	27,3	10,5	9,8	16,8
	4th qr	27,0	8,2	9,0	9,0
2002:	1st qr	14,4	54,2	40,2	32,0
	2nd qr	16,2	21,8	15,4	18,2
	3rd qr	22,5	-1,0	0,2	8,9

Growth in M3



The slowdown in aggregate monetary growth is also clear from the growth over twelve months in the monetary totals. Growth in M3 declined from 20,6 per cent in the year to May 2002 to 15,8 per cent in the year to August and 15,9 per cent in the year to September. Year-on-year growth in most of the other aggregates also gave evidence of a slowdown in overall monetary expansion. The notable exception was M1A, where quarter-to-quarter annualised growth accelerated from 16,2 per cent in the second quarter of 2002 to 22,5 per cent in the third quarter. The components of the M1A monetary aggregate were reportedly influenced by a strong increase in liquidity.

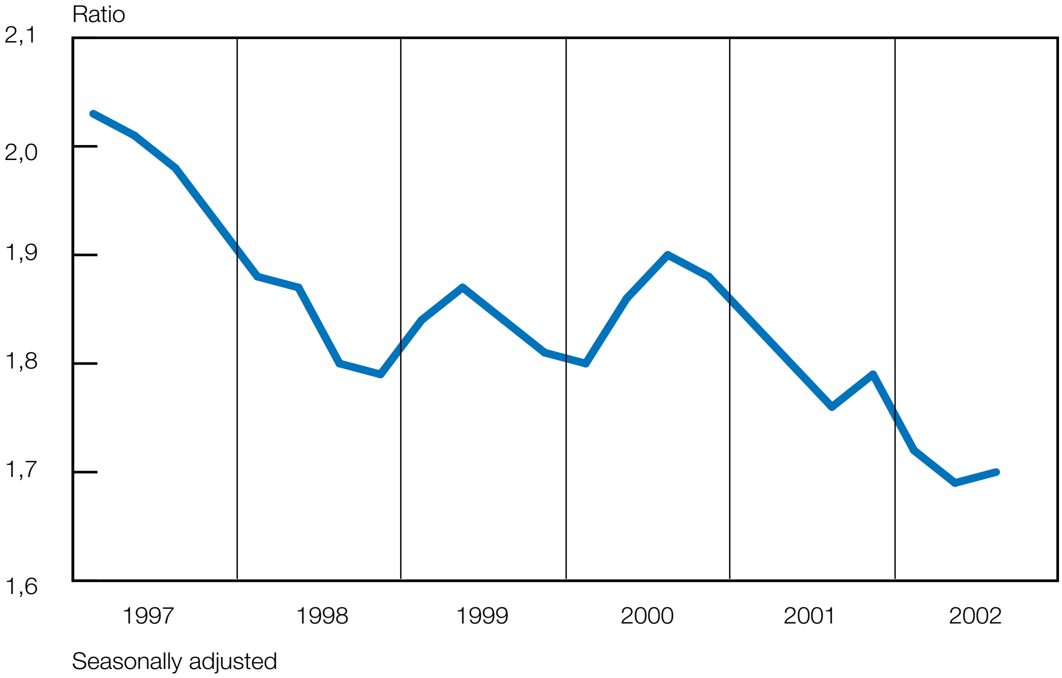
The tightening of the monetary policy stance of the Reserve Bank contributed to the slowdown in M3 growth. As investors and other market participants became increasingly convinced of the Reserve Bank's determination to curb inflationary pressures, the movement of funds to the various asset markets strengthened, or the outward movement of funds from these markets slowed down. These flows helped to constrain the growth in M3 in the second and third quarters of 2002. Even so, the quarter-to-quarter growth in M3 was still quite strong in the second quarter of 2002.

The increase in M3 deposits was heavily concentrated in the hands of the corporate sector in the first quarter of 2002, but the contribution of the household sector strengthened considerably in the second and third quarters. As much as 92,5 per cent of the total increase in M3 was accounted for by the household sector in the third quarter of 2002.

The composition of M3 growth in terms of deposit maturities changed equally drastically. In the second quarter of 2002 long-term deposits increased by more than the total increase in M3, but in the third quarter the increase in long-term deposits was equal to just 6 per cent of the total increase in M3.

The quarter-to-quarter growth in M3 exceeded the growth in nominal gross domestic product by 8,0 percentage points in the second quarter of 2002, but this gap narrowed to 1,3 percentage points in the third quarter. The income velocity of

Income velocity of M3



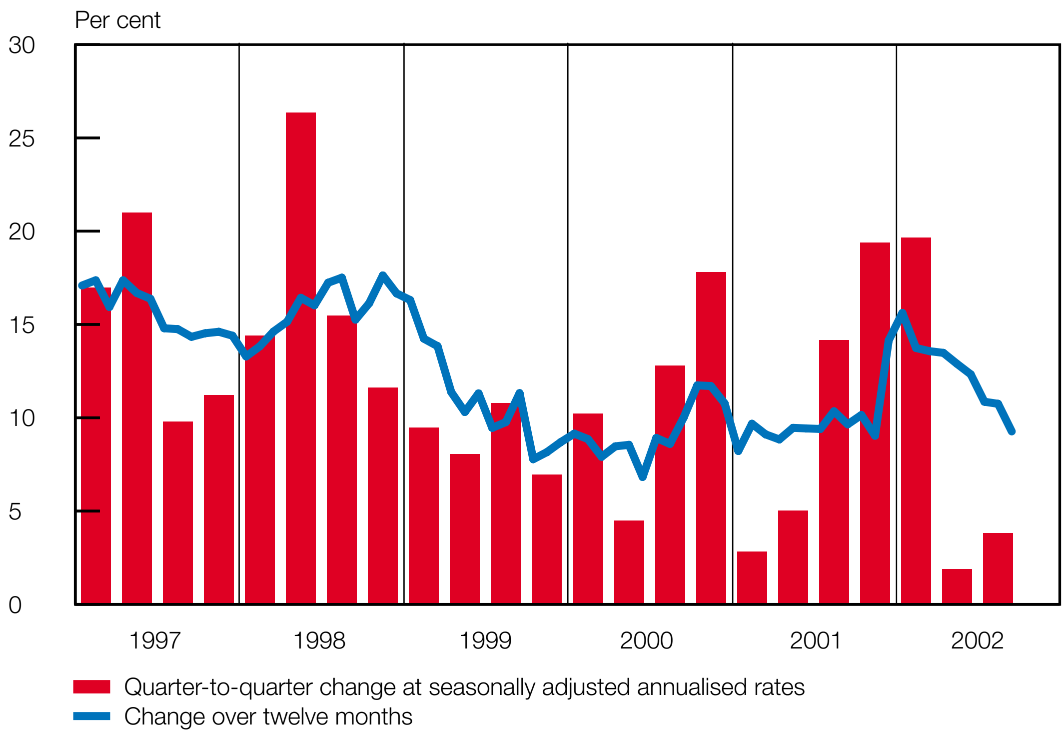
circulation of M3 accordingly declined from 1,71 in the second quarter of 2002 to 1,70 in the third quarter, the lowest level recorded in more than 25 years.

In a statistical or accounting sense, the main counterparts to the R15,1 billion rise in M3 during the third quarter of 2002 were a R31,3 billion increase in banks' net claims on the government sector and a R14,5 billion increase in banks' credit extension to the private sector. These increases were partly offset by a contraction of R31,6 billion in the "net other assets" of banks. A substantial part of the increase in banks' net claims on the government sector was occasioned by the reclassification of some of the "other assets" of the banking sector as claims on the government sector when the National Treasury issued zero-coupon bonds to the Reserve Bank as partial settlement of the outstanding balance on the Gold and Foreign Exchange Contingency Reserve Account.

Credit extension

Measured from quarter to quarter and annualised, growth in total bank credit extension (i.e. changes in claims by banks on private non-bank parties and net claims by banks on the government) fell from 20,5 per cent in the first quarter of 2002 to a nine-year low of 0,3 per cent in the second quarter and 5,4 per cent in the third quarter. The acceleration of growth in the third quarter was partly a consequence of reclassifying some of the Reserve Bank's net other assets as mentioned previously.

Credit extended to private sector



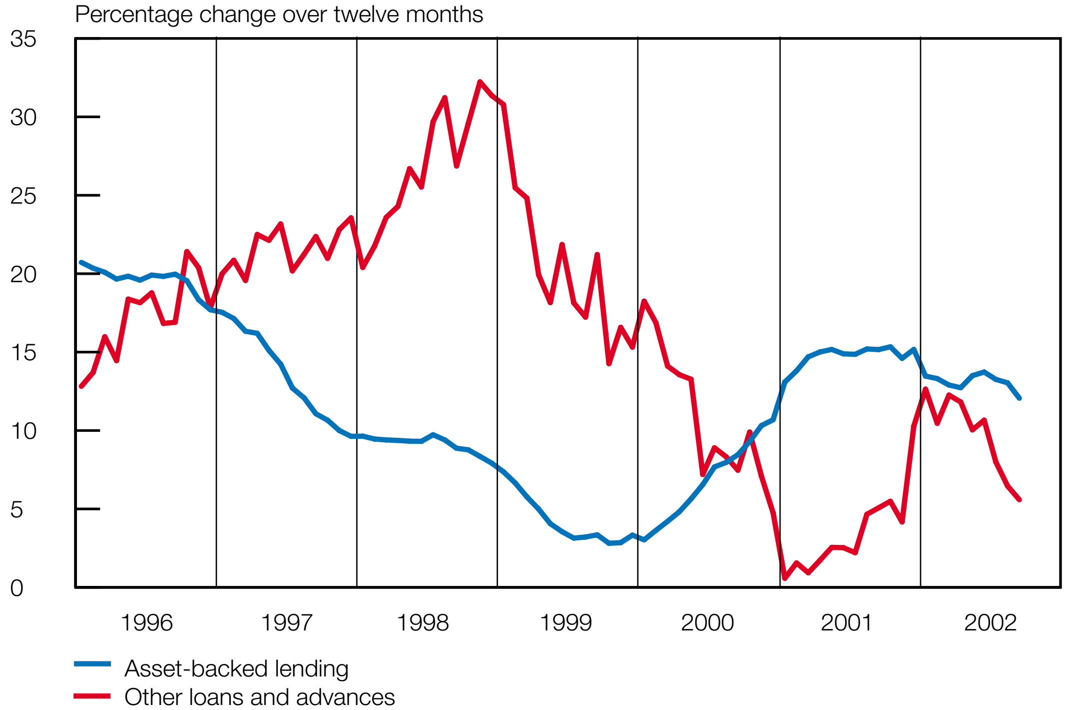
Growth in credit extended to the private sector followed a roughly similar pattern as overall credit extension, falling from 19,7 per cent (seasonally adjusted and annualised) in the first quarter of 2002 to 1,9 per cent in the second quarter and 3,8 per cent in the third quarter. A reversal in leads and lags in foreign payments and receipts and the rising cost of credit following the Reserve Bank's tightening of monetary policy, were probably the more important factors responsible for holding back growth in overall credit demand.

Growth in total domestic credit extension
Quarterly at seasonally adjusted annualised rates

Period		Private sector	Total
2001:	1st qr	2,8	2,7
	2nd qr	5,0	2,3
	3rd qr	14,2	7,4
	4th qr	19,4	17,9
2002:	1st qr	19,7	20,5
	2nd qr	1,9	0,3
	3rd qr	3,8	5,4

Among the components of bank credit extension to the private sector, "asset-backed" lending grew at year-on-year rates varying between 12 and 14 per cent throughout the first nine months of 2002. The real-estate market was quite lively in the first three quarters of 2002, pulling the demand for mortgage financing higher at year-on-year rates varying between 11,7 and 12,8 per cent in that period. Unlike the demand for mortgage lending, which was fairly robust in the first nine months of 2002, the demand for instalment sale credit and leasing finance began to show clear signs of weaker growth in the third quarter of 2002. The growth over twelve months in this type of credit, mainly required for financing the purchasing of motor vehicles and other durable goods, slowed down from 17,5 per cent in May 2002 to 13,0 per cent in September. By contrast to "asset-backed" lending, twelve-month growth in *other loans and advances* fell back from rates fluctuating between 12,6 per cent and 10,0 per cent in the first half of 2002 to 5,6 per cent in September.

Credit extended to private sector by type of credit



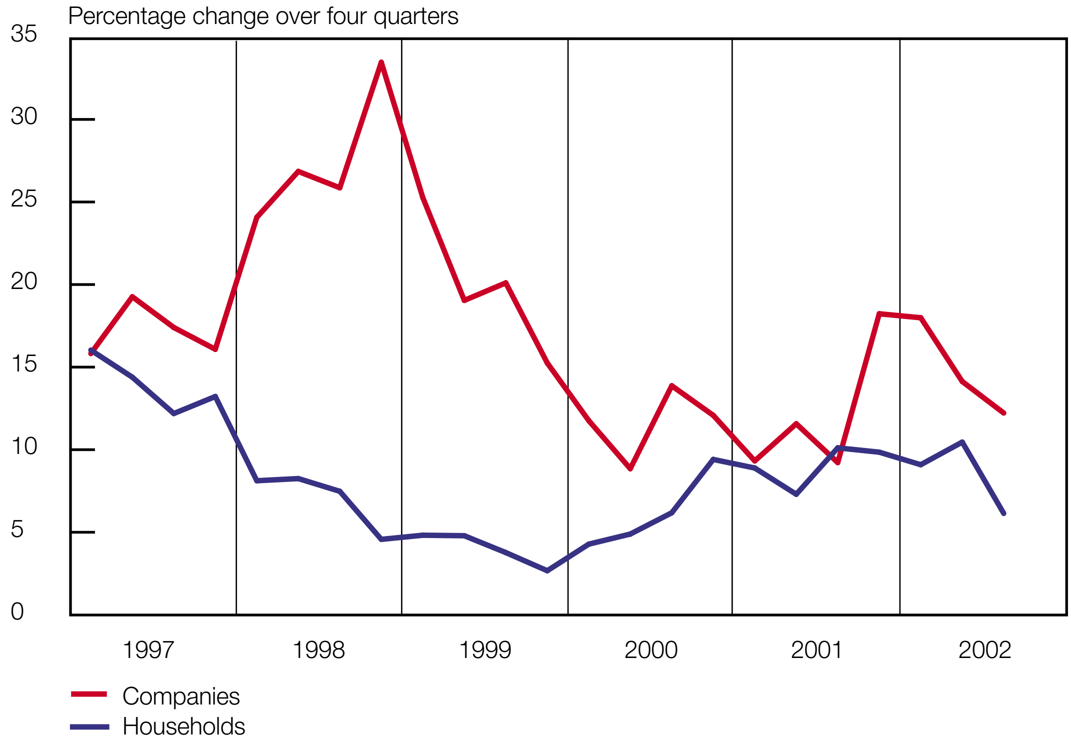
Selected categories of credit to the private sector

Percentage change over twelve months

Period		Instalment sale credit and leasing finance	Mortgages	Other loans and advances
2002:	Jan	17,5	12,1	12,6
	Feb	15,6	12,5	10,5
	Mar	15,9	11,8	12,3
	Apr	15,6	11,7	11,8
	May	17,5	12,1	10,0
	Jun	16,5	12,7	10,7
	Jul	14,5	12,8	8,0
	Aug	14,3	12,6	6,5
	Sep	13,0	11,7	5,6

The overall demand for credit by the corporate sector – the most important component of other loans and advances – slowed down from year-on-year growth of 14,1 per cent in the second quarter of 2002 to 12,2 per cent in the third quarter. Year-on-year growth in credit extended to households, which accounted for 47,1 per cent of the overall demand for private-sector credit in the third quarter of 2002, slowed down from 10,5 per cent in June 2002 to just 6,1 per cent in September.

Credit extended to households and companies

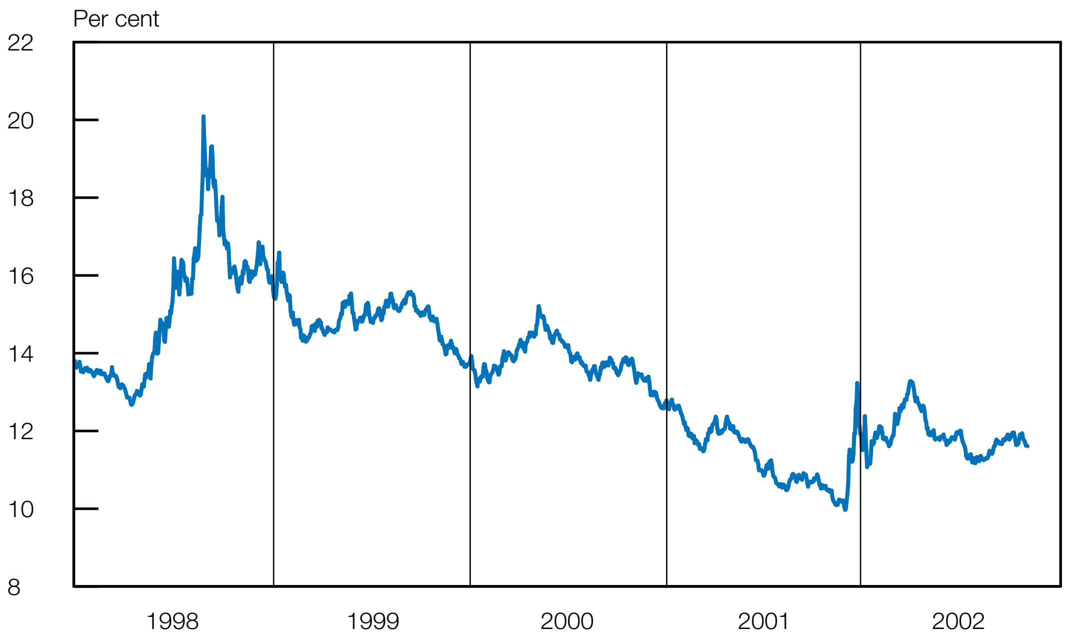


Interest rates and yields

The fall in the value of the rand in December 2001 caused yields in the market for long-term fixed-interest securities to rise steeply from November 2001 to March 2002. The market settled down in the second quarter of 2002 and the *yield on long-term government bonds* in the twelve-to-fourteen-year maturity range declined from a *monthly* average level of 12,6 per cent in March to 11,1 per cent in August.

The bond-market rally was arrested as sentiment again turned bearish, lifting the monthly average yield to 11,3 per cent in September 2002. This occurred despite a strong demonstration by the Reserve Bank of its commitment to contain inflation by increasing the Bank's repurchase rate on four occasions since the beginning of 2002. The *daily* average yield on government bonds in the seven-to-nine-year maturity interval rose from 11,17 per cent on 26 July 2002 to 11,96 per cent on 7 October.

