Quarterly Bulletin

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South African Reserve Bank

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Enquiries relating to this Bulletin should be addressed to:
The Head of Research and Senior Deputy Chief Economist
Research Department
S A Reserve Bank
P O Box 427
Pretoria 0001
Tel. 27-12-3133668/3944

E-mail: sarbrsh@resbank.co.za

http://www.reservebank.co.za

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Quarterly Economic Review

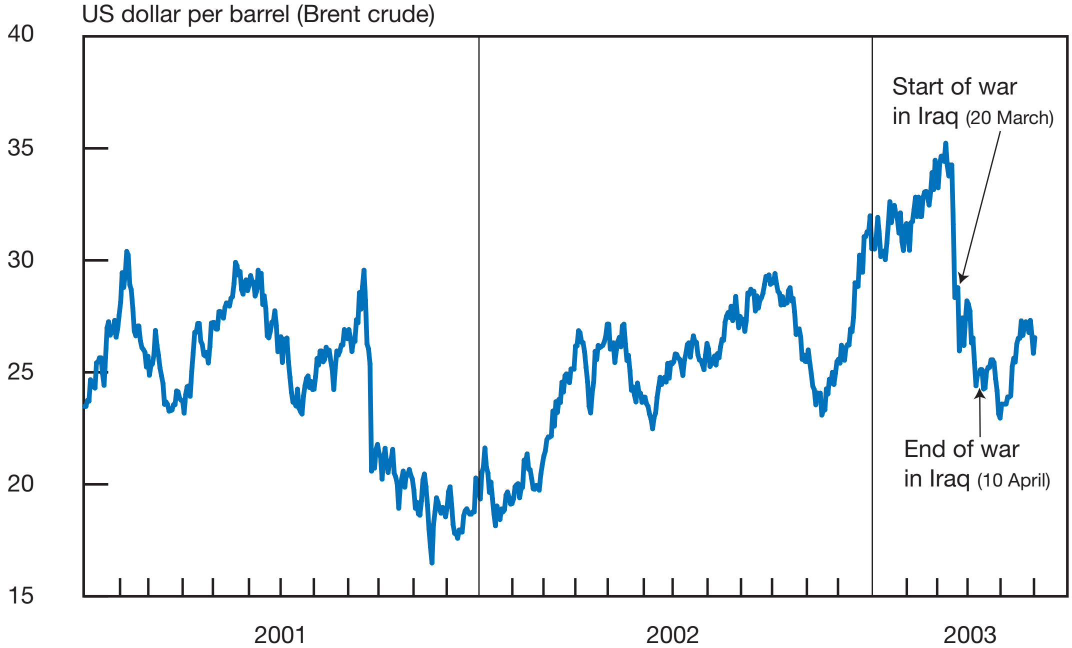
Introduction

Following a very weak performance in 2001, world output growth accelerated to a still-subdued rate of 3 per cent in 2002, with the advanced economies recording a real growth rate of less than 2 per cent. This lacklustre performance of the world economy continued in early 2003. Uncertainty was reinforced by the build-up to and the outbreak of the US-led war in Iraq – uncertainty that was also clearly evident in the behaviour of the prices of gold and oil. Evidence of fairly limited damage to the oil infrastructure as the war progressed contributed to a significant decline in the oil price. The speedy end to the war brought more certainty, but clear signs of a recovery in economic activity are still not evident. Since early 2003 concern also started to mount regarding the impact of the Severe Acute Respiratory Syndrome (SARS) epidemic around the world, in particular the Asia Pacific region. Tourism, travel and related activities have so far been the hardest hit by fears of SARS.

A limited number of countries such as Brazil continued to suffer from strong inflationary pressures, and had to maintain a tight monetary policy stance to bring inflation under control. However, with actual production falling significantly below potential output in most parts of the world, the resulting output gaps contributed to a general climate of low inflation – and in the case of Japan, negative inflation or deflation. In this environment, monetary policy could afford to be expansionary. Real interest rates in most countries were quite low, and some short-term real interest rates even negative.

During the past two years fiscal deficits widened on a cyclical basis in most parts of the world, as subdued growth suppressed tax revenues and caused payments of unemployment benefits to rise. Apart from the automatic stabilisers at work, fiscal policies with an active counter-cyclical element were also pursued in a number of

Oil price



countries and led to strongly rising government deficits. The re-emergence of so-called twin deficits in the United States – sizeable deficits on both the current account of the balance of payments and on the federal government's budgetary accounts – contributed to a significant depreciation of the US dollar against other currencies.

With its firm commitment to monetary and fiscal discipline, and having progressed a long way with a programme to improve the competitiveness and degree of international integration of the domestic economy, South Africa's sound economic performance was recognised by two international credit ratings agencies and rewarded with improved ratings. This positive sentiment also surfaced in the foreign currency market, where the South African rand remained fairly strong. Given the sound and consistent policies pursued by the authorities, relatively attractive domestic interest rates, decelerating inflation and an improvement in the terms of trade, the rand on balance appreciated by 0,9 per cent during the first five months of 2003.

However, with the sluggish world economy leaving its mark on export demand and with relatively tight monetary conditions, the South African economy could not escape a slowdown in activity. The growth rate fell back for the third successive quarter, from the brisk annualised rate of 4 per cent recorded in the second quarter of 2002 to 1½ per cent in the first quarter of 2003.

The subdued growth rate in the first quarter of 2003 arose from widespread weakness in production. Agricultural and mining output declined, while real value added in manufacturing also contracted as sluggish world markets eroded aggregate demand and foreign producers presented stiff competition to domestic producers. In the non-manufacturing secondary sectors and tertiary sectors, output continued to rise, albeit generally at lower rates.

Growth in real gross domestic expenditure slowed down slightly during the first quarter of 2003. Real household consumption expenditure remained resilient and maintained its earlier growth rate, *inter alia* supported by the income tax reductions announced in the Budget. Despite relatively high interest rates, the lowering of the household sector's debt-to-income ratio since 1998 created scope for some households to incur new debt in support of both consumption and capital expenditure. In the first quarter of 2003, households' debt-to-income ratio rose markedly.

Growth in real government consumption expenditure also continued at the same brisk pace that was recorded in the final quarter of 2002. The rate of increase in real fixed capital formation receded somewhat in the first quarter of 2003, but it still managed to record a strong growth rate of 8½ per cent. Weaker prices for agricultural products and expectations of lower production of certain crops caused a decline in fixed capital formation by the agricultural sector. In other sectors, fixed capital formation was more resilient, with general government actually accelerating its tempo of capital expenditure. The tempo of inventory accumulation decelerated somewhat in the first quarter, but kept pace with overall economic growth so that the ratio of inventories to production remained almost unchanged.

Inflation decelerated markedly in the early part of 2003 as the strengthening of the exchange rate, the sustained disciplined stance of monetary policy and the widening of the output gap moderated price pressures. Production prices declined in absolute terms during the first quarter of 2003, while the quarter-to-quarter rate of CPIX inflation decelerated from an annualised 12,1 per cent in the final quarter of 2002 to 4,8 per cent in the first quarter of 2003.

A correction in the calculation of the consumer price index was introduced by Statistics South Africa with the release of the April 2003 data, resulting in a downward revision of 1,9 percentage points in the March 2003 twelve-month rate of CPIX inflation. This brought CPIX inflation back to single-digit figures. Since recent historical inflation tends to have a strong impact on inflation expectations, the revisions could contribute to some moderation of inflationary pressures.

Productivity growth in the non-agricultural sector of the economy slowed down progressively from 3¾ per cent in the first quarter of 2002 to 1¾ per cent in the fourth quarter – the lowest rate in the past decade. With an increase of just below 10 per cent in average nominal remuneration per worker in the formal non-agricultural sectors of the economy, this resulted in nominal unit labour cost rising at a rate of 7 per cent in 2002.

Aggregate employment in the formal sectors of the economy recorded uninterrupted increases in each of the final three quarters of 2002, resulting in a cumulative employment gain of about 70 000 workers. This welcome change from the longer-term downward trend in employment came equally to the fore in the numbers of private-sector and public-sector employees.

