Quarterly Bulletin

December 2003

South African Reserve Bank

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Quarterly Economic Review

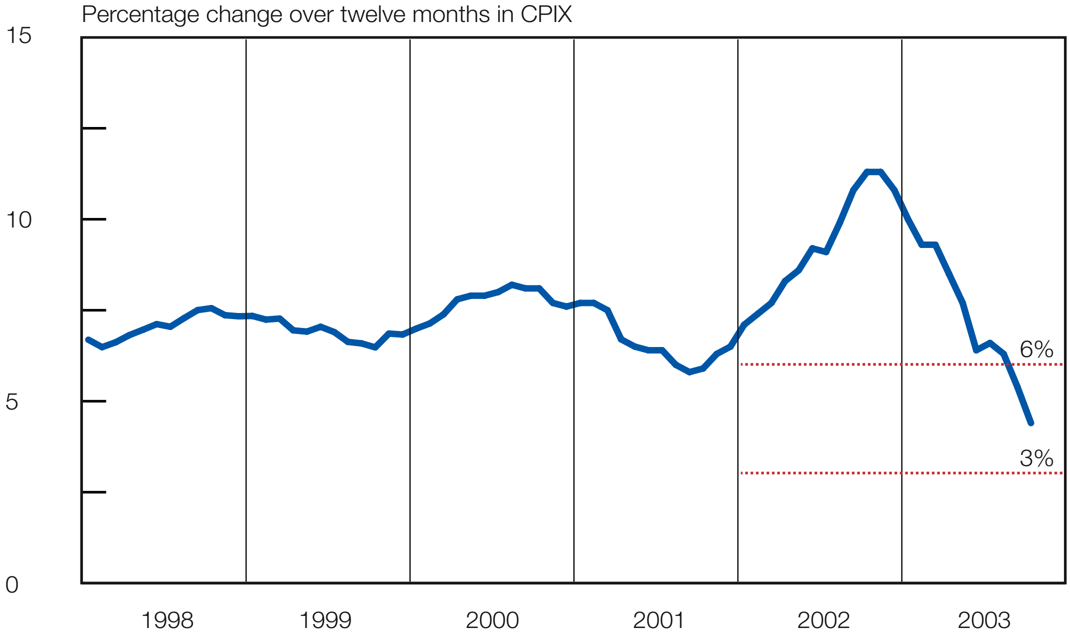
Introduction

Having recorded a recent peak rate of 5 per cent in the second quarter of 2002, real output growth in the South African economy decelerated progressively in the subsequent four quarters, bringing the growth rate in the second quarter of 2003 to a mere ½ per cent. While the pace of growth then displayed a welcome reacceleration, the annualised rate of 1 per cent recorded in the third quarter remained inadequate to signify progress on a per capita basis. This lacklustre performance to some extent clouded the success achieved when inflation was brought down to within the target range of 3 to 6 per cent in September 2003.

Domestic growth is nevertheless poised to benefit from the improvement in the global macroeconomic environment. Supported by monetary and fiscal stimulation, economic activity in the United States, Japan and a number of other Asian countries picked up strongly. Some tentative signs of a mild recovery in the euro area also emerged in recent months. While inflation remained low in most parts of the world and the general trend in short-term interest rates remained downward until recently, both the Reserve Bank of Australia and the Bank of England have raised their official central bank interest rates in the fourth quarter of 2003.

The weakness in real output in South Africa during the third quarter of 2003 was concentrated in agriculture and manufacturing. With field crop production adversely affected by poor weather, real production volumes in agriculture continued to decline. Simultaneously, real value added in the manufacturing sector registered its third successive quarter of contraction as the recovery in the exchange rate of the rand and lacklustre world demand inhibited this sector's output performance. In 2001 and 2002 this performance had been somewhat artificially boosted by the effect of the depreciation of the rand on the competitiveness of export-oriented and import-competing industries.

CPIX inflation



Real gross domestic final demand continued to rise briskly in the third quarter of 2003. While real final government consumption expenditure steadfastly maintained a growth rate of 4 per cent, growth in both real consumption expenditure by households and real fixed capital formation gained further momentum in the third quarter. Rising real incomes, declining interest rates and relatively stable goods prices supported this acceleration in real expenditure. However, the tempo of inventory accumulation fell back appreciably during the third quarter, possibly partly on account of stronger-than-expected demand for both consumer and capital goods.

Firm domestic demand was reflected in a brisk increase in the volume of merchandise imported. Export volumes rose less robustly, but with rising export commodity prices and an improvement in South Africa’s terms of trade the deficit on the current account of the balance of payments receded to just over 1 per cent of gross domestic product in the third quarter of 2003. The repatriation of export proceeds by South African companies, foreign direct investment inflows and other short-term financial flows contributed to a sizeable surplus on the financial account and to an overall surplus on the balance of payments. Consequently, the country's gross gold and foreign reserves rose to a level in excess of US$20 billion at the end of September, the positive net open foreign-currency position of the Reserve Bank rose further and the exchange rate appreciated further. The nominal effective exchange rate of the rand appreciated by 16 per cent in the first 9 months of 2003 and by a further 5½ per cent in October and the first three weeks of November.

The recovery in the exchange rate and the maintenance of prudent monetary and fiscal policies were reflected in a rapid reduction in inflation. Led by the prices of imported goods, which in rand terms fell back by 8 per cent in the year to September 2003, inflation in production prices and in the prices of consumer goods moderated significantly. Headline consumer price inflation was also reduced by the impact of the lower repurchase rate of the Reserve Bank on mortgage interest cost. CPIX inflation, which excludes mortgage interest cost, receded to a twelve-month rate of 5,4 per cent in September 2003 – the first time since late 2001 that it had moved below 6 per cent. Subsequently, this rate declined further to 4,4 per cent in October 2003. This achievement is set to have a beneficial effect on inflation expectations and on the credibility of the inflation targeting monetary policy framework.

The average level of wage settlements for the nine months to the end of September 2003 amounted to 8,9 per cent. However, quarterly surveyed formal-sector employment resumed its downward trend after the employment gains of the middle quarters of 2002, suggesting that labour productivity continued to rise. Increases in labour productivity nevertheless were generally lower than before, contributing to a fairly high rate of increase in unit labour cost.

Against the background of subdued growth in real output and low inflation – even price declines in some categories of goods and services – the demand for money expanded very slowly; in August 2003 twelve-month growth in M3 fell back to its lowest level in ten years. Monetary institutions’ loans and advances to the domestic private sector rose more briskly, recording twelve-month rates of increase of around 12 per cent in recent months. Mortgage advances, instalment sale credit and leasing finance recorded firm increases, consistent with the reductions in banks’ lending rates and with the strong performance of the real-estate market and buoyant durable goods purchases. Other bank loans to the corporate sector, however, contracted in recent months as disintermediation, in which corporate entities issue bonds and other securities rather than mobilising bank finance, picked up.

The Financial Sector Charter agreed to between key stakeholders in the financial sector was released on 17 October and was generally well received. It provides for systematic progress with human resource development and Black Economic Empowerment in the financial sector.

The Reserve Bank reduced its repurchase rate by a total of 5 percentage points in four months, the latest reduction being implemented in mid-October 2003. Since actual and expected inflation declined strongly over the same period, positive real interest rates were maintained and on each occasion the Bank's Monetary Policy Committee (MPC) satisfied itself that the interest-rate reduction would be reconcilable with the sustained achievement of the inflation target. Long-term interest rates also declined somewhat further and reached their lowest levels in 24 years.

Shares prices have risen significantly since late April 2003, despite the impact of the further recovery in the exchange rate of the rand on expected profitability in the export and import-competing sectors of the economy. Real-estate prices continued to rise strongly and property market turnover remained brisk, supported by the reductions in mortgage interest rates.

Fiscal policy became increasingly expansionary as lower tax collections from companies engaged in mining and manufacturing acted as an automatic economic stabiliser. As indicated with the release of the *Medium Term Budget Policy Statement* in November 2003, a more stimulatory fiscal policy stance will be maintained while remaining within the parameters of sustainability.

Following a recent review of the inflation targeting framework, the Minister of Finance and the Governor of the Reserve Bank have agreed to a number of technical refinements of the framework. These were announced on 12 November 2003, and are outlined in the accompanying table. The target is now to be met on a continuous basis. If inflation is thrown off target by a shock there is no escape from introducing steps to steer it back on track.

Key parameters of the inflation targeting framework

Parameter	Before 12 November 2003	From 12 November 2003
Target variable	CPIX	CPIX
Target range	3 to 6 per cent	3 to 6 per cent
To apply until	2005	2006
Measurement option	Annual average: Average CPIX inflation over a calendar year	Continuous basis: 12-month CPIX inflation must remain in the target range at all times
Exception handling	Escape clause: It is recognised that there may be some economic supply shocks or extraordinary events impacting on CPIX inflation that are unforeseen and beyond the control or influence of monetary policy. Most of these factors reverse over time. It is not possible to specify in advance all the economic shocks that could affect CPIX inflation, but such factors include a sharp rise in international oil prices, drought, changes in indirect taxes, and international financial contagion causing major changes in the exchange rate which are unrelated to domestic economic fundamentals and domestic monetary policy. Reacting to such events could result in costly losses in terms of output and jobs. In such circumstances where it is expected that the target for CPIX inflation will not be met, it will be indicated in a monetary policy statement and the Monetary Policy Committee will set out the path and time horizon over which the inflation rate will be brought back in line with the target.	Explanation clause: When the economy is buffeted by a supply-side shock similar to those envisaged by the original escape clause that will take CPIX inflation outside the target range (e.g. an oil price shock, a drought, a natural disaster, or financial contagion affecting the currency), at the subsequent meeting of the Monetary Policy Committee, the SARB will fully inform the public of the nature of the "shock", the anticipated impact on CPIX inflation and the monetary policy response to ensure that inflation returns to the target and the timeframe over which this will occur.

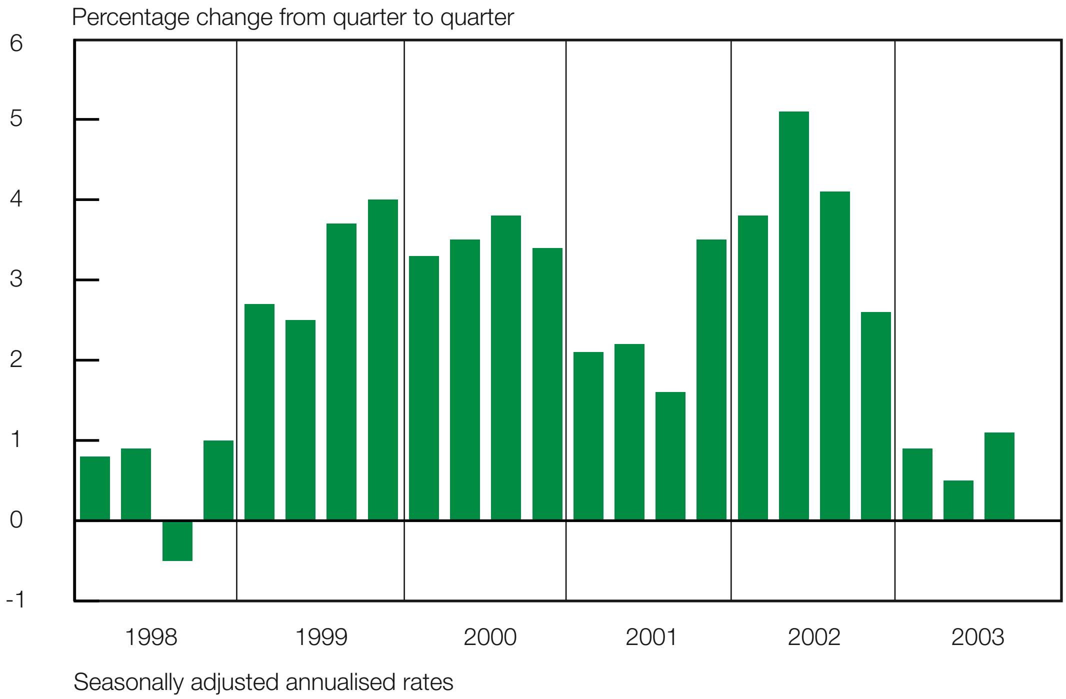
Domestic economic developments

Domestic output[1]

1 In accordance with normal practice during the final 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. The growth rates referred to in this section are based on seasonally adjusted data.

Revised and updated data indicate that after four quarters of deceleration to a rate of only ½ a per cent in the second quarter of 2003, growth in South Africa's *real gross domestic product* rose moderately to an annualised rate of 1 per cent in the third quarter. Simultaneously, growth in the real value added by the non-agricultural sector of the economy was more encouraging, picking up from its lowest value of 1 per cent in the first quarter of 2003 to 1½ per cent in the second and 2 per cent in the third quarter of 2003. For the economy as a whole, real production in the first three quarters of 2003 compared with the same period of 2002 increased by only 2 per cent, considerably lower than the 3½ per cent growth rate attained in 2002 as a whole.

Real gross domestic product



The sluggish performance of the economy reflected still subdued conditions in many parts of the world economy. Although world economic growth has started to pick up, the tentative recovery has not been evenly distributed. While the latest growth figures from the United States were high, signs of recovery in the euro area, which is South Africa's major trading partner, remained tentative. This contributed to the weakness evident in South Africa's exports and the lack of buoyancy in the domestic production side of the economy.

Real output in the primary and secondary sectors of the economy contracted in the third quarter of 2003. However, the real value added by the tertiary sector continued to grow at a solid pace. The real value added by the *primary sector* of the economy contracted in all three quarters of 2003, mainly due to declines in the real value added by the agricultural sector. By contrast, growth in real mining output accelerated steadily in the second and third quarters of 2003.

The real value added by the *agricultural sector* deteriorated progressively during the first three quarters of 2003. Agricultural conditions have been less favourable in 2003 compared with the previous year; notably, field crop production was adversely affected by poor weather. As a result, the annualised tempo of decline in real output worsened from 19½ per cent in the second quarter of 2003 to 22 per cent in the third quarter.

Real gross domestic product

Percentage change at seasonally adjusted annualised rates

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

Available indicators paint a somewhat different picture of the recent performance of the *mining sector* than had been the case in the past five years. Real mining output seems set to increase appreciably in 2003, in welcome contrast to the annual declines recorded from 1998 to 2001 and the sluggish ½ a per cent growth registered in 2002. This turnaround was primarily due to an improvement in real non-gold mining output. Platinum mining in particular benefited from continued expansion in the industry and strong international demand. This was a result of the inroads platinum group metals have made in the jewellery industry and in the automotive industry for use in catalytic converters.

The real output of diamond mining continued to increase in the third quarter of 2003. This was partly in response to a resurgence in world demand and expectations of brisk sales in the coming festive season. Real output in the coal-mining industry benefited as local mines increased production, responding to problems experienced by coal producers elsewhere in the world. The weak performance by the gold-mining sector was more than neutralised by the robust performance of the rest of the mining sector. As a result, growth in the real value added by the mining sector accelerated from an annualised rate of 5 per cent in the second quarter of 2003 to 6 per cent in the third quarter.

The real value added by the *secondary sector* contracted in the third quarter of 2003. Following a 3 per cent rate of contraction in both the first and the second quarter, output declined at a more modest annualised rate of ½ a per cent in the third quarter. This was mainly a result of a decline in the real output of the manufacturing sector. Although there was some improvement in the real value added by the sector producing electricity, gas and water as well as the construction sector, it was not adequate to counteract the poor performance of the manufacturing sector.

Subsequent to a 4½ per cent decline in the first as well as in the second quarter of 2003, the contraction in the real value added by the *manufacturing sector* moderated to an annualised rate of 1½ per cent in the third quarter. Measured over a year, virtually no growth was recorded in the first three quarters of 2003, against a brisk rate of increase of 5½ per cent attained in the 2002 calendar year.

Manufacturing output increased robustly from the fourth quarter of 2001 and peaked in the second quarter of 2002 before losing momentum, culminating in real output declining in each of the first three quarters of 2003. The growth performance of the real value added by the manufacturing sector broadly reflected lacklustre global growth trends and the recovery in the exchange rate of the rand. Whereas the export-oriented and import-competing subsectors of manufacturing made substantial gains in 2001 and 2002, partly as a result of the depreciation of the currency over the same period, the recovery of the domestic currency contributed to a more subdued performance since late 2002.

The contraction in real manufacturing output in the third quarter was spread over several subsectors, but was particularly pronounced in radio, television and communication equipment, basic metals and chemical products. Most of these subsectors were affected by increased imports as a greater proportion of domestic demand was met by competitively priced imports. Real output in the vehicle manufacturing subsector increased robustly in stark contrast with most other subsectors of industry. This was the net result of an increase in exports of motor vehicles (see box on the following page) and the buoyancy in domestic demand for new passenger cars. In addition, demand for medium and heavy commercial vehicles increased with businesses taking advantage of stable prices and lower interest rates to upgrade their fleets.

Growth in the real value added by the sector producing *electricity, gas and water* accelerated from 2 per cent in the second quarter of 2003 to 2½ per cent in the third quarter. This was mainly due to an increase in domestically generated electricity as the quantities imported from neighbouring countries were reduced. In addition, real output by the subsector supplying water benefited from increased activity in the mining sector and the fairly low rainfall in most of the summer rainfall regions towards the end of the third quarter.

Following an increase at an annualised rate of 2½ per cent in the second quarter of 2003, growth in the real value added by the *construction sector* accelerated to 4 per cent in the third quarter. This was mainly due to firm growth in new construction activity which benefited from improving confidence levels, with some of the impact of lower interest rates possibly also starting to play a role.

Growth in the real value added by the *tertiary sector* recorded its fifth consecutive quarter of growth at an annualised rate of 3 per cent in the third quarter. The most important contributors to the increase in real value added in the third quarter were the commerce and transport, storage and communication sectors.

Growth in the real value added by the *commerce sector* accelerated from 2½ per cent in the second quarter of 2003 to 4½ per cent in the third quarter. This could be attributed to an increase in the real output of the retail and motor trade subsectors which more than offset a decline in the catering and accommodation sector. Retail output benefited from lively consumer demand, particularly for durable goods. This

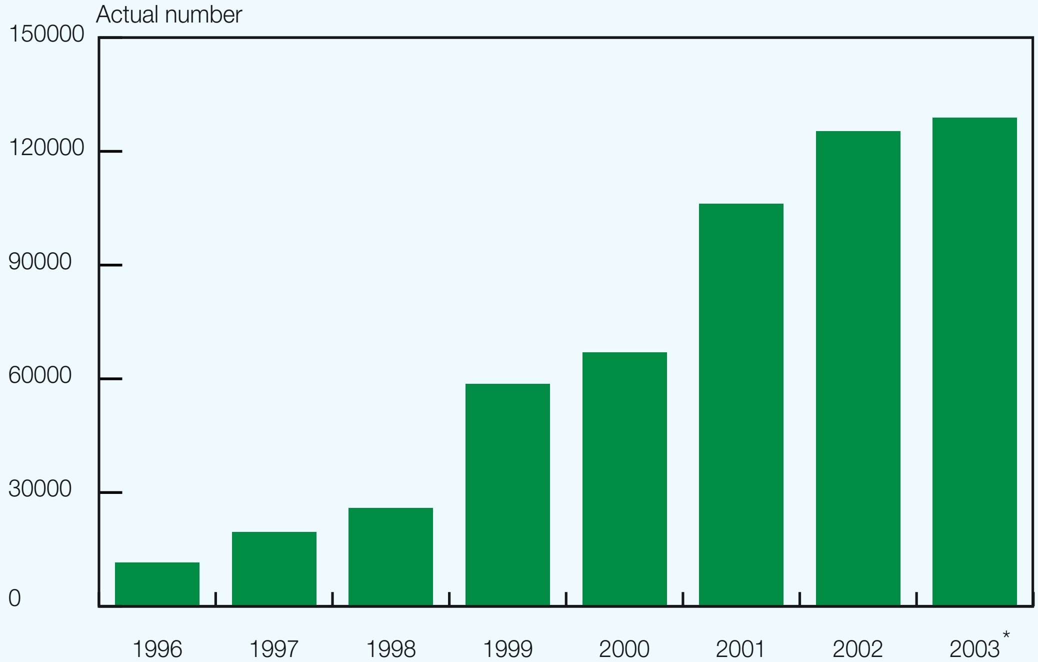
Vehicle exports

Over the past seven years vehicles and transport equipment contributed materially to growth in manufacturing exports. Vehicles and transport equipment as percentage of total exports of manufactured goods doubled from 12 per cent in 1996 to 24 per cent in the first three quarters of 2003. This increase came mainly from the growth in the volume of vehicle exports, which increased at an average annual rate of 41 per cent from 1996 to the third quarter of 2003. The volume of total vehicle production increased at an average annual rate of 3 per cent over this period. Vehicle exports as a percentage of total vehicle production increased from 3 per cent in 1996 to 26 per cent during the first three quarters of 2003.

Although the automotive industry in South Africa benefited from the local availability of factors of production and first-class infrastructure and services, the long-term certainty brought about by the Motor Industry Development Programme (MIDP) contributed to the success of the industry. Vehicle manufacturers are allowed rebates of import duty on imported vehicles against proof of exports of vehicles, encouraging them to import certain models and domestically produce other models for the world market. The success of the MIDP is also clearly evident in the expansion of production capacity by the automotive industry. The share of fixed capital formation by the manufacturers of transport equipment in total manufacturing fixed capital formation increased from about 4 per cent in 1996 to more than 20 per cent during the first three quarters of 2003.

Despite these developments, the growth in the volume of vehicle exports slowed down significantly from 58 per cent in 2001 to 18 per cent in 2002 and an average annualised rate of 3 per cent in the first three quarters of 2003. To maintain growth in vehicle exports, local manufacturers should further their global competitiveness. Growing competition from developing countries such as China and India will hamper this. Increases in unit labour cost and the recent recovery of the exchange value of the rand reduce the cost competitiveness of the South African automotive industry.

Vehicle exports



* Annualised exports for the first three quarters of 2003
Source: Naamsa

was supported by stable prices as inflation in consumer goods prices for instance came to an annualised rate of only 4 per cent in the third quarter. Growth in the real value added by the motor-trade sector accelerated on a quarter-to-quarter basis as a result of a resurgence in consumer demand as prices stabilised, helped along by the recovery in the exchange rate of the rand. In addition, motor car retailers became increasingly innovative in marketing their products, structuring financing deals at very low interest rates or including improved guarantees or maintenance plans with the purchase of a vehicle.

In the third quarter of 2003, growth in the real value added by the *transport, storage and communication sector* amounted to roughly 6 per cent for the sixth consecutive quarter. Firm growth in the cellular telephone industry, which has become the mainstay of the communication sector, more than neutralised weaker activity in land transport.

The real value added by the *finance, insurance, real estate and business services sector* increased at an annualised rate of 1½ per cent in the third quarter of 2003 compared with a 3 per cent rate attained in the second quarter. This slowdown could be attributed to a contraction in the real output by the banking sector, which was only partly countered by an improved performance by the real-estate subsector related to the solid activity in the housing market.

Domestic expenditure

After a steep increase of 5 per cent in the second quarter of 2003, growth in *real gross domestic expenditure* receded to a still-solid annualised rate of 3½ per cent in the third quarter. However, the accumulated real gross domestic expenditure for the first three quarters of 2003 stood at a level which was about 4½ per cent higher than in the corresponding period of 2002. The slowdown in aggregate real domestic expenditure was mainly confined to real inventory investment. The pace of real inventory accumulation decreased sharply in the third quarter. By contrast, growth in real domestic final demand accelerated considerably on a quarter-to-quarter basis in the third quarter of 2003.