Nominal yield on long-term government bonds



The negative sentiment in the market could be attributed to a number of factors, including

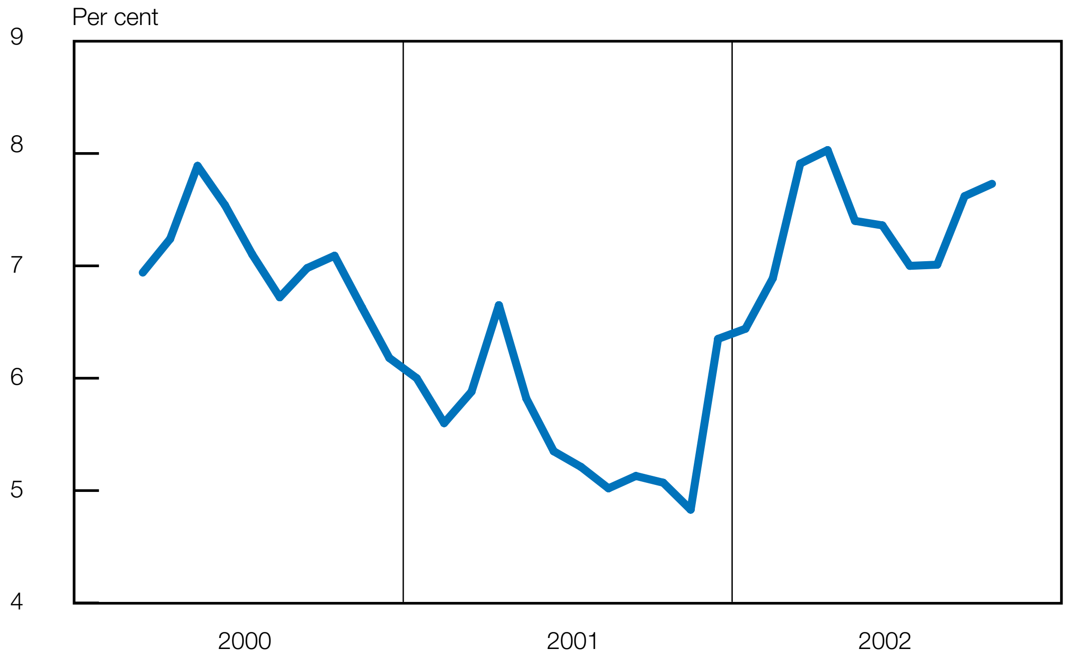
- concerns about financial contagion arising from developments in other emerging markets such as Argentina and Brazil;
- heightened uncertainty about the outlook for the world economy;
- rising global risk aversion which manifested itself in non-residents' net selling of bonds in the third quarter of 2002;
- disappointingly high inflation figures;
- the leaking of the draft empowerment charter for the mining industry which raised concerns about the riskiness of investments throughout the South African economy; and
- the deteriorating political and economic situation in Zimbabwe.

From the second week of October 2002 the daily average bond yield reflected a modest improvement in sentiment and yields drifted lower to 11,61 per cent on

31 October. This decline in bond yields was probably the result of, among other things, the relative strength of the exchange value of the rand, the market's positive response to the *Medium Term Budget Policy Statement* of the government and the release of better-than-expected money supply and bank credit data. The monthly average bond yield levelled off at a rate of 11,3 per cent in October 2002.

Since August 2002 the bond market has been signalling a deterioration in inflation expectations. *Expected longer-term inflation*, reflected by the break-even inflation rate, which is calculated as the difference between the nominal yield on conventional bonds and the real yield on inflation-linked bonds within the seven-to-eleven-year maturity range, increased from a monthly average of 7,0 per cent in August to 7,7 per cent in October. Along with the increase in measured inflation and expectations of still higher inflation in the near term, the *real yield on government's inflation-linked bond*, the R189, decreased from a monthly average of 4,2 per cent during the period April to August 2002 to a monthly average of 3,8 per cent in September and October.

Inflation expectations in the bond market

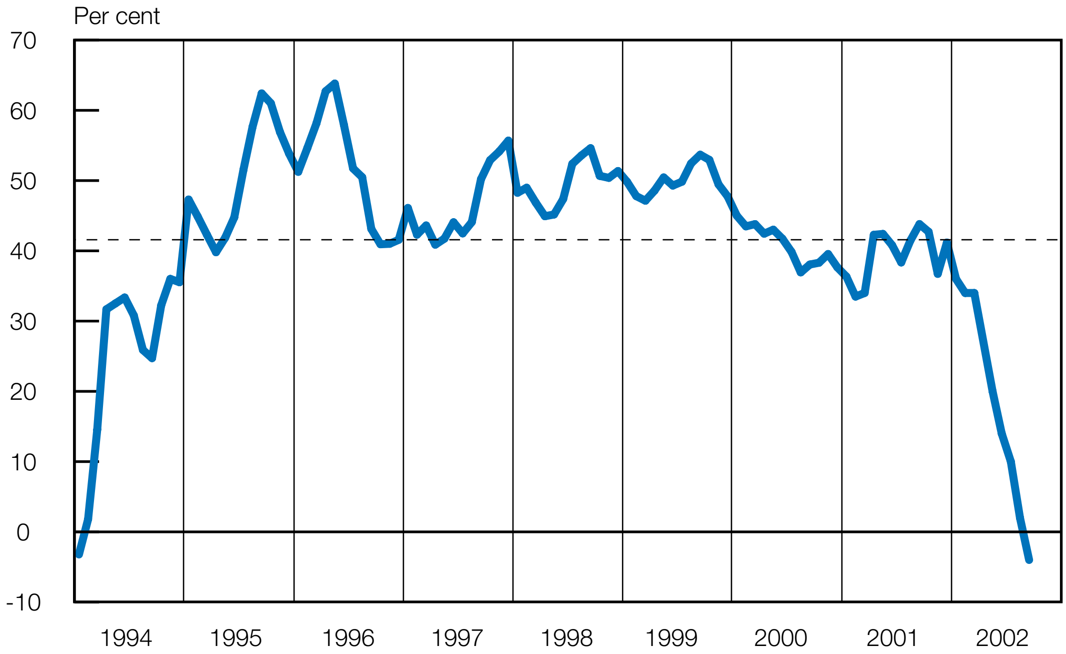


Difference between the nominal yield on conventional and real yield on inflation-linked bonds

Using past year-on-year price increases as an indicator of expected inflation, the *real* or *inflation-adjusted yield* on long-term government bonds declined to a negative value in September 2002 – the first such occurrence since January 1994. The real yield fell from 4,8 per cent in December 2001 to just 0,2 per cent in August 2002 and to a negative value of 0,4 per cent in September, mostly because of the sharp acceleration in the year-on-year CPIX inflation.

The *relative real yield*, measured as the real bond yield expressed as a percentage of the nominal yield on long-term government bonds, fell sharply from 41 per cent in December 2001 to a negative value of 3,6 per cent in September 2002. This decline reflected the impact of the increase in measured year-on-year CPIX inflation on the composition of returns in the bond market.

Relative real yield



Real bond yield expressed as a percentage of the nominal yield

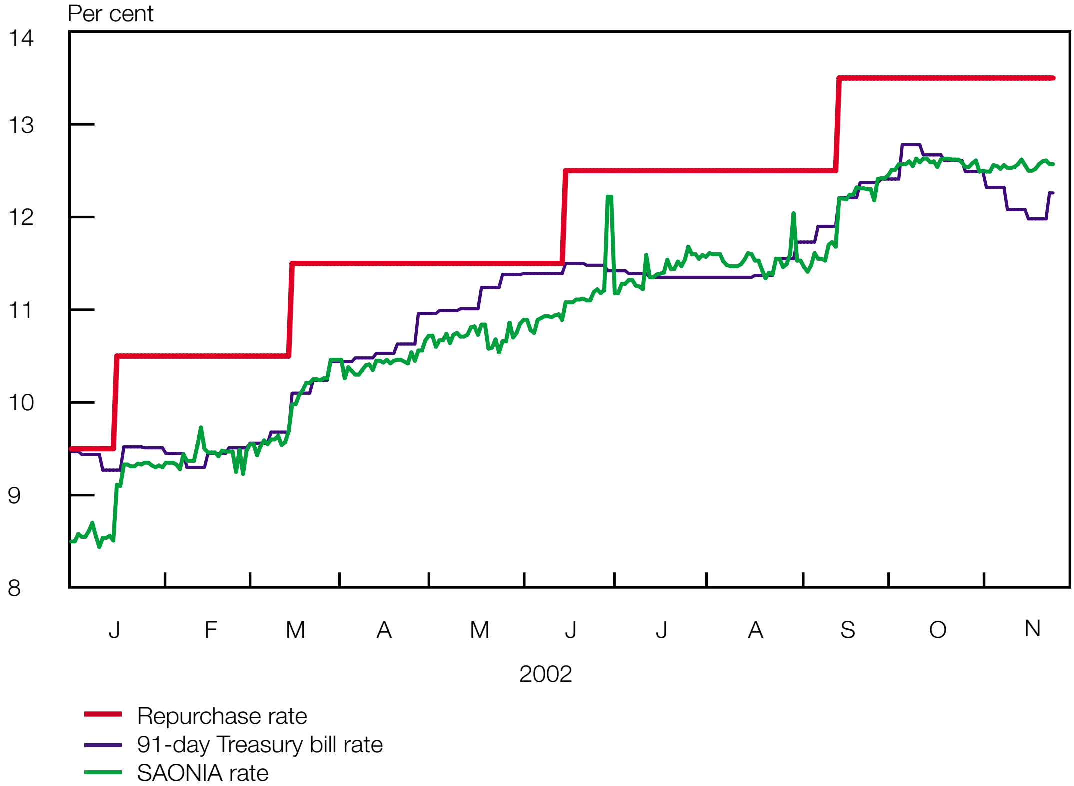
Against the backdrop of deteriorating inflationary conditions, international bond market participants increased the *currency risk premium* on South African government bonds in the two-to-four-year maturity range. This deterioration in the currency risk premium was reflected by a widening of 105 basis points in the difference between the nominal yields in the domestic market and in the United States market from July to September 2002. This increase in the currency risk premium also contributed to the increase in government bond yields in the domestic market. In October 2002 the currency risk premium improved markedly and the rate differential declined by 134 basis points when the exchange rate of the rand strengthened.

The repurchase rate of the Reserve Bank was increased on four occasions during the first nine months of 2002, each time by 100 basis points. The latest adjustment occurred on 13 September 2002 when the repurchase rate was raised to 13,50 per cent.

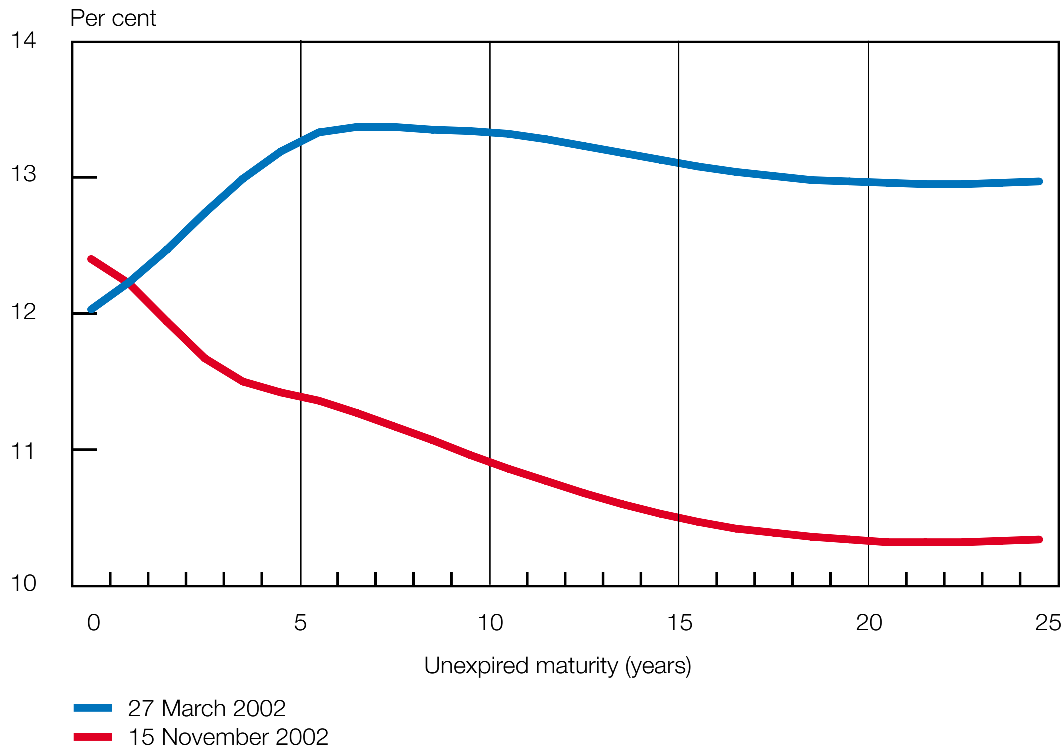
Money-market interest rates generally moved higher during the first nine months of 2002, either in response to increases in the repurchase rate or in anticipation of forthcoming increases in this interest rate. During July 2002 the rise in money-market interest rates paused for a while, only to increase sharply in the remainder of the third quarter when inflation fears worsened.

The SAONIA rate, which represents the average market interest rate on unsecured interbank call funding, generally moved higher from 11,18 per cent on 1 July 2002 to rates varying between 12,49 per cent and 12,63 per cent in October and the first three weeks of November. The rate on three-month bankers' acceptances increased by 144 basis points from 11,71 per cent on 2 July 2002 to 13,15 per cent on 23 October; the interest rate on three-month negotiable certificates of deposit rose by 153 basis points from 12,02 per cent on 1 July to 13,55 per cent on 28 October; and the discount rate on 91-day Treasury bills rose from 11,35 per cent on 15 August 2002 to 12,78 per cent on 10 October.

Money-market interest rates



Yield curves



Inflation expectations abated appreciably during the second half of October 2002, generally resulting in a decline in most money-market interest rates. For example, the rate on three-month bankers' acceptances declined from 13,15 per cent on

23 October 2002 to 13,07 per cent on 26 November, the rate on three-month negotiable certificates of deposit fell from 13,55 per cent on 28 October to 13,45 per cent on 26 November and the discount rate on 91-day Treasury bills declined from 12,78 per cent on 10 October to 12,26 per cent on 26 November. Also, the rate on 9x12-month forward rate agreements (FRAs) declined significantly from 13,21 per cent on 2 October 2002 to 11,60 per cent on 26 November. This downward movement of interest rates was helped along by government when it was announced on 29 October 2002 that the upper limit of the inflation target range for 2004 and 2005 would be increased from 5 per cent to 6 per cent.

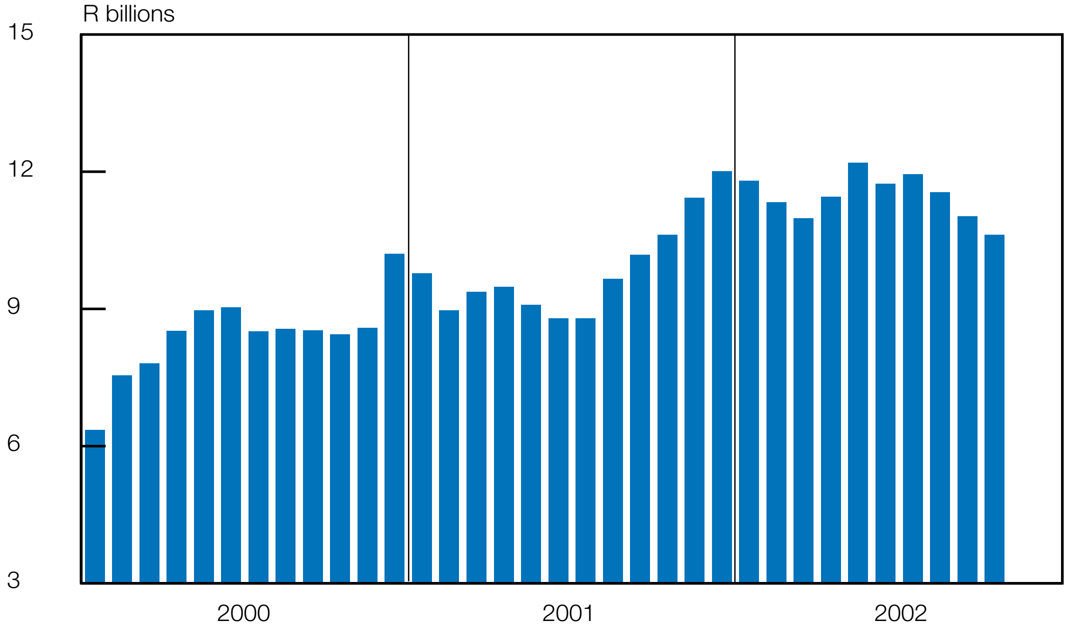
The yields on government bonds at the short end of the maturity spectrum rose in tandem with money-market interest rates during the first ten months of 2002. At the other end of the maturity spectrum, yields on long-dated bonds generally declined from March 2002 to October. The shape of the *yield curve* accordingly changed from upward sloping to downward sloping, with long-term yields appreciably lower than short-term yields. The *inverse yield gap*, i.e. the difference between bond yields at the extreme long and short ends of the curve, amounted to 174 basis points at the end of October 2002.

The private-sector banks responded to the increases in the repurchase rate during 2002 by lifting their prime overdraft rate and the *predominant rate on mortgage loans* in four steps from their initial levels of 13 per cent early in January to 17 per cent in September. The *predominant rate on twelve-month fixed deposits* with banks was raised from 8 per cent in January 2002 to 12 per cent in September – its highest level since June 1999.

Money market

The average daily liquidity requirement of the private-sector banks decreased, on balance, from R12,2 billion in May 2002 to R10,6 billion in October. The Reserve Bank kept the daily liquidity requirement fairly stable during these months by actively employing various intervention techniques aimed at offsetting additional liquidity injections arising from deficits sustained on forward foreign-exchange transactions and other money-market flows.

Average monthly liquidity requirements of private-sector banks

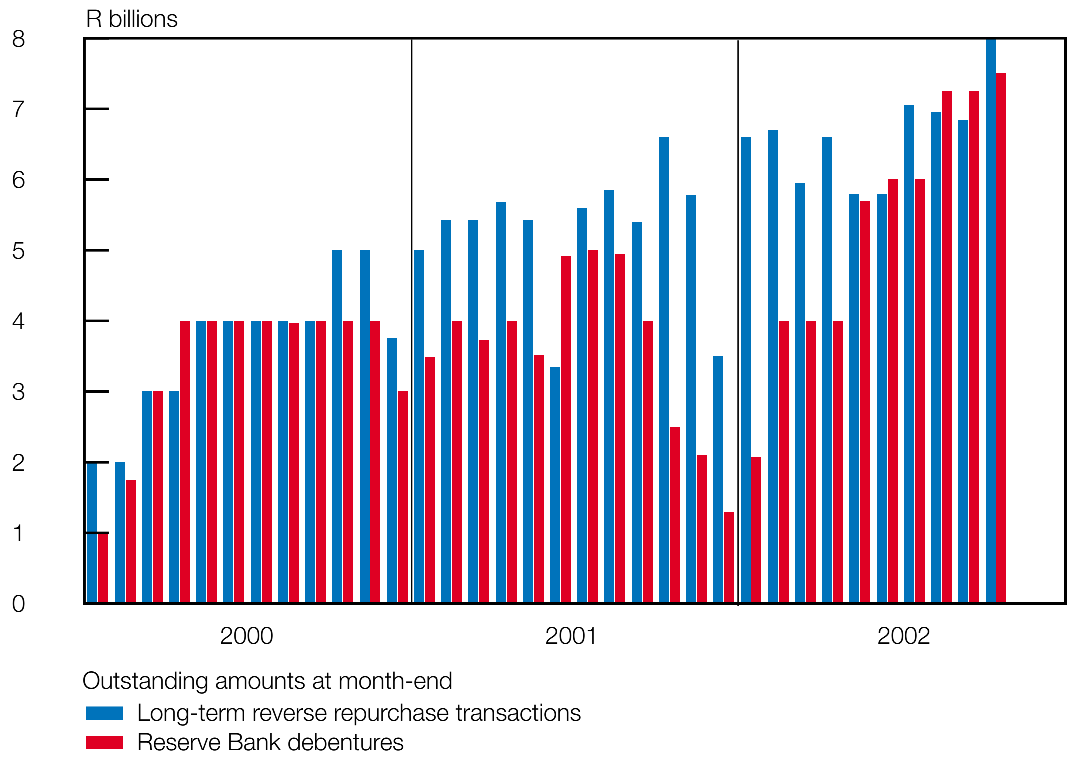


Actions by the Reserve Bank to mop up excess liquidity in the money market included foreign-currency swap transactions with private-sector parties. The outstanding amount of these swap transactions rose by R6,9 billion from the end of April 2002 to the end of August. In the ensuing two months the outstanding amount of these swaps was brought down by R3,5 billion to the end of October.