Despite an improvement in the terms of trade in the first quarter of 2003, the weakness of world demand and reduced competitiveness of South African exporters on account of the recovery in the exchange rate of the rand resulted in a small deficit being recorded on the current account of the balance of payments, following a small surplus in the fourth quarter of 2002. Exporters of manufactured goods suffered most from the contraction in the international demand for South African produced goods. The volume of imports also fell back, but not by as much as the reduction in exports.

A small net outflow of funds was recorded on the financial account of the balance of payments as non-residents reduced their portfolio and other investments in South Africa. The deficits on both the current and financial accounts of the balance of payments resulted in a decline of R5,4 billion in South Africa's holdings of international reserves. However, this decline did not significantly change the level of import cover of the international reserves, which remained broadly unchanged at around 17½ weeks' worth of imports from the end of December 2002 to the end of March 2003.

A milestone was reached when the Reserve Bank's oversold net open foreign-currency position (NOFP) was closed out in May 2003. Following declines in the NOFP earlier in 2003 as the Bank purchased modest amounts of foreign exchange in the foreign-currency market, government sold the proceeds of its €1,25 billion global bond issue to the Bank in May 2003. The Bank delivered these proceeds to private-sector parties in terms of existing forward contracts, thereby reducing the Bank's forward foreign exchange book and eliminating the NOFP. In this way, a perceived element of risk and vulnerability which had attracted much attention, especially in the late 1990s, was laid to rest.

Growth in money supply responded in the usual way to the tightening of monetary policy, decelerating progressively from high rates in the early part of 2002 to very slow growth in early 2003. From the fourth quarter of 2002 to the first quarter of 2003, annualised growth in M3 amounted to a mere 2 per cent. Apart from the marked slowdown in inflation and weaker growth in real income and expenditure, the slow growth in the monetary aggregates probably also reflected negative wealth effects arising from the downward revaluation of the financial asset holdings of South African households and firms. The growth in the underlying demand for bank credit also slowed down significantly, although the headline measures of credit extension rose briskly in early 2003 on account of changes in the reporting of derivatives instruments on the banks' balance sheets.

Against the background of an unchanged Reserve Bank repurchase rate, short-term interest rates were fairly stable during the first five months of 2003. However, from April 2003 they increasingly started to reflect expectations of decreases in the Bank's repurchase rate. Long-term bond yields declined further during the first five months of 2003, indicating expectations of lower inflation and the continued pursuit of sound policies. The yield curve therefore continued to display a strongly inverted shape.

Weakness in share prices in other parts of the world, combined with the expected impact of a stronger rand exchange rate on corporate profitability, led to further declines in domestic share prices. From a high point reached on 22 May 2002, the all-share price index declined by 37 per cent to a recent low point on 25 April 2003. Subsequently, share prices recovered by 16 per cent to the end of May, mainly due to a moderate weakening of the exchange rate of the rand.

The South African government remains fully committed to pursuing sound fiscal policies. This is demonstrated by the non-financial public-sector borrowing requirement, which amounted to only 1,0 per cent of gross domestic product in fiscal 2002/03. The widening of the deficit ratio from 0,8 per cent of gross domestic product in fiscal 2001/02 was furthermore due to a healthy reason – a much-needed increase in capital expenditure by the public sector in order to improve the country's infrastructure. Firm control over government expenditure growth continued and tax collection improved further. By containing the budget deficit, and helped by the downward revaluation of its foreign-currency denominated debt, government succeeded in reducing the ratio of its loan debt to gross domestic product from 42,9 per cent at the end of March 2002 to 37,9 per cent at the end of March 2003. This helps to contain the interest cost of servicing the government debt, freeing up resources for improved service delivery.

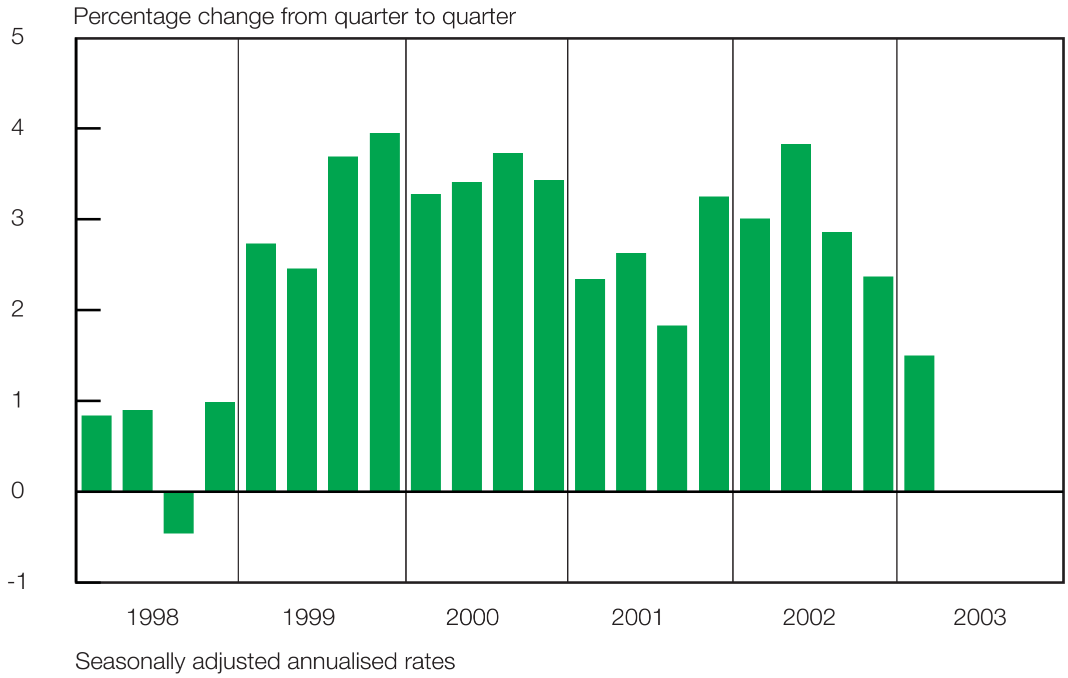
Domestic economic developments

Domestic output[1]

The growth in South Africa's *real gross domestic product* slowed down from an annualised rate of 2½ per cent in the fourth quarter of 2002 to 1½ per cent in the first quarter of 2003. The further slowdown in real economic growth was evident in all major sectors of the economy; growth in the real value added by the secondary and tertiary sectors of the economy slowed down considerably while real value added by the primary sectors declined.

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

Real gross domestic product



Growth in the real value added by the *primary sector* declined at an annualised rate of 2 per cent in the first quarter of 2003. This follows four quarters of positive growth rates in 2002, mainly due to a buoyant agricultural sector. Real output contracted in both the agricultural and mining sectors in the first quarter of 2003.

Growth in the real value added by the traditionally volatile *agricultural sector* was steadily positive throughout 2002. Field crop production maintained high levels, especially the maize crop which did exceptionally well. Early indications are that field crop production is likely to be less buoyant this year. Real output of the agricultural sector declined at an annualised rate of 3 per cent in the first quarter of 2003, spread across most subsectors of agriculture, compared with positive growth of ½ a per cent in the fourth quarter of 2002.

The real value added by the *mining sector* has been declining since the fourth quarter of 2002. After a marginal contraction in the fourth quarter of 2002, mining output declined at an annualised rate of ½ a per cent in the first quarter of 2003. This can be attributed to a contraction in real output by diamond and platinum mining. Diamond mining output suffered as a result of weak global demand. Real output of the platinum mines declined partly due to industrial action at one of the platinum mines. By contrast, real output of the coal and gold-mining sectors increased in the first quarter of 2003.

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
Primary sectors	3½	4½	2½	0	1½	-2
Agriculture	7½	9	5	½	4	-3
Mining	½	1½	1	0	-½	-½
Secondary sectors	3½	5	3	2	3½	½
Manufacturing	4	6	3½	1½	4	-½
Tertiary sectors	2½	3½	3	3	3	2½
Non-primary sectors	3	4	3	2½	3	2
Total	3	4	3	2½	3	1½

Growth in the real value added by the *secondary sector* slowed down substantially from an annualised rate of 2 per cent in the fourth quarter of 2002 to just ½ a per cent in the first quarter of 2003. This can mainly be attributed to a contraction in the real value added by the manufacturing sector and sharply lower growth in the real value added in the sector supplying electricity, gas and water. In addition, growth in the real value added by the construction sector also tapered off in the first quarter of 2003.