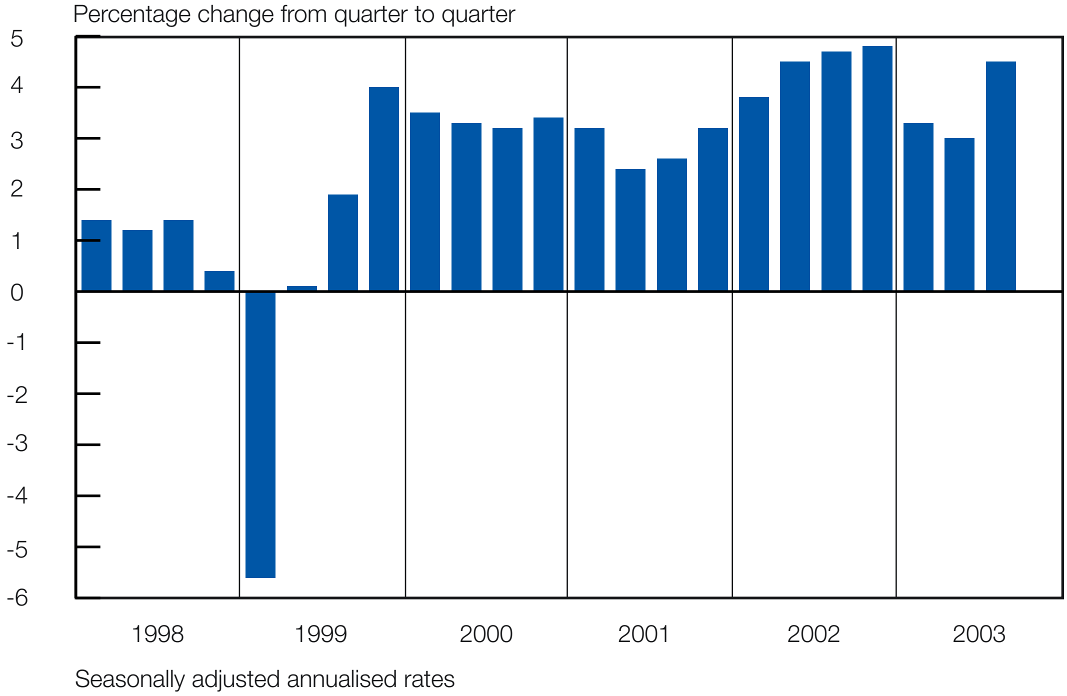
Real gross domestic expenditure

Percentage change at seasonally adjusted annualised rates

	2002					2003		
Components	1st qr	2nd qr	3rd qr	4th qr	Year	1st qr	2nd qr	3rd qr
Final consumption expenditure by households	3½	3½	3	2½	3	2½	3	4
Final consumption expenditure by general government	3½	3½	4	4	3½	4	4	4
Gross fixed capital formation	6	9	13½	16	6	5	3	7
Change in inventories (R billions*)	8,8	0,2	7,3	6,6	5,7	6,2	9,1	6,8
Gross domestic expenditure	**6½**	**½**	**8½**	**5½**	**5**	**3**	**5**	**3½**

* Constant 1995 prices

Real gross domestic final demand



Growth in *real final consumption expenditure by households* accelerated from an annualised rate of 2½ per cent in the first quarter of 2003 to 4 per cent in the third quarter as households stepped up spending in all but one of the major expenditure categories. Measured over one year, real final consumption expenditure by households increased by about 3 per cent in the first three quarters of 2003, which compares favourably with an increase of just more than 3 per cent for 2002 as a whole.

Real expenditure on *durable goods* was particularly buoyant; growth accelerated from an annualised rate of 4½ per cent in the second quarter of 2003 to 17 per cent in the third quarter. Real outlays on most categories of durable goods increased noticeably, with purchases of new passenger cars in particular quite prominent. This was partly due to very moderate changes in new car prices, reinforced by decreases in interest rates. Durable goods generally have a high import content and the recovery of the exchange rate of the rand contributed to the more stable and in some instances declining prices, making these goods more attractive to consumers.

Following an increase of 3 per cent in the second quarter of 2003, growth in real outlays on *semi-durable goods* accelerated to an annualised rate of 8 per cent in the third quarter of 2003. Robust spending on clothing and footwear, household textiles and furnishings and on vehicle parts and accessories underpinned this acceleration. Real household expenditure on *non-durable goods* increased at an annualised rate of 2 per cent in the third quarter of 2003, largely upholding the growth of the second quarter. This was mainly related to sustained growth in expenditure on food and household fuel and power. By contrast, households reduced their real spending on *services* as the cost of medical, recreational, entertainment and educational services increased relative to the prices of goods; import substitution possibilities disciplined the prices of goods rather than services.

The stronger increase in real final consumption expenditure by households in the third quarter was underscored by an acceleration in households' real disposable income – the real disposable income of households increased at an annualised rate of 4 per cent, in contrast to 3 per cent in the second quarter. To supplement their disposable income, households incurred more debt to directly or indirectly finance their expenditure. Consequently, household debt as percentage of disposable income rose from 53 per cent in the second quarter of 2003 to 53½ per cent in the third quarter.

Real final consumption expenditure by general government increased at an annualised rate of 4 per cent in the third quarter of 2003, thus maintaining the growth rate of the first two quarters. Whereas real spending on compensation of employees continued to be rather restrained, purchases of goods and non-wage services rose prominently during 2003 to date. This lifted aggregate real final consumption expenditure by general government to a level which was 4 per cent higher than in the first three quarters of 2002. Final consumption expenditure by general government as a ratio of gross domestic product remained at 19 per cent in each of the first three quarters of 2003.

Real gross fixed capital formation increased at an annualised rate of 7 per cent in the third quarter of 2003 following an increase of 3 per cent in the second quarter. Private business enterprises and general government raised their real fixed capital outlays, while capital formation by the public corporations receded somewhat. The sustained quarter-to-quarter growth in the first three quarters of 2003 increased the real gross fixed capital formation to a level which was approximately 9 per cent higher than in the corresponding period in 2002.

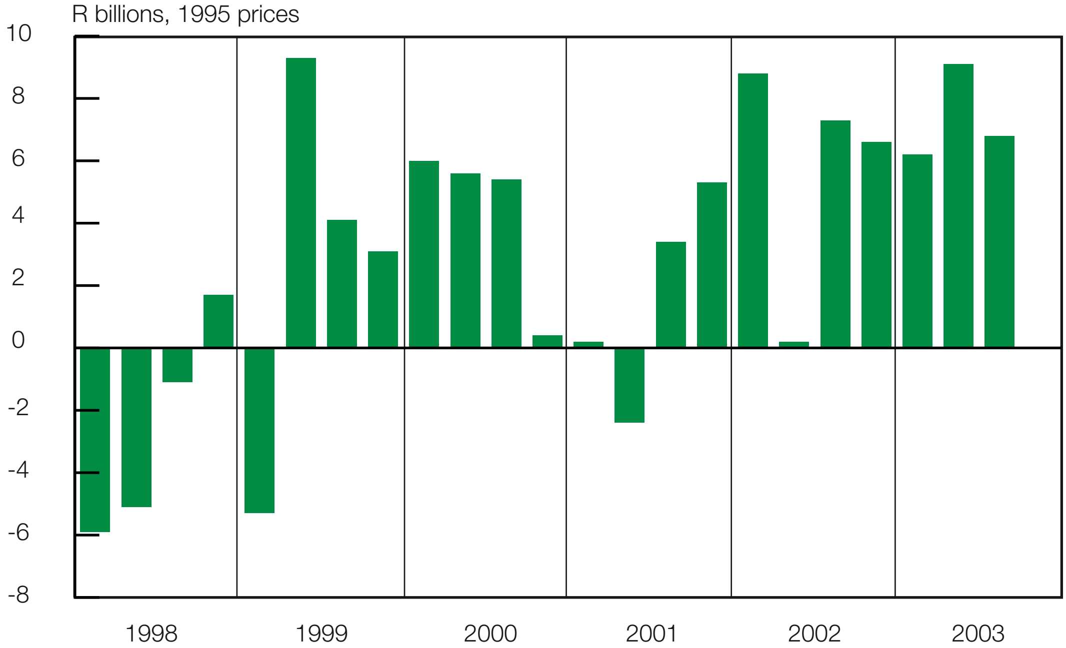
The growth in real fixed capital outlays by *private business enterprises* accelerated from an annualised rate of 6 per cent in the second quarter of 2003 to 10 per cent in the third quarter. An analysis of capital spending in the private sector by kind of economic activity indicates that the entire sector, with the exception of manufacturing, expanded capital investment in the third quarter. Businesses appeared to be making the most of conditions that favour expenditure on capital goods. Such conditions included:
- an easier monetary policy which lowered the cost of borrowing;
- an exchange rate conducive to importing capital goods;
- relatively stable prices in a low-inflation environment; and
- in the case of commodities, favourable prices in international markets.

The increase in real fixed capital expenditure was predominantly in the agricultural, and transport and communication sectors. Real fixed capital expenditure by the agricultural sector was mainly geared towards the acquisition of machinery and equipment to replace obsolete capital stock. In the transport and communication sector, network expansion by cellular telephone companies as well as the increase in private transport capacity added to capital formation. In addition, the ongoing development of capacity in the mining sector helped to underpin real fixed capital formation in the private sector.

Real gross fixed capital formation by *public corporations* declined further from the second to the third quarter of 2003. This could mainly be ascribed to a lower level of real expenditure on the communication infrastructure. All three levels of *government* stepped up expenditure on infrastructure expansion aimed at service delivery.

It is estimated that real *inventory accumulation* slowed down in the third quarter of 2003. Following an accumulation of R9,1 billion in the second quarter, inventory investment at constant 1995 prices receded to R6,8 billion in the third quarter. This slower build-up in inventories was especially pronounced in the manufacturing sector. Wholesale, retail and motor trade businesses depleted their inventory levels to meet the sustained firm growth in real domestic final demand. Subsequent to contributing 1½ percentage points to growth in expenditure on real gross domestic product in the second quarter, inventories *subtracted* about 1½ percentage points in the third quarter of 2003. However, the ratio of industrial and commercial inventories to non-agricultural gross domestic product remained at 16 per cent in both the second and the third quarter of 2003 compared with 15½ per cent in the first quarter.

Change in inventories



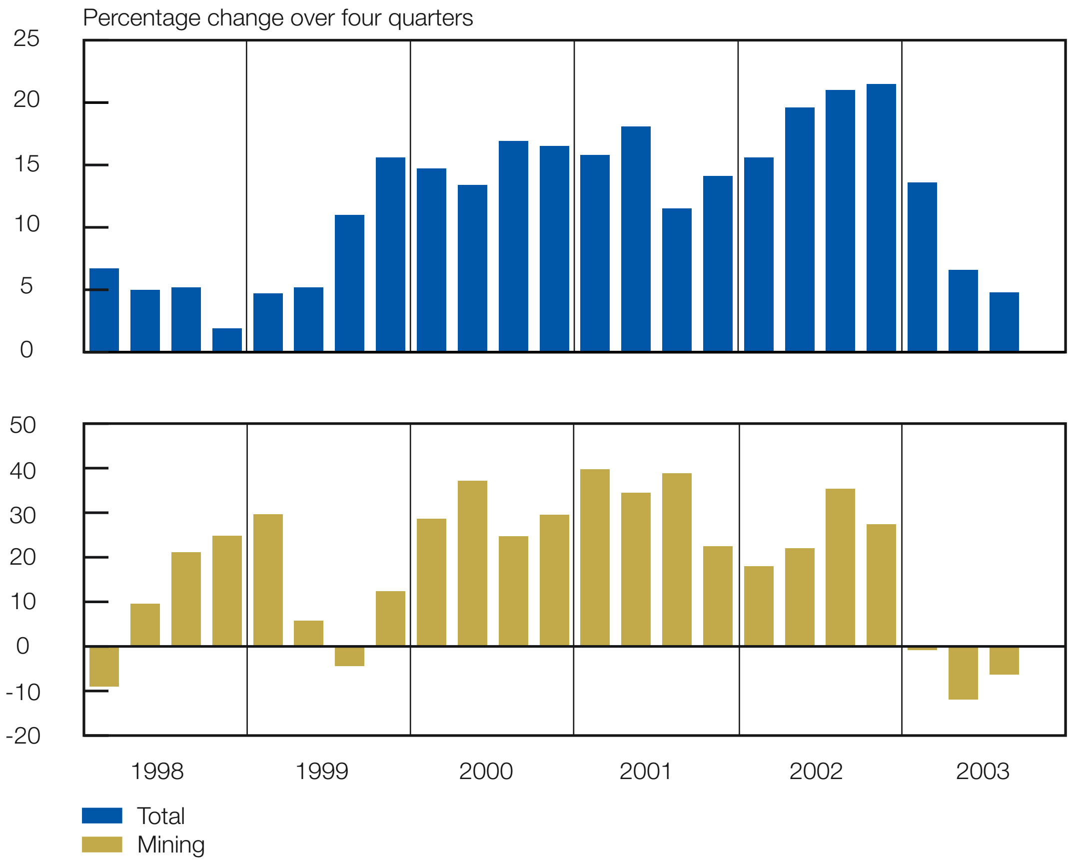
Seasonally adjusted annualised rates

Factor income

The rate of increase in *total nominal factor income measured over a year* amounted to 7 per cent in the third quarter of 2003, lower than the 8 per cent recorded in the second quarter. The slower growth was due to a restrained performance of gross operating surpluses of business enterprises in the third quarter of 2003. The level of total factor income for the first three quarters of 2003 was 8½ per cent higher compared with the same period in 2002.

Notwithstanding the lower nominal cost of capital and low inflation, the business environment has been unfavourable to many businesses. The increase in unit labour cost and the loss of pricing power, particularly in the export and import-competing market, did not augur well for them. Growth in profit margins of business enterprises therefore came under pressure. Low growth in gross operating surpluses was recorded throughout most sectors of the economy, but in mining, manufacturing and agriculture operating surpluses actually contracted. Fairly high wage settlements in the mining sector and weaker productivity and higher unit labour cost in manufacturing, together with subdued output prices, put a dent in these industries' operating surpluses. At the other extreme, relatively buoyant conditions prevailed in the commerce sector. This sector's increased profitability could, however, not fully compensate for the adverse conditions in the rest of the economy. Consequently, growth in the economy's *gross operating surplus* measured over four quarters amounted to 4½ per cent in the third quarter of 2003 compared with an average of more than 10 per cent in the first two quarters.

Gross operating surplus



Year-on-year growth in *total compensation of employees* amounted to 9½ per cent in the first quarter of 2003 and 9 per cent in both the second and third quarters. Wage settlements in the second and third quarters were above the prevailing inflation rate, especially in the mining, commerce and government sectors. However, the higher wages were counteracted by some retrenchments as companies sought to contain cost in an environment of increased competition from foreign firms.

Gross saving

Gross saving as percentage of gross domestic product amounted to 16 per cent in the third quarter of 2003, unchanged from the preceding two quarters. While household and corporate saving both edged up in the third quarter, this was neutralised by lower government saving.

Notwithstanding sluggish profit growth by the *corporate sector,* the ratio of corporate gross saving to gross domestic product rose from 11 per cent in the second quarter of 2003 to about 11½ per cent in the third quarter. The level of corporate saving was supported by lower dividend and interest payments. In addition, corporate tax payments slowed down in the first three quarters of 2003, rendering further support to corporate saving.

Gross saving by *households* as percentage of gross domestic product remained fairly stable throughout the first three quarters of 2003. It edged up slightly from 3 per cent to almost 3½ per cent in the third quarter, partly due to higher disposable income arising from attractive wage increases. The ratio of *general government* gross saving to gross domestic product receded from 2 per cent in the second quarter of 2003 to 1 per cent in the third quarter due to sluggish tax revenues which more than neutralised lower interest payments.

Employment

Recent data continued to reflect the disappointing capacity of the South African economy to create jobs. Employment numbers increased in both the second and third quarters of 2002, following prolonged periods of continuous decline. However, in the subsequent two quarters regularly surveyed employment again resumed a downward trend.

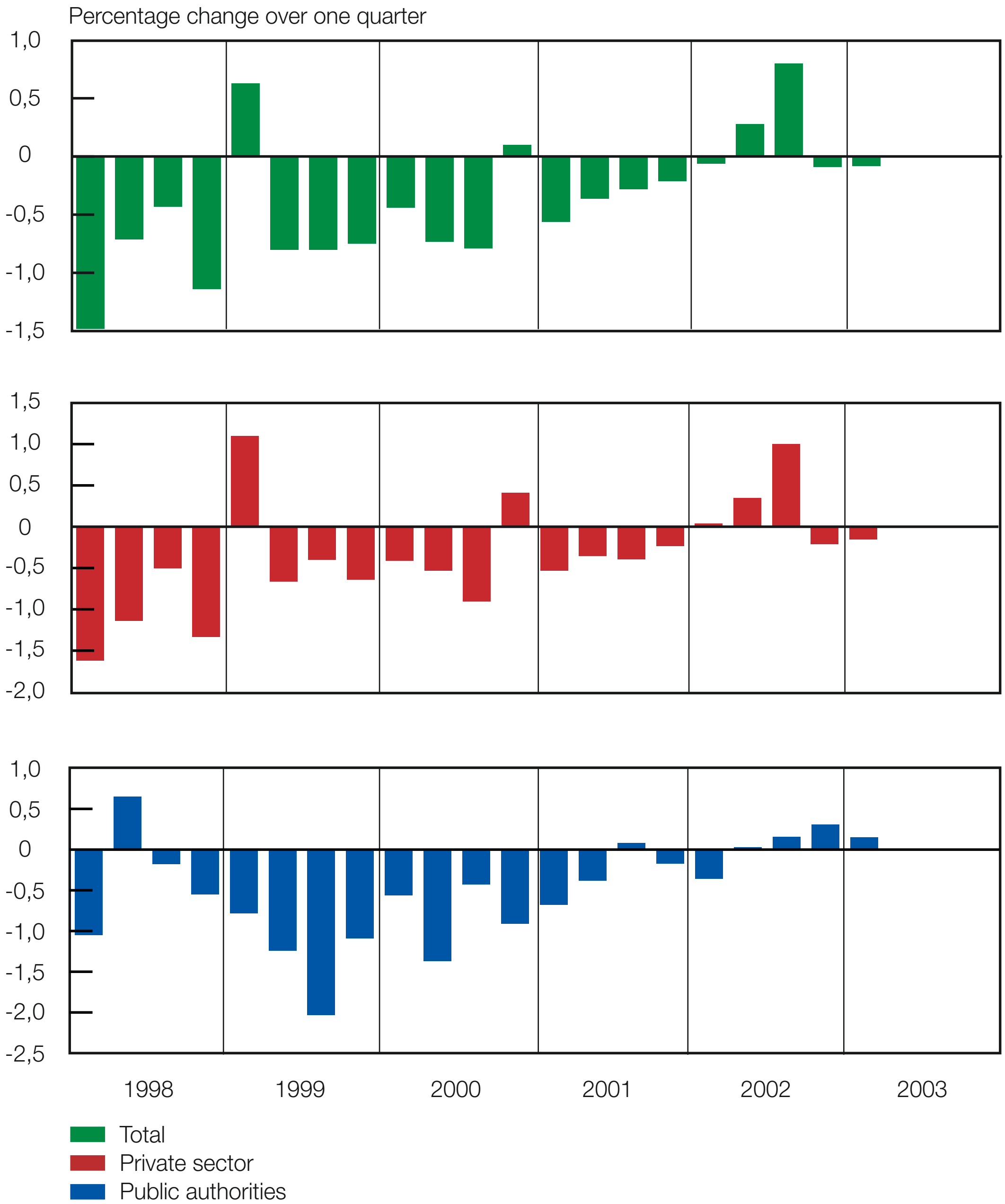
Following the implementation of the new expanded *Survey of Employment and Earnings* (SEE) in September 2002, the coverage of *formal non-agricultural employment* increased by about 40 per cent. According to this new indicator, employment in the regularly surveyed formal non-agricultural sectors of the economy increased at an annualised rate of 3,2 per cent in the third quarter of 2002. The less comprehensive series which was compiled previously also showed an increase in the second quarter of 2002.

These conditions were reversed when regularly surveyed employment decreased at an annualised rate of 0,4 per cent in the fourth quarter of 2002 and 0,3 per cent in the first quarter of 2003 – the latest available observation. Allowing for seasonal variation, employment numbers decreased by about 5 500 in the first quarter of 2003 compared with the fourth quarter of 2002. Nevertheless, on account of the strong increases in the middle quarters of 2002 the level of employment was still 0,9 per cent higher in the first quarter of 2003 than in the same quarter of the previous year.

Private-sector employment contracted at annualised rates of 0,8 per cent in the fourth quarter of 2002 and 0,6 per cent in the first quarter of 2003. As shown in the accompanying table, private-sector employment losses were most pronounced in the construction and the transport, storage and communication sectors. Nevertheless, the level of employment in the private sector was still 1,0 per cent higher in the first quarter of 2003 compared with the same period in the previous year.

Employment in the public sector increased at an annualised rate of 1,2 per cent in the fourth quarter of 2002. These employment gains extended to the opening months of 2003, amounting to an annualised rate of 0,6 per cent in the first quarter. Employment gains in the public sector were most pronounced at national and local

Non-agricultural employment



Seasonally adjusted annualised rates
Changes after adjustment for level shifts in the third quarter of 2002

government levels during the first quarter of 2003. When measured over periods of four quarters, public-sector employment increased by 0,7 per cent in the first quarter of 2003 compared with the same period in the previous year.

According to the most recent *Labour Force Survey* (LFS) by Statistics South Africa, the official unemployment rate in South Africa, which had remained stable at 30 per cent throughout 2002, increased slightly to 31,2 per cent in March 2003. Out of an economically active population of 16,8 million in March 2003, the survey found that about 5,25 million people were officially unemployed.

Change in non-agricultural private-sector employment in the first quarter of 2003*
Quarter to quarter at seasonally adjusted annualised rates

	Percentage change
Gold mining	0,2
Non-gold mining	1,7
Manufacturing	0,6
Electricity	0,3
Construction	-15,9
Trade, catering and accommodation services	-0,6
Transport, storage and communication services	-12,2
Financial intermediation and insurance	2,3
Washing and dry-cleaning services	6,5
Total non-agricultural private-sector employment	-0,6

* Based on labour statistics that were statistically linked by the South African Reserve Bank to correct for the break in consistency in the third quarter of 2002, following the publication of the new expanded *Survey of Employment and Earnings* (SEE) by Statistics South Africa

Labour cost and productivity

Information obtained from *Andrew Levy Employment Publications* (a private-sector publication) indicates that the average level of wage settlements for the nine months ending 30 September 2003 was 8,9 per cent, compared with 7,7 per cent for the nine months to the end of September 2002. The lowest settlement rate was the 7,0 per cent agreed to in the contract-cleaning sector, and the highest settlement rate was the 14,8 per cent awarded to part of the motor retail sector. It is anticipated that wage settlement rates will decelerate during 2004 as they are likely to be negotiated against the background of lower rates of inflation. The average level of settlements at the centralised level was 9,6 per cent in September 2003 compared with 8,7 per cent in September 2002. Strike action fuelled by wage negotiations was reported in only 2,8 per cent of the wage agreements up to the end of September 2003, compared with 8,1 per cent in the full calendar year 2002.

Year-on-year growth in *average nominal remuneration per worker* amounted to 10,0 per cent in 2002, the highest rate of change in four years. The year-on-year rate of increase in remuneration per employee in the formal non-agricultural sectors of the economy accelerated abruptly from 8,8 per cent in the fourth quarter of 2002 to 10,6 per cent in the first quarter of 2003. This pick-up resulted mainly from higher remuneration growth in the public sector, as private-sector remuneration growth slowed down in that quarter.

Remuneration growth in the *private sector* edged marginally higher on a year-on-year basis, increasing from an average rate of 8,8 per cent in the year 2001 to an average rate of 9,9 per cent in 2002. Wage growth in the private sector subsequently slowed down in the opening months of 2003, amounting to a year-on-year rate of 8,5 per cent in the first quarter of 2003.

By contrast, average annual growth in *public-sector* remuneration remained at around the 9,0 per cent level during 2001 as well as 2002. In the first quarter of 2003 there was a major increase in public-sector remuneration per worker when it accelerated substantially to 15,9 per cent. However, this was partly related to shifts in the timing of bonuses and other payments, and should be interpreted together with the exceptionally low increase recorded in the fourth quarter of 2002.