The Reserve Bank held regular weekly auctions of its own debentures with private-sector parties to drain additional liquidity from the money market. The outstanding amount of these transactions increased from R4,0 billion at the end of April 2002 to R7,5 billion at the end of October. The latter amount consisted of R4,2 billion in debentures with a maturity of 28 days and R3,3 billion with a maturity of 91 days. The auctions were consistently oversubscribed, with the average interest rate ranging between 10,57 per cent and 12,77 per cent for debentures with a maturity of 28 days and between 11,73 per cent and 12,90 per cent for debentures with a maturity of 91 days.

Some liquidity was temporarily injected into the money market by the Reserve Bank by reducing the amount of outstanding reverse repurchase transactions in government securities from R6,6 billion at the end of April 2002 to R5,8 billion at the end of June. In July the outstanding amount of these transactions was again increased to around R7 billion, draining liquidity from the money market. In October 2002 the amount of outstanding reverse repurchase transactions was raised further to R8 billion.

Reserve Bank operations in the money market



Notes and coin in circulation outside the Reserve Bank averaged R33,2 billion in the third quarter of 2002. This was some R0,9 billion higher than in the previous quarter, reducing liquidity in the money market somewhat. In October the level of notes and coin rose slightly, averaging R33,6 billion in that month. In September 2002 the proportion of banks' vault cash holdings that qualifies as a deduction when calculating their required cash reserve deposits with the Reserve Bank was reduced further from 75 to 50 per cent. This drained R1,7 billion from the money market, bringing the cumulative money-market impact of the vault cash exclusion to some R3,5 billion since September 2001.

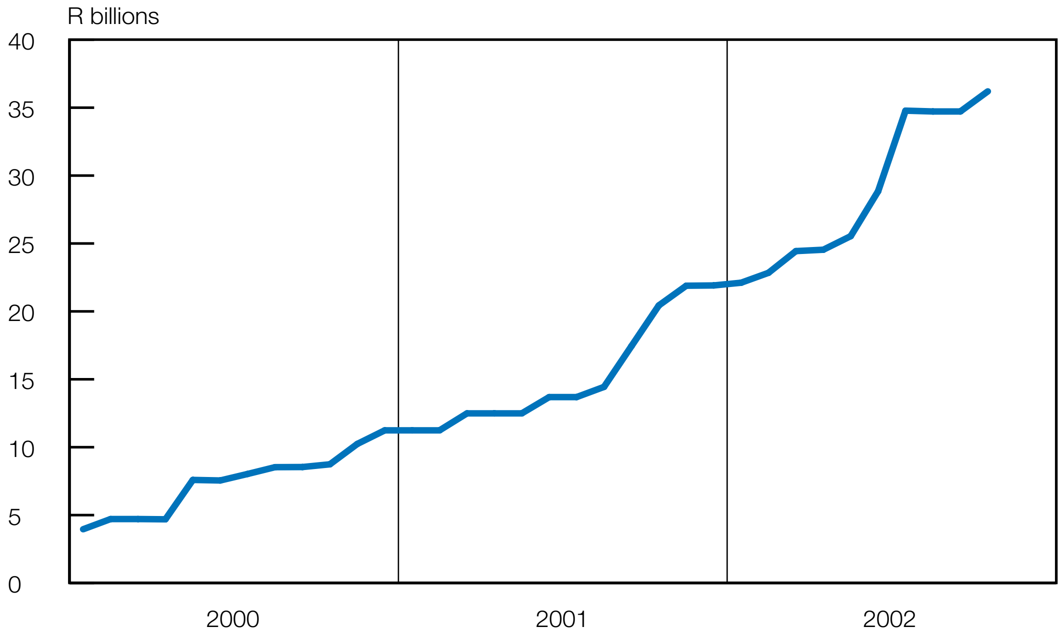
Bond market

Public-sector borrowers repaid securitised debt to the net amount of just R54 million in the first half of the current fiscal year, compared with net redemptions of R10,2 billion in the whole of fiscal 2001/02. (The zero-coupon bonds issued to the Reserve Bank were not included in these comparisons.) The limited borrowing in the domestic primary bond market was supplemented by borrowing in the *international markets*. The *national government* opened and completed its offshore borrowing programme for fiscal 2002/03 in April 2002, when an amount of R10,7 billion was raised through the issuance of a 10-year global bond with a nominal value of US$1 billion. In the public sector, Eskom raised R2 billion by issuing a three-year eurobond in October 2002, replacing a maturing bond. This issue was well received by the international investor community, especially after the country's international debt rating was improved by Fitch Ratings.

From January to April 2002 sentiment in the *eurobond market* for rand-denominated bonds improved and the net proceeds of issues by non-residents amounted to R1,7 billion compared with net redemptions in the two preceding years. Sentiment subsequently deteriorated and net redemptions of R1,7 billion were made from May to October 2002. South African borrowers also reduced their eurorand bond liabilities to the net amount of R0,2 billion in the first ten months of 2002.

The public sector's reduced demand for loanable funds left ample resources for growth in private-sector funding in the primary corporate bond market. The *outstanding nominal value of private-sector loan stock* listed on the Bond Exchange

Private-sector funding in the bond market

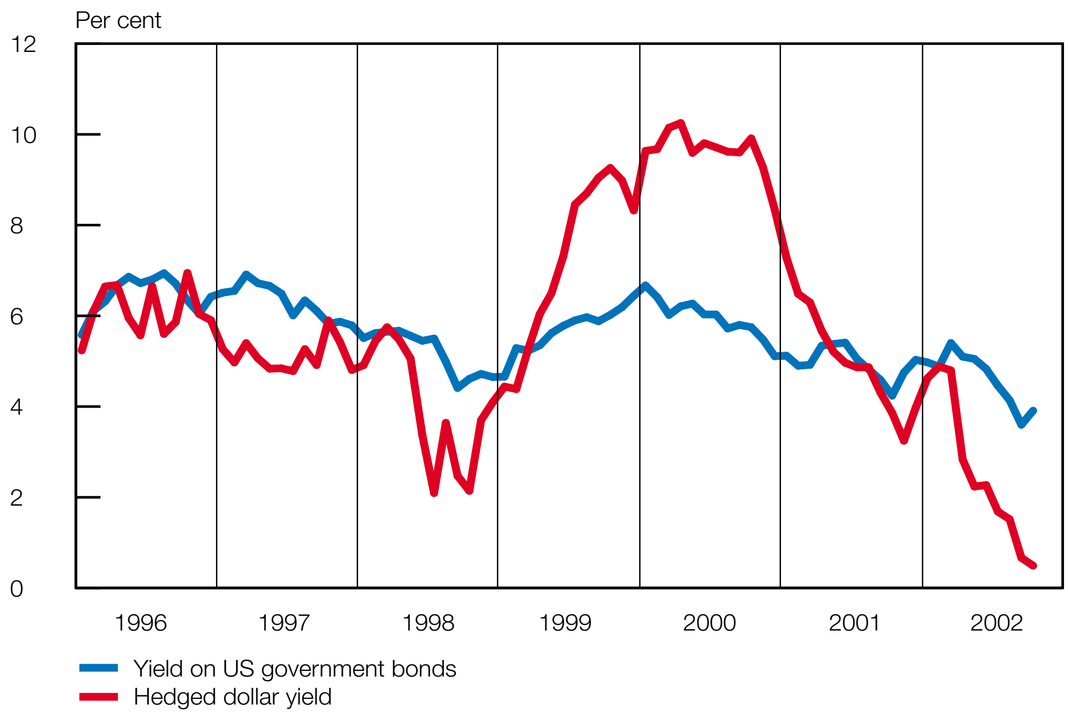


Nominal outstanding value of private-sector listed bonds of South Africa accordingly increased, on balance, from R21,9 billion in December 2001 to R36,2 billion in October 2002, i.e. by some 65 per cent. Of the R14,3 billion raised in the first ten months of 2002, R10,3 billion was raised in the period from April to July. Little interest was shown in this market during the third quarter of 2002.

Despite heightened volatility in bond yields, turnover in the *domestic secondary bond market* fell back from a record R3,5 trillion in the fourth quarter of 2001 to a quarterly average of R3,3 trillion in the first half of 2002 and R2,9 trillion in the third quarter. The value of bonds traded amounted to R1,1 trillion in October 2002. This brought turnover on the Bond Exchange of South Africa to R10,7 trillion in the first ten months of 2002 – 6 per cent more than in the corresponding period of 2001.

Non-resident investors showed keen interest in the domestic *secondary bond market* in the first half of 2002 after they had been net sellers of South African bonds in 2000 and 2001. On a net outright basis, non-resident investors bought bonds worth R6,3 billion in the first half of 2002. However, they switched back to net outright sales valued at R9,9 billion in the third quarter as concern about inflation and currency weakness resurfaced. In addition, from the perspective of a US investor, a hedged investment in South African bonds yielded a significantly lower dollar return (measured as the rand yield adjusted for the forward currency premium) than the yield on US government bonds. In the first ten months of 2002, non-residents' cumulative transactions still reflected net purchases of bonds, but only to the value of R0,8 billion.

Non-resident investors: Comparative dollar yields



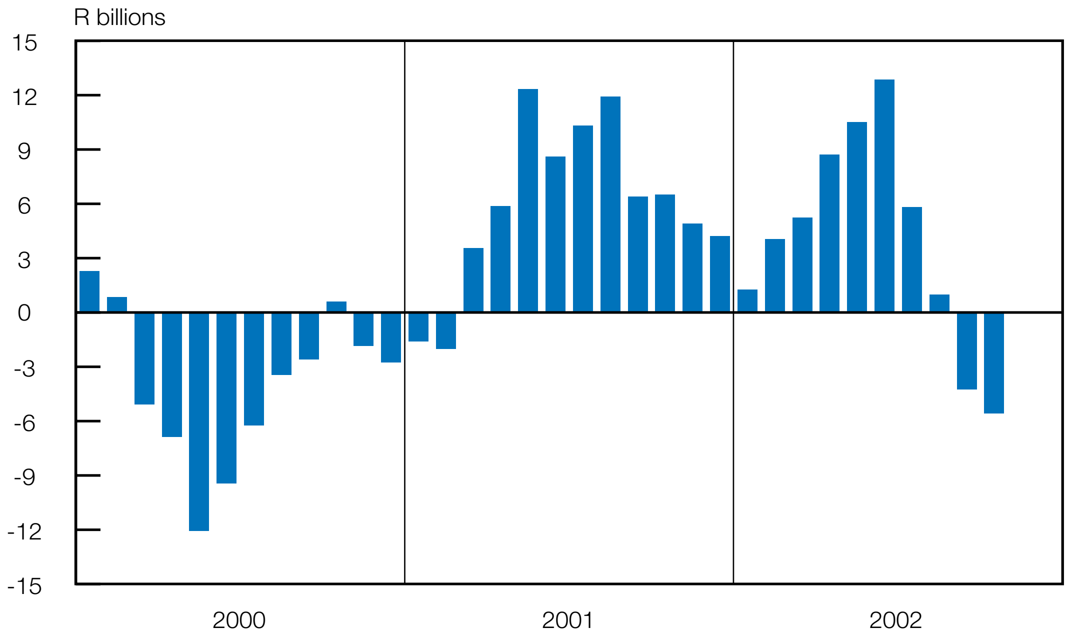
Share market

The total value of *capital* raised in the domestic and international *primary share markets* by companies listed on the JSE Securities Exchange SA amounted to R50,8 billion in the first ten months of 2002 compared with R23,6 billion in the whole of 2001. There was a bunching of activity in the third quarter of 2002 when R28,1 billion worth of capital was raised. Included in the third quarter statistics was an amount of R18,5 billion related to the acquisition of the United States brewing company, Miller, by South African Breweries plc which culminated in the creation of the merged entity SABMiller plc.

Trading in the *secondary share market* remained buoyant during the first ten months of 2002 amid heightened price volatility. The R694 billion worth of shares traded on the JSE Securities Exchange SA in the first ten months of 2002 was 41 per cent more than in the corresponding period of 2001. However, quarterly turnover fell back from a record of R236 billion in the second quarter of 2002 to R218 billion in the third quarter. Shares to the value of R64 billion were traded in October 2002.

A *net* outflow of foreign portfolio capital to the value of R6,4 billion from the *secondary share market* in the first ten months of 2002 reflected a drastic change in non-resident investor sentiment towards shares listed on the JSE Securities Exchange SA. In the first four months of 2002 non-resident investors added R7,1 billion to their holdings of listed shares but they then reduced their holdings of shares. They sold shares on a net basis to the value of R8,8 billion in the third quarter and R3,1 billion in October.

Annual cumulative purchase of bonds and shares by non-residents

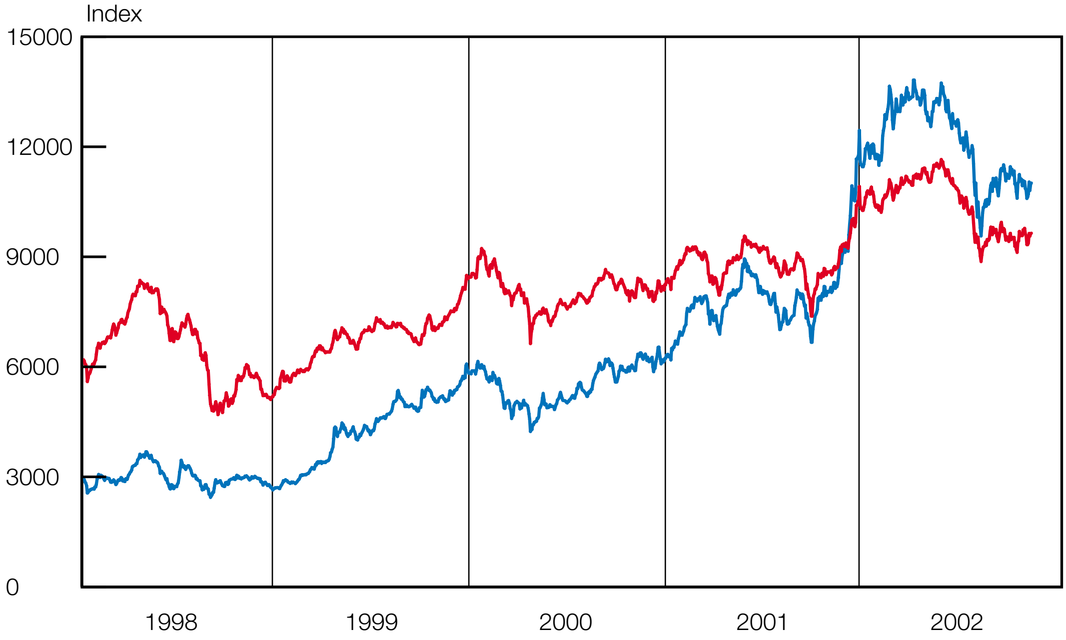


Source: JSE Securities Exchange South Africa and Bond Exchange of South Africa

A number of developments contributed to the change in the direction of foreign portfolio equity flows. These include portfolio rebalancing following the decline in share prices worldwide, fear of contagion from other emerging markets, the unwinding of asset swap arrangements which had accomplished their goals and the offshore listing of some heavily traded prominent South African companies. More directly, sentiment was adversely affected by the leaking of the empowerment charter for the mining industry that created perceptions of increased riskiness associated with investing in the South African economy.

Weakness on international markets and the general erosion of confidence in equities during a phase of weak global economic recovery contributed to the fall of 24 per cent in the *daily closing level of the all-share price index* from a record high on 22 May 2002 to 5 August. The all-share price index subsequently retraced some of these losses. The daily closing level of the all-share price index rose by 6 per cent to a level at the end of October 2002 that was some 30 per cent higher than the low point of 21 September 2001.

Share prices



Source: JSE Securities Exchange South Africa

The latest recovery in share prices was largely confined to the *resources sector* of the market. Prices in this sector, which contributes almost 50 per cent to overall market capitalisation, rose on average by 12 per cent from 5 August 2002 to the end of October. The *gold-mining index* increased by 57 per cent from 29 July 2002 to 16 September, helped along by the strong increase in the dollar price of gold, but subsequently fell back by 21 per cent. On balance, the gold-mining index rose by 24 per cent from 29 July 2002 to the end of October.

Share price movements were mirrored by changes in the level of the *dividend yield* on all classes of shares. The monthly average dividend yield increased from 3,0 per cent in the April-June 2002 period to 3,9 per cent in the August-October period. The *price-earnings ratio* of all classes of shares fell from 12,1 in May 2002 to 9,0 in October as earnings per share increased from 8,3 per cent to 11,1 per cent.

Market for derivatives

Falling prices in the underlying securities markets boosted trading in the formal derivatives markets during the third quarter of 2002. The combined number of trades in *futures and options on futures contracts* on the Financial Derivatives

Division of the JSE Securities Exchange SA picked up from 6,2 million contracts in the second quarter of 2002 to 8,2 million in the third quarter. In October 2002 trading was still at a relatively high quarterly level of 7,2 million contracts.