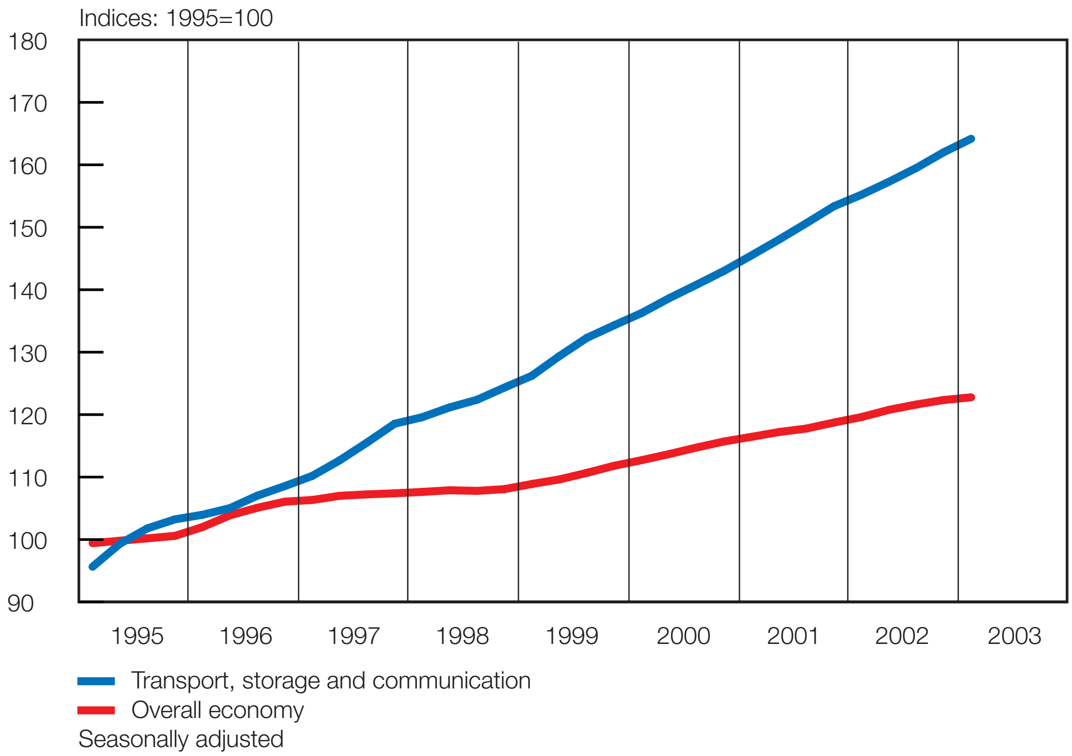
Following quarter-to-quarter annualised growth rates of between 1½ and 6 per cent in 2002, the real value added by the *manufacturing sector* declined by ½ a per cent in the first quarter of 2003. The decline was evident in a number of sectors, particularly export-oriented sectors. These include the clothing, textile and leather subsector, chemicals and chemical products, non-metallic products, basic metals, electrical apparatus and transport equipment.

The decline in the real value added by the manufacturing sector in the first quarter of 2003 can be attributed to several factors:
- The appreciation of the exchange rate of the rand, which weakened the international competitiveness of South African industries.
- Weaker-than-expected export demand from South Africa's major trading partners, whose economies remained sluggish.
- A slight slowdown in domestic demand.

Growth in the real value added in the sector that supplies *electricity, gas and water* slowed down from an annualised rate of 4 per cent in the fourth quarter of 2002 to 1½ per cent in the first quarter of 2003. This is consistent with the general slowdown in economic growth. Although growth in the *construction sector* slowed down slightly from the fourth quarter of 2002 to the first quarter of 2003, it remained quite strong owing to capital expenditure on construction works by both the private sector and public authorities. Activity in the construction sector was supported by a sustained higher level of demand for private residential construction.

Growth in the real value added by the *tertiary sector* slowed down from an annualised rate of 3 per cent in the fourth quarter of 2002 to 2½ per cent in the first quarter of 2003. This slowdown can be ascribed to weaker growth in the real value added by the commerce and the transport, storage and communication sectors where activity is slowing down for the first time in four quarters. The finance, insurance, real-estate and business services sector continued to register rather lacklustre growth in the first quarter of 2003.

Real value added in the overall economy and in transport, storage and communication



Growth in the real value added by the *commerce sector* slowed down from an annualised rate of 3 per cent in the fourth quarter of 2002 to 1½ per cent in the first quarter of 2003. This was mainly due to a decline in the real output of the wholesale subsector and slower growth in the catering and accommodation subsector. The slowdown of growth in the real value added by catering and accommodation enterprises might be a response to the stronger rand which reduced the competitiveness of South Africa's tourism industry. This more than neutralised a marginal improvement in real output by the motor trade subsector.

Growth in the real value added by the *transport, storage and communication sector* continued at a sturdy pace of 5½ per cent in the first quarter of 2003, albeit slightly weaker than the growth of 6½ per cent recorded in the fourth quarter of 2002. Air transport benefited from the ICC Cricket World Cup that was hosted by South Africa in the first quarter of 2003. Strong growth in the communications subsector was posted in the real value added by the cellular telephone industry, which continues to benefit from technological innovations. However, growth in the real value added by land transport as well as communication, other than by means of cellular phones, was weak in the first quarter of 2003.

Growth in the real value added by the *finance, insurance, real-estate and business services sector* remained constant at an annualised rate of 2 per cent in the fourth quarter of 2002 and the first quarter of 2003. This can mainly be attributed to lower growth in the real output of commercial banks and securities dealers. Lower trading volumes on the JSE Securities Exchange SA had an adverse impact on the real value added by securities dealers. The sturdy performance of the real-estate sector was not sufficiently strong to offset the slowdown in growth in the real value added by the other subsectors of this industry.

Domestic expenditure[2]

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

Aggregate real gross domestic expenditure slowed down from an annualised rate of 5 per cent in the fourth quarter of 2002 to 3½ per cent in the first quarter of 2003. This resulted from a notable slowdown in growth in real gross capital formation; growth in real final consumption expenditure by households and general government remained at the levels recorded in the fourth quarter of 2002.

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
Final consumption expenditure by households	3½	4	3	2½	3	2½
Final consumption expenditure by general government	3½	3½	3½	4	3½	4
Gross fixed capital formation	7	8	8½	11½	6½	8½
Change in inventories (R billions,1995 prices)	6,4	0,4	4,5	6,2	4,4	4,2
Gross domestic expenditure	5½	-½	7½	5	4	3½

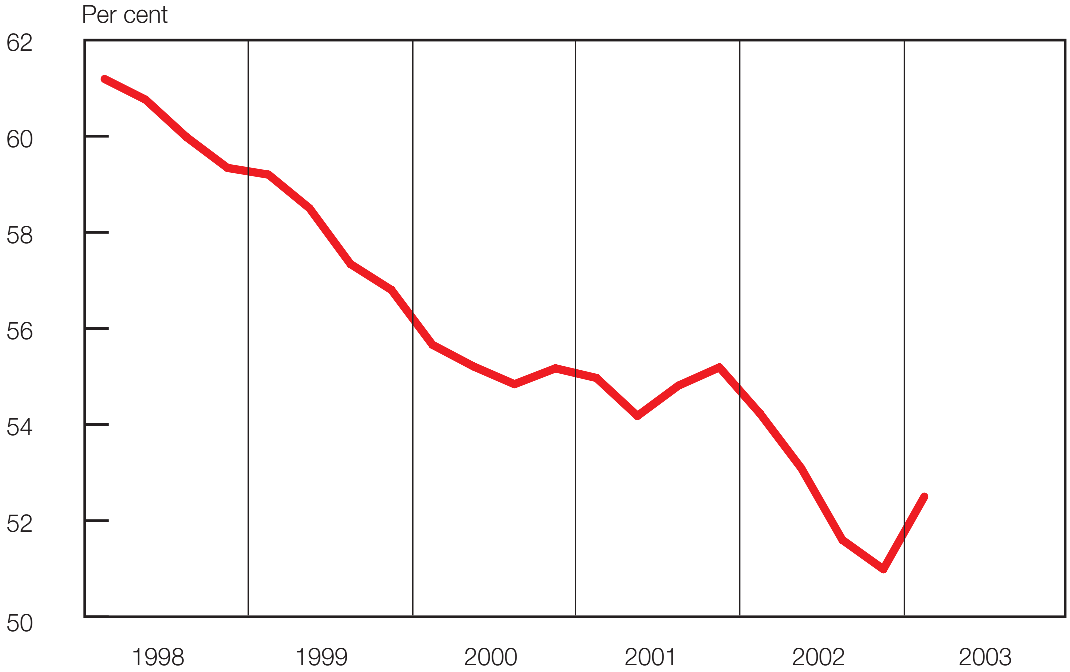
Real final consumption expenditure by households increased at an annualised rate of 2½ per cent in the first quarter of 2003, roughly similar to the rate attained in the fourth quarter of 2002. A slowdown in growth in real outlays on services was countered by an acceleration in growth in real outlays on durable, semi-durable and non-durable goods.