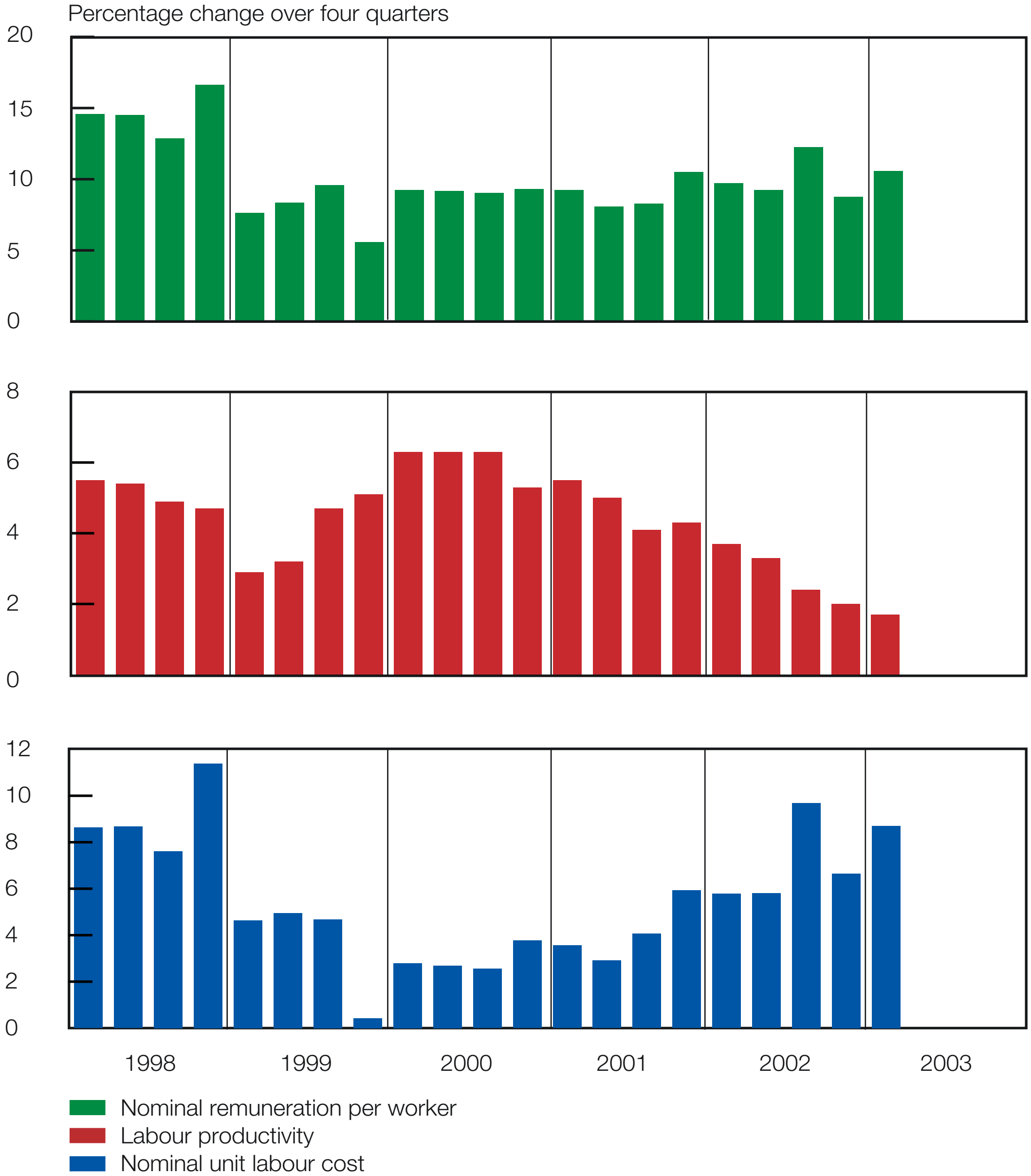
Nominal remuneration per worker*

	Percentage change over four quarters				
	2002				2003
	1st qr	2nd qr	3rd qr	4th qr	1st qr
Private sector	11,3	9,4	9,8	10,8	8,5
Public sector	6,0	8,9	18,8	4,2	15,9
Total	9,7	9,3	12,3	8,8	10,6

* Based on labour statistics that were statistically linked by the South African Reserve Bank to correct for the break in consistency in the third quarter of 2002, following the publication of the new expanded *Survey of Employment and Earnings* (SEE) by Statistics South Africa

Correcting for the structural break in data consistency in the third quarter of 2002, growth in real output per worker had decelerated steadily during the past two years. *Non-agricultural labour productivity* still rose, but at a lacklustre pace. Its growth rate

Non-agricultural remuneration, labour productivity and unit labour cost



Changes after adjustment for level shifts in the third quarter of 2002 declined further from 2,0 per cent year on year in the fourth quarter of 2002 to 1,7 per cent in the first quarter of 2003 – the lowest rate of increase in the past ten years.

Partly as a consequence of weak world demand and decreased international competitiveness following the substantial recovery of the exchange value of the rand in the closing months of 2002, growth in manufacturing production turned around and output volumes started to trend downward from then. As a result, *growth in manufacturing labour productivity* fell back steeply from a year-on-year rate of 6,7 per cent in the third quarter of 2002 to 1,4 per cent in the fourth quarter. As production volumes declined and employment levels remained virtually unchanged, production per worker in the manufacturing sector *decreased* by 1,1 per cent in the year to the first quarter of 2003.

When measured over periods of four quarters, the cost of labour per unit of output in the manufacturing sector increased by 2,5 per cent in the fourth quarter of 2002. Subsequently, *nominal unit labour cost in the manufacturing sector* increased by 7,3 per cent in the year to the first quarter of 2003. The pick-up in the rate of increase in nominal unit labour cost in the first quarter of 2003 resulted from an increase in wages which was not resonant with the lower manufacturing productivity during this period.

Following the acceleration in nominal wage growth and the slowdown in labour productivity growth in the opening months of 2003, *nominal unit labour cost in the total non-agricultural sectors* of the economy increased substantially. The year-on-year rate of increase in non-agricultural nominal unit labour cost rose from 6,6 per cent in the fourth quarter of 2002 to 8,7 per cent in the first quarter of 2003.

Prices

The waning of inflationary pressures in the South African economy since late 2002 was underpinned by the sustained application of prudent monetary and fiscal policies, alongside the recovery in the international exchange value of the rand. A general moderation in almost all the indicators of inflation illustrates the widespread nature of the abatement of inflationary pressures in recent months. The negative production price inflation which was recorded in September 2003 bodes well for lowering future inflation in the prices of consumer goods.

Following the substantial recovery in the exchange rate of the rand, the *production prices of imported goods* started to decline. The year-on-year rate of change in the prices of imported goods reversed from a rate of increase of 17,4 per cent in April 2002 to a rate of *decrease* of 8,0 per cent in September 2003 – the sixth consecutive month of decrease reported in this barometer of price change. This was underpinned by exchange rate movements; on a trade-weighted monthly average basis the rand traded at a level which was almost 35 per cent higher in September 2003 than in September 2002.

Measured from quarter to quarter and annualised, import price inflation declined from 37,4 per cent in the first quarter of 2002 to *rates of price decline* of 10,3 per cent in the second and 8,3 per cent in the third quarter of 2003.

The year-on-year rate of increase in the *prices of domestically produced goods* fell back from a thirteen-year high of 15,3 per cent in August 2002 to 2,6 per cent in August 2003. This slowdown resulted mainly from decreases in the prices of food as well as products of petroleum and coal. In September 2003, this rate of increase in the prices of domestically produced goods amounted to only 1,7 per cent. A large decline of 28,6 per cent in electricity prices was recorded in September due to the change from winter to summer electricity tariffs at Eskom, but despite this the price of electricity in September 2003 was still 11,5 per cent higher than a year earlier.

Production prices

Production prices

Quarter-to-quarter percentage changes at seasonally adjusted annualised rates

Period		Domestically produced goods	Imported goods	Overall production prices
2001:	**Year**.......................................	**7,8**	**10,0**	**8,4**
2002:	1st qr....................................	21,6	37,4	26,1
	2nd qr	14,5	12,6	13,3
	3rd qr	12,4	6,7	11,0
	4th qr	6,1	1,7	5,2
	Year......................................	**13,5**	**15,5**	**14,2**
2003:	1st qr....................................	-0,5	-9,9	-3,0
	2nd qr	0,1	-10,3	-3,2
	3rd qr	6,4	-8,3	2,5

On a quarter-to-quarter basis the prices of domestically produced goods displayed almost no change in the first and second quarters of 2003. Increases in food prices at the agricultural level, as well as in prices of basic metals and metal products and electricity, subsequently caused the quarter-to-quarter pace of change in domestically produced goods prices to rise to 6,4 per cent in the third quarter of 2003. Products of petroleum and coal as well as the “other minerals” category also edged higher during this quarter.

Driven by the slowdown in domestically produced goods inflation and *declining* prices of imported goods, the year-on-year rate of increase in the *all-goods production price index* slowed down from 15,4 per cent in September 2002 to a mere 1,2 per cent in May 2003. After electricity price increases pushed this rate to 2,3 per cent in June 2003, production price inflation fell back to 0,2 per cent in August 2003. In September, the annual percentage change in the all-goods production price index declined even further to *minus* 1,0 per cent – the first twelve-month decline in production prices since October 1959.

The quarter-to-quarter and annualised rate of change in the all-goods production price index moved from an increase of 5,2 per cent in the fourth quarter of 2002 to decreases of 3,0 per cent and 3,2 per cent in the first and second quarters of 2003, respectively. Led by food prices, it increased again at a rate of 2,5 per cent in the third quarter.

Twelve-month *CPIX inflation* on balance fell from 11,3 per cent in October and November 2002 to 6,3 per cent in August 2003 before breaking through the 6 per cent level to a value of 5,4 per cent in September and 4,4 per cent in October. The move in year-on-year CPIX inflation through the upper end of the inflation target range could have an important psychological impact on inflation expectations, raising confidence that inflation will be sustained within the target for the foreseeable future. However, CPIX services inflation remained well above the inflation target range, recording year-on-year rates of 8,6 per cent and 8,3 per cent in September and October 2003, respectively. The rigidity of CPIX services inflation was symptomatic of the limits to exchange-rate driven disinflation. Also of concern in the monthly CPIX inflation figures for October 2003 was the 1,6 per cent month-on-month rate of increase in the category for household operations. This was largely due to a new survey of domestic workers' wages which reflected an increase of 2,2 per cent month-on-month in October 2003.

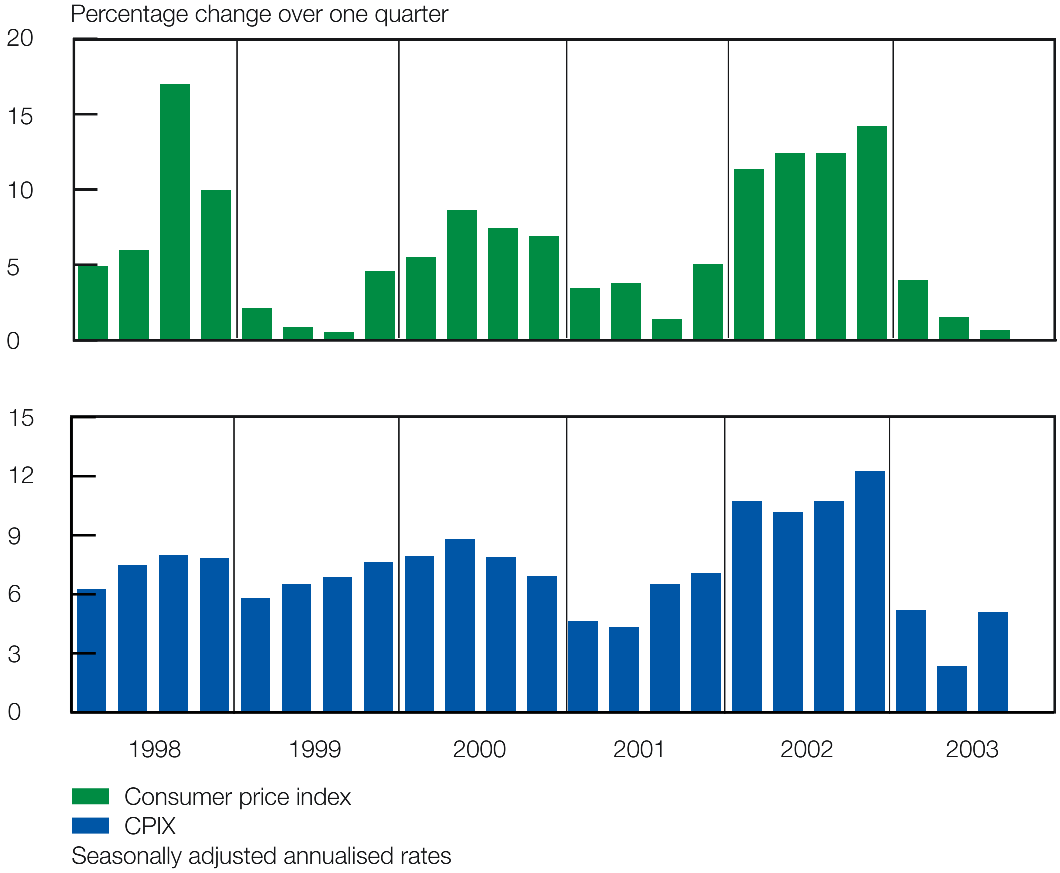
CPIX

Percentage changes over twelve months

Period		Food	Goods	Services	Total
2002:	Sep	20,2	12,7	7,0	10,8
	Oct	20,9	13,4	7,4	11,3
	Nov	19,9	13,3	7,5	11,3
	Dec	17,8	12,5	7,6	10,8
	Annual average	16,7	10,5	7,0	9,3
2003:	Jan	17,0	11,5	7,3	10,0
	Feb	15,3	10,7	6,9	9,3
	Mar	13,4	9,8	8,3	9,3
	Apr	11,6	8,7	8,3	8,5
	May	11,5	7,2	8,3	7,7
	Jun	9,0	5,4	8,0	6,4
	Jul	7,5	5,6	8,3	6,6
	Aug	5,9	5,2	8,4	6,3
	Sep	3,8	3,8	8,6	5,4
	Oct	2,4	2,4	8,3	4,4

Measured from quarter to quarter and annualised, CPIX inflation decelerated meaningfully from 12,1 per cent in the fourth quarter of 2002 to 2,2 per cent in the second quarter of 2003. The improvement in CPIX inflation over this period was due to the sustained positive effects of exchange rate passthrough as well as the continued moderation in food price inflation. Food price inflation within the CPIX inflation measure, when calculated as a percentage change over twelve months, came down from 20,9 per cent in October 2002 to 2,4 per cent in October 2003. The quarter-to-quarter pace of change in CPIX thereafter increased again to an annualised 5,1 per cent in the third quarter of 2003 as both goods and services inflation picked up somewhat.

Consumer price index and CPIX



“Headline” or *overall consumer price inflation,* measured over periods of twelve months, fell from 13,0 per cent in October 2002 to 1,5 per cent in October 2003. This decrease was mainly due to cuts in mortgage interest rates and the moderation in food and transport goods price inflation.

The seasonally adjusted and annualised quarter-to-quarter rate of increase in the overall consumer price index slowed down significantly from a rate of 14,1 per cent in the fourth quarter of 2002 to 0,8 per cent in the third quarter of 2003. This short-term pace of increase was the lowest since the third quarter of 1999.

Lower rates of increase in the prices of services, other than transport services, contributed to a waning in *consumer services price inflation* to an annualised rate of only 3,4 per cent in the second quarter of 2003. Largely reflecting the four consecutive mortgage interest rate cuts since early June 2003, this rate of change thereafter slowed down considerably and services prices *declined* at a rate of 3,0 per cent in the third quarter of 2003.

Consumer prices
Quarter-to-quarter at seasonally adjusted rates

Period		Services	Goods	Overall CPI	CPIX
2001:	**Year**	**5,5**	**5,6**	**5,7**	**6,6**
2002:	1st qr	10,4	12,9	11,5	10,7
	2nd qr.	10,4	13,1	12,3	10,2
	3rd qr	15,0	10,6	12,4	10,7
	4th qr.	15,7	13,3	14,1	12,1
	Year	**7,8**	**10,2**	**9,2**	**9,3**
2003:	1st qr	5,9	3,0	4,1	5,2
	2nd qr.	3,4	-0,8	1,4	2,2
	3rd qr.	-3,0	3,4	0,8	5,1

Declines in services price inflation generally follow declines in goods inflation with a time delay because the prices of non-tradeable services do not benefit directly from imported disinflation. A number of service providers also face little competition domestically, causing prices to be sticky in the downward direction. The year-on-year rate of increase in the prices of consumer services fell back meaningfully from 13,2 per cent in December 2002 to 0,8 per cent in October 2003.

Quarter-to-quarter changes in the *prices of consumer goods* on balance decelerated from an annualised rate of increase of 13,3 per cent in the fourth quarter of 2002 to a rate of *decline* of 0,8 per cent in the second quarter of 2003. Price increases in all the major consumer goods categories caused the quarterly annualised rate of change to increase again to 3,4 per cent in the third quarter of 2003.

Measured over periods of twelve months, inflation in the prices of consumer goods moderated from a most recent high of 13,0 per cent in October 2002 to 2,1 per cent in October 2003. The most significant deceleration was displayed by the prices of food, furniture and transport goods.

Foreign trade and payments

International economic developments

The global macroeconomic environment has improved considerably in recent months following a series of adverse shocks in the first half of 2003. The improvement in activity has been underpinned by strong economic data in the United States (US), Japan and a number of Asian countries, especially China. The Organisation for Economic Cooperation and Development (OECD) composite leading indicator continued its upward trend in September 2003, pointing to a strengthening of global growth during the second half of 2003 and 2004. The monetary and fiscal policy stimulus in several countries and the gradual reduction in the after-effects of the bursting of the bubble in international equity markets are likely to support greater buoyancy in economic activity.

Monetary policies were eased in most advanced economies and developing countries during 2003 against the background of declining inflation and subdued economic conditions. However, as global growth accelerates, markets have begun to anticipate the start of a global tightening cycle. The Reserve Bank of Australia and the Bank of England have both recently increased their official central bank interest rates by 25 basis points. Both central banks cited the pick-up in the domestic economy, rapid growth in household borrowing and the global economic recovery as the main reasons for the tightening in their monetary policy.

Current account[2]

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

Essentially because of an improvement in the trade surplus and a reduction in net payments to non-residents, the deficit on the current account of the balance of payments narrowed to R13,4 billion in the third quarter of 2003, after having widened considerably to R16,4 billion in the second quarter. As a percentage of gross domestic product, the deficit on the current account in the third quarter of 2003 amounted to 1,1 per cent compared with 1,4 per cent in the second quarter.

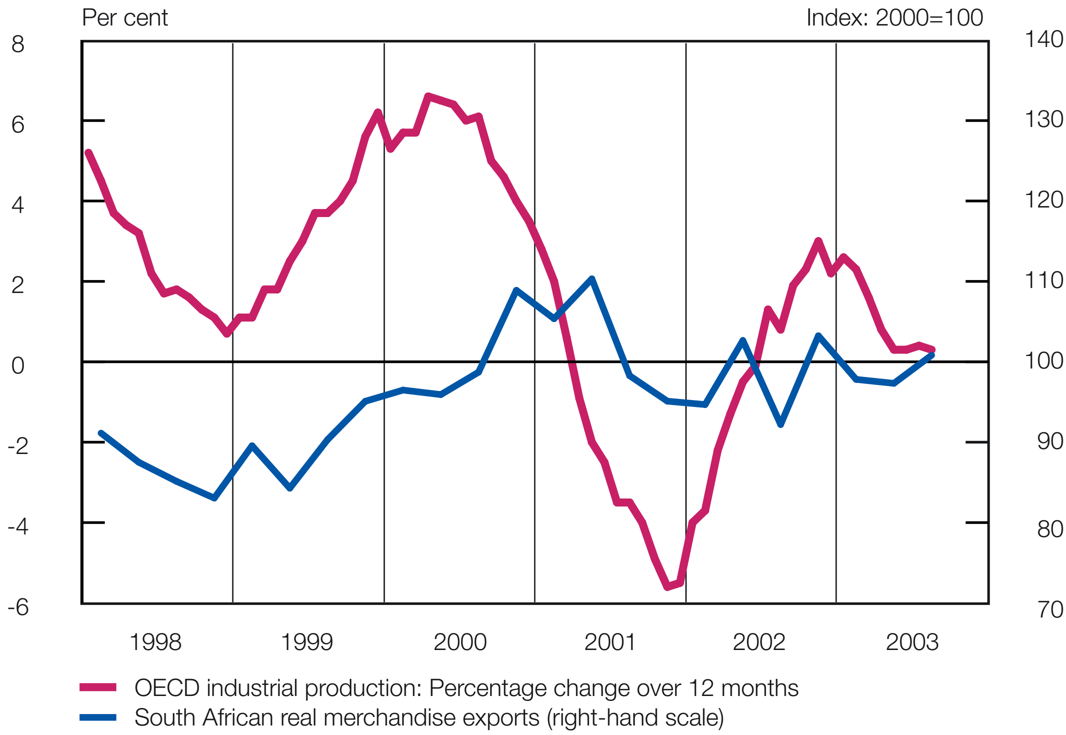
Balance of payments on current account
Seasonally adjusted and annualised
R billions

	2002			2003		
	3rd qr	4th qr	Year	1st qr	2nd qr	3rd qr
Merchandise exports	272,1	295,9	283,4	257,8	248,9	252,6
Net gold exports	46,9	40,2	42,6	35,6	33,7	34,2
Merchandise imports	-276,8	-293,0	-279,8	-261,4	-259,1	-260,5
Trade account	**42,2**	**43,1**	**46,2**	**32,0**	**23,5**	**26,3**
Net service, income and current transfer payments	-44,4	-38,8	-42,9	-38,8	-39,9	-39,7
Balance on current account	**-2,2**	**4,3**	**3,3**	**-6,8**	**-16,4**	**-13,4**

The widening of the trade surplus resulted from a better export performance together with a marginally higher value of merchandise imports. The trade surplus widened from R23,5 billion in the second quarter of 2003 to R26,3 billion in the third quarter.

Merchandise export volumes, which were previously adversely affected by a decline in demand from South Africa's major trading partners, improved moderately in the third quarter of 2003 as economic activity in Japan, the US and Asia picked up. The impact of the higher foreign demand for domestically produced goods outweighed the contractionary effect of reduced competitiveness on account of the appreciation of the rand, with the result that the volume of merchandise exports rose by 3½ per cent in the third quarter of 2003. Exports of diamonds, platinum group metals, machinery and electrical equipment and vehicles and transport equipment held up well during the quarter concerned.

OECD industrial production and South African real merchandise exports

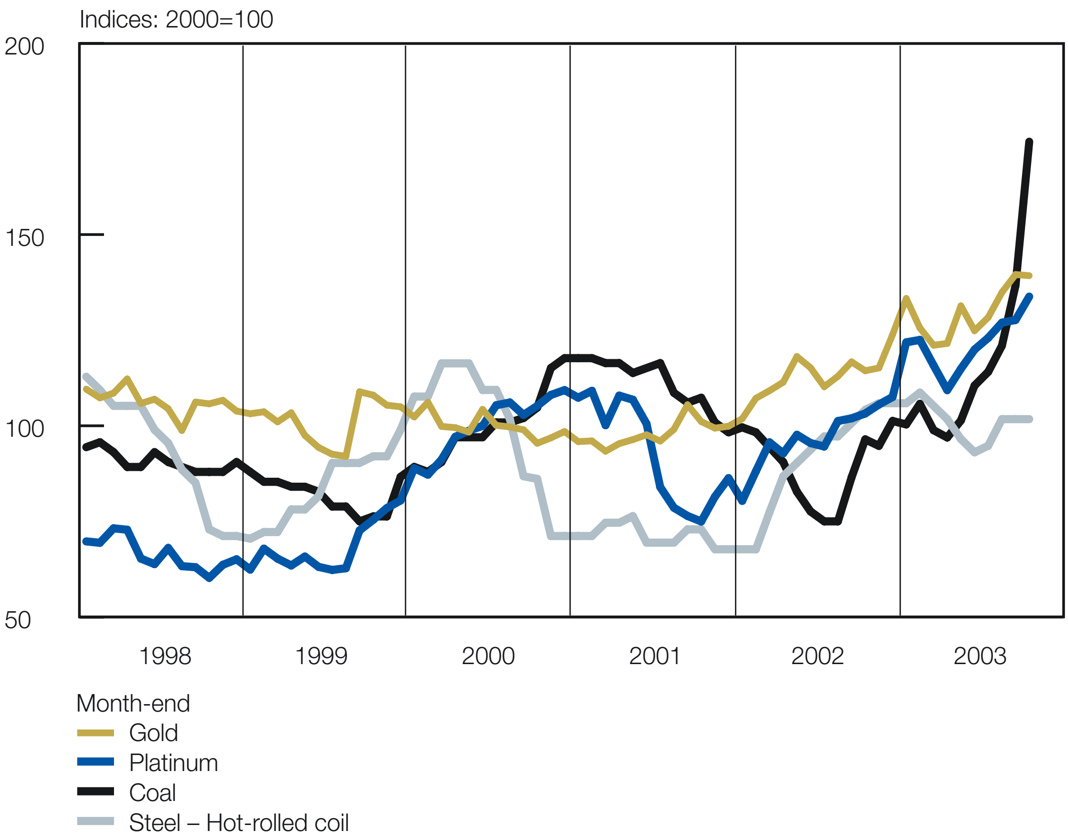


The rand prices of merchandise exports continued to decline in the third quarter of 2003, albeit at a slower pace than before. The downward trend in the realised rand prices of exported goods was a consequence of the appreciation in the exchange value of the rand, partly neutralised by rising foreign-currency prices of South Africa's main export commodities. In the third quarter of 2003 the rand prices of exported goods fell by 2 per cent following a decline of 3 per cent in the second quarter.