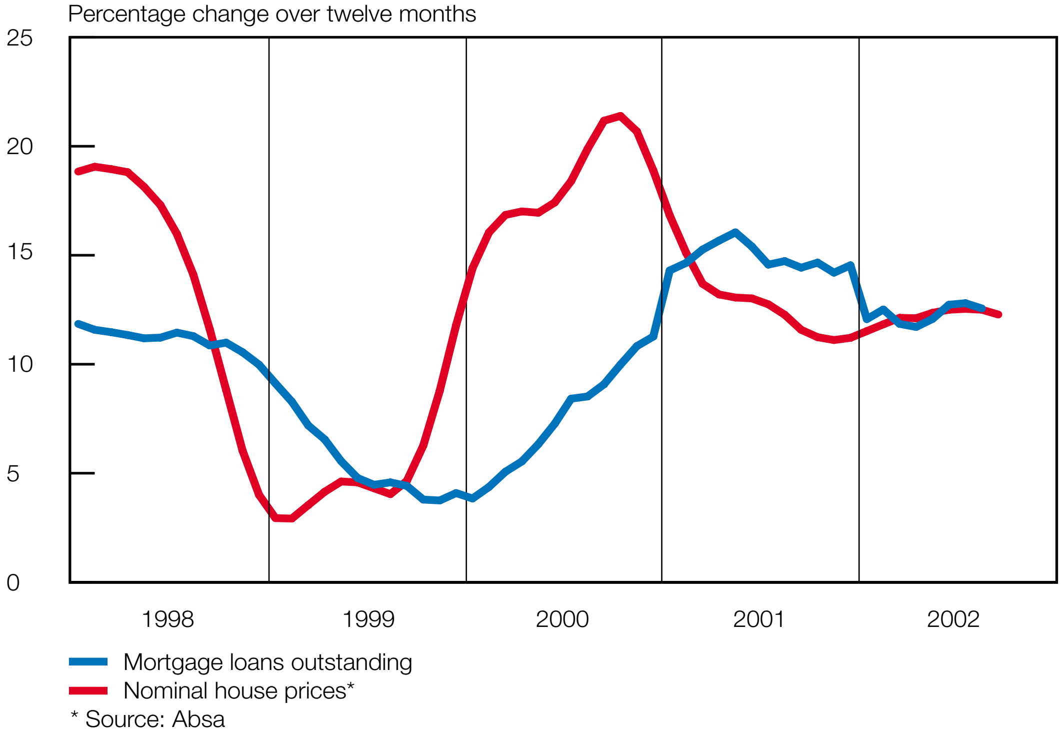
The number of *warrants* written on shares listed on the JSE Securities Exchange SA declined from the end of 2001 to the end of October 2002. Consequently, the number of trades in warrants also declined from a record level of 7,9 billion in the third quarter of 2001 to 5,4 billion in the third quarter of 2002 and to a quarterly number of 3,6 billion in October. This decline in the number of traded warrants could have been even greater were it not for an increase in the number of warrants written on the shares of listed gold-mining companies. As a percentage of the total number of warrants traded, warrants underpinned by gold-mining companies increased from 3 per cent in July 2001 to 39 per cent in October 2002.

Price movements of agricultural products underpinned trading in commodity derivative instruments on the Agricultural Products Division of the JSE Securities Exchange SA. The number of *commodity futures contracts and options* on such contracts traded increased from 329 000 in the fourth quarter of 2001 to a quarterly average of 504 000 in the second and third quarters of 2002. In July 2002 the number of commodity derivative contracts traded surpassed the total number recorded in 2001 and for the first ten months of 2002 trading in commodity derivative contracts was 56 per cent more than in 2001 as a whole.

Real-estate market

Although still very lively, trading activity in the *real-estate market* slowed down somewhat in the first nine months of 2002. The seasonally adjusted turnover in the real-estate market, measured by *transfer duty paid*, increased by 25 per cent in the first nine months of 2002 compared with the first nine months of 2001. However, a softer undertone became apparent during 2002 as trading activity declined by

Real-estate market



almost 3 per cent from the first to the second quarter and almost 4 per cent from the second to the third quarter.

The increase in interest rates in the first nine months of 2002 had a dampening effect on growth in the *home loan market*. This was reflected by the deceleration in year-on-year growth in outstanding home-loan balances at banks from almost 15 per cent in 2001 to 12 per cent in the first nine months of 2002. The increase in the cost of mortgage finance affected the affordability of owner-occupied dwellings, curbing demand and slowing the year-on-year growth in nominal house prices. Since July 2002 the year-on-year rate of increase in house prices, as measured by Absa Bank, has slowed down.

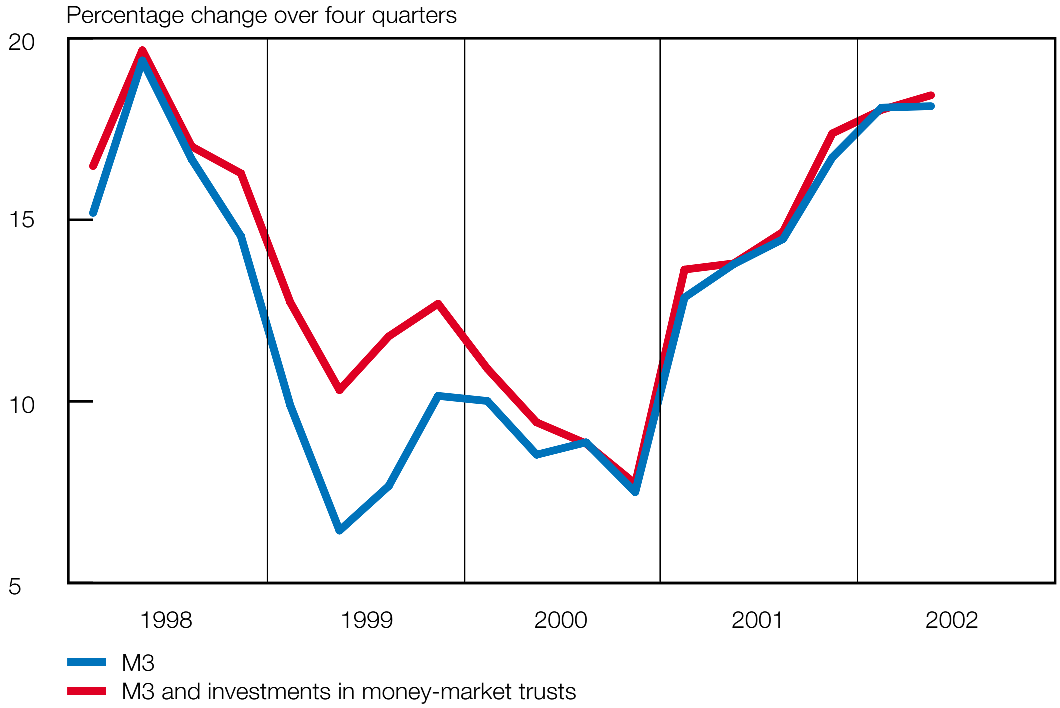
Non-bank financial intermediaries

Asset price volatility and uncertainty in the financial markets showed up in strong growth in *money-market unit trusts*. In less than six years, the *market value of the net assets* of these funds increased to almost R50 billion in June 2002. The value of the net assets of money-market unit trusts as a percentage of the net asset value of *all unit trusts* rose to 28 per cent in the third quarter of 1999, but then stabilised at around 25 per cent.

In 1997 and 1998 money-market funds invested on average about 40 per cent of their portfolios in *cash and deposits with banks*. This allocation subsequently declined to an average level of 20 per cent in the period to June 2002. This occurred despite the sharp increase in the absolute value of funds placed with banks to R14 billion in the second quarter of 2002.

Investments with money-market funds are close substitutes for M3 deposits with banks. These funds' holdings of cash and deposits with banks form part of M3. The assets of money-market unit trusts *other than cash and deposits with banks* consist of mostly liquid investments in short-term money-market instruments such as Treasury bills. These investments represented only about 5 per cent of the M3 money supply in June 2002.

Money-market unit trusts and M3

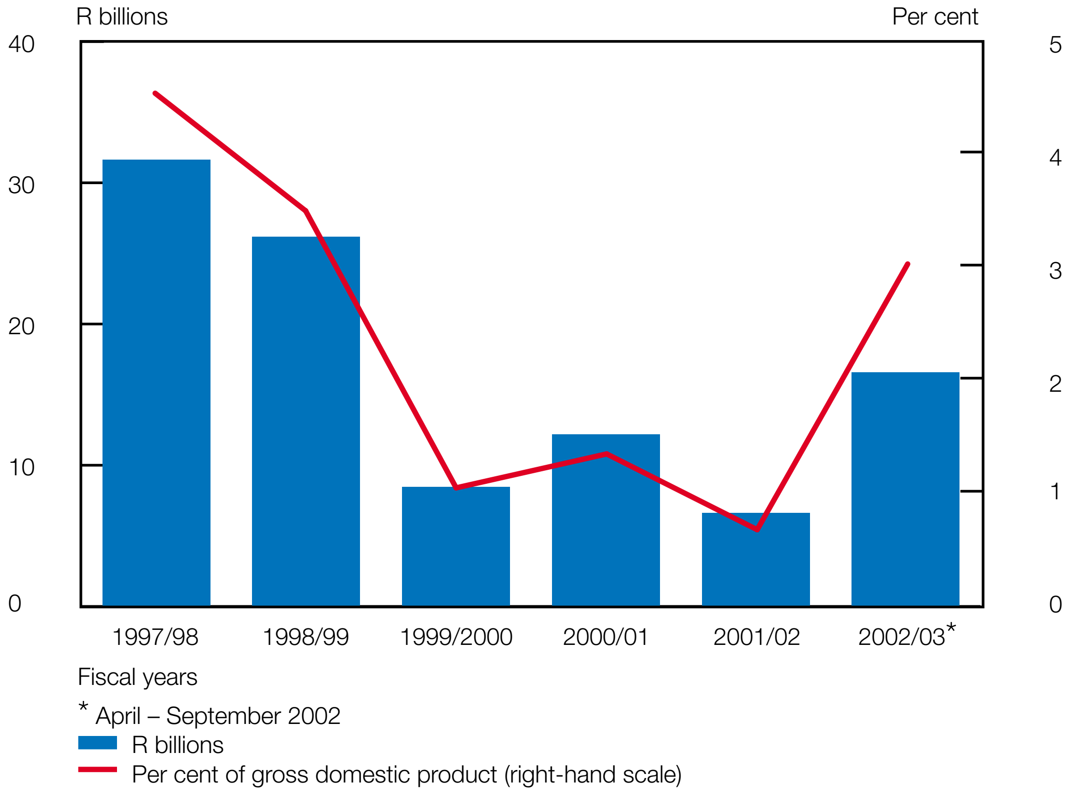


Public finance

Non-financial public-sector borrowing requirement

The borrowing requirement of the non-financial public sector (i.e. the deficit before borrowing and debt repayment of the consolidated central government, provincial governments, local governments and non-financial public-sector businesses) amounted to R17,9 billion in the July-September quarter of 2002, compared with R4,7 billion in the corresponding quarter of 2001. This brought the non-financial public-sector borrowing requirement for the first half of fiscal 2002/03 to R16,6 billion, which is R12,5 billion more than in the same period of the previous fiscal year. As a ratio of gross domestic product, the borrowing requirement of the non-financial public sector increased from 0,8 per cent in the first half of fiscal 2001/02 to 3,0 per cent in the first half of fiscal 2002/03.

Non-financial public-sector borrowing requirement



The increase in the borrowing requirement of the non-financial public sector can partly be ascribed to the inclusion of a capital transfer of R7 billion from the national government to the Gold and Foreign Exchange Contingency Reserve Account, which is managed by the South African Reserve Bank on behalf of the government. Furthermore, a marked deterioration in the finances of provincial governments was recorded in the July-September quarter of 2002. Also, the financial results of non-financial public businesses indicate a narrowing of their consolidated financial surpluses from R2,3 billion in the first half of fiscal 2001/02 to R1,9 billion in the first half of fiscal 2002/03.

The borrowing requirement of the consolidated general government amounted to R19,3 billion in the July-September quarter of 2002, bringing the borrowing requirement for the first six months of fiscal 2002/03 to R18,5 billion, compared with a borrowing requirement of R6,3 billion recorded in the first six months of fiscal 2001/02.

The *Statement of Provincial Government Revenue, Expenditure and Borrowing* indicated that provincial governments recorded a deficit of R5,3 billion in the July-September 2002 quarter; their overall surplus therefore amounted to R1,0 billion in the first six months of fiscal 2002/03 – a surplus of R7,7 billion was recorded in the first six months of fiscal 2001/02. The equitable share of nationally raised revenue transferred to provincial governments amounted to R60,3 billion, representing an increase of 10,0 per cent over the same period a year earlier. However, provincial government expenditure increased at a year-on-year rate of 24,1 per cent in the July-September quarter of 2002.

Conditional grants to the amount of R3,0 billion were transferred to provincial governments in the July-September quarter of 2002, bringing the total of conditional grants in the first six months of fiscal 2002/03 to R6,1 billion. Provincial governments utilised their bank balances to defray part of their expenditure, leading to a decrease in their deposits with private banks from R11,9 billion at the end of June 2002 to R8,9 billion at the end of September. Their overall indebtedness with banks remained unchanged at R0,4 billion in the July-September quarter of 2002.

Although comprehensive data on the financial position of local governments for the first half of fiscal 2002/03 are not yet available, preliminary indications are that local governments experienced an estimated deficit of R5,0 billion during this period.

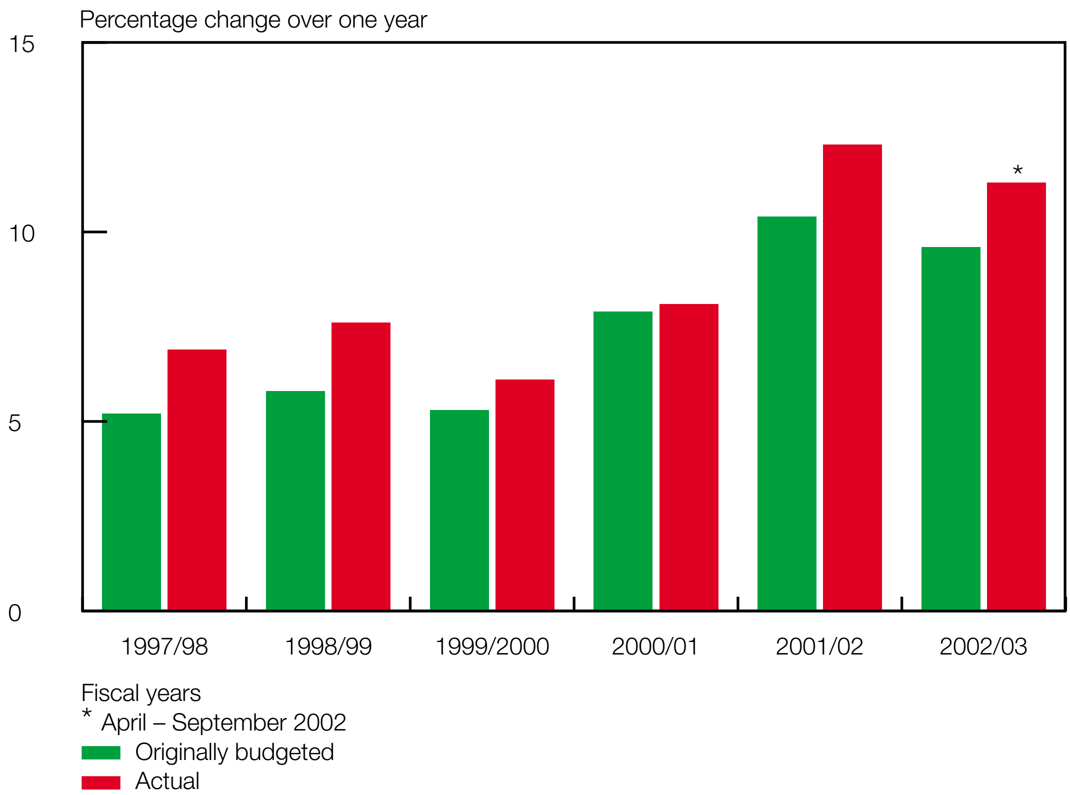
National government finance

National government expenditure increased by 11,3 per cent in the first six months of fiscal 2002/03 to R143,6 billion. The original budget estimated that expenditure would increase at a rate of 9,6 per cent for the fiscal year as a whole. Realised expenditure represents 49,9 per cent of the originally budgeted expenditure of R287,9 billion for the full fiscal year. The year-on-year growth in national government expenditure in the first six months of fiscal 2002/03 was slightly less than the 11,6 per cent growth recorded in the previous fiscal year, but exceeded the average growth of 8,9 per cent recorded in the first six months of the five fiscal years prior to that.

Interest paid on government debt decreased by 2,4 per cent from the first half of fiscal 2001/02 to the first half of fiscal 2002/03. Approximately 40,2 per cent of the R18,7 billion originally budgeted for capital projects was spent in the first six months of fiscal 2002/03, representing a rate of increase of 19,2 per cent compared with the same period in the previous fiscal year. Funds spent on capital projects were mainly for justice and protection services and the development of infrastructure.

National government expenditure as a ratio of gross domestic product amounted to 26,1 per cent in the first six months of fiscal 2002/03, close to the ratio of 26,2 per cent in the corresponding period of the previous fiscal year. After allowing for cash-flow adjustments (i.e. transactions recorded in the government accounting system but not yet cleared in the banking system, and late departmental requests) cash expenditure amounted to R144,4 billion, representing an increase of 11,9 per cent in the first half of fiscal 2002/03 compared with the corresponding period of the previous fiscal year.

Expenditure of national government



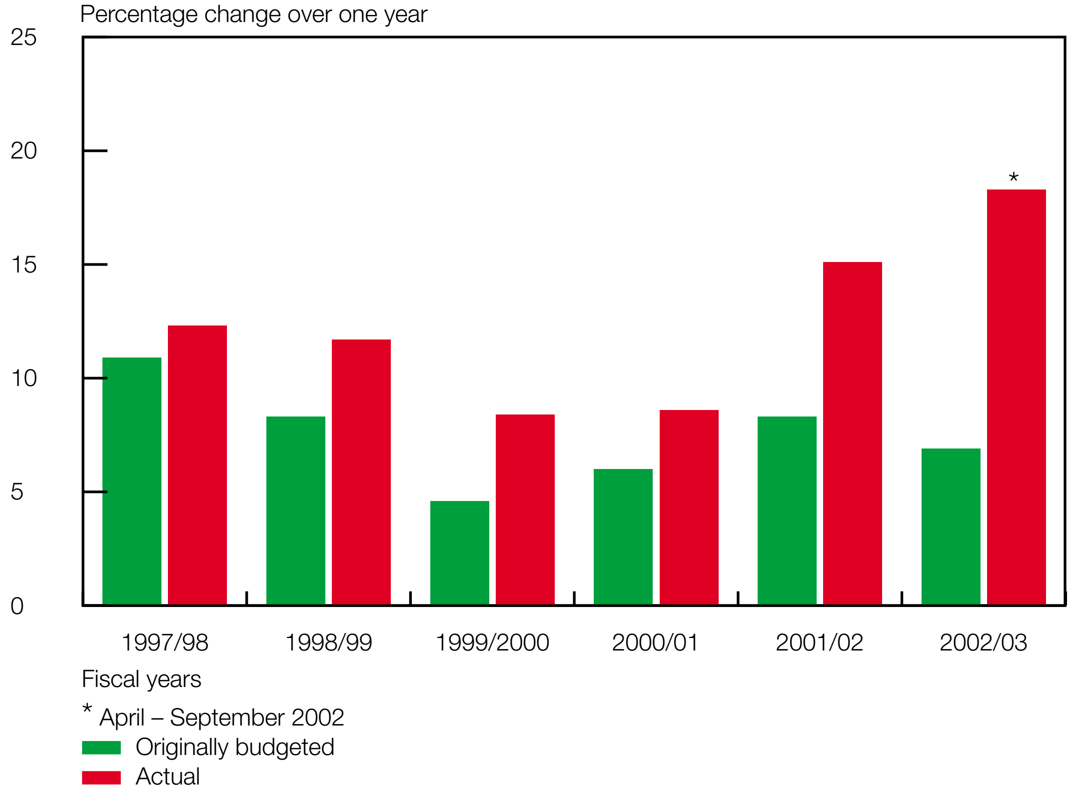
National government revenue in the first six months of fiscal 2002/03 amounted to R133,8 billion or 50,4 per cent of the originally budgeted revenue of R265,2 billion for the fiscal year as a whole. The year-on-year rate of increase in revenue amounted to 18,3 per cent, which comfortably exceeded the originally budgeted growth of 6,9 per cent for the full fiscal year. Although the rate of increase in national government revenue in the first six months of fiscal 2002/03 was only slightly higher than the 17,2 per cent growth recorded in the corresponding period of the previous fiscal year, it was well above the average growth rate of 10,9 per cent recorded in the corresponding period of the preceding five fiscal years.