The steady growth in real final consumption expenditure by households was underpinned by a resurgence in consumer confidence in the first quarter of 2003, probably in anticipation of higher disposable income following personal tax reductions. However, the growth rate in real household disposable income edged down from 2,6 per cent in the fourth quarter of 2002 to 2,3 per cent in the first quarter of 2003. Some households were unable to maintain consumption expenditure without incurring more debt, while others made use of credit facilities to acquire capital assets. The ratio of household debt to disposable income increased from 51 per cent in the fourth quarter of 2002 to 53 per cent in the first quarter of 2003, in contrast to its general downward movement since 1998.

After declining in the fourth quarter of 2002, real outlays on *durable goods* increased somewhat in the first quarter of 2003. This was mainly due to an increase in real expenditure on furniture and household appliances, and on transport equipment.

Real outlays on furniture and household appliances were boosted by a decline in the prices of electronic goods, in turn related to these goods' high import content and the strengthening of the exchange rate of the rand. In addition, the prices of new cars stabilised, which helped to support demand.

Household debt as percentage of disposable income



Seasonally adjusted

Growth in real expenditure on *semi-durable goods*, particularly clothing and footwear, accelerated in the first quarter of 2003. This can partly be attributed to a slight decline in the price levels of clothing and footwear in the first quarter of 2003 compared with the average level of these prices in the fourth quarter of 2002.

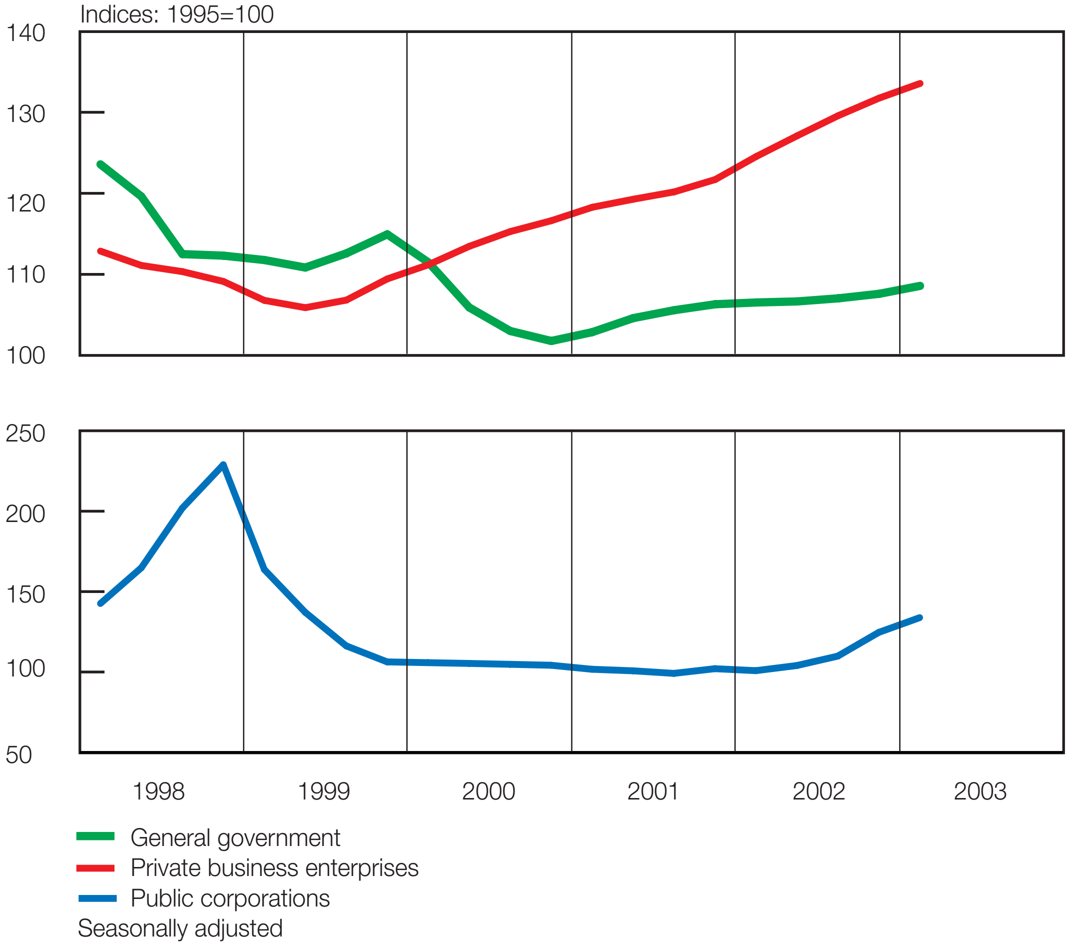
After virtually no growth was recorded in the fourth quarter of 2002, growth in real outlays on *non-durable goods* accelerated to an annualised rate of 2 per cent in the first quarter of 2003, led by higher expenditure on food and beverages, medical and pharmaceutical products, and petroleum products. Real outlays on food increased alongside declining food inflation, while real expenditure on petroleum products benefited from lower petrol prices.

In contrast to other categories of household expenditure, growth in real outlays on *services* slowed down in the first quarter of 2003. This was mainly due to a slow-down in real expenditure on transport and communication services. In addition, households spent less on recreational and entertainment services in the first quarter of 2003 than in the fourth quarter of 2002.

Real final consumption expenditure by general government increased at an annualised rate of 4 per cent in the first quarter of 2003, broadly maintaining the rate attained in the fourth quarter of 2002. Expenditure on non-wage goods and services rose significantly. In addition, compensation of employees increased marginally from the fourth quarter of 2002 to the first quarter of 2003. Final consumption expenditure by general government as a percentage of gross domestic product remained at 19½ per cent in both the fourth quarter of 2002 and the first quarter of 2003.

Growth in *real gross fixed capital formation* slowed down from a very high quarter-to-quarter annualised rate of 11½ per cent in the fourth quarter of 2002 to 8½ per cent in the first quarter of 2003. This can be attributed to slower growth in real capital outlays by private business enterprises and public corporations. By contrast, growth in real capital expenditure by general government accelerated from the fourth quarter of 2002 to the first quarter of 2003.

Real gross fixed capital formation



Growth in real fixed capital outlays by *private business enterprises* slowed down from an annualised rate of 7 per cent in the fourth quarter of 2002 to 5½ per cent in the first quarter of 2003. This can be ascribed to a decline in growth in real outlays by the agricultural sector, following a high rate of increase in real capital outlays in the fourth quarter of 2002. The weakening in the prices of key agricultural products and the expected decline in the size of some field crops resulted in reduced capital outlays on machinery and equipment. However, lively capital formation continued in the other sectors of the economy, especially the mining sector where most of the capital expenditure is related to long-term capacity-creating projects.

Growth in real gross fixed capital formation by *public corporations* slowed down in the first quarter of 2003, following a sharp rise in the fourth quarter of 2002. The acquisition of three Airbus aeroplanes by South African Airways contributed to growth in real fixed capital outlays by public corporations during the past two quarters. Real gross fixed capital formation by public corporations was further supported by continued expenditure on the Coega harbour project.