The joint effect of the increase in the volume of exported goods and the marginal fall in rand prices of such goods in the third quarter was an increase of 1½ per cent in the value of merchandise exports.

The value of South Africa's *net gold exports* rose by 1½ per cent in the third quarter of 2003. The physical quantity of gold exported rose by 6½ per cent in the third quarter, but this increase was partially neutralised by a decline of 5 per cent in the average realised rand price of gold exports. Mainly as a result of the appreciation of the exchange value of the rand, the average realised rand price of gold exports decreased from R2 778 per fine ounce in the second quarter of 2003 to R2 643 per fine ounce in the third quarter. Over the same period, the average fixing price of gold on the London market rose from US$347 per fine ounce to US$363 per fine ounce as the physical demand for gold increased, especially in Asia, while the US dollar's exchange rate against most other currencies also depreciated somewhat. In November the price of gold at one stage touched on US$400 per fine ounce.

Spot prices in US dollar of key South African export commodities



The overall physical quantity of *merchandise imports* increased by 6 per cent in the third quarter of 2003, partly owing to a noticeable increase in the quantity of imported oil. Apart from crude oil, the volume of other merchandise imports also rose slightly. This was spurred by fairly robust domestic final demand in the third quarter of 2003 and by a decline in the price of imported goods relative to the prices of domestically produced goods. This raised the import penetration ratio of South Africa (i.e. the ratio of real merchandise imports to real gross domestic expenditure) from 18,5 per cent in the third quarter of 2002 to 20,1 per cent in the third quarter of 2003. While imports of oil and agricultural products were brisk, that of manufactured goods weakened in the third quarter mainly due to declines in the subcategories for vehicle and transport equipment, and machinery and electrical equipment.

Declining output prices in South Africa's main trading partner countries and a further mild appreciation in the average effective exchange value of the rand from the second to the third quarter of 2003 resulted in a decline of approximately 5 per cent in the prices of imported goods in the third quarter. The net result of the increase in volume and reduction in the prices of imported goods outlined above was an increase in the value of merchandise imports of ½ a per cent in the third quarter of 2003.

Net service and transfer payments to non-residents, which had been fluctuating around the level of about R40 billion since the fourth quarter of 2002, contracted marginally to R39,7 billion in the third quarter of 2003. A reduction in investment in the South African securities markets by non-residents contributed to lower interest and dividend payments in the third quarter of 2003. This decline was, however, largely countered by a reduction in income earned by South African residents on their foreign investments, while a slight increase in payments for transportation of imported goods was also recorded.

Travel receipts, which constitute over 45 per cent of total services receipts, were fairly stable from the second to the third quarter of 2003 despite the stronger external value of the exchange rate of the rand. Travel expenditure by foreigners touring the country declined by approximately 3 per cent in the third quarter of 2003 after a steep decline of about 15½ per cent in the second quarter.

Financial account

The first three quarters of 2003 were characterised by significant swings in capital movements. During the first quarter the *financial account of the balance of payments* recorded a net capital outflow of R4,2 billion, which changed to a substantial inflow of R28,3 billion during the second quarter before receding to a net inflow of R11,5 billion in the third quarter. Cumulatively this resulted in net inflows of R35,6 billion in the first three quarters of 2003. The most important identified factor in explaining the contraction in the financial account balance during the third quarter of 2003 was the turnaround in net portfolio investment flows which changed from inflows of R22,6 billion in the second quarter to outflows of R4,6 billion in the third quarter.

Net financial transactions not related to reserves
R billions

	2002			2003		
	3rd qr	4th qr	Year	1st qr	2nd qr	3rd qr
Change in liabilities						
Direct investment	2,1	-0,7	7,9	0,2	0,6	1,8
Portfolio investment	-12,9	-1,8	5,4	-6,5	22,4	-4,3
Other investment	-3,9	-7,7	-1,1	-5,8	3,3	-4,4
Change in assets						
Direct investment	2,3	-2,2	4,2	-0,1	0,7	-1,5
Portfolio investment	-0,8	-1,2	-9,7	-0,4	0,2	-0,3
Other investment	3,2	10,3	12,0	2,4	-2,3	5,8
Total financial transactions*	**-0,2**	**0,6**	**33,5**	**-4,2**	**28,3**	**11,5**

* Including unrecorded transactions

Foreign-owned assets in South Africa

Foreign direct investment into South Africa, which has remained paltry throughout the past year, increased slightly from R0,6 billion in the second quarter to R1,8 billion in the third quarter of 2003. The inflow during the third quarter of 2003 was mainly in the form of short-term loan capital to direct investment enterprises in South Africa.

Foreign portfolio investors reduced their holdings of South African equity and fixed-interest securities in the third quarter of 2003, resulting in a net outflow of R4,3 billion. This was in direct contrast to the inflow of R22,4 billion recorded in the second quarter. The outflow in the third quarter of 2003 could probably partly be attributed to profit-taking by international investors whose investments in South African equity and debt instruments had appreciated significantly in foreign-currency terms.

Other foreign investment into South Africa turned from an inflow of R3,3 billion in the second quarter to an outflow of R4,4 billion in the third quarter of 2003. This outflow was mainly as a result of the repayment of a US$750 million loan by national government.

South African-owned assets abroad

Outward direct investment which recorded an inflow of R0,7 billion in the second quarter of 2003 turned around in the third quarter and recorded an outflow of R1,5 billion, as South African companies acquired controlling interests in offshore companies.

Portfolio investment abroad by South African investors remained subdued during the third quarter of 2003, recording an outflow of R0,3 billion, as opposed to an inflow of R0,2 billion in the second quarter of 2003.

Other investment from South Africa recorded an inflow of R2,4 billion and R5,8 billion in the first and third quarters of 2003, respectively, while recording an outflow of R2,3 billion in the second quarter. The inflow during the third quarter of 2003 was mainly as a result of the repatriation of export proceeds by South African companies.

Foreign debt

South Africa's total outstanding foreign debt increased by US$3,4 billion from US$32,7 billion at the end of December 2002 to US$36,1 billion at the end of June 2003. This increase in South Africa's foreign debt was distributed roughly equally between increases in foreign-currency denominated debt and rand-denominated debt, as shown in the accompanying table.

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

	1999	2000	2001	2002	2003*
Foreign-currency denominated debt........	23,9	24,9	24,0	25,0	26,4
Rand-denominated debt.........................	15,0	12,0	6,8	7,7	9,7
Total foreign debt	**38,9**	**36,9**	**30,8**	**32,7**	**36,1**

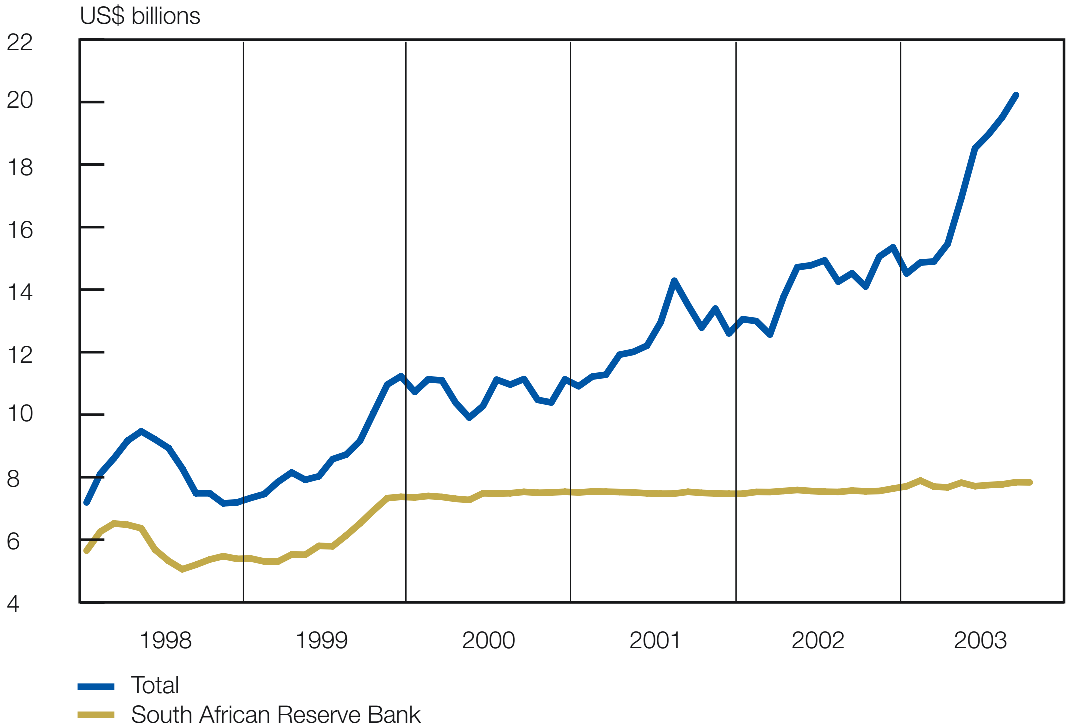
* End of June 2003

Foreign reserves

South Africa's net international reserve assets increased by R7,2 billion in the third quarter of 2003. The country's net international reserves rose by R24,2 billion from the end of December 2002 to the end of September 2003, compared with an increase of R34,7 billion in the same period of 2002.

The value of the country's gross gold and other foreign reserves increased from US$18,5 billion at the end of June 2003 to US$20,2 billion at the end of September 2003. Due to the appreciation of the exchange rate, the increase in rand terms was far less significant, increasing from R138,9 billion to R140,9 billion over the same period. The level of import cover (i.e. the value of gross international reserves expressed in relation to the value of imports of goods and services) increased from 20 weeks' worth at the end of June 2003 to 21 weeks' at the end of September.

Gross gold and other foreign reserves



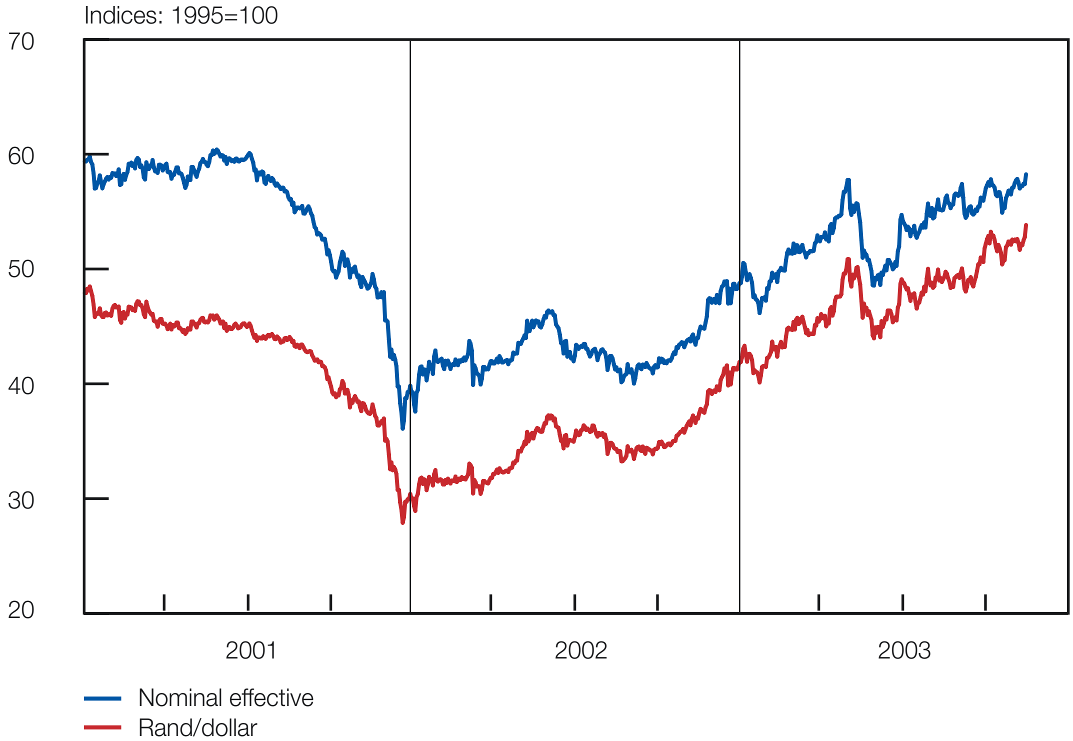
The gross gold and other foreign reserves of the Reserve Bank decreased from R57,9 billion at the end of June 2003 to R54,6 billion at the end of September, and further to R54,0 billion at the end of October. In US dollar terms the value of these reserves remained roughly unchanged at US$7,8 billion. Short-term credit facilities utilised by the Bank decreased from R22,2 billion at the end of June 2003 to R20,9 billion at the end of September. This decline continued in October, recording a level of R20,6 billion at the end of the month. However, over the same period the value of the short-term credit facilities in US dollar terms also remained roughly unchanged at US$3,0 billion.

The net open foreign-currency position of the Reserve Bank increased from an overbought value of US$1,1 billion at the end of June 2003 to US$1,8 billion at the end of September and further to US$2,7 billion at the end of October.

Exchange rates

The nominal effective exchange rate of the rand, which had increased by 7,5 per cent and 4,4 per cent, respectively, in the first and second quarter of 2003, rose further by 3,2 per cent during the third quarter of 2003. It continued to rise in October and the first three weeks of November.

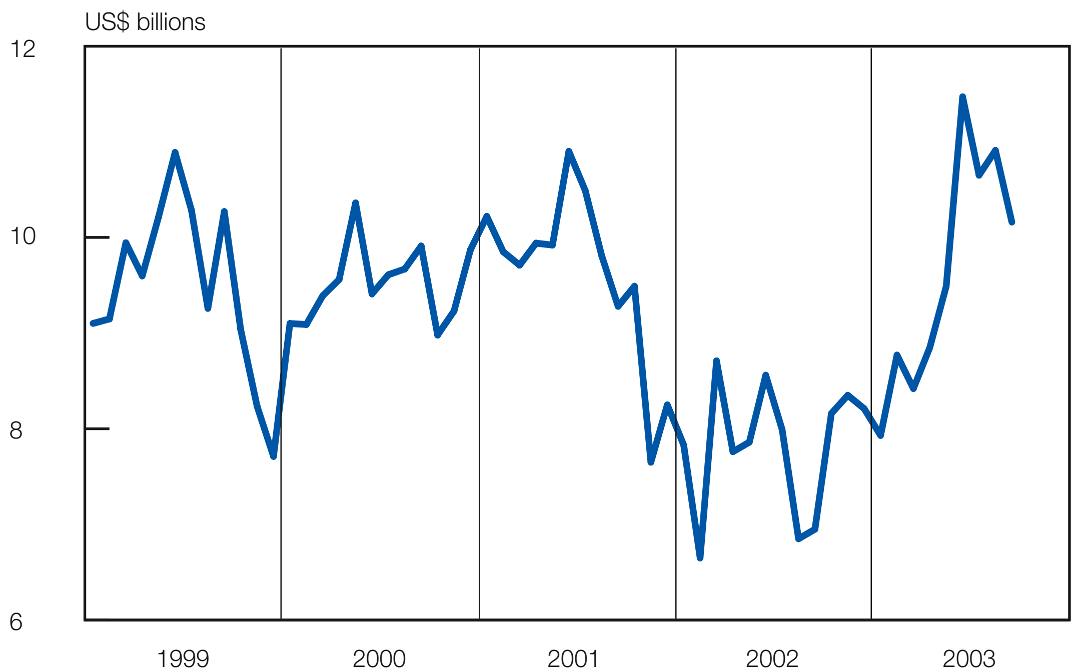
Daily exchange rates of the rand



The further appreciation of the rand from mid-2003 could be attributed to several factors, including:

- rising foreign-currency prices of South Africa's export commodities;
- the positive, although declining, interest rate differential between South Africa and its main trading partners;

Average daily net turnover in the South African foreign exchange market



- the improvement in the net positive open foreign-currency position of the Reserve Bank, which rose further; and
- continued commitment of national government and the Reserve Bank to prudent fiscal and monetary policy.

The net average daily turnover in the domestic market for foreign exchange, which had increased to US$9,9 billion in the second quarter of 2003, rose further to US$10,6 billion in the third quarter of 2003, the highest quarterly average since the second quarter of 1998. The value of transactions in which non-residents participated increased from US$6,2 billion per day to US$7,2 billion over the same period. Participation by resident parties declined from US$3,7 billion in the second quarter of 2003 to US$3,4 billion in the third quarter.

The real effective exchange rate of the rand increased by 14 per cent from December 2002 to August 2003. The average level of the real effective exchange rate of the rand was approximately 24 per cent higher in the first eight months of 2003 than in the corresponding period in 2002.

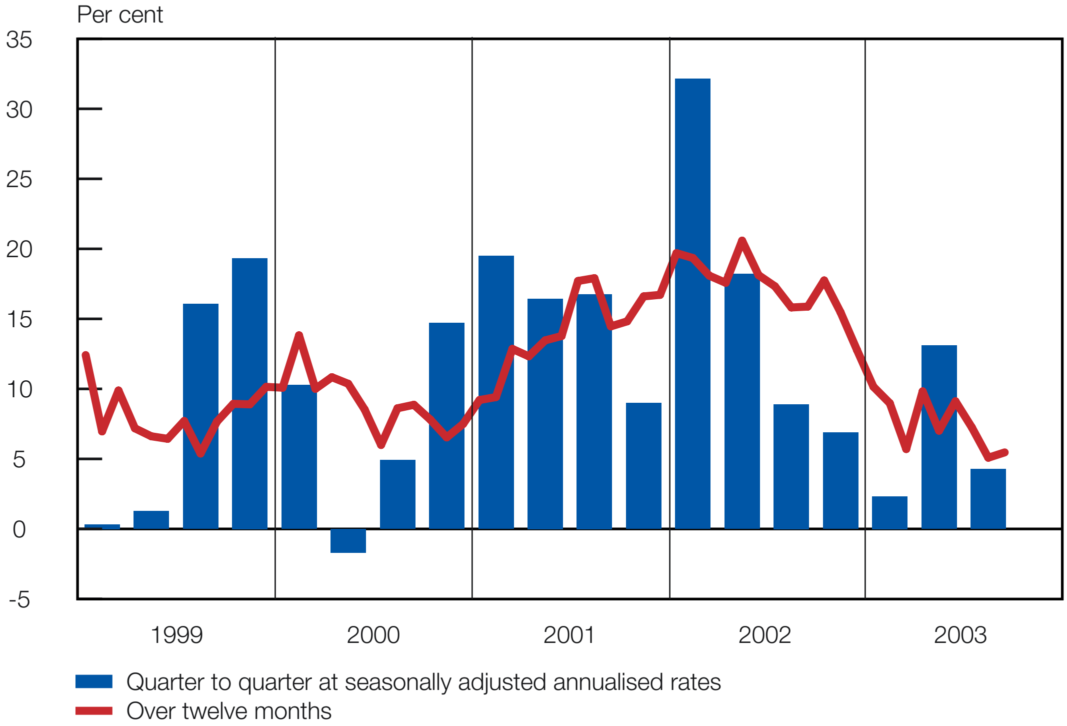
Monetary developments, interest rates and financial markets

Money supply [3]

3 Annualised growth rates referred to in this section are based on seasonally adjusted data.

The subdued growth in domestic economic activity, the low inflation environment and the significant easing of monetary policy were reflected in decelerating growth in the broadly defined money supply (M3). Annualised quarter-to-quarter growth in M3 decelerated from 13,1 per cent in the second quarter of 2003 to 4,4 per cent in the third quarter.

Growth in M3



Measured over twelve months, growth in M3 registered a ten-year low rate of 5,1 per cent in August 2003 but picked up somewhat to 5,5 per cent in September. The low growth rate in August partly arose from a high base for year-on-year growth calculations in 2002, coupled with the end-August date for the payment of interest on government bonds falling on a weekend. This resulted in these payments only being effected on 1 September 2003, at which time it lowered government deposits and raised M3. Apart from this technical factor, demand for M3 – which consists mainly of interest-bearing deposits – was reduced by the significantly lower interest rates on deposits from June 2003.

Lower interest rates on deposits of all maturities may have contributed to the pick-up in cheque and transmission deposits in the third quarter, as displayed in the table on the following page. The opportunity cost of holding low-yielding but convenient cheque deposits is reduced when interest rates in general decline.

Monetary aggregates

Quarter-to-quarter percentage change at annualised rates

Monetary aggregates	2003		
	1st qr	2nd qr	3rd qr
Coin and banknotes in circulation	12,1	7,9	16,7
Cheque and transmission deposits	-5,9	-9,6	12,5
M1A	**-0,4**	**0,8**	**12,9**
Other demand deposits	-2,8	-7,1	-11,1
M1	**-1,5**	**-3,6**	**1,3**
Other short and medium-term deposits	22,9	47,6	13,8
M2	**7,3**	**16,5**	**7,9**
Long-term deposits	-28,0	-18,5	-14,5
M3	**2,3**	**13,1**	**4,4**

During the third quarter of 2003 households' deposits rose by R5,1 billion. This was consistent with firm growth in real disposable income of the household sector, supported by above-inflation wage settlements effected during the quarter. By contrast, the bank deposits of the private corporate sector declined by R12,3 billion during the third quarter of 2003. This could have been related to the significant decline in deposit rates, leading to an increased opportunity cost of holding deposits at a time when the prices of alternative financial assets were recovering. Moreover, during the third quarter there were greater opportunities to invest in other domestic financial assets, as there was a strong increase in the issuance of corporate bonds and shares.

Annualised quarter-to-quarter growth in M3 exceeded growth in nominal gross domestic product by 2,5 percentage points in the third quarter of 2003. The income velocity of circulation of M3 accordingly receded marginally from 1,76 in the second quarter of 2003 to 1,75 in the third quarter, suggesting the availability of ample underlying liquidity.

As suggested by the statistical counterparts of change in M3 in the accompanying table, the decline in M3 during the third quarter emanated from a significant decline in *net other assets and liabilities*, whereas increases in claims on the private sector and net foreign assets counteracted this somewhat.

The decline in *net other assets and liabilities* was brought about by an increase in liabilities of the monetary sector. In turn, this was due to:
- an increase in the banks' capital and reserves;
- profits realised on the Reserve Bank's forward foreign exchange transactions which reduced the balance on the Gold and Foreign Exchange Contingency Reserve Account; and
- a significant increase in liabilities in respect of derivatives instruments as a result of revaluation changes which were aligned with interest and exchange-rate movements.

On the other hand, net foreign assets were raised by the overall surplus recorded on the balance of payments as well as by the relaxation of the endowment capital definition for South African branches of foreign banks, which came into effect on 1 May 2003, making it possible for such branches to acquire more foreign assets. Foreign liabilities also declined during the third quarter.