National government revenue

Revenue source	R billions		Percentage change*
	Fiscal 2002/03 Originally budgeted	April – Sep 2002 Actual	
Taxes on income and profits	155,7	74,5	12,2
Payroll taxes	3,0	1,6	25,8
Taxes on property	4,6	2,6	20,8
Domestic taxes on goods and services	92,8	46,5	16,3
Taxes on international trade and transactions	10,6	4,7	10,2
Other revenue	6,8	8,0	151,8
Less: SACU** payments	8,3	4,1	0,7
Total revenue	**265,2**	**133,8**	**18,3**

* April – September 2001 to April – September 2002
** Southern African Customs Union

Revenue of national government



The strong growth in national government revenue is primarily due to high rates of increase in taxes on income and profits, and value-added tax collections. The better-than-expected tax collections can be attributed to the effects of higher-than-expected economic growth, the effects of inflation on household spending and revenue gains from higher profits of export-oriented companies.

National government revenue as a ratio of gross domestic product amounted to 24,3 per cent in the first six months of fiscal 2002/03, slightly higher than the ratio of 22,9 per cent recorded in the corresponding period of the previous fiscal year. National government's cash revenue (after cash-flow adjustments stemming from timing differences in the recording of transactions and bank clearances) amounted to R133,2 billion, representing a year-on-year rate of increase of 19,3 per cent in the first six months of fiscal 2002/03.

The net result of the revenue and expenditure of the national government recorded in the first six months of fiscal 2002/03 was a deficit of R9,8 billion. This deficit represents 43,2 per cent of the R22,7 billion deficit originally budgeted for the full fiscal year. As a ratio of gross domestic product, the deficit amounted to 1,8 per cent in the first six months of the fiscal year, compared with a ratio of 3,2 per cent in the corresponding period of the previous fiscal year. Due to the decrease in interest payments and the strong growth in revenue, the primary balance (i.e. the balance before borrowing recalculated by excluding interest payments from total expenditure) increased from a surplus of R7,7 billion recorded in the first six months of fiscal 2001/02 to a surplus of R13,2 billion in the first six months of the current fiscal year. This resulted in an improvement in the primary surplus as a ratio of gross domestic product from 1,6 per cent to 2,4 per cent during the same period.

Cumulative deficit of national government

The cash deficit before borrowing and debt repayment amounted to R11,2 billion in the first six months of fiscal 2002/03. Although government revenue was bolstered by a R1,3 billion profit on the revaluation of maturing foreign loans and the receipts from Transnet's disposal of its equity holding in M-Cell, national government had to pay a premium of R0,3 billion on the restructuring of its domestic debt portfolio. Apart from this payment, the National Treasury also made an extraordinary payment of R7,0 billion to the South African Reserve Bank. This was in partial payment of the liability resulting from the losses accumulated on the Gold and Foreign Exchange Contingency Reserve Account which is managed by the Bank on behalf of the

National government finance

R billions

	Fiscal 2002/03 Originally budgeted	April – Sep 2002 Actual
Cash deficit	**22,7**	**11,2**
Plus: Extraordinary payments	1,6	7,3
Cost/profit on revaluation of foreign loans*	...	-0,3
Less: Extraordinary receipts	12,0	1,0
Net borrowing requirement	**12,3**	**17,2**
Domestic primary capital market		
Government bonds	...	13,6
Less: Discount on government bonds	...	0,9
Net receipts from government bonds issued	**-11,0**	**12,7**
Treasury bills	4,0	0,3
Foreign loans	16,3	13,4
Change in available cash balances**	3,0	-9,2
Total net financing	**12,3**	**17,2**

* Cost +, profit -

** Increase -, decrease +

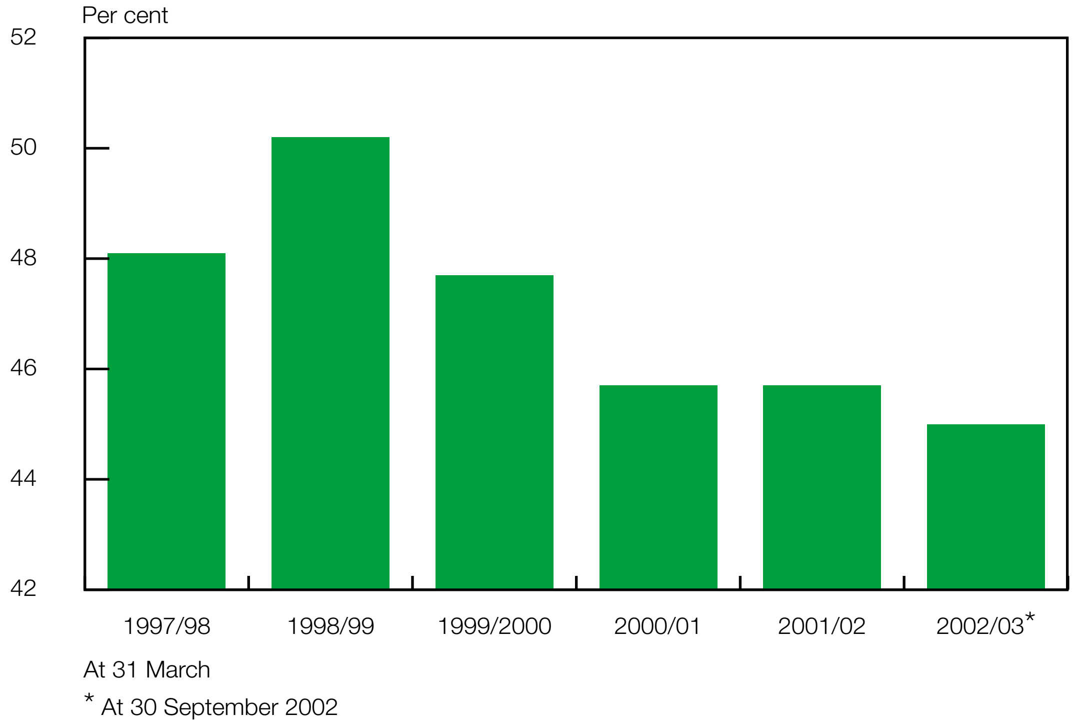
National Treasury. This extraordinary expense increased the net borrowing requirement of national government to R17,2 billion.

The net borrowing requirement of national government in the first six months of fiscal 2002/03 was financed mainly by issuing bonds in the foreign and domestic capital markets. A ten-year dollar-denominated bond was issued, yielding R10,8 billion, and R3,8 billion was mobilised in terms of foreign export credit facilities arranged for the financing of the strategic defence procurement programme. During July 2002 government had to provide for an amount of R920 million to compensate for adjustments in the outstanding rand value of a dual currency loan which arose from changes in the exchange value of the euro *vis-à-vis* the US dollar. In the domestic capital market, R7 billion of zero-coupon bonds were issued to the Reserve Bank as mentioned above. These bonds will be converted into fixed-income instruments in accordance with a timetable negotiated between the National Treasury and the Bank.

In the first six months of fiscal 2002/03 the net receipts of R12,7 billion from the issuance of domestic government bonds included the zero-coupon bonds issued to the Reserve Bank. The balance of R5,7 billion was issued at an average cost of 11,5 per cent per year and short-term instruments were sold at an average rate of 10,9 per cent per year. These rates can be compared with budget assumptions of 11,4 per cent and 9,7 per cent respectively.

The net borrowing of national government, jointly with the discount on new government bonds issued and the revaluation of foreign debt, led to an increase in the total debt of national government from R460,3 billion at the end of March 2002 to R479,8 billion at the end of September 2002. This caused the national government debt as a ratio of gross domestic product to decline from 45,7 per cent at the end of March 2002 to 45,0 per cent at the end of September.

Total debt of national government as percentage of gross domestic product



Adjusted estimates of national government finance

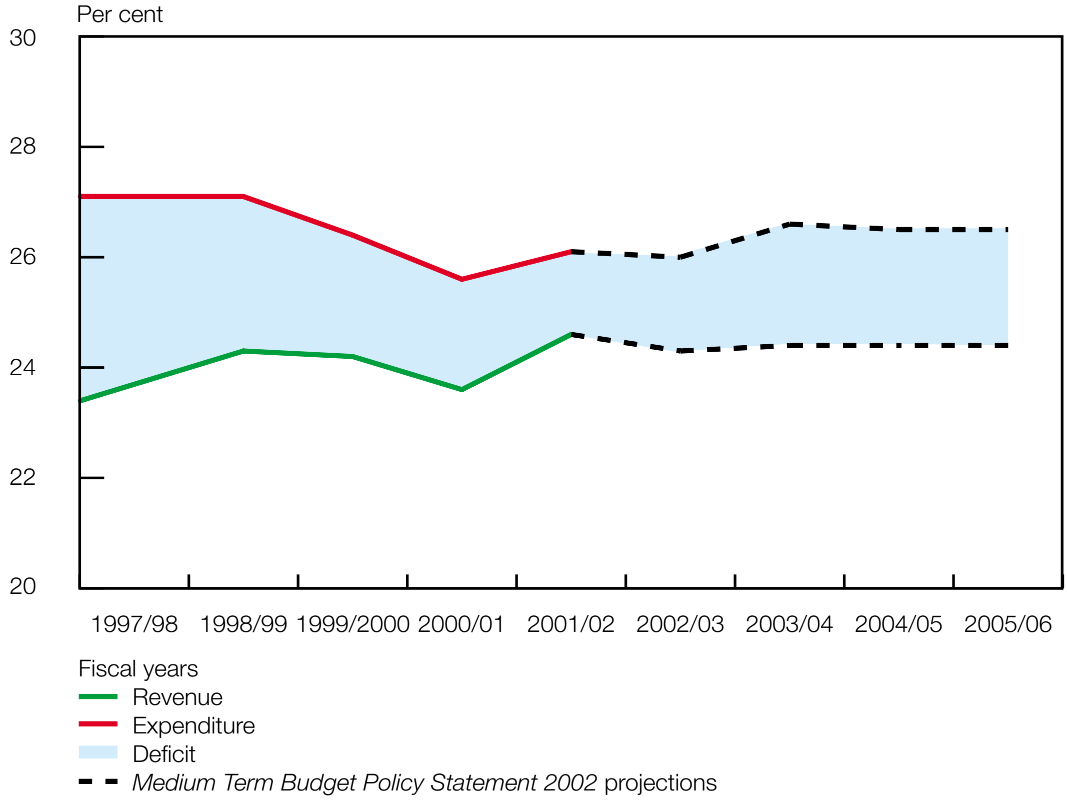
The *Adjusted Estimates of National Expenditure 2002*, tabled in the National Assembly by the Minister of Finance on 29 October 2002, sought approval for additional government spending to the amount of R9,3 billion for fiscal 2002/03. However, a contingency reserve for unforeseen expenses to the amount of R3,3 billion and a supplementary infrastructure allocation of R700 million had already been provided for in the main estimates presented to Parliament in February 2002.

Revised Budget estimates for fiscal 2002/03
R billions

Originally budgeted expenditure	287,9
Plus: Additional expenditure	5,4
Less: Roll-overs, savings and suspensions	1,5
Total adjusted expenditure	**291,8**
Originally budgeted revenue	265,2
Plus: Estimated additional collections	8,1
Total adjusted revenue	**273,3**
Adjusted deficit	18,5
Adjusted deficit as percentage of gross domestic product (per cent)	1,6

The increase in expenditure was mainly related to the higher-than-estimated remuneration increases for government employees. The remuneration adjustments and provision for unforeseen and unavoidable expenditure are largely allocated to provincial governments. Including adjustments to conditional grants, the additional allocations to provincial governments amount to R4,5 billion and will assist in

National government finances as percentage of gross domestic product



meeting remuneration adjustments, adjustments to social grants, faster-than-expected growth in the number of beneficiaries of social grants, increases in expenditure on education for learner support materials and unanticipated cost increases in health services following the depreciation of the rand.

The additional expenditure is to be financed from an expected increase in the revenue of national government. National government revenue is expected to yield R8,1 billion more than originally envisaged, mainly because of the higher-than-expected revenue from taxes on income and profits. This will bring revenue for the full fiscal year to 24,3 per cent of gross domestic product – close to the target of 24,5 per cent. The overall implication for national government revenue and expenditure is a decrease in the budgeted deficit before borrowing and debt repayment. This estimated deficit of R18,5 billion (originally budgeted at R22,7 billion) is expected to equal 1,6 per cent of the estimated gross domestic product for the full fiscal year.

The Medium Term Budget Policy Statement

On 29 October 2002 the Minister of Finance presented the *Medium Term Budget Policy Statement 2002* (MTBPS) to the National Assembly. The MTBPS sets out the macroeconomic context and fiscal policy considerations against which the Budget for fiscal 2003/04 will be formulated and medium-term policy decisions taken.

It was indicated that the healthy balance-of-payments position in the first half of 2002 afforded government the opportunity to announce further steps in exchange control liberalisation with the specific aim of promoting involvement with the rest of the African continent. It was announced that
- the allowance for South African companies for new approved direct investment in Africa was increased from R750 million to R2 billion; and
- South African companies will be allowed to “top up” existing foreign direct investment in approved investments in Africa.

Fiscal projections

	2002/03 Revised estimates	Medium-term estimates		
		2003/04	2004/05	2005/06
	R billions			
National government				
Revenue	273,3	302,1	330,3	358,3
Expenditure	291,8	329,4	358,4	388,1
Deficit before borrowing	18,5	27,3	28,1	29,8
Consolidated general government borrowing requirement	18,1	30,8	32,1	36,3
Public-sector borrowing requirement	17,7	31,1	33,2	37,5
	Ratio of gross domestic product (per cent)			
National government				
Revenue	24,3	24,4	24,4	24,4
Expenditure	26,0	26,6	26,5	26,5
Deficit before borrowing	1,6	2,2	2,1	2,0
Consolidated general government borrowing requirement	1,6	2,5	2,4	2,5
Public-sector borrowing requirement	1,6	2,5	2,5	2,6

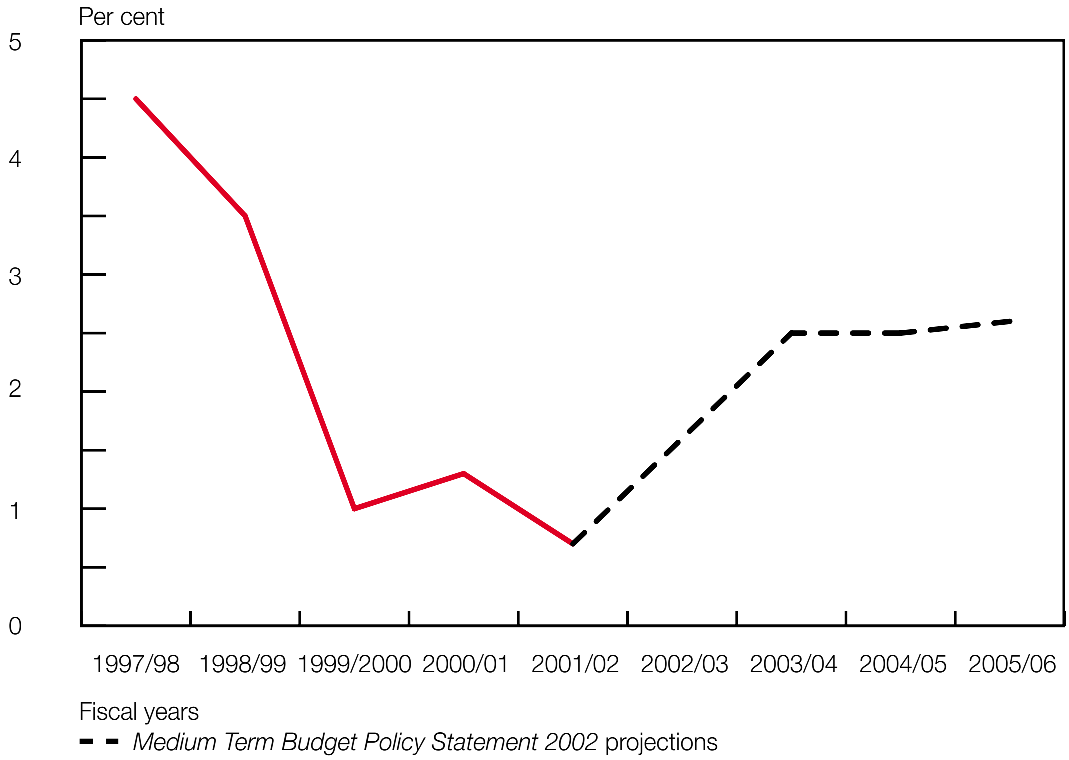
It was announced that the priorities directing planning for the *Medium Term Expenditure Framework* (MTEF) include

- extending social assistance, health and education programmes administered by provincial governments;
- enhancing investment in municipal infrastructure and basic services in support of rural development and urban renewal strategies;
- expanding capacity in the safety sector to prevent and combat crime, including improvement of the functioning of the courts system;
- higher education restructuring, including support for institutional mergers and investment in infrastructure;
- accelerating the land reform and land restitution programmes;
- re-engineering services to citizens provided by the Department of Home Affairs;
- increasing support for the national research and development strategy to enhance growth and technology advancement; and
- a growing international role through increased regional representation, support for the African Union and New Partnership for Africa's Development (NEPAD).

As indicated in the accompanying table, government envisaged that fiscal prudence would prevail at all levels of the public sector. The national government deficit is projected to average 2,1 per cent of gross domestic product over the three-year period and consolidated general government's borrowing requirement is projected to average 2,5 per cent of gross domestic product. Similarly, the public-sector borrowing requirement is projected to be contained at around 2,5 per cent of gross domestic product in the medium term.

The tax reforms in recent years underpinned a consolidated tax policy regime and robust growth in government revenue. It was indicated that this would allow for a

Public-sector borrowing requirement as percentage of gross domestic product



moderate real reduction in the personal income tax burden next year, concentrated on lower and middle-income earners.