Growth in real gross fixed capital formation by *general government* accelerated from an annualised rate of 2 per cent in the fourth quarter of 2002 to 3½ per cent in the first quarter of 2003. This was mainly due to an acceleration in real capital outlays by the central government and at local government level. Local government capital expenditure was mainly aimed at infrastructural development and improved service delivery.

Real inventory accumulation slowed down from R6,2 billion in the fourth quarter of 2002 to about R4,2 billion in the first quarter of 2003, broadly in line with the general slowdown in production and expenditure growth. An analysis of inventory investment by economic sector indicates that the slower inventory accumulation took place mainly in the manufacturing sector. This is consistent with the decline in real manufacturing output. As a result of these developments, the ratio of industrial and commercial inventories to non-agricultural gross domestic product remained unchanged from the fourth quarter of 2002 at some 15½ per cent.

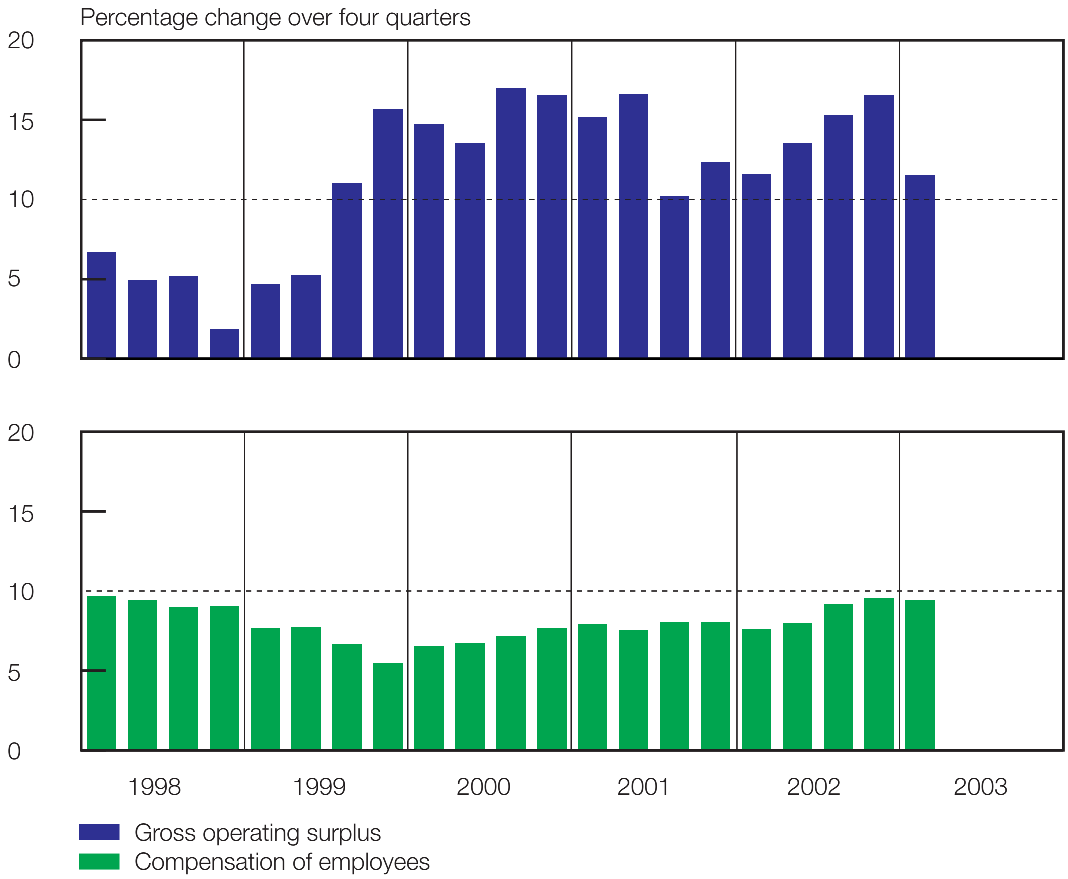
Factor income

The growth in *total factor income*, measured over four quarters, slowed down from 13 per cent in the fourth quarter of 2002 to 10½ per cent in the first quarter of 2003. This was the result of a slowdown in the growth of gross operating surpluses of business enterprises. Year-on-year growth in total compensation of employees in the first quarter of 2003 remained at the rate of 9½ per cent recorded in the fourth quarter of 2002.

The 9½ per cent increase in *total compensation of employees* in the first quarter of 2003 was broadly consistent with the general wage settlements during the second half of 2002 and the relatively stable employment conditions in the formal sector of the economy. Steady growth in compensation of employees was recorded in the manufacturing and commerce sectors, while growth in the mining and finance, insurance, real-estate and business services sectors accelerated somewhat.

Measured over a year, growth in *gross operating surpluses* of business enterprises slowed down from 16½ per cent in the fourth quarter of 2002 to 11½ per cent in the first quarter of 2003. This can mainly be ascribed to a decline in the operating surpluses of the mining sector and slower growth recorded by other sectors. Gross operating surpluses of the agricultural sector were adversely affected by a decline in the international prices of agricultural commodities. This was exacerbated by the strengthening of the exchange rate of the rand. The operating surpluses of the mining sector, whose products are mostly export-oriented, were affected by the strengthening of the rand. This was also the case in the manufacturing sector where the stronger rand eroded export earnings and subjected local producers to heightened import competition. By contrast, the operating surpluses of the services sector, which is largely insulated from exchange rate volatility, continued to expand briskly in the first quarter of 2003.

Gross operating surplus and compensation of employees



Gross saving

Gross saving as a percentage of gross domestic product weakened somewhat from 17 per cent in the fourth quarter of 2002 to 16 per cent in the first quarter of 2003. This can mainly be attributed to weaker saving by general government, while gross saving by the corporate sector and households relative to gross domestic product remained broadly unchanged in the first quarter of 2003.

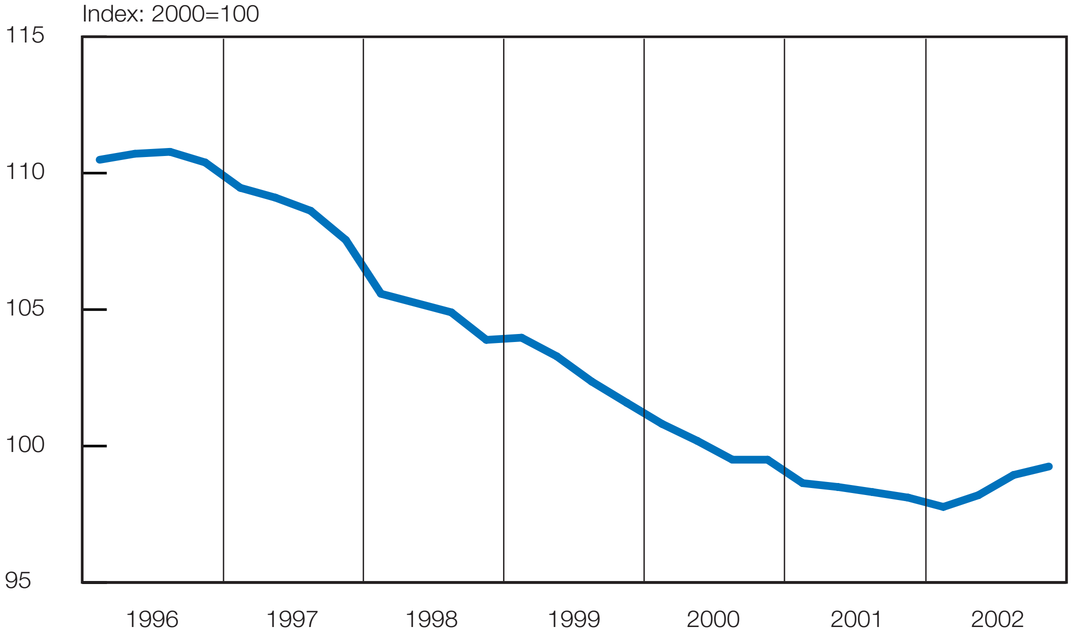
Gross saving by the *corporate sector* as a percentage of gross domestic product remained at 11½ per cent in the first quarter of 2003. Slower growth in operating surpluses kept the corporate saving ratio at about the same level as in the fourth quarter of 2002. There was also an increase in dividend payments to non-resident shareholders. Dividend payments to the rest of the world as a percentage of total dividends paid by incorporated business enterprises amounted to 32 per cent in the first quarter of 2003 compared to about 20 per cent in the fourth quarter of 2002.