Counterparts of change in M3

R billions

Counterparts	2nd qr 2003		3rd qr 2003	
Net foreign assets		26,4		17,2
Net claims on the government sector		0,4		-0,7
Gross claims	16,6		1,9	
Government deposits (+decrease; -increase)	-16,2		-2,6	
Claims on the private sector		13,4		27,1
Net other assets and liabilities		-7,2		-50,9
Total change in M3		**33,0**		**-7,3**

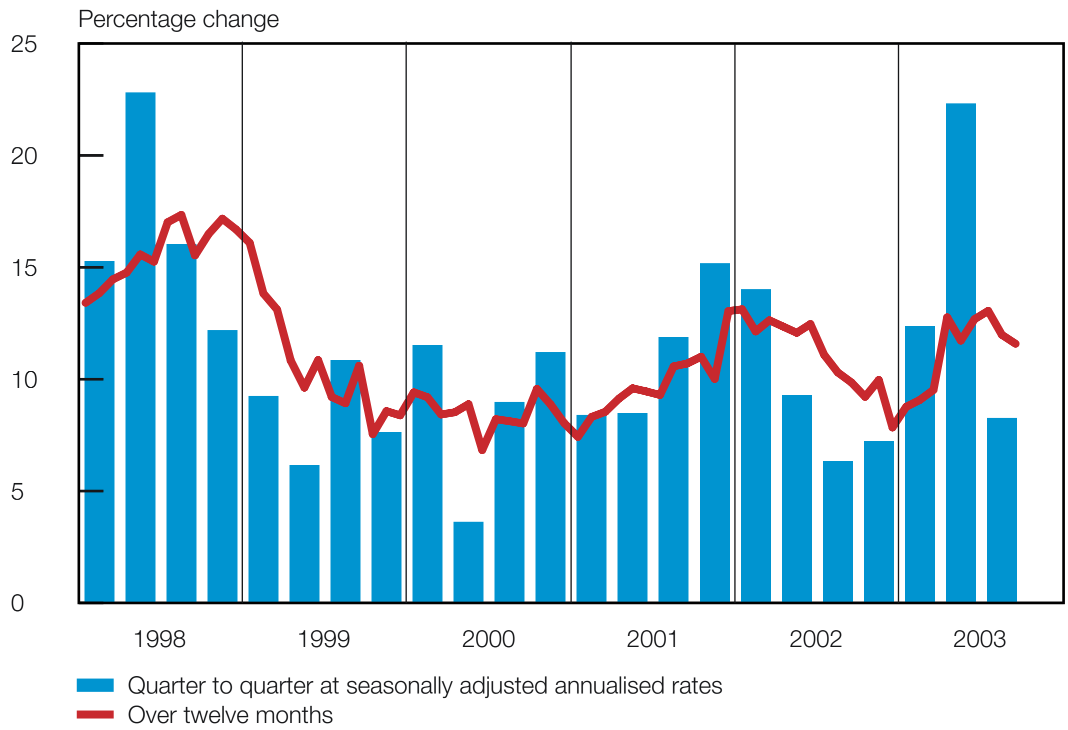
Claims on the private sector rose significantly in the third quarter as loans and advances expanded and as revaluation changes increased the value of derivatives instruments.

Credit extension

During the third quarter of 2003 demand for credit by the private sector was supported by lower interest rates, wealth effects associated with a prolonged period of strong house price increases, and growth in disposable income following above-inflation salary and wage settlements. However, the corporate private sector utilised less credit from the banking system during the third quarter. Consequently, although still growing at robust rates, growth in total loans and advances to the private sector[4] decelerated during the third quarter, registering a quarter-to-quarter annualised rate of increase of 8,3 per cent compared with 22,3 per cent in the second quarter of 2003. Its twelve-month growth rate decelerated on balance from 12,7 per cent in June to 11,6 per cent in September 2003.

4 Total loans and advances to the private sector consist of mortgage advances, instalment sale credit, leasing finance, overdrafts, credit card and general advances. The last three categories together are referred to as "other loans and advances".

Total loans and advances to private sector



With the corporate sector utilising less bank credit during the third quarter of 2003, the *other loans and advances* category declined in absolute terms by R6,5 billion, compared to an increase of R16 billion in the second quarter. In contrast to the second quarter of 2003 when the corporate sector utilised *other loans and advances* to finance, among other things, fixed capital formation and inventory accumulation, the decline during the third quarter could indicate that companies used alternative sources of finance, such as corporate bonds, commercial paper, asset-backed securities and share issues, to fund outlays. Some disintermediation is suggested by the brisk pace of such issues during the third quarter.

Nevertheless, growth in asset-backed credit extended to the private sector by the monetary sector was buoyant in recent months. Measured over twelve months, growth in such credit accelerated from 12,4 per cent in July 2003 to 14,3 per cent in September, as shown in the accompanying table.

Credit extended to the private sector by type of credit

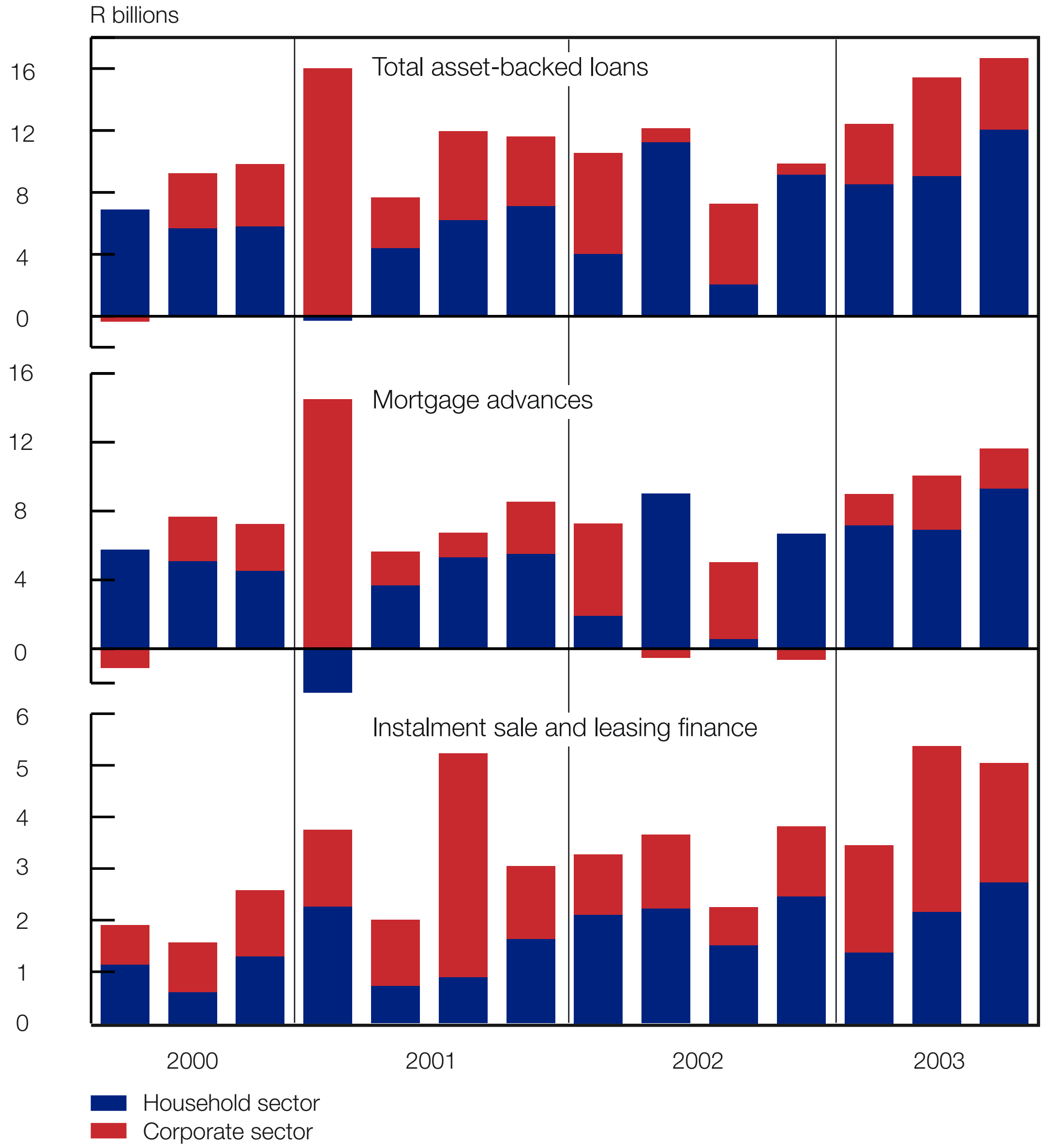
Percentage change over twelve months

Period		Asset-backed credit			Other loans and advances	Total loans and advances
		Instalment sale and leasing finance	Mortgage advances	Total asset-backed credit		
2002:	Sep............	13,0	11,7	12,1	6,8	9,8
	Oct	13,4	11,0	11,7	5,8	9,2
	Nov............	15,2	11,2	12,3	6,7	10,0
	Dec............	13,7	10,4	11,2	3,2	7,8
2003:	Jan	14,0	10,2	11,2	5,4	8,8
	Feb............	14,7	9,9	11,2	6,1	9,1
	Mar............	13,4	10,7	11,4	6,8	9,5
	Apr	14,8	11,2	12,2	13,6	12,8
	May	15,0	11,2	12,2	11,0	11,7
	Jun.	14,8	11,0	12,0	13,7	12,7
	Jul.	15,4	11,3	12,4	14,0	13,1
	Aug............	16,1	11,7	12,9	10,6	12,0
	Sep............	17,3	13,1	14,3	7,7	11,6

Mortgage advances rose by no less than R11,6 billion during the third quarter of 2003, with the household sector accounting for more than 80 per cent of the increase. It not only reflected the impact of a lower interest rate environment and increases in house prices making investment in property attractive, but also the introduction of various new mortgage finance products offered at competitive rates and improved efficiency in the processing of applications. Accordingly, twelve-month growth in mortgage advances accelerated from levels of around 11 per cent registered since March 2003 to 13,1 per cent in September.

Although the prices of durable goods remained virtually unchanged in the third quarter of 2003, year-on-year growth in *instalment sale and leasing finance* accelerated from 14,8 per cent in June 2003 to 17,3 per cent in September. This was supported by the decline in interest rates, attractive vehicle-financing packages offered by the industry and purchases by the rental car and government sectors. Accordingly, new business payouts of instalment sale credit and leasing finance increased from R19,3 billion in the second quarter of 2003 to a new high of R20,7 billion in the third quarter. A significant share of such credit was directed towards vehicle finance.

Contributions to quarterly changes in asset-backed credit



The strong growth rates in total asset-backed credit indicate favourable bank lending conditions. The low level of and continued decline in banks' non-performing loans also suggests that banks are not extending credit imprudently.

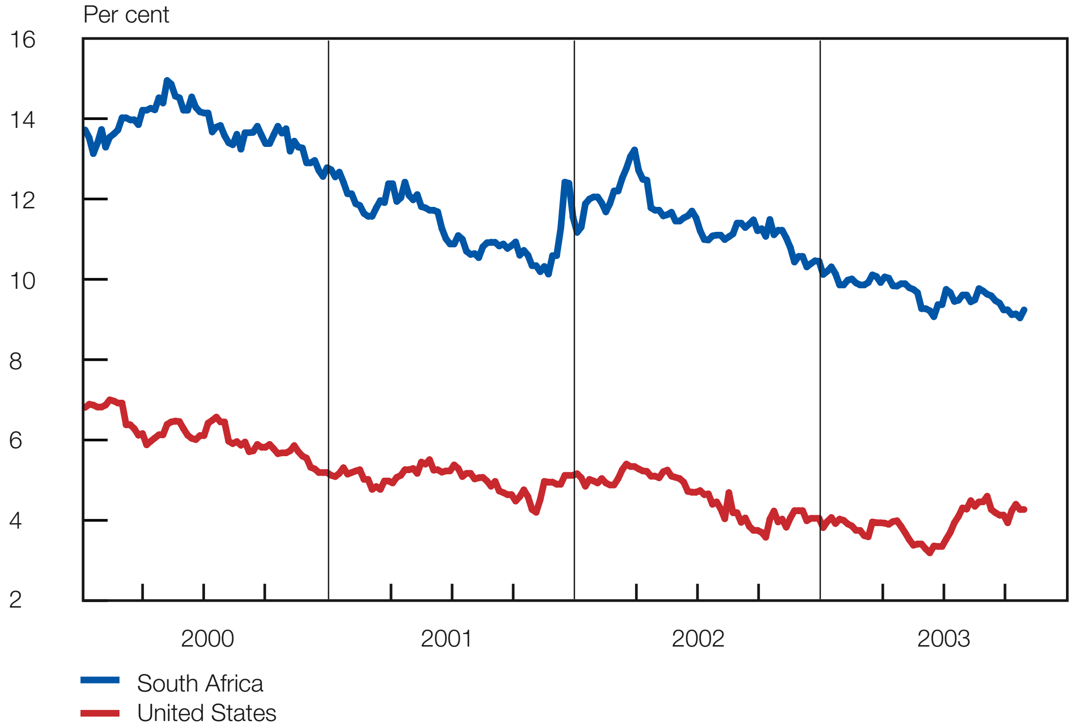
Interest rates and yields

The more accommodative monetary policy stance of the Reserve Bank from June 2003 resulted in short-term interest rates and yields moving downwards. Simultaneously long-term bond yields, which enjoyed a bull run from April 2002, levelled out within a narrow range as market participants assessed the implications of the new policy direction for longer-term economic growth and inflation.

The *monthly average yield on long-term government bonds* declined from 12,6 per cent in March 2002 to 9,3 per cent in June 2003 in response to the appreciation of the exchange value of the rand and improved near-term inflation prospects. Following the 150-basis-point reduction in the repurchase rate in June, the monthly average yield on long-term government bonds increased moderately to 9,6 per cent in July. It remained at this level until September, despite further declines in the repurchase rate in August and September. Bond yields became sensitive to, among other things:

- national government's increased recourse in fiscal 2003/04 to funding in the domestic bond market, after two years of net redemptions;
- a sharp increase in the issuance of corporate bonds from the second half of 2003;
- net sales of bonds by non-residents from July to October; and
- the spill-over effect of higher bond yields in developed markets as market participants responded to signs of improving global growth.

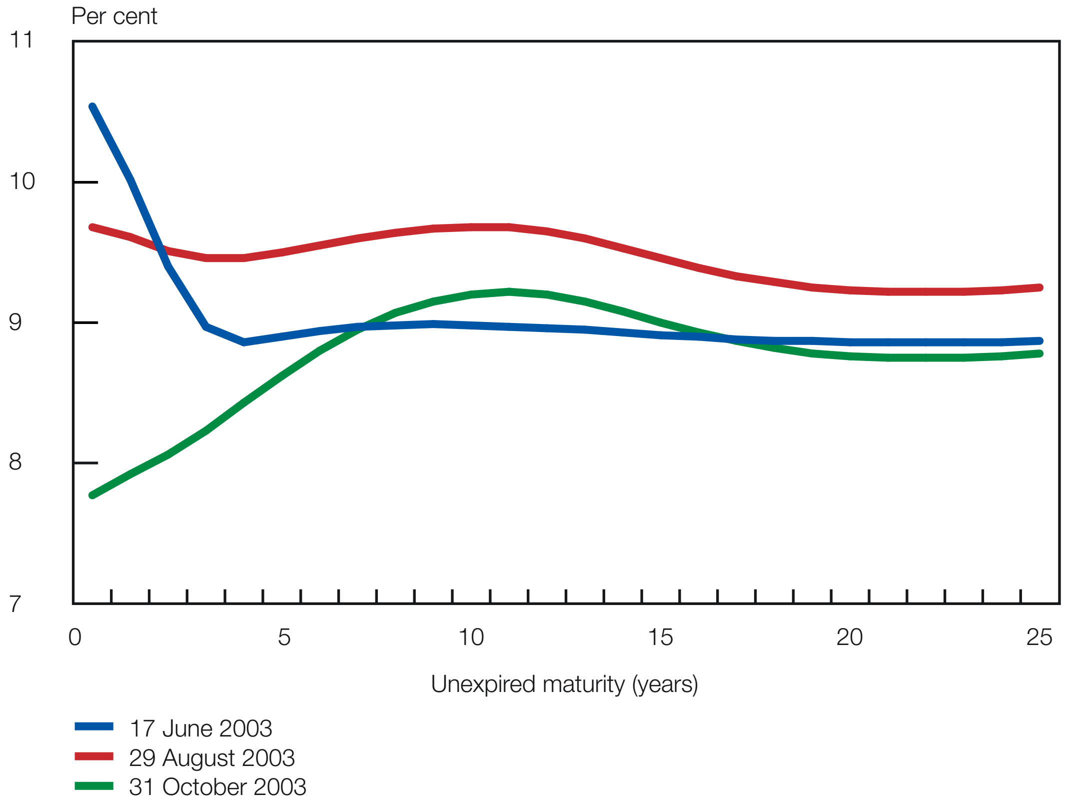
Yields on long-term government bonds



In the wake of the 250-basis-point reduction in the repurchase rate from early June to August 2003, the *daily average yield* on long-term government bonds fluctuated upwards from 9,07 per cent on 17 June 2003 to 9,82 per cent on 4 September. The daily average bond yield then drifted lower to a new recent low of 8,99 per cent on 24 October as a result of improved inflation expectations following the release of a negative value for September 2003 production price inflation, the sustained appreciation in the exchange value of the rand and renewed reductions in the repurchase rate on 11 September and 17 October, together amounting to a further 250 basis points. The daily average bond yield increased moderately to 9,06 per cent on 31 October 2003. The monthly average bond yield nonetheless reached a new 24-year low of 9,1 per cent in October 2003.

The *yield curve* changed from downward sloping in June 2003 to upward sloping in October following the change in the monetary policy stance. The slope of the yield curve initially remained inverted as the curve shifted downwards across the full maturity spectrum, following the reduction in the repurchase rate on 13 June. Subsequent to the further reduction in the repurchase rate on 15 August, the yield curve flattened out as short-term yields declined further, while longer-term yields increased moderately. In response to the reductions in the repurchase rate on 11 September and 17 October the level of the yield curve again moved downwards – more at the short end than at the long end – as bond yields across the maturity spectrum declined to levels last experienced in the 1980s. Short-term bond yields followed the repurchase rate downwards while long-term bond yields declined somewhat on account of lower inflation prospects in the wake of the sustained strength of the rand and demand for fixed-interest securities.

Yield curves



The *yield gap*, i.e. the difference between bond yields at the extreme long and short ends of the yield curve, changed from a negative value of 167 basis points on 17 June 2003 to a positive value of 101 basis points on 31 October.

Following the first and second of the current series of reductions in the repurchase rate, the *break-even inflation rate*, calculated as the difference between the nominal yield on conventional bonds and the real yield on inflation-linked bonds within the six-to-ten-year maturity range, increased by 73 basis points from 26 June 2003 to 4 September. Yields on conventional bonds rose as overbought bond markets in other parts of the world started adjusting and as Statistics South Africa released higher-than-expected inflation data. The subsequent resilience of the exchange value of the rand and the release of a substantially lower production price inflation figure at the end of August resulted in the break-even inflation rate resuming its downward trend from 4 September 2003, despite further monetary easing in September and October. According to this indicator expected long-term inflation is seen to have decreased, on balance, by 316 basis points from 7 October 2002 to 31 October 2003. It currently indicates inflation expectations that are consistent with the Reserve Bank's inflation target range of 3 to 6 per cent.

The deceleration in CPIX inflation during the first nine months of 2003 benefited the real returns on fixed-interest securities. The *real* or *inflation-adjusted yield on long-term government bonds* (using historical year-on-year increases in CPIX as an indicator of expected price changes) improved from a negative value of 0,4 per cent in November 2002 – the first negative real return since January 1994 – to positive values from January 2003. It reached 4,5 per cent in October as the deceleration in CPIX inflation exceeded the decline in nominal bond yields.

Against the background of the relatively accommodative monetary policy stance, improving inflationary conditions and the sustained recovery of the rand, the *currency risk premium* on South African government bonds narrowed significantly towards the shorter end of the maturity spectrum. This was reflected in a decline of 212 basis points from May 2003 to September in the differential between nominal yields on South African government bonds in the one-to-three-year maturity range issued in the domestic market and those issued in the United States market. The decline also followed in the wake of the upgrade on 29 August of South Africa's foreign currency long-term rating, to BBB+ with a stable outlook, by the Rating and Investment Information (R&I) rating agency of Japan – the seventh rating agency upgrade in twenty-one months. The yield differential narrowed by a further 57 basis points in October as the rand remained strong despite a further lowering of the repurchase rate.

The private banks reduced both their *prime overdraft rate* and *predominant rate on mortgage loans* in four steps from 17,0 per cent in May 2003 to 12,0 per cent in October 2003, congruent with the reduction of 500 basis points in the repurchase rate during the period. This brought the banks' prime overdraft rate to its lowest level since 1986.

In anticipation of monetary policy easing banks reduced the *predominant rate on twelve-month fixed deposits* from 12 per cent in April 2003 to 11 per cent in May, followed by five further reductions to 6,75 per cent in October. The total reduction of 525 basis points was larger than the reduction in the prime overdraft rate.

The *official rate of interest* applicable to fringe benefit taxation, as defined by the Income Tax Act, was reduced from 13 per cent to 12 per cent, effective from 1 September 2003. On 21 November 2003 the *maximum annual finance charge rates* on money loans and credit and leasing transactions, as laid down by the Usury Act, were lowered by two percentage points to 22 per cent for amounts less than R10 000 and to 19 per cent for amounts above R10 000, but not exceeding R500 000. The decrease follows a 300-basis-point reduction in October, and brings the total reduction thus far in 2003 to 700 basis points.

With several key data releases, market expectations and the Reserve Bank's inflation forecasts all pointing to a favourable outlook for inflation, the MPC started to reduce the repurchase rate in June 2003. A 150-basis-point reduction on 12 June 2003 was followed by a further 100 basis points on 14 August. On 5 September 2003, the Bank announced that it would hold an extra MPC meeting on 10 September; on the latter date, the MPC decided on a further 100-basis-point cut in the repurchase rate. Finally, on 16 October the MPC reduced the repurchase rate by a further 150 basis points. Within a matter of four months the repurchase rate was lowered by 500 basis points, bringing this rate to 8,50 per cent on 17 October – a level of the Bank's key refinancing rate last seen in 1981.

The current downward phase in the Bank's official repurchase rate which started on 13 June 2003 has more than reversed the 400-basis-point tightening incurred during the first nine months of 2002. Being accompanied by a rapid unwinding of inflation, the reductions in the repurchase rate nevertheless did not signal an imprudent monetary policy and, in fact, at all stages remained consistent with the attainment of the 3 to 6 per cent inflation target.

Money-market interest rates responded to the successive reductions and anticipated decreases in the repurchase rate. As can be seen from the movement in the forward rate agreement (FRA) curve from 4 to 11 September as depicted in the accompanying graph, the announcement on 5 September that a special MPC meeting was to be held was unexpected and market participants immediately started discounting a reduction in the repurchase rate.

The movement at the short end of the FRA curve between 4 and 9 September 2003 indicated expectations of a 100 basis points cut in the repurchase rate – which in fact materialised. The September rate reduction steered other money-market interest rates that are closely anchored to the repurchase rate to levels convincingly below 10 per cent – levels last seen during late 2001.

Events leading to the scheduled October meeting prompted expectations of another rate cut by market participants. This was probably fuelled by releases of economic indicators which pointed to a favourable inflation outlook. A poll of market participants suggested expectations of a 100-basis-point reduction, while the spread between the rate on 1x4-month FRAs and the three-month Johannesburg interbank agreed rate (Jibar) was around 107 basis points.

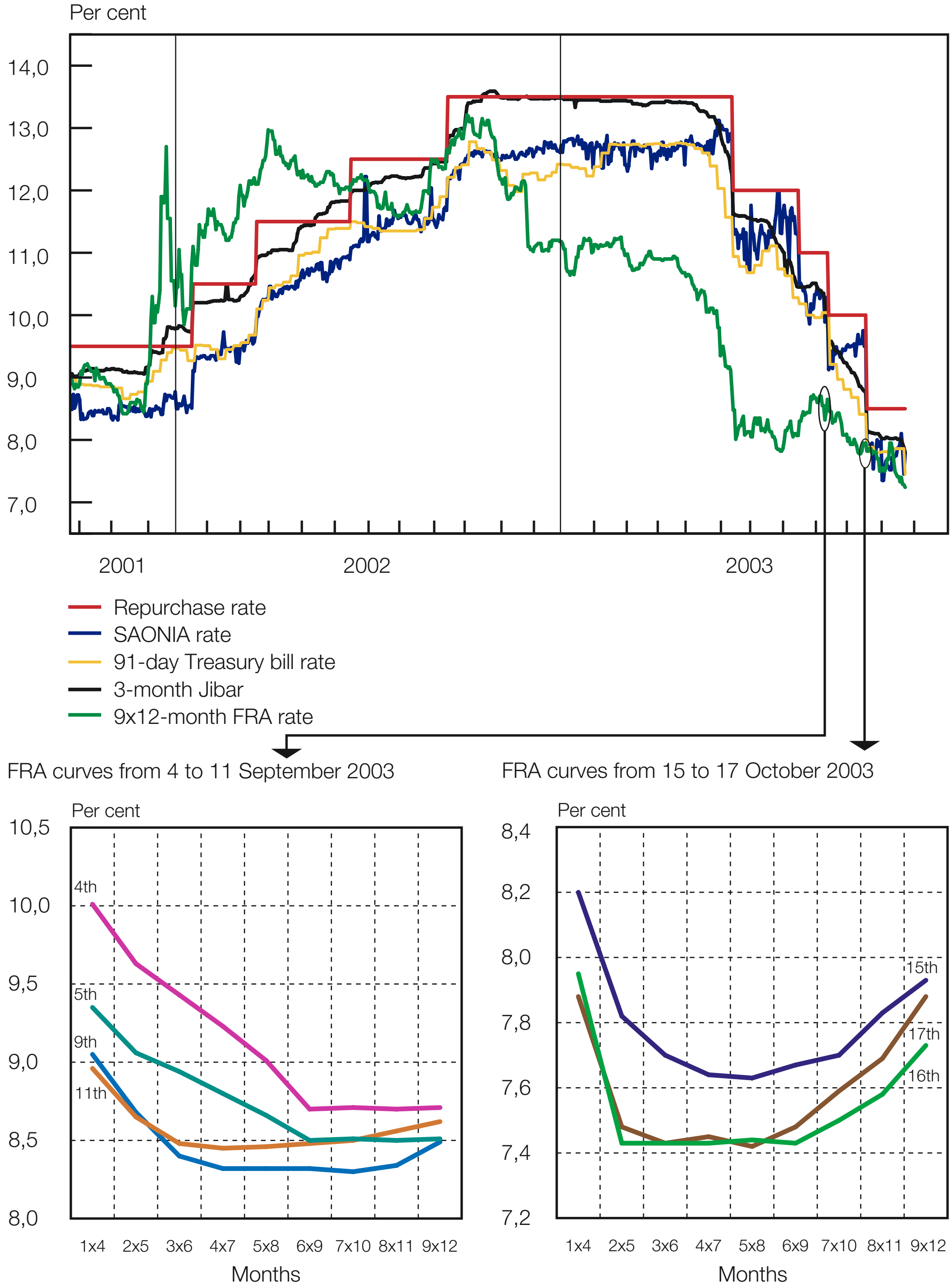
On 15 and 16 October the committee met and decided on a 150-basis-point cut in the repurchase rate – larger than the market had expected, but reconcilable with inflation falling within the inflation target range for 2004 and 2005. (The full MPC statement which followed this meeting is reproduced elsewhere in this *Quarterly Bulletin.)* Money-market interest rates generally fell back further in response to the higher-than-expected reduction in the repurchase rate.