The MTEF provided for *real* non-interest spending to grow at an average rate of 4,7 per cent per annum and a continuous decline in debt servicing cost relative to gross domestic product, releasing resources for spending on public services. Increased spending on health services, with special reference to a programme addressing the HIV/Aids epidemic, was also announced in the Statement.

Renewed emphasis was placed in the MTEF on social spending, enabling increases in social grants to be effected, expanding services and increasing funds available for education and health services. Government's continued commitment to social upliftment was also enunciated in the envisaged growth in capital spending. The provision made for investment in new infrastructure and the rehabilitation of existing infrastructure in a number of spending categories, resulted in an additional R3,0 billion earmarked for capital expenditure in fiscal 2003/04 with the upward trend expected to continue over the medium term.

Statement of the Monetary Policy Committee

12 September 2002

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

The year-on-year increase in the consumer price index for metropolitan and other urban areas, excluding the influence of mortgage interest cost (CPIX), increased from 5,8 per cent in September 2001 to 9,9 per cent in July 2002. The acceleration in the quarter-to-quarter CPIX inflation rate was even more pronounced from an annualised rate of only 3,8 per cent in the second quarter of 2001 to 11,5 per cent in the second quarter of 2002. The twelve-month rate of increase in the all-goods production price index also rose from 7,8 per cent in September 2001 to the high level of 15,2 per cent in July 2002.

This increase in inflationary pressures arose largely because of the sharp downward movement in the value of the rand in the last quarter of 2001. In addition, the international price of oil increased from a monthly average of about US$19 per barrel in December 2001 to nearly US$26 per barrel in July 2002. The depreciation in the external value of the rand at first mainly influenced food prices. From the beginning of 2002 the rise in prices became more widespread and inflationary expectations began to increase. When excluding food price changes, CPIX inflation picked up from a year-on-year level of 5,4 per cent in December 2001 to 7,8 per cent in July 2002. Containment of these price increases, including administered prices, is essential to reduce inflation. This requires a concerted effort by all concerned.

The continued increase in year-on-year production price inflation indicates that consumer price inflation will rise further in the coming months because there is normally a lag of approximately 2 months before production price increases affect consumer prices. Although the quarter-to-quarter rate of increase in production prices declined somewhat in the second quarter of 2002, it is still very high at a seasonally adjusted and annualised level of 14,2 per cent. Moreover, this slowdown can to a large extent be attributed to a strengthening of the rand in the first five months of 2002. By contrast, the price of domestically produced manufactured goods continued to increase at annualised rates in excess of 20 per cent in the first two quarters of 2002.

Taking these developments into consideration, it is not surprising that inflationary expectations have increased significantly despite efforts by the Reserve Bank to curtail price increases. According to the expectations survey of the Bureau for Economic Research of the University of Stellenbosch done for the Reserve Bank, respondents expect CPIX inflation to amount to 7½ per cent in 2003 and then to decline only slightly to 7,0 per cent in 2004. At these levels, inflation expectations are well above the upper level of the inflation target range, but they moderate over time.

Nominal unit labour cost rose from 2,9 per cent in 2000 to 4,8 per cent in 2001 and 6,4 per cent in the year to March 2002. Faster growth in nominal unit labour cost is usually associated with higher consumer price inflation. According to survey results obtained from NMG-Levy Consultants and Actuaries, the average annual rate of wage settlements in the first half of 2002 amounted to about 7,5 per cent, i.e. wage increases did not accelerate in the first six months of the year. Recent wage settlement rates announced in the media are, however, considerably higher. This implies that if labour productivity does not increase commensurately, there could be further upward pressure on consumer prices.

Another factor that could lead to increased inflationary pressures is the decline in the nominal effective exchange rate of the rand of 11½ per cent from the end of May 2002 to the end of August. This weakness of the exchange rate coincided with a reduction in the holdings of domestic securities by non-residents, amounting to nearly R12 billion in July and August, which almost neutralised the net purchases of securities by non-residents in the first six months of the year. This probably reflected concerns about problems in emerging markets, including Zimbabwe. Although the draft mining charter is not government policy it was nonetheless perceived negatively by foreign and domestic investors, particularly in an environment of heightened risk aversion to emerging-market assets following the crisis in Argentina and fears of a debt default in Brazil.

The developments that have so far led to higher inflation are therefore mainly exogeneous or cost-push factors, which cannot be directly influenced by changes in the level of short-term interest rates. At present there are no signs of excess spending or production capacity constraints, while fiscal discipline has been maintained by the authorities. It is, however, always important to take into consideration that cost-push and excess monetary demand factors are interacting elements or different aspects of the same process, rather than totally separate causes of different processes. Autonomous cost-push or exogeneous factors cannot on their own lead to an inflationary process if they are not accommodated by a monetary expansion. When autonomous price increases occur without increases in the money supply, bank credit extension and inflationary expectations, such increases are self-terminating. But when they are supported by accommodating monetary developments, inflationary pressures will become self-perpetuating.

As already indicated, inflationary expectations are already very high. Moreover, growth over twelve months in the broadly defined money supply (M3) amounted to 17,4 per cent in July 2002. Although this growth rate was lower than the 20,6 per cent recorded in May 2002, the reduction was to a large extent due to increased tax collections, which reduced the private sector's deposits with banks included in M3 while raising government deposits which do not form part of money supply. It is also true that a large part of this increase in M3 was the result of increases in long-term deposits, which are less likely to be related directly to aggregate nominal spending on goods and services. The narrower defined monetary aggregates, however, also rose significantly. To the extent that the deposits at banks could be used to purchase goods and services, they are an indication of possible spending that may exceed the economy's production potential in the future, and therefore create inflationary pressures.

The growth over twelve months in bank credit extended to the private sector slowed down moderately from a high level of 15,6 per cent in January 2002 to 11,7 per cent in July. Measured from quarter to quarter, growth in credit extension to the private sector fell from 19,6 per cent in the first quarter of 2002 to only 1,9 per cent in the second quarter. This considerably decreased rate of credit expansion was mainly the result of a reversal in the leads and lags in the payments for and receipts from foreign transactions. Earlier borrowing associated with these international trade transactions was mostly repaid in the second quarter when the external value of the rand strengthened. It therefore reflected a slower rate of credit extension to the corporate sector. Credit extended to households by banks hardly seems to have been affected by the increase in interest rates during 2002 and continued to rise rapidly.

In view of these accommodating monetary developments, the Monetary Policy Committee has decided to increase the repurchase rate by a further 100 basis points to 13,50 per cent with effect from 13 September 2002. It is expected that this will lead to similar adjustments in deposit and lending rates in the domestic market. Although this will mean that interest rates in South Africa have been increased by 4 percentage points from the beginning of the year, this will in fact bring the banks' real prime overdraft rate back to approximately the level prevailing during the first few months of 2002. The banks' real twelve-month deposit rate before taxation will amount to only approximately 2 per cent if it is adjusted by this increase. The inflation-adjusted yield on long-term government bonds in July 2002 came to only 1,2 per cent.

Consequently, the level of interest rates cannot be regarded as a major factor which has had or will have a significant constraining effect on production growth. This statement is supported by the fact that domestic final demand has continued to grow strongly. Moreover, export volumes increased considerably in the second quarter of 2002, as part of the lagged effect of the depreciation of the rand. Export growth contributed to maintaining a surplus on the current account of the balance of payments, which alleviated the pressure on the exchange rate of the rand mainly arising from the recent portfolio capital outflow. Export increases should further assist the economy in the attainment of healthy growth levels, while the current increase in interest rates should bring the inflation rate to within the target range.

Household debt, wealth and saving

By J W Prinsloo[1]

Introduction

Household debt ratios are important analytical tools because they allow policy makers, analysts, economic researchers and others to evaluate households' financial situation and to forecast final consumption expenditure. Households' consumption expenditure currently represents more than 60 per cent of South Africa's gross domestic product. Consequently, fluctuations in households' expenditure patterns affect the economy's output performance. Rising levels of consumption expenditure by households generally stimulate the economy, whereas slower growth or declines in aggregate consumption expenditure by households have a dampening effect on economic growth.

In general, the spending and saving behaviour of individuals is determined by various factors such as their material and social needs, tradition, standard of living, existing indebtedness, net worth and disposable income. Consumption expenditure by households is therefore determined to an important degree by the extent of and the actual and anticipated changes in the income of consumers, as well as their ability to spend future income now by making use of credit.

Credit extension is also an important link in the transmission mechanism that relays changes in monetary policy to changes in the total demand for goods and services and the rate of inflation. A change in interest rates by the monetary authority could have an effect on credit extended to households, and this would ultimately influence aggregate demand. The availability of credit from reliable financial institutions could help channel resources into their most productive uses and so increase economic growth and prosperity. In addition, greater access to credit makes it easier for business enterprises to initiate new capital formation projects, augment stock levels and expand their activities. The availability of credit also makes it easier for households to spend. An increase in credit could entice consumers to buy now instead of postponing buying for the future. Therefore, it is important to measure household debt appropriately in order to evaluate consumer spending behaviour.

The purpose of this article is to analyse household debt and other relevant aspects, particularly those related to wealth and saving. Consequently, the objective of the first section is to define household debt. The section after that reviews the structural developments in household debt with specific emphasis on the relative importance and composition of household debt. This is followed by an analysis of the household sector's indebtedness. Further sections discuss household debt relative to real and financial assets, and an analysis of household debt and its relationship to wealth and saving. The last section encompasses a summary and concluding remarks.

Defining household debt

Generally debt (including household debt) refers to an obligation or liability arising from borrowing money or taking goods or services "on credit", i.e. against an obligation to pay later. Usually a debt contract is an essential part of the debt agreement between one person or organisation and another. A debt contract states the terms of borrowing,

1 The author is grateful for the statistical assistance by Mrs M Swanepoel of the Reserve Bank's Research Department in the preparation of this article. However, the views expressed here are those of the author and do not necessarily reflect those of the South African Reserve Bank.

the interest and redemption payments that the borrower must make and what collateral the borrower has to provide. In addition, secured debt refers to debt where the borrower provides collateral, which the lender is entitled to take over if the borrower does not make the promised payments. One kind of secured debt is mortgage debt secured on houses, other buildings or land. By contrast, if debt is unsecured the lender has no special claim on any particular part of a defaulting borrower's assets.

Households may, in practice, be willing to enter into credit transactions for various reasons. The use of consumer debt is mainly related to consumers' eagerness to consume now rather than later. Households surrender future consumption because they will use the income earned at a later stage to settle debts and meet interest commitments. Consequently, they will have less money to spend at that later stage, even if they do not further increase their commitments relative to income growth.

The two major components of household sector debt are customarily classified into household credit and mortgage advances. Household or consumer credit is, in turn, subdivided into open accounts, personal loans at banks, other personal loans, credit card facilities, instalment sale transactions and lease agreements.

According to national accounts practices the household sub-account reflects all current transactions of private households, unincorporated business enterprises (proprietors and partnerships) and non-profit institutions. Consequently, household sector debt includes the credit extended to unincorporated business enterprises and the debt commitments of non-profit institutions serving households. Empirical data show, however, that consumer debt (private household debt) in South Africa accounted on average for more than 93 per cent of total household debt. At this level it is clear that a correlation between private consumption expenditure and predictable consumer credit will mainly be subject to consumers' borrowing behaviour.

Credit extended to the household sector

As mentioned in the previous section, there are five methods or types of credit facilities which the household sector can use for borrowing money for current consumption expenditure. These facilities are discussed in more detail in the following paragraphs.

Open account

Open accounts of households include all outstanding debits to dealers, and also those amounts payable to buy-aid associations for the purchase of goods and services from dealers.

Financing by way of open accounts is generally used for the purchase of durable and semi-durable goods and the rendering of consumer services. The period of credit extension is short and outstanding balances are normally payable within one calender month of the date of the transaction. However, instalments over periods of up to six months are common, especially where semi-durable goods are involved.

Personal loans at banks

Personal loans granted by banks consist of overdraft facilities made available by banks to their clients and other advances granted to individuals. Overdraft facilities are available to the holders of current accounts at banks, enabling clients to withdraw funds from such accounts over and above the amounts deposited into the clients' accounts. Only that part of the overdraft facility that is actually drawn by the consumer is included in consumer credit. The conditions for the repayment of overdrawn accounts at banks are particularly flexible and are arranged at the discretion of the banks and with the client's needs and financial capabilities in mind. "Other bank advances" to individuals may be made even though these individuals may not necessarily be holders of current or deposit accounts at that particular bank. The repayment of such debt is usually more precisely scheduled than the repayment of overdrawn accounts, and repayment is normally required within a fixed period.

Other personal loans

Other personal loans consist of loans granted to individuals by long-term insurers where the surrender value of a policy serves as security for the loan (called "loans against policies"). Loans made to farmers to finance consumption expenditure are, irrespective of the institution granting the credit, also classified as personal loans. However, loans entered into by farmers for the sole purpose of financing farming activities are not regarded as part of outstanding consumer credit.

Credit cards

Banks make credit card facilities available to consumers, offering a convenient method of making purchases and deferring the payment of the purchase price. Debit balances on credit card accounts are usually payable within one calendar month after the cardholders receive their accounts, but "budget" facilities are also provided to postpone the payment over longer periods. The outstanding debit balances at the end of each calendar month, and not the total credit available, are taken into account in calculating total consumer credit.

Instalment sale and lease agreements

An instalment sale agreement (hire-purchase agreement) is a transaction in terms of which goods or services are provided to the buyer, but where the purchase price is paid in instalments over a period in the future. Although the buyer takes possession of the goods, he or she does not become the owner and the seller is entitled to repossess the goods if the buyer does not comply with the provisions of the agreement. Instalment sale transactions are used almost exclusively to finance the purchase of durable consumer goods with prices that are high in relation to the income of the buyer, and where the expected economic lifetime of the goods is long, for instance three to five years or longer.

Lease agreements are transactions in terms of which goods are leased but where there is no arrangement that the debtor will become the owner of the goods at any time during or after the expiry of the lease period. As the credit-taker or debtor does not acquire ownership in terms of the agreement, the outstanding commitments can perhaps strictly speaking not be regarded as consumer debt. The Statement of Generally Accepted Accounting Practices, however, lays down guidelines according to which the commitments of persons in terms of finance lease transactions are included in consumer debt. The finance lease agreement is regarded as an alternative to a credit sale transaction and all the risks and remuneration involved in the right of ownership of the asset concerned are transferred from the lessor to the lessee. However, the same considerations do not apply in the case of operating lease transactions, and the commitments in terms of these agreements should accordingly not be included in the estimates of total consumer credit.

Mortgage advances

Mortgage advances come into play when households enter into loans (home mortgages) to buy homes and other fixed property and provide the property concerned as security for the loan. One feature of such loans is that the borrowers (mortgagees) will, under normal circumstances, have to pay off a certain portion of the price of the property themselves before the lender (mortgagor) makes the remaining portion of the purchase amount available. The size of the loan is usually determined according to the annual income of the borrower and the value of the pledged property. The loan is repaid over a long period that ranges from 20 to 30 years, although shorter periods may also be arranged.

In South Africa the interest on mortgage loans is normally determined at a variable rate and the lender may adjust the interest rate after giving one month's notice. Recent developments also allow for a fixed-rate option that protects the mortgagee against sharp increases in mortgage rates. The maximum period that the banks are prepared to lock into such a fixed-rate agreement depends mainly on the expected change in interest rates. The mortgagee may redeem the mortgage debt at any stage without being penalised, but repayment usually takes place in monthly instalments. The amount repaid each month may vary in accordance with interest rate movements, if a variable rate was chosen.

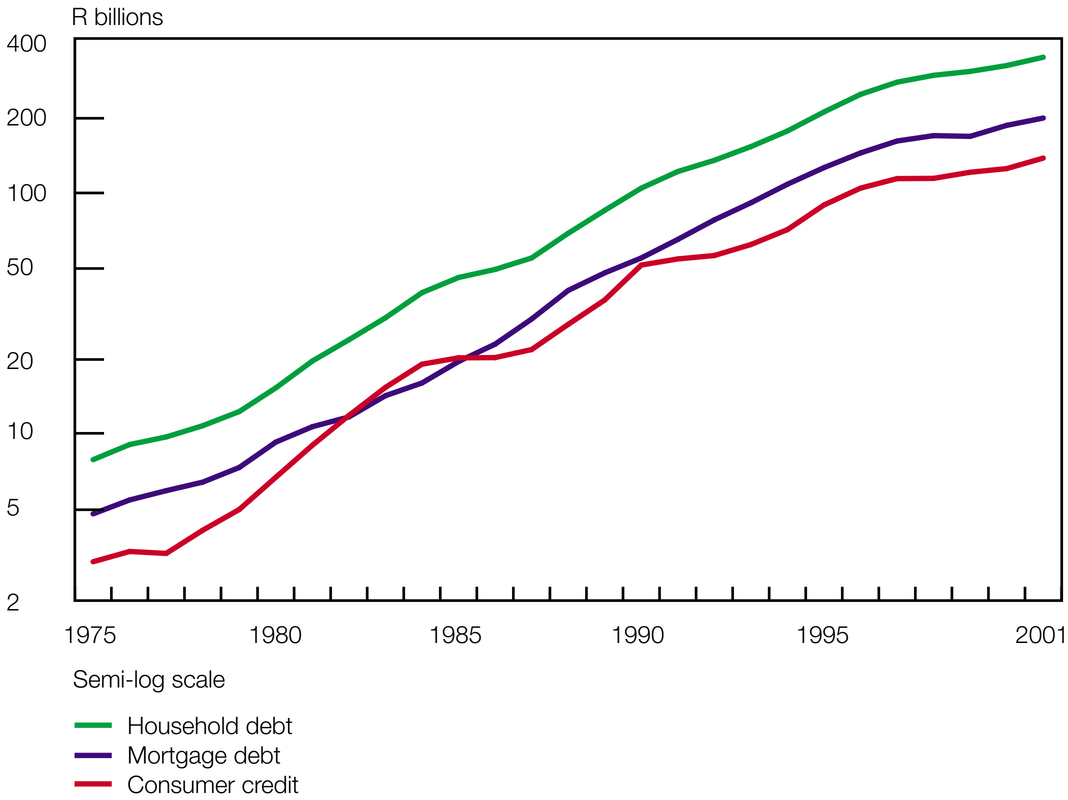
The South African retail credit markets changed markedly during the 1990s. Consequently, the retail finance sector has seen new developments, particularly in private-label credit cards and unsecured loans. As part of these developments, households enter into mortgage loans to acquire funds for purposes other than the purchase of fixed property. In such a case the fixed property owned by a household is pledged as security for the loan. The keen competition among the various financial institutions in South Africa since the first half of the 1980s has caused mortgage advances to be promoted increasingly for purposes other than the financing of transactions in fixed property.

Structural developments in household debt

Total lending to households by financial institutions continues to rise, but the pace slowed down towards the end of the 1990s and the beginning of the new millennium (see Graph 1). The year-on-year rate of increase in total household debt declined from an average of about 20 per cent in 1995 to approximately 3½ per cent during 1999 before it rose again to 9½ per cent for the first half of 2002. At the beginning of the 1980s and again between 1989 and 1990 increases in excess of 30 per cent and 25 per cent, respectively, were recorded. Rapid growth in borrowing has always been associated with a deterioration in the saving ratio – a development also clearly manifested in South Africa's saving history.