Gross saving by *households* as a percentage of gross domestic product remained rather weak in the first quarter of 2003 at a rate of 3 per cent – approximately the same level where it has been for the past year. Gross saving by general government as a percentage of gross domestic product edged lower from an average of 2 per cent in 2002 to about 1½ per cent in the first quarter of 2003. The increase in employee compensation by general government and a strong rise in expenditure on other goods and services counteracted the potential gain in general government saving of higher tax revenues.

Employment

Following five years of decline, *regularly surveyed formal non-agricultural employment* registered a lower turning point in the first quarter of 2002, rising noticeably in each of the subsequent three quarters. This welcome reversal of the trend was accompanied by a cumulative employment gain of about 70 000 workers. Regularly surveyed employment increased by 1,2 per cent in the year to the fourth quarter of 2002. However, the quarterly increase of 15 000 workers in the fourth quarter was less impressive than the increase of 35 000 recorded in the third quarter of 2002.

Non-agricultural employment



Employment in the *private sector* rose at a rate of 1,2 per cent in the year to the fourth quarter of 2002. These employment gains were most pronounced in transport, storage and communication, washing and laundering services, non-gold mining, and manufacturing. On average, private-sector employment rose by 0,3 per cent in 2002 – the first year-to-year rate of increase in seven years.

Year-to-year changes in non-agricultural private-sector employment in 2002

Sector	Percentage change*
Gold mining	-3,1
Non-gold mining	5,5
Manufacturing	0,6
Electricity supply	-1,3
Construction	-1,9
Trade, catering and accommodation services	0,1
Transport, storage and communication	7,2
Financial intermediation and insurance	-3,2
Washing and laundering services	11,7
Total private sector	**0,3**

* Annual average for 2002 compared to that for 2001

Employment in the *manufacturing sector* – apart from government the main sector with the highest number of employees – increased by 2,3 per cent in the year to the fourth quarter of 2002. The growth in employment in the manufacturing sector in particular reflects the success of industrial policy, the expansion in domestic demand and the boost to exports from the exchange rate depreciation in 2001, trade agreements such as the free-trade agreement with the European Union, and opportunities created by the African Growth and Opportunity Act of the United States.

Public-sector employment increased at a year-on-year rate of 1,2 per cent in the fourth quarter of 2002. Employment gains were especially noticeable in national government departments where employment numbers grew at a rate of 5,7 per cent in the year to the fourth quarter of 2002. Measured over one quarter and annualised, public-sector employment increased at a rate of 4,6 per cent in the fourth quarter of 2002. The appointment of temporary employees such as examiners and moderators by some universities and technikons contributed to public-sector employment in the fourth quarter of 2002. A marked decrease in employment numbers in the public transport, storage and communication sector during 2002 weighed on employment growth rates in the public sector throughout the year. Accordingly, average annual employment in the public sector as a whole remained at the same level as in 2001.

The pick-up in formal non-agricultural employment suggests that employment has begun to be somewhat more responsive to economic growth. This may indicate that the restructuring process and productivity increases which have characterised the economy since the early 1990s had progressed to the point where further increases in output increasingly require more labour input. The improvement in employment prospects can be attributed to steady growth in the economy, the introduction of skills development programmes and the tax incentives introduced to boost industrial growth and employment. Broader measures such as agricultural support programmes, increased access of small businesses to financial services and a further easing of the tax burden on low and middle income earners may also have played a role.

The unemployment rate in South Africa remained stable at around the 30 per cent level from February to September 2002. The most recent *Labour Force Survey* by Statistics South Africa confirms that a *smaller* proportion of people were reported to have lost jobs in the six months prior to the September 2002 survey. Out of an economically active population of 15,8 million in September 2002, the survey found that about 4,8 million people were officially unemployed.

Unemployment remains one of the main challenges that face policy makers in the medium term. This issue featured prominently at the Growth and Development Summit held on 7June 2003 between government, labour, business and organised community groupings. At the summit, sectoral and developmental agreements to foster economic growth and job creation were formulated, and the social partners committed themselves to halving the unemployment rate by 2014.

To consolidate the Government’s various initiatives on employment creation, a National Employment Plan was formulated in February 2003. The plan intends to reduce unemployment levels to a target rate of 12 per cent over time.

Labour cost and productivity

The year-to-year growth in *average nominal remuneration per worker* in the formal non-agricultural sectors of the economy accelerated from 9,1 per cent in 2001 to 9,9 per cent in 2002 – the highest rate of increase in the past four years. Remuneration growth in the private sector edged higher on a year-to-year basis, reaching a level just above the 10 per cent mark in 2002. By contrast, average annual growth in public-sector remuneration remained at around the 9,5 per cent level during the past three years to 2002.

Information obtained from the Automated Clearing Bureau regarding average salaries, wages and pensions deposited into the bank accounts of almost 5 million salaried and retired workers suggests that the pace of increase in nominal wage growth probably slowed down in the first quarter of 2003. By contrast, survey results obtained from *Andrew Levy Employment Publications* show that the average rate of wage settlements in collective bargaining agreements rose slightly from an annual average of 8 per cent in 2002 to 8,7 per cent in the first quarter of 2003. It is, however, expected that settlement rates in most sectors will be limited to around the 8 to 9 per cent level in 2003 and that they are unlikely to accelerate further. PE Corporate Services, a leading private-sector labour consultancy, envisages salary increases of around 9 per cent in 2003 as a whole. In those areas where skills shortages are acute, salary increases ranging from 10 to 11 per cent are envisaged.

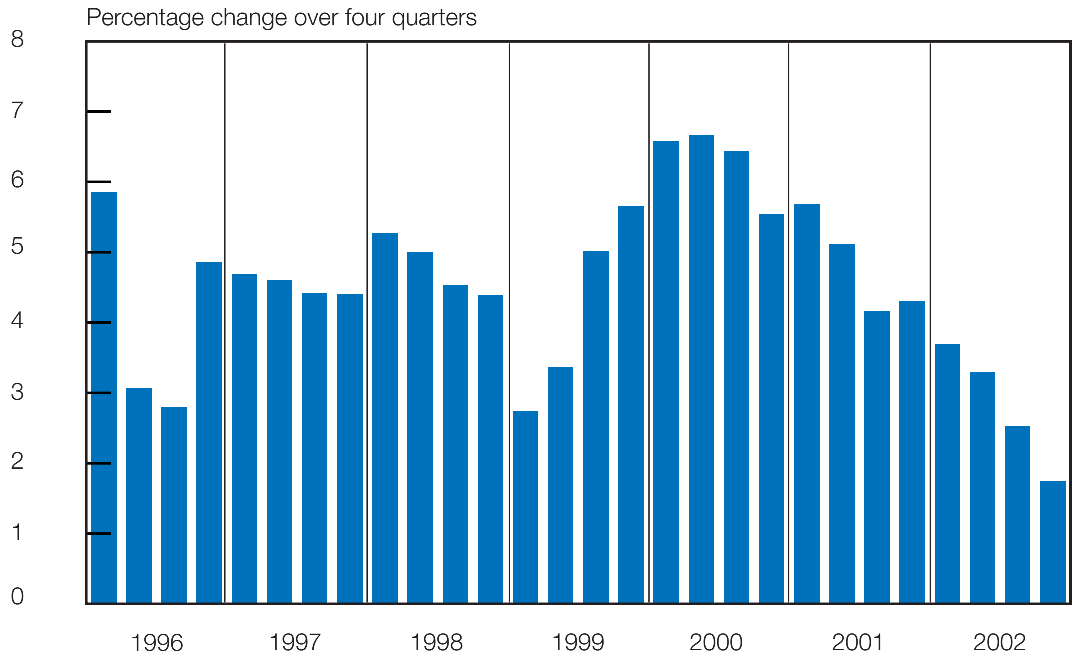
Growth in the average nominal compensation per worker in the *private sector* accelerated from a year-on-year rate of 9,4 per cent in the second quarter of 2002 to 10,3 per cent in the fourth quarter. Gainfully employed workers in the private non-agricultural sector of the economy earned on average some 10,3 per cent more in 2002 than in 2001. In a number of subsectors, remuneration growth rates remained below 10 per cent during 2002, but in financial services, trade, catering and accommodation services, transport, storage and communication, and construction, salary increases in excess of ten per cent were granted. Remuneration increases in the banking and insurance sector were on average almost 17 per cent during 2002.