The South African Overnight Interbank Average (SAONIA) rate broadly followed movements in the repurchase rate and declined by a total of 267 basis points from 10,51 per cent on 15 August to 7,85 per cent on 17 October 2003. It stood at 7,98 per cent on 25 November.

Along with further cuts in the repurchase rate in September 2003 and October, the three-month Jibar declined and shed a total of 189 basis points from 9,96 per cent on 1 August 2003 to 8,07 per cent on 17 October. The rate amounted to 7,69 per cent on 25 November.

The downward trend in the repurchase rate was also mirrored in the declining trend displayed by the rate on 91-day Treasury bills, shrugging off the impact of the increased amounts of such bills on offer. (The weekly amounts were raised from R1,25 billion to R1,50 billion from 3 October 2003.) This rate shed a total of 230 basis points from 10,18 per cent on 15 August to 7,88 per cent on 17 October, and subsequently declined to 7,45 per cent on 21 November 2003.

Money-market interest rates



Money market

Money-market liquidity conditions tightened somewhat during the three months to October 2003. This was indicated by the increase in the average daily liquidity requirement of banks which, on balance, rose from R10,3 billion in July to R11,4 billion in September and further to R13,0 billion in October. The amount of liquidity provided at the weekly main refinancing auction was raised from R11,1 billion to R13,0 billion from the last auction in September, following the disqualification of a further 25 per cent of banks' vault cash as statutory cash reserves. Several factors drained excessive liquidity from the market during this period, the most important ones being:

- profits realised on forward foreign exchange transactions which rose as high as R2,3 billion in September alone, following the continued recovery in the exchange rate of the rand;

- coupon interest received on 1 September on government bonds held in the Bank's monetary policy portfolio;

- the rand equivalent amount of foreign currency drawn from the Bank's reserves when government redeemed a €273 million eurobond loan in October, together with other foreign exchange transactions concluded with government;

- the effective increase in banks' required cash reserve deposits with the Bank arising from the less lenient vault cash dispensation, as mentioned above; and

- an increase in the level of notes and coin in circulation outside the Bank.

In total, these factors drained R14,0 billion worth of rand liquidity during the three months to the end of October 2003. In turn, it allowed the Reserve Bank to unwind a substantial amount of its own liquidity-draining instruments. The total amount of liquidity drained from the money market through the use of these instruments declined to R19,2 billion at the end of October 2003 as reflected in the accompanying table.

The most significant change was the unwinding of foreign-currency swaps with deposits entered into with private-sector parties; the outstanding amount of these transactions declined by R14,0 billion from R17,6 billion at the end of July to R3,6 billion at the end of October. The composition and outstanding amounts of the Bank's major money-market intervention instruments are provided in the table below.

Outstanding balances of selected money-market intervention instruments
R billions

End of		Foreign-currency swaps with deposits	Reserve Bank debentures			Reverse repurchase agreements			Total instruments outstanding
			Total	28 days	91 days	Total	28 days	91 days	
2002:	Oct	51,6	7,5	4,2	3,3	8,0	7,1	0,9	67,1
	Nov	49,6	7,5	5,6	1,9	8,6	6,8	1,7	65,7
	Dec	45,3	7,7	4,7	3,0	7,6	5,1	2,5	63,6
2003:	Jan	45,3	7,6	3,9	3,7	10,5	6,4	4,1	63,3
	Feb	42,9	8,0	3,4	4,6	10,0	6,4	3,6	60,9
	Mar	34,9	7,9	4,7	3,2	10,3	5,8	4,5	53,1
	Apr	30,1	8,0	4,4	3,6	10,3	6,3	4,0	48,3
	May	27,3	8,0	5,2	2,8	10,3	7,0	3,3	45,5
	Jun	20,6	8,0	5,0	3,0	9,0	5,0	4,0	37,8
	Jul	17,6	8,0	2,4	5,6	10,3	0,5	9,8	35,9
	Aug	15,3	8,0	2,8	5,2	10,3	0,6	9,7	33,6
	Sep	11,0	7,8	2,6	5,1	9,7	2,1	7,6	28,5
	Oct	3,6	7,0	3,0	4,0	8,6	2,9	5,7	19,2

As stated in the *Budget Review 2003*, government issued zero-coupon bonds with a face value of R7,0 billion to the Bank in September 2003, as part compensation for the accumulated deficit on the Gold and Foreign Exchange Contingency Reserve Account. During October these zero-coupon bonds were converted to R194 fixed interest-bearing bonds to the same value. As agreed with National Treasury, the Bank, in an attempt to restructure government securities in its *monetary policy portfolio,* conducted a *cash-neutral* switch auction with the primary dealers in government bonds on 22 October 2003 where R2 billion worth of R194 bonds were on offer to be switched for R150 bonds. The switch was undertaken to shorten the average maturity of government securities in the Reserve Bank's portfolio, which could further enhance liquidity management. It would also create the possibility of permanently draining liquidity from the market once the R150 bonds mature in their various tranches. Interest in the switch auction was substantial and 24 bids worth R8,925 billion were received. However, because the Reserve Bank reserves the right to allot as it deems appropriate and refrains from entering into transactions at unfavourable prices, this auction was under-allotted – only R1,15 billion worth of R194 bonds were allotted, corresponding to only three bids. Since the switch auction was conducted on a *cash-neutral basis*, the value of government bonds in the Bank's portfolio remained unchanged and only the composition of the portfolio changed. On 29 October a further auction was held in which the full R2 billion worth of R194 bonds on offer was successfully switched.

Bond market

Public-sector borrowers' demand for loanable funds in the *domestic primary bond market* increased significantly during the first half of fiscal 2003/04, supported by national government directing its funding strategy more towards the domestic market. The net issuance of public-sector fixed-interest securities increased to R30,3 billion in the first half of the current fiscal year. This compares to net issues of R6,9 billion in the first half of 2002/03 and net *redemptions* of R9,7 billion for the whole of fiscal 2002/03. Public-sector borrowers redeemed fixed-interest securities to the net amount of R4,1 billion in the first quarter of 2003, but then issued new debt to the net amount of R14,4 billion in the second quarter. Further issues to the value of R15,9 billion followed in the third quarter. Included in this amount was an extraordinary issue of R7 billion in zero-coupon bonds made to the Reserve Bank in September 2003 to defray part of the realised losses previously accumulated on the Gold and Foreign Exchange Contingency Reserve Account.

National government opened and completed its offshore borrowing programme for fiscal 2003/04 in May 2003 when an amount of R10,6 billion was raised in the *international bond market* through the issuance of a ten-year €1,25 billion global bond. Foreign debt was, however, reduced by R8,7 billion in July 2003 with the partial redemption of a dual-currency loan, and by a further R2,1 billion in October 2003 when a Deutsche Mark bond, issued in 1996, matured.

Following rather subdued market conditions in the first half of 2003, the issuance of fixed-interest securities in the *primary corporate bond market* increased markedly from August 2003 as private-sector companies took advantage of keen investor demand for fixed-income debt instruments. The outstanding nominal value of private-sector loan stock listed on the Bond Exchange of South Africa increased from R38,9 billion in December 2002 to R54,4 billion in October 2003, i.e. by some 40 per cent. Of the R15,5 billion raised in the first ten months of 2003, R7,3 billion was raised in the third quarter while another R5 billion was raised in October. The financing needs of the private sector were furthermore supplemented by the issuance of short-term commercial paper. The outstanding nominal value of listed commercial paper grew tenfold from an initial listing of R364 million in December 2002 to R3,7 billion in June 2003, and subsequently doubled again to R7,8 billion in October 2003.

Contrasted to the heightened domestic demand for rand-denominated debt, interest in rand-denominated bonds in the international bond market remained subdued. The scheduled redemptions of rand-denominated bonds issued by non-residents in the *European bond markets* exceeded new issues by R1,6 billion during the first ten months of 2003, surpassing the net redemptions of R1,4 billion for the whole of 2002. In addition, South African borrowers abstained from the eurorand market during the first ten months of 2003; their last recorded transaction was in June 2002 when liabilities to the net amount of R150 million were repaid.

Turnover in the *domestic secondary bond market* improved markedly from April 2003, aided by national government's return to domestic funding activities, as well as investors adjusting their bond portfolios in reaction to the easing of monetary conditions. The quarterly value of bonds traded increased from R2,6 trillion in the first quarter of 2003 to R3,4 trillion in the third quarter – the highest quarterly value since the last quarter of 2001. The value of bonds traded amounted to R1,1 trillion in October. Turnover on the Bond Exchange of South Africa of R10,2 trillion in the first ten months of 2003 was, however, still 5 per cent less than in the corresponding period of 2002.

Non-resident interest in South African debt securities deteriorated markedly in the third quarter of 2003 as investors throughout the world reassessed their investment portfolios amid growing confidence in the global economic recovery and improving international share markets. Non-residents reduced their holdings of South African debt securities by R6,2 billion in the third quarter of 2003 after they had purchased bonds to the net value of R2,7 billion in the first half of the year. Further net sales of R0,1 billion followed in October. From the beginning of 2003 to the end of October, non-residents' net cumulative sales in the secondary bond market amounted to R3,6 billion.

Share market

Fluctuations in domestic and international share prices impacted on the amount of funding sought in the domestic and international *primary share markets* by companies listed on the JSE Securities Exchange SA (JSE). The total value of equity capital raised amounted to only R16,6 billion in the first ten months of 2003, well down from the R50,9 billion raised in the corresponding period of 2002. The quarterly value of capital raised declined sharply from R28,1 billion in the third quarter of 2002 to only R2,2 billion in the second quarter of 2003, before increasing to R5,2 billion in the third quarter. Equity financing in the primary share market declined slightly to R1,3 billion in October, compared to a monthly average of R1,7 billion in the third quarter.

In an attempt to promote the equity financing of small and medium-sized companies, the first alternative exchange in Africa, named Alt^x, was launched by the JSE on 27 October 2003. Alt^x specifically targets black empowerment and junior mining companies. No companies have thus far been approved to list on the new market, which runs parallel to the Main Board, but with separate listing requirements and reduced fees. Companies with a minimum share capital of R2 million can apply for a listing; a profit history is not required. These companies will be supported by the JSE through public forums and directors' education courses subsidised by the Department of Trade and Industry.

Turnover in the *secondary share market* improved by 42 per cent from an 18-month low of R47 billion in April 2003 to R66 billion in October 2003, along with the 21 per cent increase in the all-share price index over the same period. The R621 billion worth of shares traded on the JSE in the first ten months of 2003 was, however, still 11 per cent less than in the corresponding period of 2002. Market liquidity, measured by annualised turnover as a percentage of market capitalisation, continued to rise from 47 per cent in the first ten months of 2002 to 51 per cent over the same period in 2003. The market capitalisation of the JSE, which decreased by 32 per cent from May 2002 to April 2003, recovered by 28 per cent to reach R1 666 billion in October.

Non-resident trading activity on the JSE fluctuated noticeably during the first ten months of 2003. Non-resident portfolio investment flows changed from net purchases to the value of R0,6 billion in the first half of 2003 to net sales of R1,9 billion in the third quarter. The South African share market became somewhat more appealing to foreign investors in September and October 2003, evidenced by net purchases worth R0,4 and R0,1 billion in these two months. Non-resident participation in the share market, measured by their purchases and sales as a percentage of the total value of shares traded on the JSE, moderated from 26 per cent in 2002 to 22 per cent in the first ten months of 2003. From the beginning of 2003 to October, non-residents' net cumulative sales in the secondary share market amounted to R1,2 billion.

The continued improvement of international share markets, together with a lower domestic interest rate environment, contributed to the recovery in the domestic share market from a nineteen-month low in April 2003. These factors tended to lessen the impact of the sustained recovery in the exchange rate of the rand on the

Share price indices

Source: JSE Securities Exchange SA

profitability and revenue growth of dual-listed and export-oriented companies. The *monthly average price level of all classes of shares* listed on the JSE recovered by 21 per cent in rand terms from the low in April 2003 to October, and by 33 per cent in dollar terms. Over the same period the S&P 500 composite index in the United States increased by 17 per cent, although it already showed signs of recovery from March 2003.

The *daily closing level of the all-share price index* fell by 37 per cent from a record high on 22 May 2002 to its lowest level in nineteen months on 25 April 2003, before posting a gain of 33 per cent to 31 October. By contrast, the daily closing level of the price index for medium-sized companies (mid-cap index) declined by only 7 per cent from May 2002 to April 2003, before increasing by 32 per cent to 31 October. The mid-cap companies mostly rely on earnings inside South Africa.

The monthly average price level of *industrial shares* increased by 28 per cent from April 2003 to October, and the monthly average price level of the *resources sector* increased by 21 per cent over the same period, as demand for raw materials benefited from improving international economic activity. The monthly average *gold-mining share price index,* a subcomponent of the resources sector, increased by 22 per cent from April 2003 to October. This increase followed in the wake of an increase, on balance, of 5 per cent in the rand price of gold over the period, notwithstanding the exchange value of the rand appreciating by 10 per cent against the dollar.

Despite the prospect of increased credit extension and fewer bad debts, supported by lower interest rates from June 2003, the prices of *financial shares* decreased by 3,6 per cent from July 2003 to September. However, the monthly average price level of shares in the financial sector increased by 3,8 per cent in October following the latest reduction in the repurchase rate. Demand for financial shares may have been influenced by the anticipation and subsequent release of the Financial Sector Charter on 17 October 2003, which is touched on in the accompanying box. Although the charter was well received by the market, the daily closing level of the *banking index* declined by 3,5 per cent from 17 October to the end of October.

The *dividend yield* on all classes of shares increased from 3,0 per cent in May 2002 to 4,6 per cent in April 2003 – its highest level since 1990 – before receding to 3,5 per cent in October. Mirroring the share price movements, the *earnings yield* on all classes of shares increased from 7,3 per cent in May 2002 to 10,3 per cent in April 2003, before receding to 8,4 per cent in October. Conversely, the *price-earnings ratio* of all classes of shares increased to 11,9 in October 2003 from 9,7 in April 2003 – its lowest level since September 2001.

Market for derivatives

Steadily rising prices in the underlying securities markets led to lively trading activity in the derivatives market. The quarterly number of *futures and options on futures contracts* traded on the Financial Derivatives Division of the JSE increased from 6,4 million in the first quarter of 2003 to 7,9 million in the second quarter and 8,5 million in the third quarter. In October trading activity remained strong with 2,4 million contracts being traded, representing a quarterly equivalent of 7,2 million contracts. In total 25,3 million contracts were traded in the first ten months of 2003, representing an increase of 2 per cent when compared with the same period in 2002. Both individual equity and index-related contracts experienced heightened trading activity over the period.

Financial Sector Charter

The Financial Sector Charter, released on 17 October 2003, constitutes a framework establishing the principles upon which Black Economic Empowerment (BEE) will be implemented in the financial sector. It was voluntarily developed by key stakeholders in the financial sector and outlines processes for implementing the charter and mechanisms to monitor and report on progress. The charter sets out targets which will be pursued from January 2004 to December 2014.

The focus of the charter includes, among others:
- Investment in *human resource development* aimed at reaching a minimum of 20 to 25 per cent black people at senior management level by 2008, of which 4 per cent should be black women.
- A *procurement policy* which targets 50 per cent of all procurement from BEE accredited companies by 2008 and 70 per cent by 2014.
- A commitment to BEE *enterprise development*.
- Improved delivery and *access to financial services*, such as bank savings products and life assurance industry products, to a greater segment of the low-income population.
- The mobilisation of resources for *empowerment financing*.
- A minimum of 25 per cent black *ownership*, of which 10 per cent by way of direct ownership measured at holding company level, by 2010.
- *Control* in the financial sector is targeted at 33 per cent black people, of which 11 per cent should be black women, on the board of directors by 2008.
- The encouragement of *shareholder activism* in promoting the objectives of the charter.
- The directing of 0,5 per cent per annum of after-tax operating profits to *corporate social investment* aimed at education, training and job creation.

Each financial institution will report annually to the Charter Council on its progress in implementing the provisions of the charter and publish for general information an annual BEE progress report, which will include an audited scorecard measured against the targets set out in the charter.

Trade in *warrants* fell back significantly from the high levels recorded in 2001 and 2002 as investors' appetite for this instrument became saturated while the range of warrants on offer was also narrowed considerably. The number of warrants traded on the JSE more than halved from 3,2 billion contracts in the fourth quarter of 2002 to 1,2 billion contracts in the third quarter of 2003. A total of 4,8 billion warrant contracts were traded in the first ten months of 2003, substantially lower than the 17,7 billion traded in the corresponding period of 2002. The number of warrants listed on the JSE has subsequently fallen from a peak of 662 in February 2002 to only 273 in October 2003.

The prices of agricultural products, which generally declined in the wake of the sustained appreciation in the exchange value of the rand, continued to stimulate lively trading in commodity derivative instruments on the Agricultural Products Division of the JSE. Although trading in *commodity futures contracts and options* on such contracts declined from a record turnover of 652 000 contracts in the first quarter of 2003 to 499 000 contracts in the third quarter, the volume of trade from January 2003 up to October of 2 million contracts already surpassed the number of contracts traded during the whole of 2002.

Real-estate market

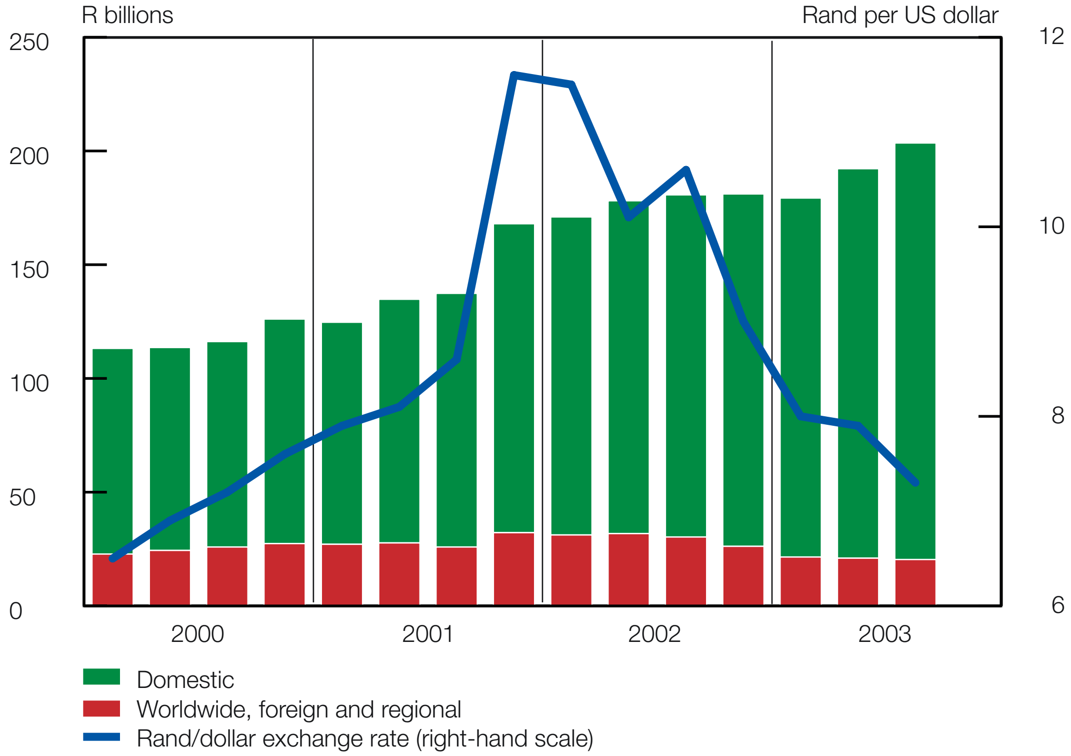
The lowering of the cost of mortgage finance from June 2003 buoyed trading activity and pricing behaviour in the *real-estate market* in the first nine months of 2003. The overall seasonally adjusted value of turnover in the real-estate market, measured by *transfer duty paid*, increased by 25 per cent in the first nine months of 2003 compared with the same period in 2002. Purchases in anticipation of lower interest rates, the growing demand from the emerging black middle class and the attractiveness of property as an asset class relative to shares and bonds, contributed to the resilience of the property market.

The *month-on-month* rate of increase in *residential property prices,* as measured by Absa Bank, accelerated from an *average* of just above 1 per cent in 2002 to 2 per cent in April 2003, before slowing to 0,6 per cent in October. Calculated over twelve months the rate of increase in residential property prices increased from 16,8 per cent in December 2002 to a high of 20,9 per cent in June 2003 before receding to a still high 18,6 per cent in October. A levelling out in the twelve-month rate of increase in house prices from mid-2003 was recorded as income growth fell behind the rate of increase in house prices. Increased sales by property investors in an effort to realise capital profits, and weaker foreign demand due to the strength of the rand reportedly also had a mildly adverse effect on the recent growth in property prices.

Non-bank financial intermediaries

Focused mainly on longer-term investment, the non-bank financial intermediaries, consisting of, among others, unit trusts, long and short-term insurers, official and private pension and provident funds, experienced a significant slowdown in portfolio growth from the second quarter of 2002. While the continued recovery in the exchange value of the rand had a dampening effect on the domestic share market, the stronger rand also resulted in foreign exchange translation losses, which contributed to the decline in asset values.

Unit trusts: Market value of net assets



The market value of the share portfolio of the *unit trust* industry, for example, declined by 10,4 per cent from the second quarter of 2002 to the first quarter of 2003. Subsequently, its share holdings increased by 13,4 per cent to the third quarter of 2003, exceeding the value recorded in the second quarter of 2002 by 1,6 per cent. The market value of the net assets of worldwide, foreign and regional unit trusts, which focus their investment towards international markets, recorded a decline of 36 per cent from the second quarter of 2002 to the third quarter of 2003, despite the gains recorded in global equity markets.