The more pronounced slowdown in the growth of both secured (mortgage debt) and unsecured borrowing in the South African economy since 1997, also brought to an end the big differences between the growth of these two aggregates prevailing during the mid-1980s and the beginning of the 1990s. Prudent monetary policy and sharp increases in interest rates during the second half of the 1990s made consumers less inclined to incur debt. Consequently, the demand for secured and unsecured debt declined. Households' desired debt levels will always depend partly on interest charges on borrowing. Accordingly, that part of secured lending not used to fund investment in housing, but to buy other durable consumer goods, became less attractive in the second half of the 1990s as the interest rates on mortgage loans for dwelling units peaked in 1998.

Graph 1 Household debt



The relative importance of household debt

To analyse the importance of household debt it is necessary to distinguish between the components of household debt, namely consumer credit and home mortgage debt, and the movement of these aggregates relative to total credit extended to the domestic private sector by banks.

The broadening of banks' lending activities to households, particularly during the 1980s, caused consumer credit to expand at a much faster pace than bank lending to the private sector. During the 1970s consumer credit extension by banks and other monetary institutions, as a percentage of total credit extension by these institutions to the domestic private sector, amounted to about 19½ per cent. This ratio rose rapidly between 1980 and 1984 to reach a level of 29½ per cent in the latter year, but this strong rise ended during the recession of 1984 – 1986. However, at the beginning of the 1990s this ratio rose again to reach its most recent high of 26½ per cent in 1996. In the subsequent years it has declined progressively to 20½ per cent in 2001.

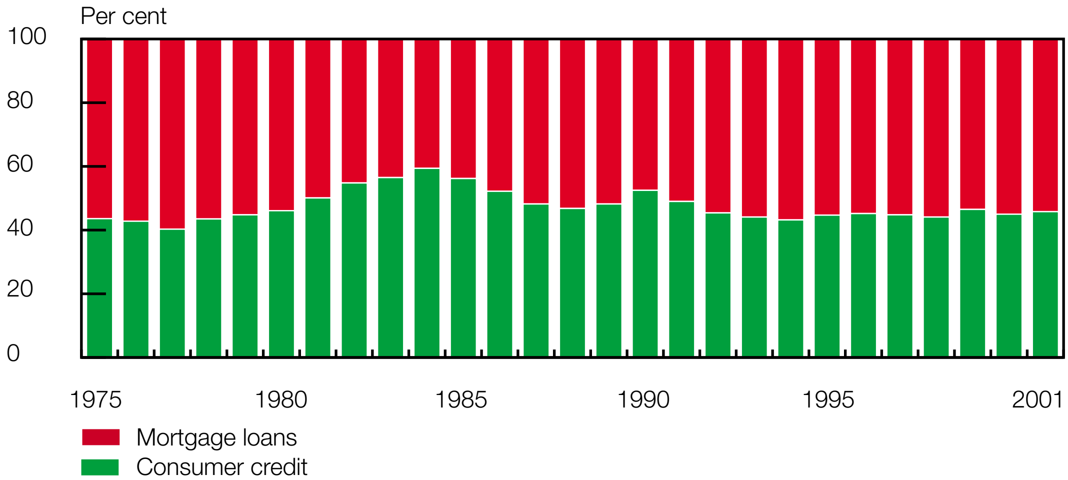
By contrast, the share of mortgage advances to households relative to total credit extended to the private sector by banks declined from a level of about 33 per cent at the beginning of the 1970s to a low of 24½ per cent in 1984. In the subsequent years this ratio increased again to a high of 38 per cent in 1994 and 1995, before it gradually declined to 29 per cent in 2001.

In addition, total household debt, i.e. mortgage lending to households plus consumer credit, as a percentage of total credit extended by banks to the private sector, amounted to an average of 51½ per cent in the 1970s. During the 1980s this ratio moved higher to an average of 53 per cent, before accelerating in the 1990s to reach a high of 64 per cent in 1996. This was the net result of sharp increases in consumer credit and mortgage advances to households. Total household debt as a percentage of total credit extended by banks to the private sector had declined again in the past three years to reach the relatively low level of 49½ per cent in 2001.

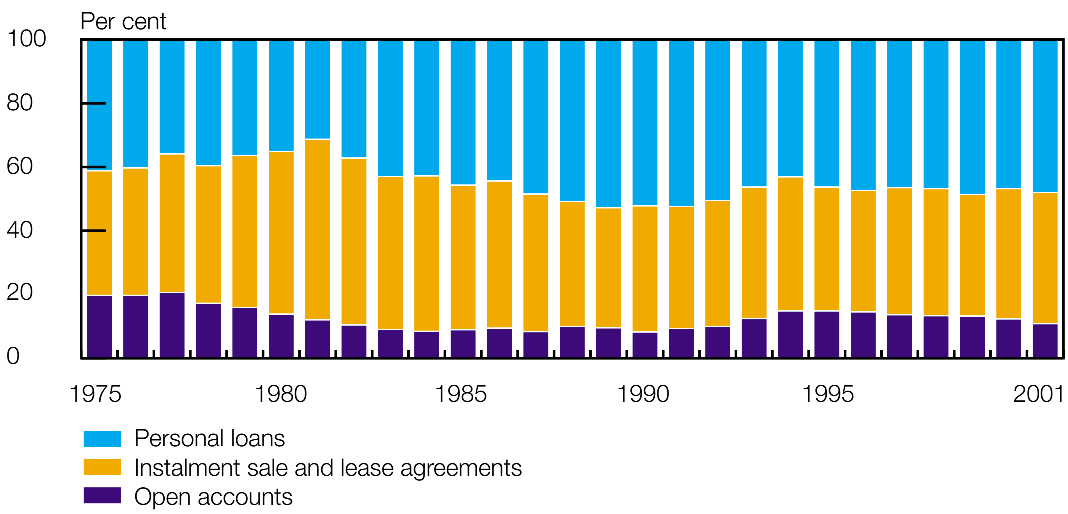
The composition of household debt

An analysis of the components of total household debt shows that mortgage advances accounted, on average, for 57 per cent of aggregate household debt during the 1970s (see Graph 2). Since the beginning of the 1980s the relative importance of mortgage debt has decreased, as reflected in the ratio of consumer credit to total household debt rising to a high of 59½ per cent in 1984. This could mainly be attributed to sharp increases in consumer credit at an annual rate of 31½ per cent from 1979 to 1984 compared with only 17½ per cent in the case of mortgage debt. These developments were mainly associated with the deregulation

Graph 2 Composition of household debt



Composition of consumer credit



of the financial sector in the beginning of the 1980s, the general buoyancy in economic activity during the heyday of the gold price boom at the end of the 1970s and the beginning of the 1980s, coupled with the upswing phases of the business cycle from 1978 to 1981 and again from 1983 to 1984 when negative real interest rates prevailed for most of the time.

From 1985 the importance of consumer credit changed substantially as several factors such as the high level of nominal interest rates, the depreciation in the value of the rand, adverse socio-political developments and the debt “standstill” agreement with foreign banks impacted negatively on consumer confidence and caused a slowdown in the expansion of consumer credit. The net result of these developments was an increase in mortgage debt relative to total household debt, reaching a level of 53 per cent in 1988. This ratio decreased again to 47½ per cent in 1990, but the relatively buoyant demand for mortgage advances since 1991 has again resulted in a sharp increase in the share of mortgage debt in aggregate household debt. In 1994 mortgage advances relative to total household debt reached a recent high of about 57 per cent. Although this ratio came down to an average of 54½ per cent in 2001 it is still high, compared with some periods in the past.

The composition of outstanding consumer credit has changed substantially over the past three decades. The relative importance of credit extended by way of open accounts in total consumer credit decreased over the period 1970 to 2000. Since the beginning of the 1970s the relative share of open accounts in total consumer credit has declined from more than 20 per cent to about 8½ per cent in the mid-1980s. In subsequent years the aggressive marketing of open accounts and the ready availability of such financing throughout the 1990s to a broader spectrum of consumers helped to increase the share of open-account balances in total consumer credit to an average of about 13½ per cent in the second half of the 1990s.

In contrast to the declining relative share of open accounts in total consumer credit, the importance of instalment sale and lease transactions increased considerably. At the beginning of the 1970s approximately 33½ per cent of all consumer credit extended to households was in the form of instalment sale and lease transactions. This ratio increased to a high of 56½ per cent in 1981, reflecting the buoyancy in households' consumption demand and the fact that meeting the increasing demand for consumer credit has been facilitated by the lifting of direct control over credit extension in August 1980 and adopting a more market-oriented system of monetary policy making since 1981. Since 1984 the relative importance of instalment sale credit and lease transactions has varied along a downward trend to a level of 39 per cent in 2001.

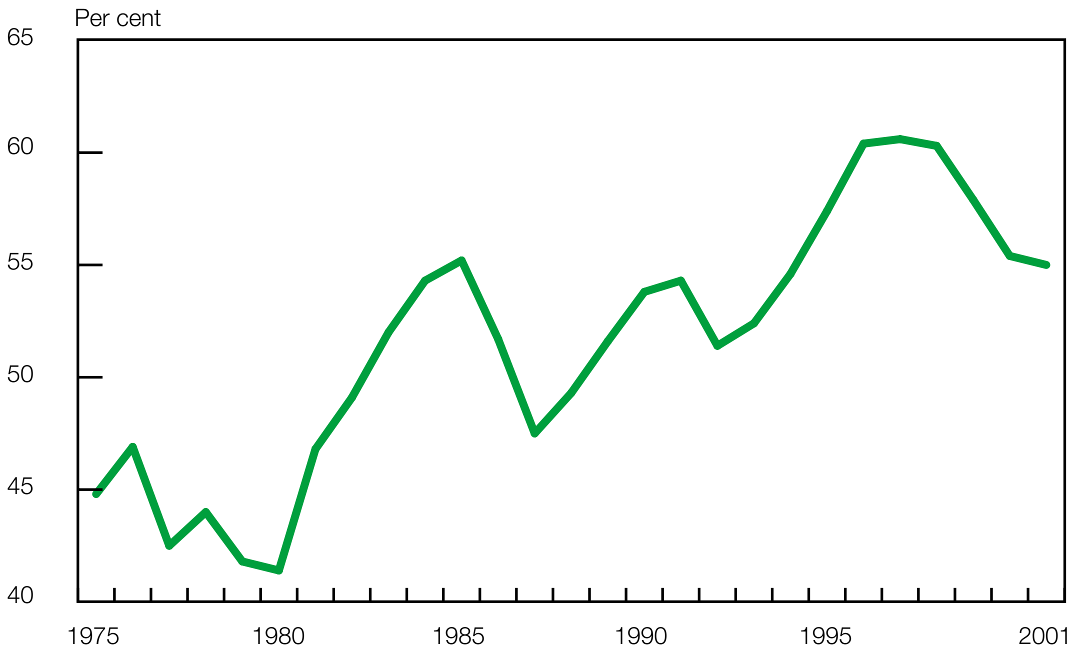
Credit granted to households by way of personal loans grew at a far slower pace between 1970 and 1980 than total outstanding consumer credit. As a result the relative importance of personal loans declined from 45 per cent in 1970 to 31½ per cent in 1981. Since 1982, however, personal loans have increased more rapidly than total consumer credit. Between 1989 and 1991 personal loans constituted about 52½ per cent of total consumer credit, but more recently this ratio fell back to an average of about 49 per cent.

Structural changes in the composition of consumer credit reduced the relative importance of open accounts to total consumer credit from 22 per cent in 1970 to 11 per cent in 2001. By contrast, the importance of personal loans (including overdraft and credit card facilities), instalment sale credit and leasing rose from 78 per cent to 89 per cent in the corresponding period. This increase may have strengthened the effects of monetary policy changes on aggregate demand, because the impact of interest rate changes is evidently more directly linked to personal loans, instalment sale and lease agreements than to open accounts.

Household sector indebtedness

As shown in Graph 3, it is clear that during most of the 1970s the household sector's indebtedness rose at a rate that more or less corresponded with the rate of increase in the disposable income of households. Consequently, the ratio of outstanding debt to the disposable income of households remained virtually unchanged and varied around an average rate of approximately 45 per cent. Indebtedness rose even slower than disposable income between 1978 and 1980. However, this trend was reversed in the period 1980 to 1985, when aggregate household debt, as a percentage of disposable income, rose from an average of 41½ per cent in 1980 to 55 per cent in 1985.

Graph 3 Household debt as percentage of households' disposable income



Because of the slowdown in consumer credit extended during 1985 and 1986, when monetary policy measures were decisively tightened, the ratio of total household debt to personal disposable income receded sharply to an average of 47½ per cent in 1987. However, in subsequent years the use of consumer and mortgage credit accelerated again and at the beginning of 1994 the ratio of household debt to disposable income exceeded the high levels of the mid-1980s. In addition, the strong growth in credit demand in the mid-1990s was underpinned by the introduction of private-label credit cards. Leading retail outlets in partnership with banks and through an aggressive marketing campaign, encouraged the use of private-label credit cards to a broad spectrum of clients and consumers. Partly as a result of these developments, household debt as a percentage of personal disposable income surged to an all-time high of more than 61 per cent in the first quarter of 1998. Subsequently, however, credit demand has weakened because private-label credit cards became unpopular during 1997 when a stringent monetary policy and rising interest rates left households with historically high levels of indebtedness. The lower growth in credit demand relative to the growth in households' disposable income since the middle of 1998 has led to a decline in households' debt ratio, amounting to an average of 55 per cent in 2001 and 53½ per cent in the first half of 2002.

An international comparison shows that although South Africa's ratio of household debt to disposable income increased strongly in the 1980s and again in the first half of the 1990s, it is lower than most of the Organisation for Economic Cooperation and Development (OECD) countries, and significantly lower than in the United States of America, Japan, Canada and the United Kingdom, where household debt ranges between 100 and 120 per cent of disposable income.

Another development related to household debt has been the growth in the micro-lending industry since the beginning of the 1990s. The exponential growth of the micro-lending industry in South Africa, especially during the 1990s, firmly established the role that micro lenders have played in increasing access, particularly by low-income households, to credit extension in South Africa. The expansion of the micro-lending industry was also partly responsible for growing concern about the levels of indebtedness of the household sector. Micro loans are targeted at the middle to low-income section of households, whereas cash lenders are more active among households with minimum living standards.

South Africans were in debt to micro lenders (gross loans outstanding) to an amount of R13,5 billion in 2001. Relative to total household debt outstanding, estimated at a level of about R322 billion at the end of 2001, the debt extended by micro lenders amounted to less than 5 per cent. In addition, very little of the gross loans granted by the micro-lending industry can be added to the existing level of household debt. This can be explained by the fact that 52 per cent of the debt granted by micro lenders comes from banks and is consequently already measured as part of household debt. Another 3 per cent of the loans extended by micro lenders comes from co-operations and trusts, which are essentially part of the household sector. The remaining 45 per cent of debt granted to individuals comes from close corporations, and public and private companies and should be added to aggregate household debt. However, this component of household debt is negligible and cannot significantly affect the current indebtedness of the household sector.

Household debt and capital gearing

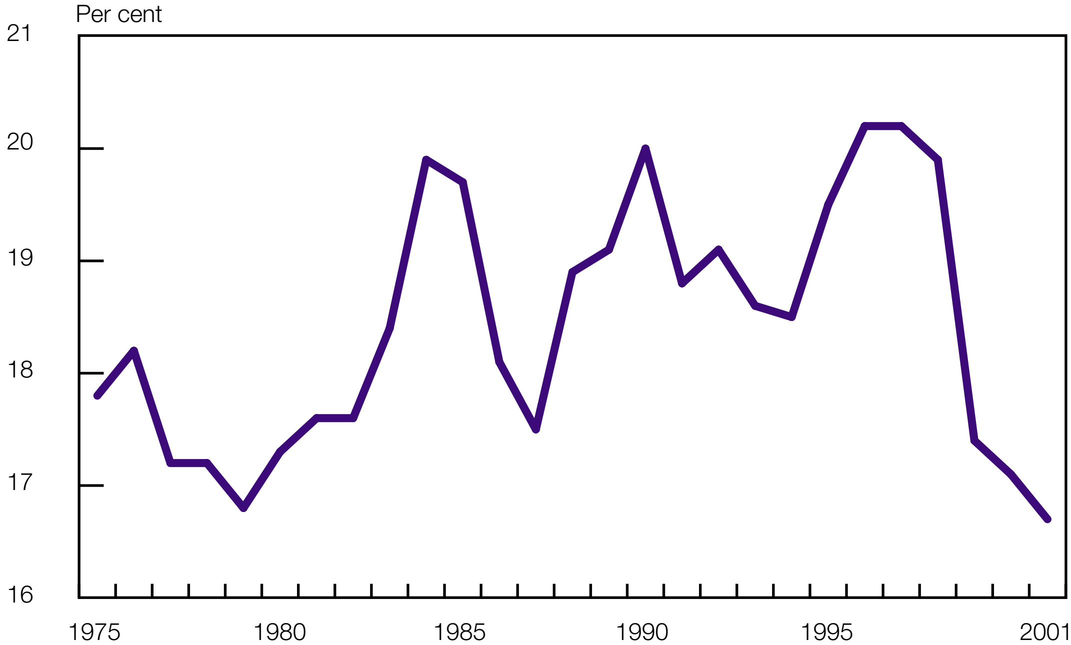
The deterioration in households' indebtedness since the early 1980s is also discernible in their "capital gearing", i.e. the ratio of household debt to the total assets of the household sector (see Graph 4).

Household debt relative to fixed assets for the period 1974 to 1984 fluctuated around an average of 44 per cent, but subsequently rose faster, reaching a high of 98 per cent in the first quarter of 1997. Since then this ratio has declined to an average of 83 per cent in the calendar year 2001.

By contrast, household debt relative to financial assets reacted much more favourably, improving from an average ratio of approximately 29 per cent between 1975 and 1984 to an average of 24½ per cent in the second half of the 1990s. In 2001 this ratio receded to an average of 21 per cent. These developments can mainly be attributed to the fact that an increasing share of personal saving has gone into acquiring financial assets, especially during the 1990s. The high level of inflation in South Africa over the long term caused distortions which encouraged people to concentrate their personal saving in risk-avoiding institutions and financial assets in preference to riskier undertakings and fixed assets. This is probably an indication that the general public has increasingly become financially sophisticated over the past decade or so, allocating income to tax-immune types of assets and consequently requiring larger borrowing to support ordinary consumer spending. The recent introduction of capital gains tax (CGT) and the 25 per cent tax on income from retirement funds are likely to change the saving and investment behaviour of households once again as they reduce the attractiveness of financial assets somewhat.

The total capital gearing of households deteriorated slightly from an average of 17½ per cent in the 1970s and the beginning of the 1980s to an average of 20 per cent in 1996 and 1997. However, this ratio declined to about 16½ per cent in 2001, as consumers became less inclined to incur debt.