The year-on-year rate of increase in nominal remuneration per worker in the *public sector* varied between 21,2 per cent in the third quarter of 2002 (when remuneration was bolstered by annual salary increases and the payment of performance bonuses) and 2,7 per cent in the fourth quarter (when the year-on-year growth rate was compressed by a high value for the fourth quarter of the preceding year). On average, though, nominal remuneration growth per worker in the public sector amounted to 9,5 per cent in 2002. This rate of increase is on a par with those rates of increase in the preceding two calendar years, signalling no moderation in wage growth in the public sector during 2002.

Partly as a result of increased international competitiveness following the sharp depreciation of the rand in the closing months of 2001, growth in manufacturing production picked up strongly to a year-on-year rate of 7,6 per cent in the third quarter of 2002. Consequently, growth in labour productivity in the manufacturing sector (measured as real output per worker) rose, on balance, from a year-on-year rate of 4,5 per cent in the first quarter of 2002 to 6,4 per cent in the third quarter. Subsequently, this rate of increase fell back to 0,6 per cent in the fourth quarter of 2002 as manufacturing production slowed down and more employment was absorbed in the production process.

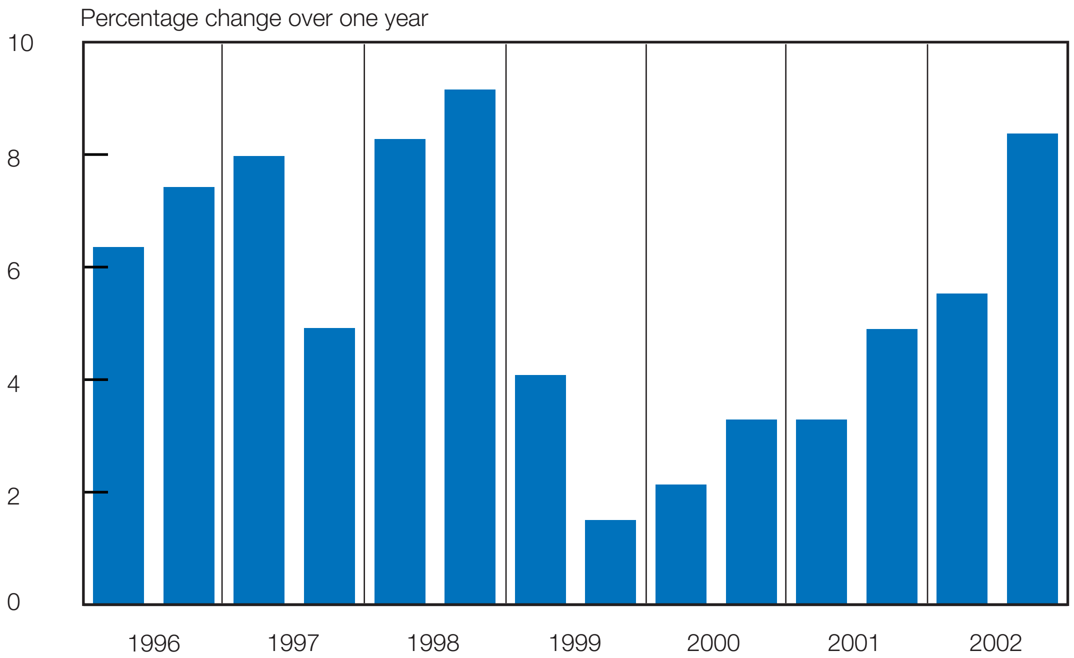
Economy-wide labour productivity growth was far more sedate than in the manufacturing sector, amounting to a year-to-year rate of only 2,8 per cent in 2002 compared with 4,6 per cent in the manufacturing sector. Average productivity growth over one year in both the overall non-agricultural sector and the manufacturing sector in particular, slowed down during 2002. When measured over periods of four quarters, productivity growth in the non-agricultural sector of the economy slowed down progressively from 3,7 per cent in the first quarter of 2002 to 1,8 per cent in the fourth quarter – the lowest rate of increase in the past decade.

Non-agricultural labour productivity



The sharp fallback in the rate of increase in labour productivity, combined with an increase in nominal wage growth, propelled the pace of increase in *nominal unit labour cost in the manufacturing sector* from a year-on-year rate of 0,6 per cent in the third

Non-agricultural nominal unit labour cost



quarter of 2002 to 9,0 per cent in the fourth quarter. On average, though, the increase in nominal unit labour cost in the manufacturing sector amounted to 4,1 per cent in 2002. This rate of increase was marginally higher than in the preceding year but almost twice as high as when the unit labour cost cycle bottomed out in 2000 at a rate of 2,4 per cent. The favourable outcome of growth in nominal unit labour cost in the manufacturing sector in 2002 as a whole contributed meaningfully to the moderation of production price inflation during that year.

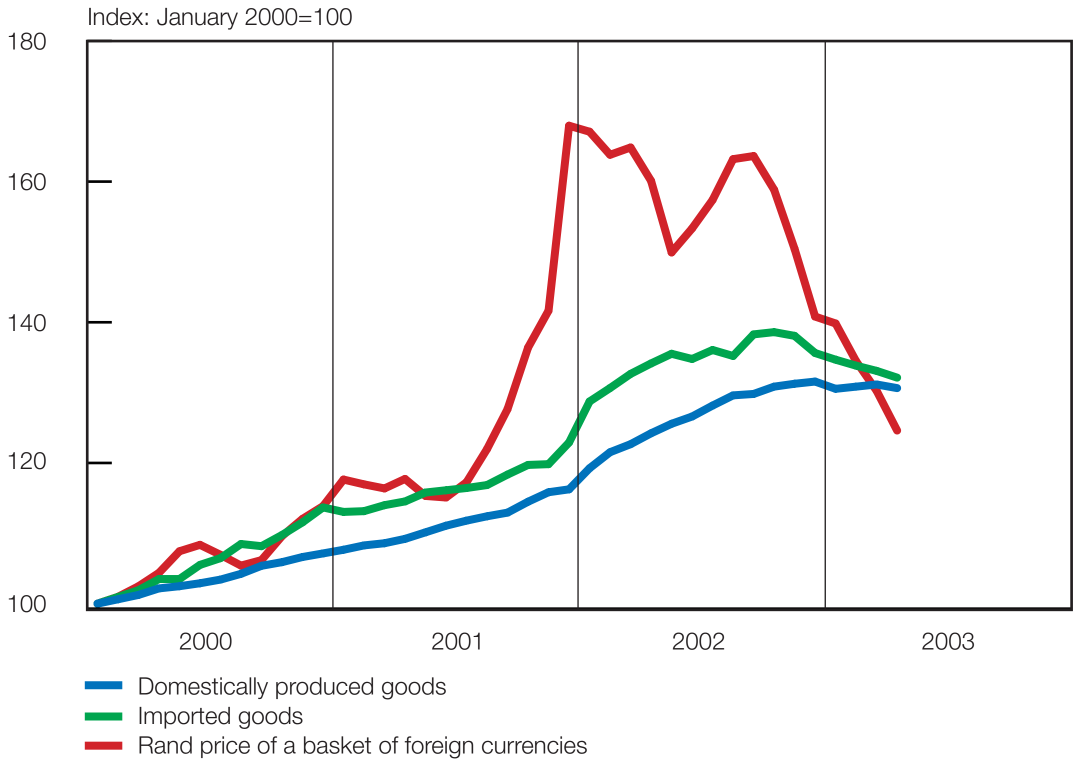
Contrary to the acceleration in the growth in nominal unit labour cost in the manufacturing sector towards the end of 2002, nominal unit labour cost in the other sectors of the economy advanced at a much slower pace. Nonetheless, in 2002 as a whole, a slowdown in economy-wide labour productivity and rising nominal wage growth resulted in *nominal unit labour cost in the overall formal non-agricultural sector of the economy* increasing at a rate of 7,0 per cent. This rate of increase is almost twice as high as in 2001 and is not fully consistent with the inflation target set by government.