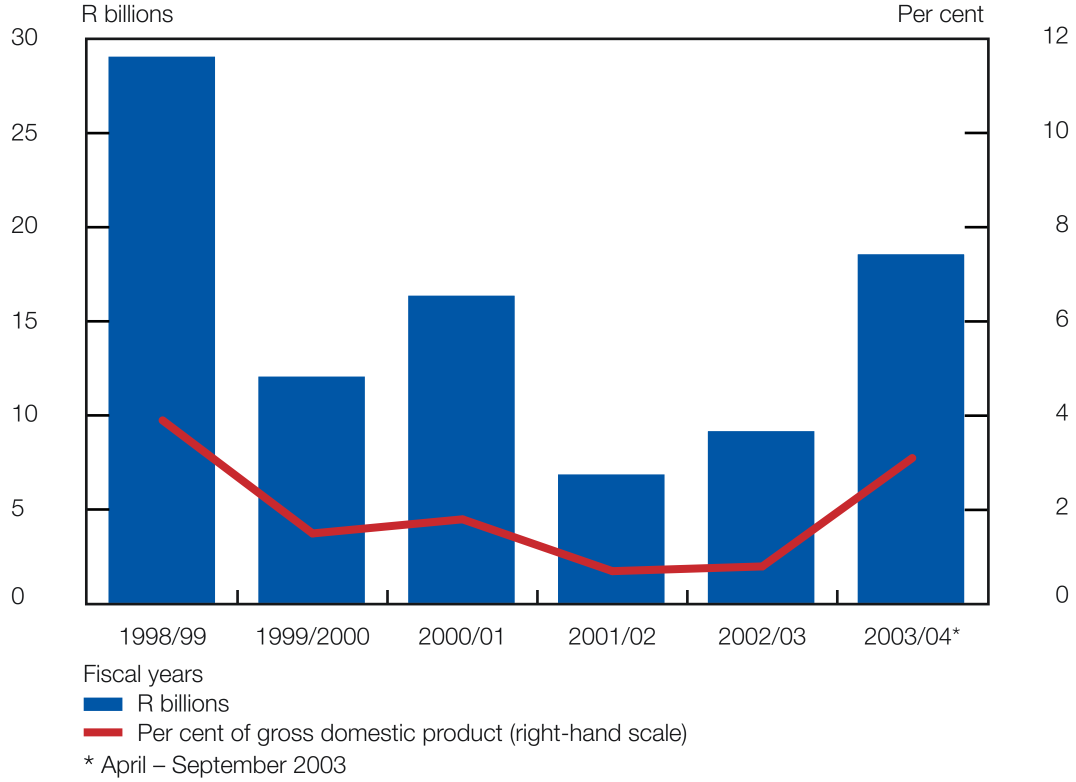
The contribution of foreign funds to the market value of the net assets of all unit trusts declined from 20 per cent in 2001 and 17 per cent in 2002 to only 10 per cent in the third quarter of 2003. However, mainly due to the improved returns on domestic investments, the market value of the net assets for all unit trusts as at the end of September 2003 amounted to R204 billion, an increase of 14 per cent from June 2002. New inflows into the industry were biased towards domestic funds, especially fixed-interest, asset allocation and money-market funds.

Public finance

Non-financial public-sector borrowing requirement

The *borrowing requirement of the non-financial public sector* (calculated as the cash deficit of the consolidated central government, provincial governments, local governments and non-financial public enterprises and corporations) amounted to R22,6 billion in the July-September quarter of fiscal 2003/04, compared with R12,1 billion recorded in the corresponding quarter of the previous fiscal year. For the first six months of fiscal 2003/04 it amounted to R18,6 billion – R8,9 billion more than in the corresponding period of the previous fiscal year. As a ratio of gross domestic product, this cash deficit for the first six months of fiscal 2003/04 amounted to 3,1 per cent, higher than the 1,7 per cent deficit recorded in the corresponding period of the previous fiscal year.

Non-financial public-sector borrowing requirement



The analysis of government finance statistics for *national government* indicates that cash receipts from operating activities increased by 6,5 per cent in the July-September quarter of 2003 when compared with the same period in the previous fiscal year. Cash payments for operating activities of national government increased by 20,6 per cent. Including the net cash outflow amounting to R1,0 billion due to investment in non-financial assets, national government's cash deficit amounted to R26,0 billion in the July-September quarter of 2003 compared with a cash deficit of R13,9 billion recorded in the same period of the previous fiscal year.

Provincial governments recorded a small cash *deficit* of R0,8 billion in the July-September quarter of 2003, bringing the provincial cash *surplus* for the first six months of fiscal 2003/04 to R3,9 billion compared with a surplus of R1,0 billion recorded in the same period of the previous fiscal year. The higher surplus was realised despite a substantial increase to R3,4 billion of investment in non-financial assets by the provincial governments as infrastructure provision was stepped up. Cash receipts rose sufficiently during this six-month period to offset increases in this and other expense items: of the nationally raised revenue, the equitable share transferred to provincial governments amounted to R71,2 billion, reflecting a hefty year-on-year rate of increase of 18,1 per cent compared to a budgeted increase of 15,3 per cent for the fiscal year as a whole.

The cash surplus of the provincial governments was reflected in an increase in their bank deposits from R8,3 billion at the end of March 2003 to R10,5 billion at the end of September 2003, while their overall indebtedness to banks decreased slightly from R0,5 billion at the end of March 2003 to R0,3 billion at the end of September 2003.

The cash *deficit* of *local governments* in the July-September quarter of 2003 was estimated at R1,5 billion, accumulating to a deficit of R1,0 billion for the first six months of fiscal 2003/04. This was lower than the R3,1 billion deficit recorded in the same period of the previous fiscal year. Preliminary data on the finances of the *extra-budgetary institutions* and *social security funds* indicate that they both recorded cash surpluses in the July-September quarter of 2003, as had also been the case in the April-June quarter.

After the consolidation of the government's accounts, general government recorded a cash deficit of R25,2 billion in the first half of the 2003/04 fiscal year compared with R14,5 billion in the same period of the previous fiscal year. The financial surplus of non-financial public enterprises and corporations increased slightly from R4,8 billion in the first six months of 2002/03 to R6,6 billion in the first six months of 2003/04.

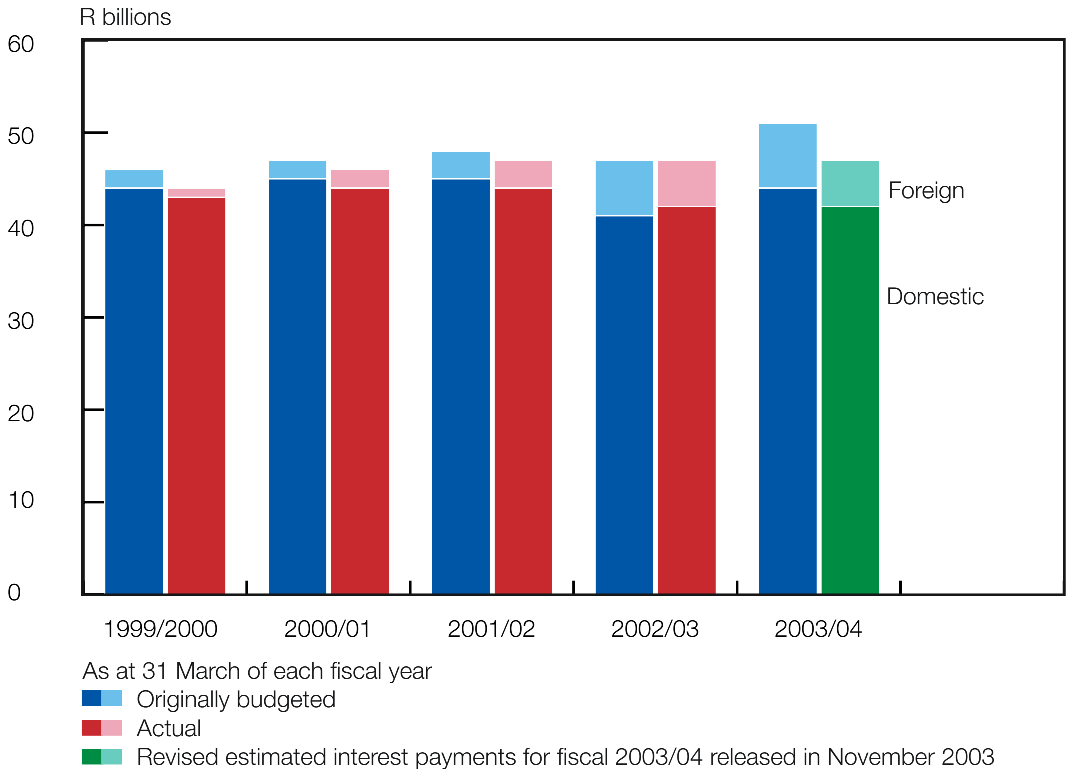
Budget comparable analysis of national government finance

Following a slow start in the April-June quarter of 2003, growth in *national government expenditure* was stepped up, recording a year-on-year rate of increase of 13,0 per cent in the first six months of fiscal 2003/04. This was higher than the 11,3 per cent growth rate recorded in the first half of the previous fiscal year and also exceeded the average growth rate of 8,6 per cent recorded in the first six months of the five fiscal years prior to that. The original budget estimates provided for a rate of increase of 14,7 per cent for the fiscal year as a whole. Expenditure incurred represented 48,6 per cent of the originally budgeted expenditure of R334,0 billion for the full fiscal year.

Interest paid on government debt decreased by 0,7 per cent from the first half of fiscal 2002/03 to the first half of fiscal 2003/04. In the original budget proposal for the full fiscal year 2003/04, total interest payable on domestic debt was estimated to amount to R43,6 billion and interest payable on foreign debt was estimated to amount to R7,1 billion. For the six months under review, interest paid on domestic debt amounted to R20,6 billion, representing an increase of 0,3 per cent from the same period of the previous year, while interest paid on foreign debt amounted to R2,2 billion representing a decrease of 7,1 per cent. The strengthening of the rand and the unscheduled redemption of the dual currency loan originally drawn down in

April 2002 as well as lower domestic interest rates were the main causes of the decline in interest obligations. The reduction in interest payments was also reiterated in the *Medium Term Budget Policy Statement* released in November 2003, as reflected in the accompanying graph.

National government interest payments



Although spending on capital projects grew at a rate of 14,7 per cent in the first six months of fiscal 2003/04, it remained well below the originally budgeted projection of 19,2 per cent for the fiscal year as a whole.

National government expenditure as a ratio of gross domestic product amounted to 26,7 per cent in the first six months of fiscal 2003/04, appreciably higher than the ratio of 25,4 per cent recorded 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 R161,0 billion, representing an increase of 11,5 per cent in the first half of fiscal 2003/04 when compared with the corresponding period of the previous fiscal year.

National government revenue in the first six months of fiscal 2003/04 amounted to R141,1 billion or 46,4 per cent of the originally budgeted revenue of R304,5 billion for the full fiscal year. The year-on-year rate of increase in revenue amounted to 5,5 per cent, notably lower than the originally budgeted projection of 9,4 per cent for the fiscal year as a whole. The rate of increase in national government revenue in the first six months of fiscal 2003/04 was also considerably lower than the 18,3 per cent growth recorded in the corresponding period of the previous fiscal year, when revenue benefited from the depreciated exchange rate of the rand. It was also well below 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 2003/04 Originally budgeted	Apr – Sep 2003 Actual	
Taxes on income and profits	177,9	82,4	5,6
Payroll taxes	3,6	1,9	16,6
Taxes on property	5,9	3,2	22,2
Domestic taxes on goods and services	109,6	49,3	6,0
Taxes on international trade and transactions	11,3	3,9	-16,5
Other revenue	5,9	5,3	18,6
Less: SACU** payments	9,7	4,9	17,7
Total revenue	**304,5**	**141,1**	**5,5**

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

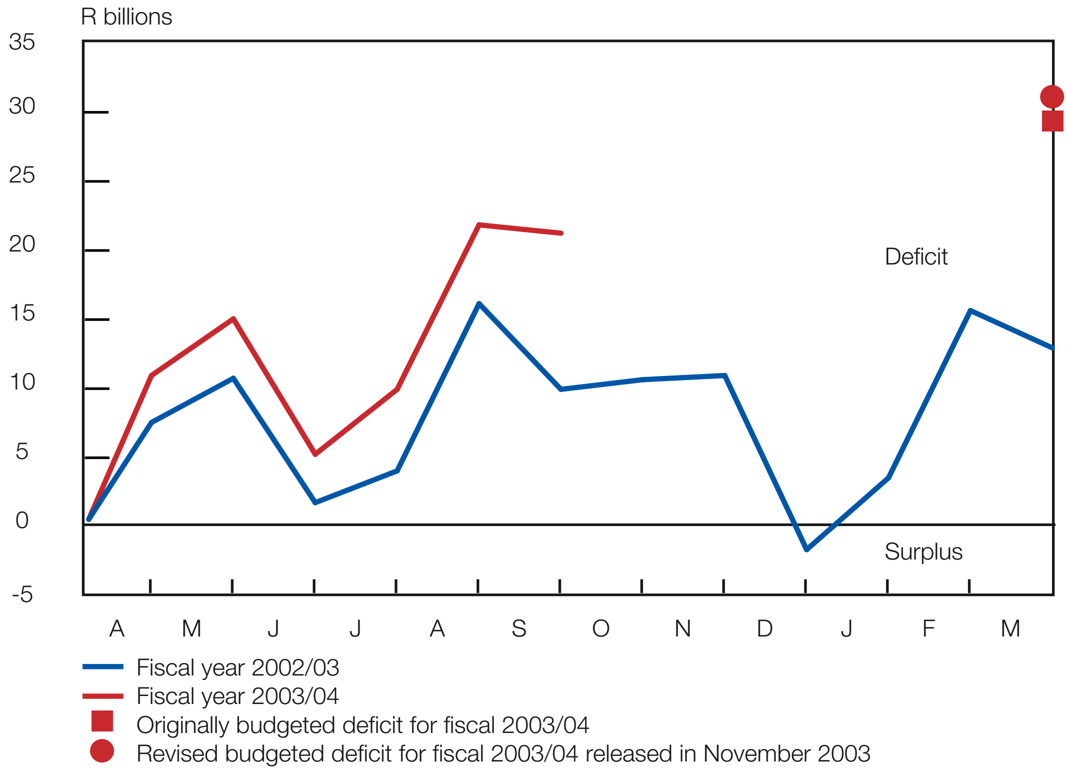
The shortfall in government revenue was largely due to underperformance of company tax receipts. A breakdown of revenue into its major categories indicates a substantially lower-than-estimated growth in taxes on income and profits of 5,6 per cent compared with the budget estimate of 8,1 per cent. The performance of companies in the mining and manufacturing sectors was influenced by the recovery of the rand and weak foreign demand, eroding their profits and reducing their tax payments. Taxes collected on international trade and transactions fell in absolute terms due to a decrease in the rand value of imports. Taxes on property out-performed budgetary expectations during the first six months of fiscal 2003/04, in contrast with the underperformance of other categories of revenue.

National government revenue as a ratio of gross domestic product amounted to 23,2 per cent in the first six months of fiscal 2003/04, slightly lower than the ratio of 23,7 per cent recorded in the corresponding period of the previous fiscal year. This ratio was also moderately lower than the ratio of 24,7 per cent recorded in the original budget proposals. National government's cash revenue (after cash-flow adjustments stemming from timing differences in the recording of transactions and bank clearances) amounted to R141,5 billion, representing a year-on-year rate of increase of 6,3 per cent in the first six months of fiscal 2003/04.

The net result of the revenue and expenditure of national government recorded in the first six months of fiscal 2003/04 was a deficit of R21,1 billion. At the same stage in 2002/03 the deficit had amounted to only R9,8 billion, illustrating the significant adjustment in the fiscal stance for 2003/04. A deficit of R29,5 billion was originally budgeted for the current fiscal year.

The cash deficit before borrowing and debt repayment amounted to R19,4 billion in the first six months of fiscal 2003/04. Although an amount of R6,0 billion was projected to be received from the restructuring of government assets in fiscal 2003/04, to date virtually no funds were received from this source. A revaluation profit of R3,0 billion was recorded at the partial redemption of the dual currency loan, which brought the net borrowing requirement to R23,4 billion during the period under review. An extraordinary payment was recorded in respect of the issue of zero-coupon bonds with a face value of R7,0 billion to the South African Reserve Bank. This issue, which was provided for in the original Budget for fiscal 2003/04, was made to the South African Reserve Bank in September 2003 to defray part of the realised losses on the Gold and Foreign Exchange Contingency Reserve Account.

Cumulative deficit of national government



As indicated in the accompanying table, the net borrowing requirement in the first six months of fiscal 2003/04 was financed mainly through the issuance of long-term bonds in the domestic capital market. Net receipts from government bonds

National government finance
R billions

Item or instrument	Fiscal 2003/04 Originally budgeted	April – Sep 2003 Actual
Deficit	**29,5**	**19,4***
Plus: Extraordinary payments	7,0	7,0
Cost/profit on repayment of foreign loans**	1,8	-3,0
Less: Extraordinary receipts	6,3	0,0
Net borrowing requirement	**32,0**	**23,4**
Domestic government bonds	9,3	31,0
Treasury bills	6,0	-1,8
Foreign loans	13,6	4,7
Changes in available cash balances***	3,1	-10,5
Total net financing	**32,0**	**23,4**

* Cash-flow deficit
** Revaluation gains or losses. Cost +, profit -
*** Increase -, decrease +

issued in the domestic bond market amounted to R31,0 billion during the first six months of fiscal 2003/04, a figure surpassing the budget for the full year. Long-term nominal fixed-interest bonds were issued at an average rate of 10,6 per cent, compared with the Budget assumption of 10,2 per cent. Short-term bills were issued at an average rate of 11,5 per cent compared with the Budget assumption of 12,1 per cent.

In May 2003 the National Treasury issued a new eurobond which amounted to €1,25 billion. This global benchmark bond with a coupon rate of 5,250 per cent and a maturity of 10 years, yielded R10,6 billion to the National Revenue Fund. This foreign bond issue concluded government's budgeted funding programme in the international bond market for fiscal 2003/04 as envisaged in the *Budget Review 2003*. However, during July 2003 the national government made an early partial redemption of US$750 million in respect of the dual currency loan originally drawn in April 2002. This early redemption has led to a decrease in the reliance on foreign funding for fiscal 2003/04, if compared with budget estimates. It also resulted in the September 2003 average outstanding maturity of government's foreign bonds remaining at 85 months as recorded at the end of March 2003, in spite of the new bond issue. An amount of R2,9 billion was drawn on the foreign export credit facilities for the financing of the strategic defence procurement programme in the first six months of fiscal 2003/04.

The funding activities of national government resulted in an increase of R10,5 billion in government bank balances during the first six months of fiscal 2003/04, bringing the bank balances to R20,2 billion at the end of September 2003.

In October 2003 a Deutsche mark bond to the amount of €256 million was redeemed. The total amount of the redemption was R2,1 billion at the redemption date – this amount comprised capital outstanding to the amount of R1,5 billion and an exchange rate loss amounting to R0,6 billion.

Total loan debt of national government increased from R426,1 billion at the end of March 2003 to R456,9 billion at the end of September. This caused the national government loan debt as a ratio of gross domestic product to increase from 37,1 per cent at end of March 2003 to 38,3 per cent at the end of September 2003. While the increase could largely be attributed to the net borrowing by national government, it was also partly the result of the restructuring of the composition of total debt of national government due to the issuance of zero-coupon bonds in part payment of the outstanding balance on the Gold and Foreign Exchange Contingency Reserve Account. As the official balance on this account decreased, there was a simultaneous increase in the outstanding government bonds to the same value. Consequently, total debt of national government was not affected. Total debt of national government (comprising of loan debt and the balance on the Gold and Foreign Exchange Contingency Reserve Account) as a ratio of gross domestic product increased from 40,2 per cent at the end of March 2003 to 40,8 per cent at the end of September 2003.

Total foreign debt amounted to 16,4 per cent of the total national government loan debt at the end of September 2003 compared with 17,4 per cent at the end of March 2003. This lower foreign debt ratio could to a large extent be attributed to the restructuring of the composition of total debt of national government. Another contributing factor was the revaluation of outstanding foreign loans at a stronger exchange rate.

Adjusted estimates of national government finance

The *Adjusted Estimates of National Expenditure 2003*, tabled in the National Assembly by the Minister of Finance on 12 November 2003, sought approval for additional government spending to the amount of R6,8 billion during fiscal 2003/04. However, R3,0 billion of this amount would be defrayed from the contingency reserve for unforeseen expenses already provided for in the main estimates presented to Parliament in February 2003, leaving a net increase in spending in the current year of R3,8 billion.

A large part of the increase in unforeseen and unavoidable expenditure was allocated to provincial governments in order to cover the higher than anticipated growth in grant beneficiary numbers, particularly for disability grants. Also included in this amount was an allocation provided for the recapitalisation of the Post Office to the amount of R750 million, to facilitate the separation of the Post Bank from the rest of the Post Office business. The estimates also provide for disaster relief, additional costs related to the medical treatment of HIV/Aids, costs associated with South Africa’s involvement in peace missions and higher-than-estimated remuneration increases for government employees. A substantial amount was allocated to deal with cost arising from basic water supply services. The adjustments also provided for R1,1 billion of departmental expenditure originally approved for fiscal 2002/03, but rolled over to be spent in fiscal 2003/04.

Roll-overs, savings and suspensions to the amount of R6,3 billion were envisaged in the Adjusted Estimates. Amongst these, national government was anticipating a cost saving of R3,8 billion in interest payments resulting from the revised financing requirement, lower interest rates and lower rand costs of servicing foreign debt. This saving would bring the debt service costs down to 3,9 per cent of gross domestic product from the 4,1 per cent recorded in the previous year, again releasing resources for allocation to productive expenditure. The adjustments provided for brought the revised estimate of national government expenditure to R331,5 billion for fiscal 2003/04.

Revised budget estimates for fiscal 2003/04
R billions

Originally budgeted expenditure	334,0
Plus: Additional expenditure	3,8
Less: Roll-overs, savings and suspensions	6,3
Total adjusted expenditure	**331,5**
Originally budgeted revenue	304,5
Plus: Increase in other revenue collections	1,9
Less: Decrease in taxes on income and profits	4,6
Less: Decrease in taxes on international trade and transactions	1,9
Total adjusted revenue	**299,9**
Adjusted deficit	**31,6**

National government revenue was expected to decrease by R4,6 billion against the originally envisaged budget projection, partly because the economy was growing more slowly than initially anticipated, with corporate profits falling in the wake of the economic slowdown and the appreciation of the rand. This would bring total adjusted revenue for the full fiscal year to R299,9 billion or 24,8 per cent of gross domestic product – almost equivalent to the target set in the original Budget in

February 2003. Overall, the revised projections implied a slight increase in the budgeted deficit before borrowing and debt repayment. This estimated deficit of R31,6 billion (originally budgeted at R29,5 billion) was expected to equal 2,6 per cent of the estimated gross domestic product for the full fiscal year compared with 2,4 per cent in the original Budget. This increase in the deficit would be financed through the issuance of long-term bonds in the domestic capital market.

The *Medium Term Budget Policy Statement*

On 12 November 2003 the Minister of Finance also tabled the *Medium Term Budget Policy Statement 2003* (MTBPS) in the National Assembly. This publication forms the background against which the Budget for fiscal 2004/05 will be formulated and presents the medium-term expenditure framework. The MTBPS 2003 set a strategy to endorse growth and development through investment in infrastructure, education and skills development, poverty reduction programmes and public service delivery.

Certain key initiatives were identified that would form the basis for improvements in the performance of the economy. These initiatives, building on the sound macroeconomic achievements thus far, included:
- enhancing public infrastructure capacity, including critical transport and communication linkages;
- an expanded public works programme, that would extend job creation initiatives across a broad development front;
- improving the regulatory environment and resolving obstacles that stand in the way of the expansion of small businesses;
- expanding education and training and accelerating enrolment in learnership programmes to support long-term job creation;
- deepening social security programmes to provide income support to the most vulnerable;
- a broad black economic empowerment strategy; and
- strengthening sectoral partnerships and local development initiatives.