Graph 4 Capital gearing of households



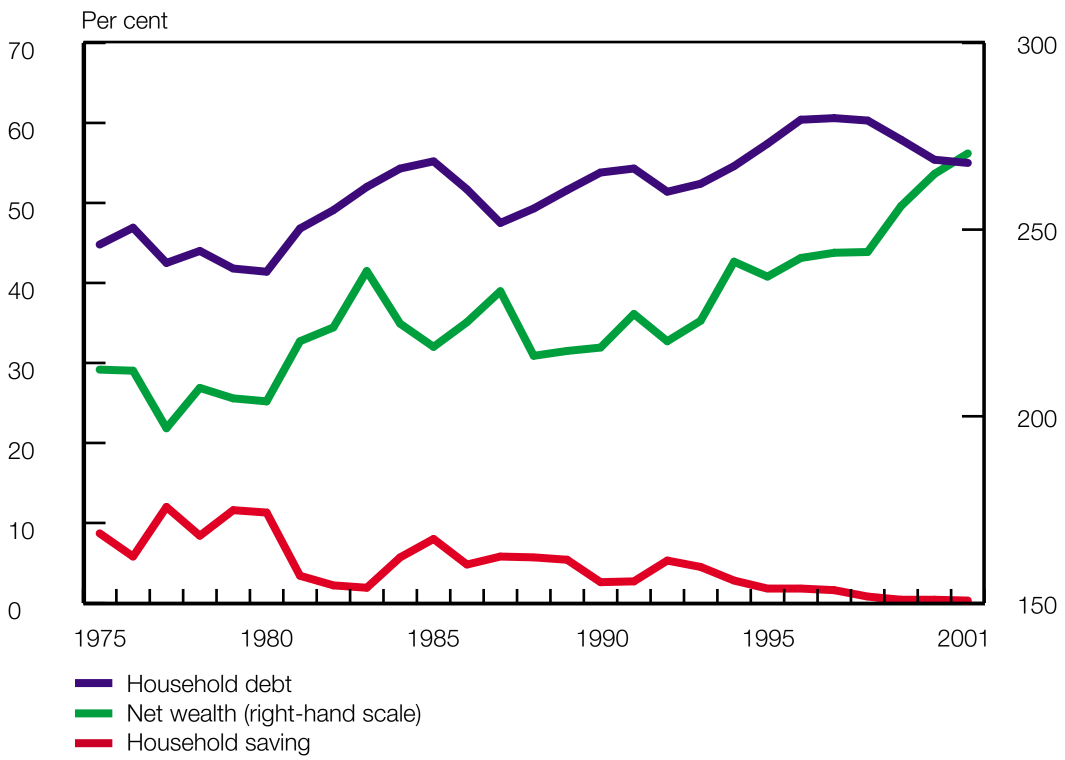
There are several reasons for the growth of indebtedness since the mid-1980s. One is the deregulation of financial institutions, which is believed to have encouraged an expansion of personal debt. Another is the strong demand for residential mortgage loans, spurred by inflation and the relatively high level of house prices as well as other factors, such as the aggressive marketing of sectional title units and the government initiative to boost owner-occupied dwelling units among certain lower-income communities. More recently, households' fear for their safety and security has also contributed to an increasing demand for residential development in security complexes. In addition, the household sector's indebtedness, particularly in the form of mortgages, rose much faster than disposable income in the second half of the 1980s. This ratio continued to increase during the 1990s and reached a high of 33½ per cent in 1998, before declining to 29½ per cent in 2001 and the first half of 2002.

Household debt, wealth and saving

Saving by the household sector is defined as that part of current income, after the payment of direct taxes, that is not consumed or transferred as part of household current expenditure. Dissaving occurs when current expenditure exceeds current income. In terms of standard accounting practices, the saving of a household or of any other organisation will be equivalent to the increase in the net asset value of the household or organisation. Increases in the credit commitments of households will accordingly lead to a decline in their saving, unless this is counteracted by similar or stronger increases in the assets of households. Generally speaking, an inverse relationship can be expected between increases in the utilisation of consumer credit and the saving of private households over time.

In South Africa a clear inverse relationship can be discerned from the beginning of the 1980s between the ratio of household debt to personal disposable income and between household saving in relation to the personal disposable income of households. The deterioration in the saving ratio of households at the beginning of the 1980s coincided with the greater use of credit by households. Alongside these developments, there was an increase in the net wealth of households relative to their personal disposable income (see Graph 5).

Graph 5 Household debt, saving and net wealth as percentage of personal disposable income



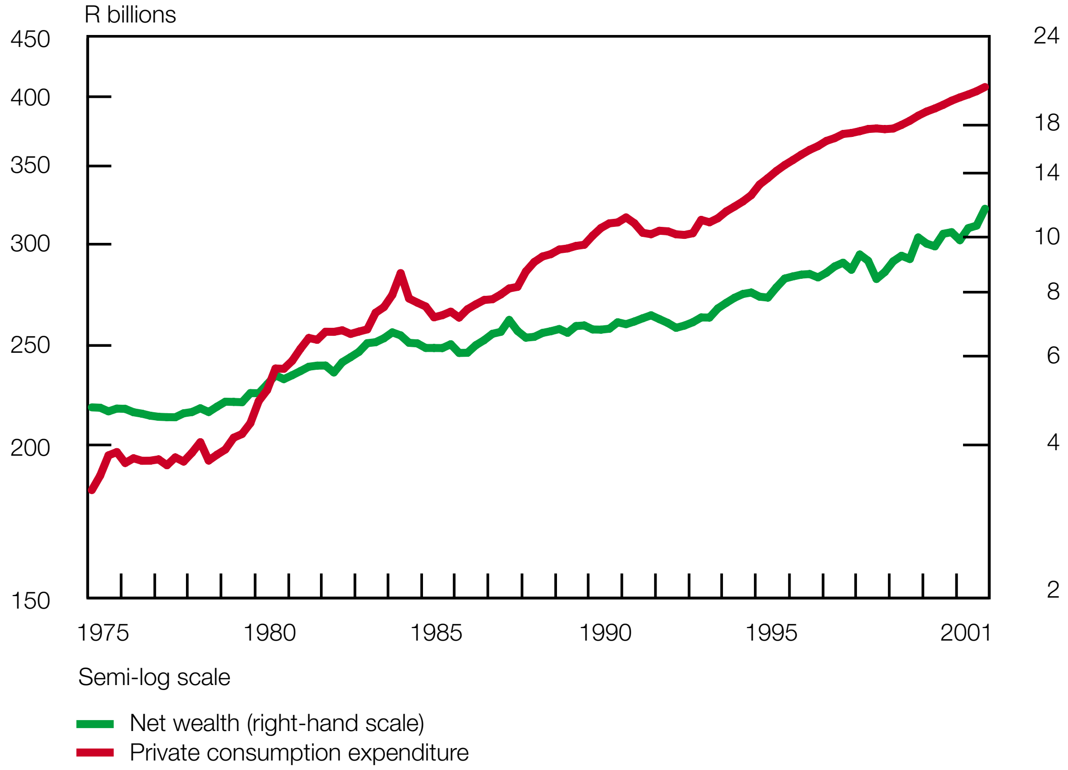
Though there is no scope in this analysis to identify and discuss the determinants of households' saving behaviour, it suffices to state that most studies rely on some variant of the life-cycle, or permanent-income, hypothesis. These theories assert that households maximise the benefits of consumption over their lifetime, subject to the constraints of expected lifetime income and initial wealth. Interest rates indicate the terms of the trade-off between current and future consumption, whereas demographic variables and wealth are accordingly singled out as the potential causes of changes in consumer behaviour. Other determinants that may influence households' decisions about saving include changes in average income levels, the distribution of income among households, tax policies, government saving, corporate saving and the ability to save through the corporate sector rather than directly, unemployment, and financial deregulation.

Major financial policy and institutional changes, including the liberalisation of financial markets during the 1980s, created many new lending opportunities for the financial sector. Financial institutions such as banks found that they could fund new lending in a less constrained way than had previously been the case. These changes enabled households to increase their borrowing in relation to their income. The changes also whetted financial institutions' appetite for household lending. Although it is not possible to quantify the direct effect that the general deregulation of the financial sector has had on saving over the past two decades, it has undoubtedly contributed to the rapid rise in outstanding credit and the concomitantly high level of household debt, resulting in a lower rate of household saving.

Another fundamental cause of the decline in households' saving is that consumers, at least to a certain extent, have rationally decided to lower their saving rates or alternatively to keep consumption expenditure at a relatively high level. The deterioration of households' saving in 1993/94 and the very low level of saving during 1999/2000 were accounted for by lower growth in real personal disposable income relative to growth in consumption expenditure by households – an indication that other factors have supported consumption growth. If it is assumed that at any particular time, consumption by households should also reflect their perceptions of the "wealth effect", then ultimately what households care about is their net worth – total assets minus liabilities. Household wealth has risen sharply since the mid-1980s, but more specifically from 1993 onward. This rise was driven by increases in both equity and house prices. Consequently, households' low saving rate is a sign that consumers feel comfortable with the evolution of their net worth and that they see little reason to curtail consumption as a way to increase their net worth even further. The positive correlation between an increase in the real net wealth of households and real consumption expenditure by households is illustrated in Graph 6. The higher rate of growth in household wealth since 1993 was closely followed by accompanying increases in private consumption expenditure.

The effect of any wealth revaluation remains difficult to quantify. Changes in asset prices can have a powerful impact on household consumption through wealth effects. For example, owner-occupiers of dwellings may perceive higher house prices as an addition to their wealth, and reduce their saving out of current income. However, individuals planning to purchase their own houses may reduce their consumption in the wake of higher house prices as they will have to save more for higher deposits and repayments. For these reasons, the impact of the wealth effect is uncertain. In addition, the changes in house values may influence household consumption, even if wealth effects are absent, to the extent that they influence the borrowing capacity of households. Households' ability to borrow will, in practice, depend strongly on their capacity to supply collateral as security for repayments, and real estate is the most widely used collateral asset. Consumers can withdraw part of the increase in housing equity by increasing their borrowing secured on rising property values, and use part of the proceeds to finance additional consumption.

Graph 6 Households' real final consumption expenditure and net wealth



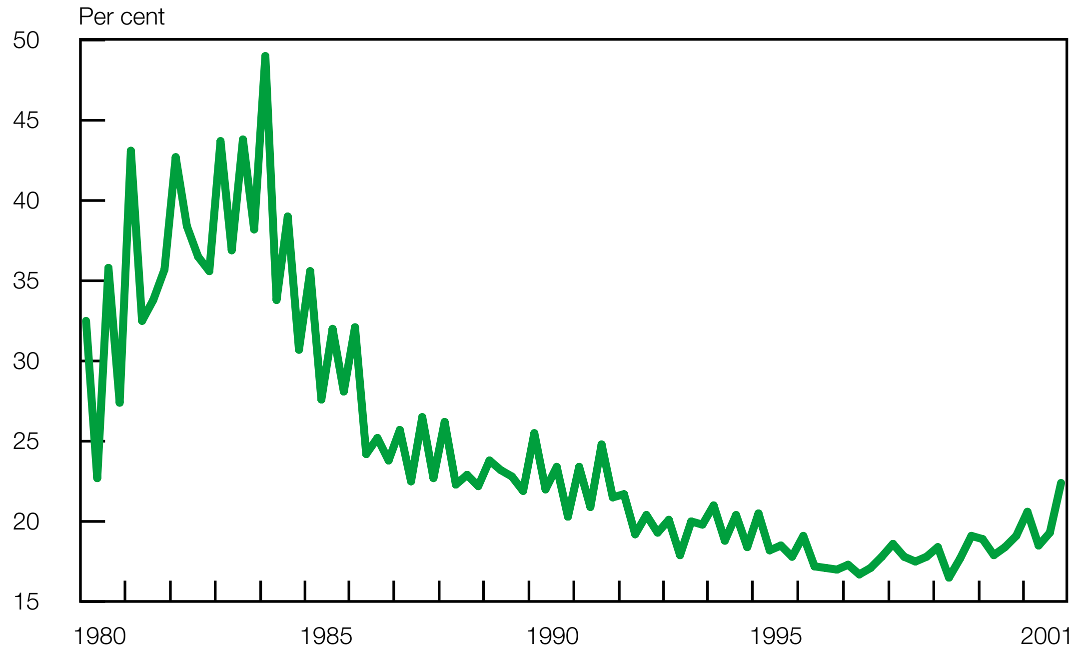
In the real-estate sector, residential equity probably plays the most important role in the transmission mechanism of monetary policy. Although the share of fixed assets in total household wealth has declined over the past 15 years as a result of financial deregulation, financial innovation and the strong rise in equity prices, it still accounts for more than 20 per cent of total household assets.[2]

Equity markets have experienced some volatility in recent years, but house prices continued growing at a solid pace. An analysis of average house prices in South Africa relative to disposable income *per capita* shows a persistent upward trend since the beginning of 1997 (see Graph 7). Although the ratio of house prices to disposable income *per capita* rose from a low base towards the end of 1996, it is still far below the average level recorded at the beginning of the 1990s – and there is no evidence that residential property is repeating the bubble conditions that prevailed in the early 1980s. As a result of these developments, the wealth effects of rising property prices have supported economic activity in South Africa during the recent downturn from December 1996 to August 1999, as the wealth effect induced the growing number of property owners to raise their consumption. In addition, the relative strength of house prices compared to equity prices bottomed out towards the end of 1995 and has risen since then (see Graph 8). Part of this probably reflects a shift of flows away from equity towards real estate.

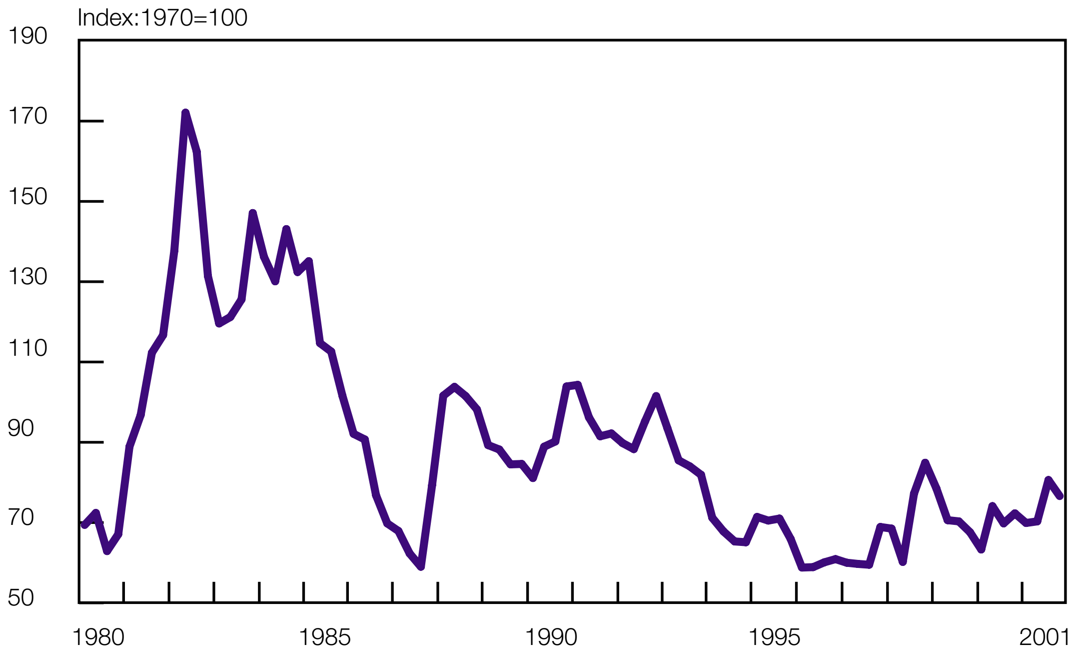
The relatively strong increases in households' consumption expenditure over the past two to three years and the concomitant subdued performance of saving by households, could, on balance, be partly ascribed to the net effect of a number of factors, such as the steady increase in real-estate prices, the underlying strength in equity values, the increase in owner-occupied dwellings among a broader spectrum of the population (which increased the borrowing capacity of households) and a sustained high level of consumer confidence.

2 In the United States of America this ratio is around 20 per cent and in Europe it is more than 30 per cent.

Graph 7 Average house prices relative to personal disposable income *per capita*



Graph 8 Average house prices relative to equity prices



Summary and conclusion

The empirical estimates presented in this overview indicate that household borrowing patterns have changed substantially over the past three decades. After having varied only slightly around an average of approximately 45 per cent in the

1970s, the ratio of household debt to personal disposable income increased sharply to 55 per cent in 1985. During the ensuing period until 1993 the debt-to-income ratio of households varied around an average of 51½ per cent, before rising to a new high of 60½ per cent during the period 1996 to 1998. Over the past two-and-a-half years, the debt-to-income ratio of households has gradually declined to an average level of 53½ per cent in the first half of 2002.

Likewise, the composition of household debt was also subject to change. Mortgage advances to households relative to total household debt declined from an average of 57 per cent in the 1970s to a low of 40½ per cent in 1984. A mirror image of this development was that the importance of consumer credit as a portion of household debt increased to a high of 59½ per cent in the corresponding period. In the mid-1990s mortgage advances relative to total household debt increased again and reached a level of 57 per cent in 1994 – recently this ratio slipped back to 54½ per cent. The growing popularity of mortgage debt can partly be attributed to an increase in the use of mortgage equity withdrawals, facilitated by the more flexible mortgage advance procedures created by the banks.[3]

3 Mortgage equity withdrawal represents borrowing that is secured on the housing stock but not invested in it. Hence it makes additional funds available (at a lower cost than unsecured loans) for reinvestment in financial assets or to finance consumption expenditure.

The increased importance of bank-intermediated credit to households in the first half of the 1980s and the greater flexibility in household mortgage advances since the beginning of the 1990s seem to indicate that the rising household debt burden was partly caused by financial deregulation and the liberalisation of financial markets during these periods. In general, increased competition in credit markets probably contributed to the lower cost and wider availability of consumer credit. Accordingly, these developments may have allowed some households that had previously been credit-constrained, to move closer to their “optimal” consumption levels, contributing to the underlying strength of borrowing and consumption growth.

In recent years the impact of rising asset prices on household wealth has probably contributed substantially to the subdued performance of households’ saving ratio and the prevailing high level of household debt. An important source of the perceived wealth of households was the steady rise in house prices in recent years and households also benefited by the capital gains from rising equity prices. These developments, coupled with a decline in the rate of inflation, have probably allowed households to achieve a given level of wealth with less saving over the past three years.

Though monetary policy can influence real economic activity in several ways, changes in households’ balance sheets may have implications for the way that a change in policy-controlled interest rates (the interest rate on repurchase transactions) affects output and the Reserve Bank’s ultimate objective, namely price stability. Monetary policy affects the economy “directly” through the impact of market interest rates on expenditure. However, changes in the repurchase rate can have additional effects through the movements induced in asset values and balance sheets. When long-term interest rates decline in response to a change in the monetary policy stance, this will result in an increase in asset values and, accordingly, in household wealth. Consequently, a higher level of wealth should enable households to reduce their saving and increase their consumption.

Although the household debt and wealth estimates provide valuable information about the changes in the balance sheet of households, full balance sheets are not currently compiled for the South African economy. This area provides an opportunity for further research that will undoubtedly improve the analysis of the links between monetary policy changes and the saving and spending decisions of households.

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