Following recent inflation-targeting results and international best practice, the Minister of Finance and the Governor of the South African Reserve Bank agreed on amendments to the inflation-targeting framework. The annual average inflation target was replaced with a continuous inflation target of between 3 and 6 per cent for twelve-month CPIX inflation. It was announced that this target would remain in place at least up to 2006 or beyond. The “escape clause” was reformulated as an “explanation clause”: in the event of shocks moving inflation out of the target, the Monetary Policy Committee would be required to inform the public of the nature of

Macroeconomic projections underlying fiscal projections
Per cent

	Medium-term estimates						
	2003/04		2004/05		2005/06		2006/07
	Feb*	Oct**	Feb*	Oct**	Feb*	Oct**	Oct**
Real GDP growth	3,4	2,2	3,8	3,5	4,0	3,8	4,0
CPIX inflation	6,1	5,6	5,1	5,3	5,1	5,4	5,1

* *Budget Review 2003*
** *Medium Term Budget Policy Statement 2003*

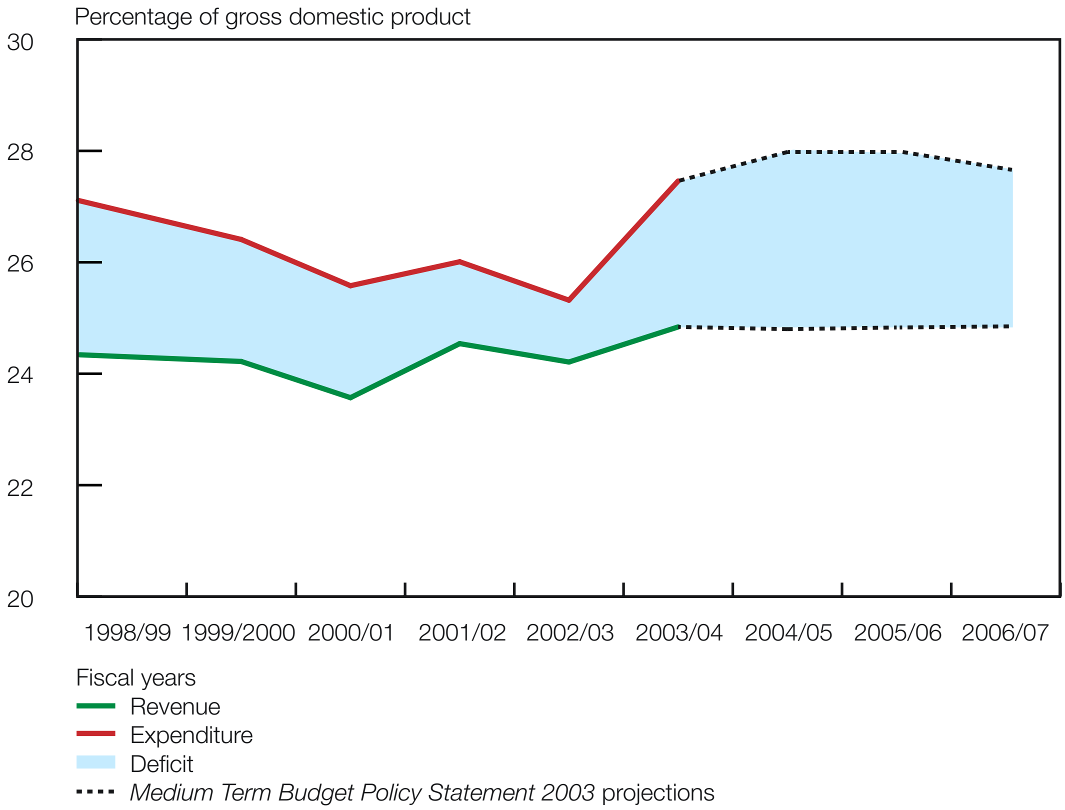
the shock, its anticipated impact on inflation, the monetary policy response adopted to steer inflation back to within the target and the timeframe in which this would occur.

It was also indicated that tax reforms in recent years have put tax policy on a sound footing. Further refinements to the tax structure were under consideration, but would not jeopardise the maintenance of a stable overall tax burden. It was also announced that the deadline for the foreign exchange amnesty announced in February this year was extended to 29 February 2004.

Government's commitment to encourage investment was reinforced through measures supporting the private sector. These measures include:

- stable macroeconomic and fiscal policies, including inflation targeting to anchor long-term inflation expectations;
- maintaining a competitive tax environment for both domestic and foreign investment;
- enhanced crime prevention strategies to mitigate uncertainty;
- an industrial strategy based on enhanced microeconomic efficiency, improved regulation, and enhanced business climate for small, medium and micro enterprises;
- facilitating international market expansion through trade negotiations;
- land reform and sustained public infrastructure expansion to support economic activity; and
- further enhancement of the provision of key economic services, particularly telecommunications and transport services.

National government revenue and expenditure



As indicated in the accompanying table, government once again envisaged that fiscal caution would prevail at all levels of the public sector. The national government deficit is projected to average 3,0 per cent of gross domestic product over the three-year period and consolidated general government's borrowing requirement is projected to average 3,3 per cent of gross domestic product. Similarly, the public-sector borrowing requirement is projected to be contained at around 3,3 per cent of gross domestic product in the medium term. This framework provides for strong growth in infrastructure investment by national and provincial governments, while also accommodating the increasing capital requirements of the major parastatals, including Eskom, Transnet and its subsidiaries and the larger water utilities in the years ahead.

Fiscal projections

	2003/04 Revised estimates	Medium-term estimates		
		2004/05	2005/06	2006/07
	R billions			
National government				
Revenue	299,9	325,7	357,8	391,0
Expenditure	331,5	367,5	403,1	435,3
Deficit before borrowing	31,6	41,8	45,4	44,3
Consolidated general government borrowing requirement	39,9	45,6	50,2	43,7
Public-sector borrowing requirement	39,4	45,9	51,3	44,9
	Ratio of gross domestic product (per cent)			
National government				
Revenue	24,8	24,8	24,8	24,8
Expenditure	27,5	28,0	28,0	27,7
Deficit before borrowing	2,6	3,2	3,1	2,8
Consolidated general government borrowing requirement	3,3	3,5	3,5	2,8
Public-sector borrowing requirement	3,3	3,5	3,6	2,9

The medium-term expenditure framework (MTEF) provided for *real* non-interest spending to grow at an average rate of 4,4 per cent over the medium term, and for a continuous decline in debt servicing cost relative to gross domestic product, releasing resources for spending on public services. The public expenditure on social grant programmes received priority, in line with government’s core commitment to human capital and social development. A gradual shift in the division of revenue in favour of provincial and local governments was envisaged. These levels of government receive a larger share of revenue in recognition of their vital role in service delivery to the community.

National government financing will be supplemented by the proceeds from the restructuring of state-owned entities of R2,5 billion in both fiscal 2004/05 and fiscal 2005/06. Domestic long-term loans will be the primary instrument used to finance the budget deficit over the medium-term period. Total gross loan debt is estimated to amount to 37,8 per cent of gross domestic product at the end of fiscal 2003/04, increasing slightly to 39,0 per cent of gross domestic product at the end of fiscal 2006/07. Foreign debt as a percentage of total loan debt is projected to increase from 17,4 per cent at the end of fiscal 2002/03 to 19,6 per cent at the end of fiscal 2006/07.

Statement of the Monetary Policy Committee

16 October 2003

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

Introduction

The Monetary Policy Committee on 15 and 16 October 2003 undertook a detailed assessment of recent economic and financial developments in South Africa and the rest of the world. The main findings of the Committee were that the international economy is continuing to recover, albeit in a protracted and uneven fashion; there seems to be little reason for inflationary pressures to rise in South Africa's main trading-partner countries; there has been a major realignment of currencies in the world as a result of developments around the US dollar; domestic economic growth has slowed down; the external value of the rand has recovered to levels last seen in the middle of 2001; domestic final demand is continuing to increase, supporting domestic production as well as the growth in the volume of imported goods, although there are imbalances particularly in the externally-exposed sectors; employment creation remains one of the main problems in South Africa; and most importantly from a monetary policy perspective, inflation pressures have abated further and this is expected to continue.

The inflation outcome

The year-on-year rate of increase in the CPIX (the overall consumer price index for metropolitan and other urban areas, excluding the interest cost of mortgage bonds), which had dropped from 11,3 per cent in October 2002 to 6,4 per cent in June 2003, picked up marginally to 6,6 per cent in July before falling again to 6,3 per cent in August. Although this brought the rate of increase in the CPIX to its lowest level in twenty-one months, it was still above the upper boundary of the inflation target.

The deceleration in CPIX inflation was mainly due to a slower rate of increase in food prices and transportation costs. If energy and food prices are excluded from the CPIX, the twelve-month rate of increase in the prices of other goods and services declined from 7,7 per cent in October 2002 to 6,8 per cent in June 2003. Subsequently, this rate of increase rose to 7,0 per cent in July and then declined to 6,9 per cent in August.

More disconcerting, however, is the fact that the year-on-year rate of increase in the prices of services included in the CPIX has continued to accelerate from 7,4 per cent in October 2002 to 8,0 per cent in June 2003 and 8,4 per cent in August. This acceleration in service prices excluding mortgage costs was mainly due to increases in rental costs and in the prices of medical, communication and education services.

Moreover, the rate of change over one month in the CPIX accelerated markedly in July and August 2003 to levels last recorded in the closing months of 2002. The recent more rapid rise in CPIX inflation was to a large extent the result of increases in the running costs of motor vehicles, which can fluctuate considerably from month to month. The prices of a number of other goods, however, also rose at somewhat higher rates. However, the average month-on-month annualised percentage changes in CPIX for the latest three months amounted to 4,83 per cent.

Recent developments in production prices have been far more promising. The twelve-month rate of increase in the all-goods production price index, which had dropped from 14,6 per cent in October 2002 to 2,3 per cent in June 2003, fell further to 0,2 per cent in August. The driving force behind this slowdown in production prices was the recovery in the international exchange value of the rand from about the second half of 2002. As a result of this recovery in the exchange rate of the rand, the prices of imported goods generally declined in absolute terms from March 2003.

The year-on-year rate of increase in the prices of goods produced domestically also decelerated markedly from 14,2 per cent in October 2002 to 4,4 per cent in June 2003 and 2,6 per cent in August. Most of the prices of the various categories of domestically produced goods showed similar slower rates of increase, with the notable exception of the prices of tobacco and metal products which continued to rise at increasing rates. Food prices fell by 11,4 per cent in the year to August 2003, as the prices of grain, fruit, meat and some other agricultural products declined. At the manufactured level, food prices decreased at a year-on-year rate of 0,5 per cent in August 2003, whereas the corresponding rate of increase in September 2002 amounted to 30,1 per cent.

The inflation outlook

The decline in the production prices of food and the slower rate of increase in the all-goods production price index bode well for a slowdown in consumer price inflation in the coming months provided that discipline is applied, particularly in the determination of administered prices. Changes in production prices generally affect consumer prices with a lag before the benefits of lower production price inflation are passed on to consumers.

A number of other developments also suggest that consumer price inflation could subside further. Among these, the most important is probably that inflation expectations, which are of great importance in the price determination process in South Africa, have improved considerably during 2003. This is clearly illustrated by the decrease in the break-even inflation rate, measured as the difference between the nominal yield on conventional bonds and the real yield on inflation-linked bonds. Expected inflation derived in this way has decreased from 8,0 per cent in February 2002 to 5,0 per cent in September 2003. The inflation expectations survey of the Bureau for Economic Research (University of Stellenbosch) substantiates these findings. According to this survey, CPIX inflation is expected to fall in the next three years.

In addition, there are at present no signs of any supply constraints in the economy which could have an impact on prices. The increase of 1½ per cent in gross domestic product in the first half of 2003 was well below the potential growth rate of the economy, while manufacturing output declined in the first eight months of 2003. The increasing gap between actual output growth and potential growth is clearly illustrated by the capacity utilisation index of manufacturing which came down to 79 per cent in the second quarter of 2003.

The fiscal discipline applied by government also favours a further decline in the inflation rate. Although a more expansionary fiscal policy stance has been adopted, the fiscus still projects a deficit before borrowing and debt repayment for the fiscal year 2003/04 that should have little effect on prices. The results of national government finance for the first five months of the fiscal year confirm government's commitment to prudence.

A further development signalling lower future inflation is the slowdown in the growth of the monetary aggregates. The increase over twelve months in the broadly defined money supply (M3) came down from 9,1 per cent in June 2003 to 5,1 per cent in August 2003. The narrower monetary aggregates on the whole showed a similar pattern, but the loans and advances of the banks to households and business enterprises increased at a year-on-year rate of 12 per cent in August. This was probably a reflection of the sustained domestic final demand for goods and services. Large increases in mortgage advances reflecting the expansion in the real-estate market made a major contribution to the rise in bank credit extension to the private sector.

Finally, the recovery in the nominal effective exchange rate of the rand from the exceptionally low level at the end of 2001 should be of assistance in containing inflation. The trade-weighted value of the rand increased by 24 per cent in 2002 and by nearly 16 per cent in the first nine months of 2003. At its current level the nominal effective exchange rate of the rand is close to levels attained in the middle of 2001. Although this has somewhat affected the profitability of exports and the price competitiveness of domestically produced goods, the recovery in the external value of the rand has contributed materially to the lowering of the inflation rate. The impact of the rand recovery on the current account of the balance of payments has so far been moderate and has been easily financed.

The projections of our econometric models confirm this favourable domestic inflation outlook. These projections, based on the current policy stance, indicate that it is likely that CPIX inflation will move below the upper boundary of 6 per cent of the inflation target during the fourth quarter of 2003 and remain well within the target range in 2004 and 2005.

A major risk to this projected inflation outcome is the recent wage settlement rates of around 10 per cent. These settlements have been made after the year-on-year rate of increase in nominal remuneration per worker in the formal non-agricultural sectors of the economy averaged 10,6 per cent in the first quarter of 2003. At the same time productivity growth has continued to slow down. In the first quarter of 2003 the year-on-year rate of increase in labour productivity amounted to 1,7 per cent, with the result that the corresponding rate of increase in nominal unit labour cost came to 8,7 per cent. Such a rate of increase in nominal unit labour cost can be absorbed over the short term without an acceleration in inflation. Over the long term it will inevitably lead to an acceleration in price increases. However, since wage negotiations have been backward looking, the recent improvement in the inflation rate could bring about a moderation in wage demands in the coming months.

Monetary policy stance

In view of this generally favourable inflation outlook and taking into consideration the positive impact of the current monetary policy stance on inflation in South Africa going forward, the Monetary Policy Committee has decided to reduce the repo rate by a further 150 basis points to a level of 8,5 per cent effective from 17 October 2003. The Monetary Policy Committee will continue to monitor all the risk factors to the inflation outlook. If the outlook deteriorates, the Committee will not hesitate to change the monetary policy stance.

Dates of Monetary Policy Committee meetings for 2004

The Governor's Committee has scheduled six MPC meetings for 2004, which will take place on the following dates:

Monetary Policy Committee meetings for 2004

1	2	3	4	5	6
27 February	22 April	10 June	12 August	14 October	9 December

A note on changes in income and asset values of long-term insurers

by Michael A Kock[1]

Introduction

This note briefly reviews the influence of financial markets and economic conditions on the income stream and the total value of the assets of long-term insurers in South Africa.

1 The views expressed are those of the author and do not necessarily reflect the views of the South African Reserve Bank.

Changes in income and assets

The composition of long-term insurers' total income is summarised in Table 1, and the various components are then briefly discussed in the sections below.

Table 1 Composition of long-term insurers' total income

Current investment income	interest + dividends + rent
Plus: Net capital profits	on the sale of investments and assets
Plus: Net asset revaluations	as a result of changes in exchange rates and market prices
Total investment income	
Plus: Current income surplus	premium income + other net operating income - current expenditure - dividend payments
Total income	

Annual current investment income of long-term insurers increased by 143 per cent and total assets by 131 per cent between 1994 and 2002, yielding an average annual rate of return on such assets of 5,42 per cent[2]. Net capital profits and asset revaluations boosted returns further to an average annual rate of 8,68 per cent, while introducing additional volatility.

2 Data source: Registrar of Long-term Insurance, Annual Reports up to 1990 and South African Reserve Bank survey data in later years.

The total of net capital profits and asset revaluations varied from a profit of R103 billion in 1999 to a loss of R50 billion in 2002. From 1997 to 2002, the cumulative current income surplus was negative to the value of R37 billion, which weighed on overall asset growth during this period. In 2002

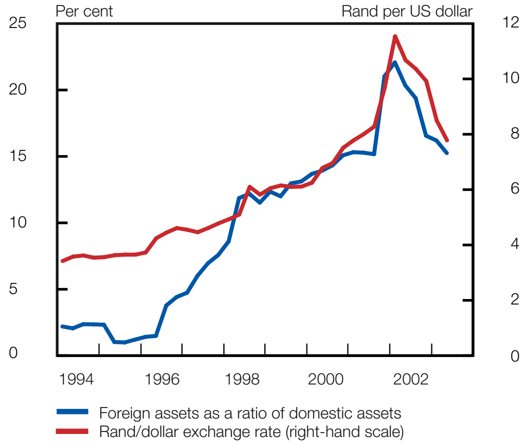
- the current income shortfall was at its highest since 1999;
- total investment income recorded an annual shortfall; and
- the value of total assets shrunk.

A recovery in domestic share prices would help to restore asset values as the industry's domestic equity exposure was some 51 per cent of total domestic assets in December 2002.

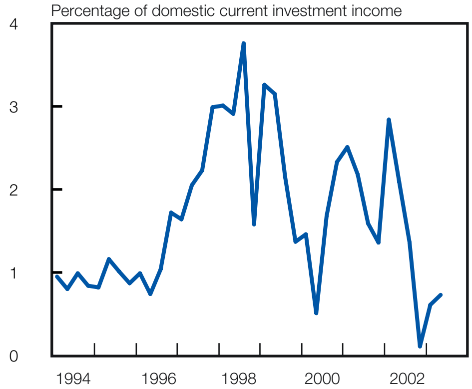
Current investment income

Holdings of foreign assets by long-term insurers as a ratio of domestic assets increased from 1 per cent in the third quarter of 1995 to 22 per cent in the first quarter of 2002, before receding to 15 per cent in the second quarter of 2003 as shown in Graph 1.

Graph 1 Foreign asset holdings of long-term insurers



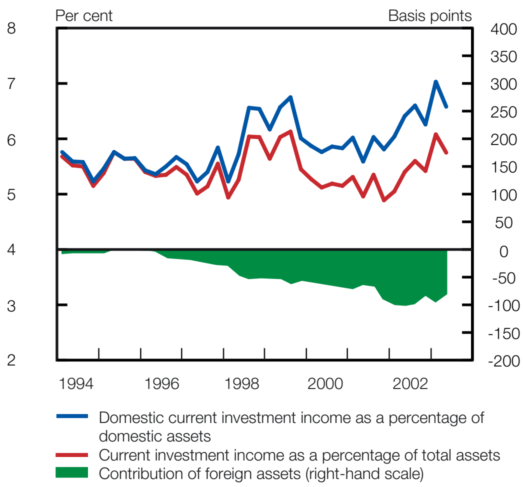
Graph 2 Foreign current investment income of long-term insurers



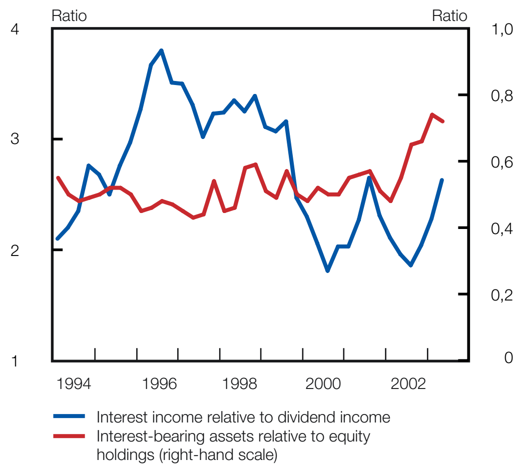
The change in this ratio resulted from the diversification of asset holdings across national boundaries and from the change in the exchange value of the rand. However, foreign assets contributed little to current investment income in comparison with the contribution made by domestic assets. From 1994 to 2002 foreign current investment income as a ratio of domestic current investment income averaged only approximately 1,6 per cent (see Graph 2). It should, however, be kept in mind that the amount of foreign assets was limited by regulation, and that nominal returns on such assets were generally lower than in South Africa, partly due to lower inflation abroad.

By contrast, domestic annual current investment income as a percentage of domestic assets averaged 5,87 per cent in the period 1994 to 2002. This was 45 basis points higher than the 5,42 per cent average return recorded by overall annual current investment income as a percentage of total assets in the period 1994 to 2002. The yield difference was directly related to the lower returns on foreign assets. The margin between these ratios peaked at more than 100 basis points in the second quarter of 2002, before narrowing to 82 basis points in the second quarter of 2003 (see Graph 3). Changes in the margin were due to differences between foreign and domestic interest rates, bond yields, dividend yields and movements in the exchange rate.

Graph 3 Current investment income of long-term insurers



Graph 4 Composition of domestic current investment income and assets of long-term insurers



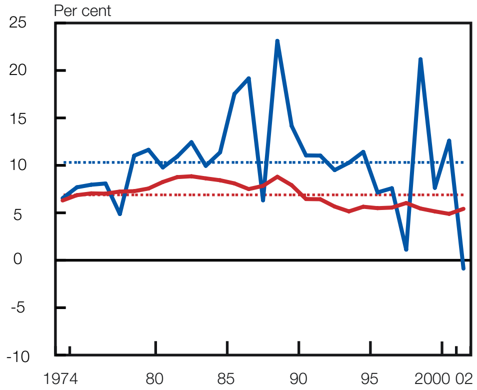
As yields on interest-bearing assets were higher than the dividend yield on equities, annual interest income on domestic investments accounted for 68 per cent of annual domestic investment income during the period 1994 to 2002, despite the holdings of these types of assets representing just 28 per cent of total domestic asset holdings. By contrast, holdings of domestic equities represented 54 per cent of domestic assets but generated dividends accounting for only 26 per cent of domestic investment income.

As indicated in Graph 4, the influence of the general downward trend in domestic interest rates and yields since 1996 is reflected in a decline in the ratio of domestic interest income relative to domestic dividend income from 3,8 in the third quarter of 1996 to 2,6 in the second quarter of 2003. Simultaneously, the ratio of domestic interest-bearing assets relative to the holdings of domestic shares increased from 0,48 to 0,72 as equities were substituted for fixed-income assets.

Net capital profits and asset revaluations

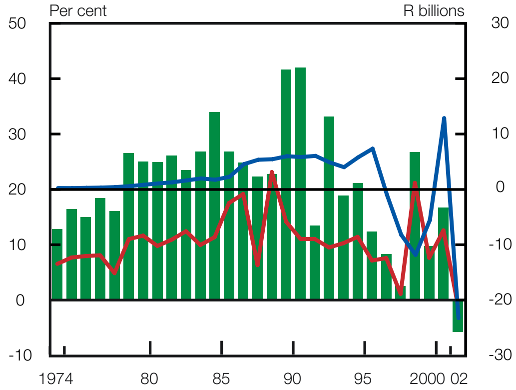
Overall returns on investments are influenced by the realising of capital gains and losses when assets are actively bought and sold and by the revaluation of assets at varying exchange rates and market prices. For example, annual current investment income of long-term insurers as a percentage of total assets averaged 6,9 per cent in the period 1974 to 2002 but when net realised and unrealised capital profits are added to obtain total investment income, the average yield increased by 350 basis points to 10,4 per cent (see Graph 5).

Graph 5 Investment income of long-term insurers as percentage of total assets*



* Assets valued at book value prior to 1990 and at market value in later years

Graph 6 Changes in income and assets of long-term insurers*



*Assets valued at book value prior to 1990 and at market value in later years

** Including other net operating income from 1993

Inflation had an eroding effect on investment income between 1974 and 2002. Total annual nominal investment income as a percentage of total assets averaged 10,4 per cent between 1974 and 2002, while the average inflation-adjusted return[3] was negative to the value of 1 per cent. However, to this may be added further unrealised capital profits on long-term insurers' holdings of fixed property that are not fully accounted for in the reporting of total investment income. The substantial difference between nominal and real returns nevertheless bears testimony to the importance of keeping inflation low over the longer term so as to preserve the purchasing power of investments.

3 Nominal returns were adjusted using changes in the overall consumer price index for metropolitan areas.

Asset values

The year-on-year percentage change in the market value of the total assets of long-term insurers is determined by changes in their total investment income and by their current income surplus. Graph 6 shows that capital profits and asset revaluations added to asset growth in 1999 and 2001 but that asset revaluations were mainly responsible for an absolute decline in the market value of assets in 2002. The decline in the current income surplus from 1996 to 2002 curbed the growth in the asset values of long-term insurers. This decline in cash flows was, among other things, a result of

- perceptions of poor investment performance in the industry which impacted negatively on premium income; and
- high interest rates and associated financial distress among policyholders which contributed to an increase in lapses and surrenders of policies.

Summary

In 2002, the finances of the long-term insurance industry reflected the unfavourable influence of financial market and economic conditions on returns in the industry. The return-enhancing and risk-reducing outcome which was expected to follow the deliberate diversification of asset holdings across international markets failed to materialise. On balance, investment income from foreign assets compressed investment returns.

The shift away from equities to cash and bonds in the domestic asset allocation of long-term insurers added to investment income, while active asset management capitalised on changes in asset prices and further enhanced returns. However, wide fluctuations in capital profits and losses made cash flows quite volatile. Inflation further eroded real returns.

The combined effect of these events, together with a current income shortfall and the negative effect of asset revaluations, reduced asset growth. This helped to explain the absolute decline in the market value of assets in 2002.

The total asset base of long-term insurers is expected to increase swiftly when share prices recover. Real returns on assets are also likely to benefit from the lower level of inflation brought about by the consistent application of counter-inflationary policies.