Prices

Largely driven by movements in the exchange rate of the rand, production price inflation and, some time later, consumer price inflation reached their peak values in the course of 2002. The inflationary momentum which had built up was moderated by a more conservative monetary policy stance and the marked strengthening of the exchange value of the rand up to April 2003. Inflationary pressures therefore waned in the final months of 2002 and the early part of 2003.

Changes in *production prices,* which generally precede changes in consumer prices, fell back considerably from a peak year-on-year inflation rate of 15,4 per cent in September 2002 to 3,3 per cent in April 2003. Slowdowns in the pace of increase in

Production prices and rand price of a basket of foreign currencies



the prices of both imported and domestically produced goods assisted this slowdown in production price inflation. The two main drivers of slowing production price inflation were the substantial appreciation of the rand and the associated moderating food price inflation at both the agricultural and manufacturing levels. Viewed from quarter to quarter and annualised, the pace of change in the all-goods production price index reversed from an increase of 25,8 per cent in the first quarter of 2002 to a decrease of 3,2 per cent in the first quarter of 2003.

Production prices

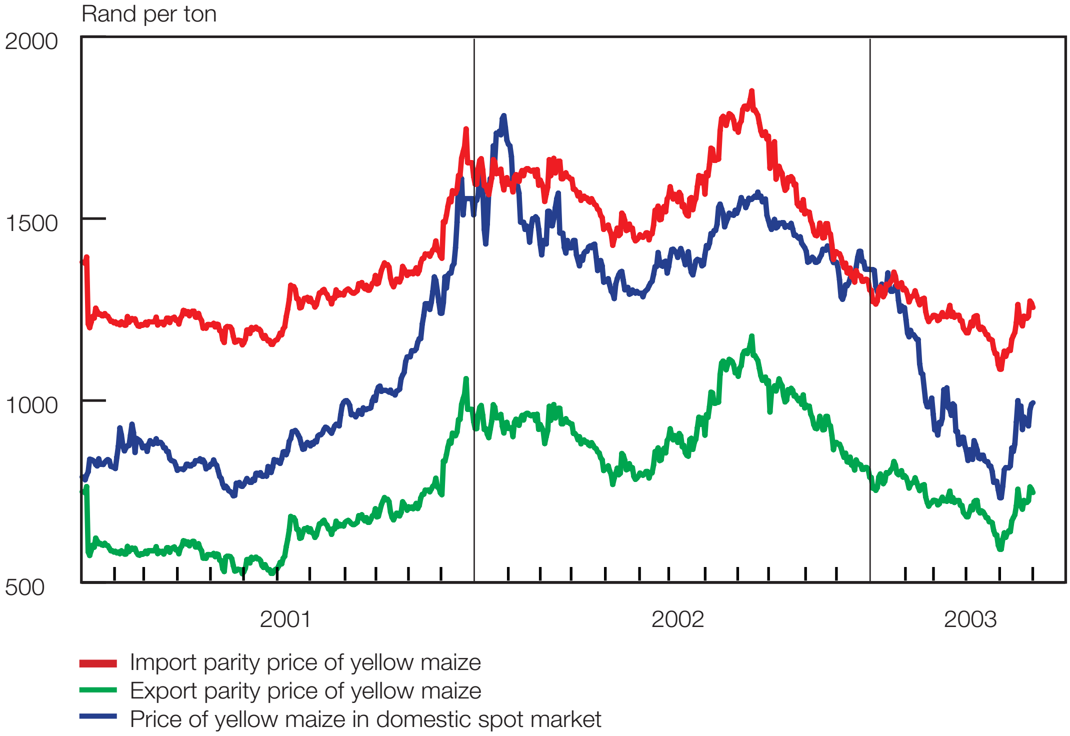
Quarter-to-quarter percentage changes at seasonally adjusted annualised rates

Period		Domestically produced goods	Imported goods	Overall production prices
2001:	1st qr	6,5	6,4	6,7
	2nd qr	7,5	7,6	7,4
	3rd qr	8,3	6,1	7,9
	4th qr	11,7	12,9	11,6
	Year	**7,8**	**10,0**	**8,4**
2002:	1st qr	21,1	36,9	25,8
	2nd qr	14,9	13,3	14,0
	3rd qr	12,4	5,1	10,6
	4th qr	6,2	2,7	5,3
	Year	**13,5**	**15,5**	**14,2**
2003:	1st qr	-0,9	-10,0	-3,2

Year-on-year inflation in the production prices of *domestically produced goods* receded appreciably from around 13 per cent in the closing months of 2002 to 5,1 per cent in April 2003. This slowdown resulted mainly from decreases in the prices of agricultural food products, notably grain, and a slower pace of increase in the prices of manufactured food products. In turn, the easing in food price inflation resulted from good crops and the strengthening of the rand. By April 2003, the rand price of maize – central in the staple diet of many South Africans – had more than halved since the beginning of 2003. Both the import parity and export parity price of this commodity fell in rand terms, and the actual spot price receded from levels close to import parity to levels approximating export parity. Subsequently, the spot price of maize rose again in tandem with increases in both the import and export parity price. In recent months changes in the prices of most other domestically produced goods also contributed to the lower production price inflation, although increases in the prices of transport equipment, metal products, and wood and wood products remained stubbornly high. An increase in nominal unit labour cost during 2002, driven by relatively high rates of increase in nominal remuneration per worker that were not matched by labour productivity growth, prevented a more rapid deceleration in inflation in the prices of domestically produced goods.

The quarter-to-quarter pace of change in the prices of domestically produced goods, which was still proceeding at an annualised inflation rate of 12,4 per cent in the third quarter of 2002, moved to *deflation* at a rate of 0,9 per cent in the first quarter of 2003. All the main categories of domestically produced goods either experienced lower rates of inflation in the first quarter of 2003 or outright deflation in their prices. The largest fall in prices was registered by agricultural food prices, which declined at an annualised rate of no less than 37,9 per cent in the first quarter of 2003.

Maize prices



As could be expected, *imported goods inflation* benefited most from the strong appreciation of the rand. The year-on-year rate of change in the prices of imported goods declined from a peak increase of 16,7 per cent in September 2002 to a decrease of 1,4 per cent in April 2003. This was partly due to a high base for year-on-year growth calculations: a very sharp increase in the price index for imported goods occurred in the period December 2001 to April 2002. More importantly, however, the trade-weighted exchange rate of the rand appreciated by 28,5 per cent in the twelve-month period to April 2003. The fallback in imported goods inflation was even more pronounced when measured over one quarter and expressed at an annualised rate. The short-term pace of increase in the prices of imported goods changed from an annualised inflation rate of 36,9 per cent in the first quarter of 2002 to *deflation* at a rate of 10,0 per cent in the first quarter of 2003. This drastic reversal was recorded notwithstanding rising international oil prices in early 2003.

Diminishing price pressures at the production level contributed to an easing of the pressure on end-product prices. Overall *consumer price inflation* declined from a revised twelve-month rate of 13,0 per cent in October 2002 to 8,8 per cent in April 2003.

When measured from quarter to quarter and annualised, overall consumer price inflation slowed down significantly from a rate of 14,4 per cent in the fourth quarter of 2002 to 3,8 per cent in the first quarter of 2003. Annualised inflation in the prices of both consumer goods and services abated to fairly low single-digit levels in the first quarter of 2003.

Lower rates of inflation in the prices of *consumer goods* were an important force in the recent slowdown in overall consumer price inflation. Inflation in the prices of consumer goods declined from a year-on-year rate of 13,0 per cent in October 2002 to 8,2 per cent in April 2003, not least due to lower food inflation.

Consumer prices

Quarter-to-quarter changes at seasonally adjusted annualised rates

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

When measured from quarter to quarter, inflation in the prices of consumer goods slowed down over a wide front in the first quarter of 2003. In fact, lower rates of increase were recorded in all the major consumer goods categories, including an outright decline in the prices of clothing and footwear. The annualised rate of consumer goods price inflation declined steeply from 13,7 per cent in the fourth quarter of 2002 to 2,7 per cent in the first quarter of 2003 – the lowest rate of increase since the third quarter of 1995.

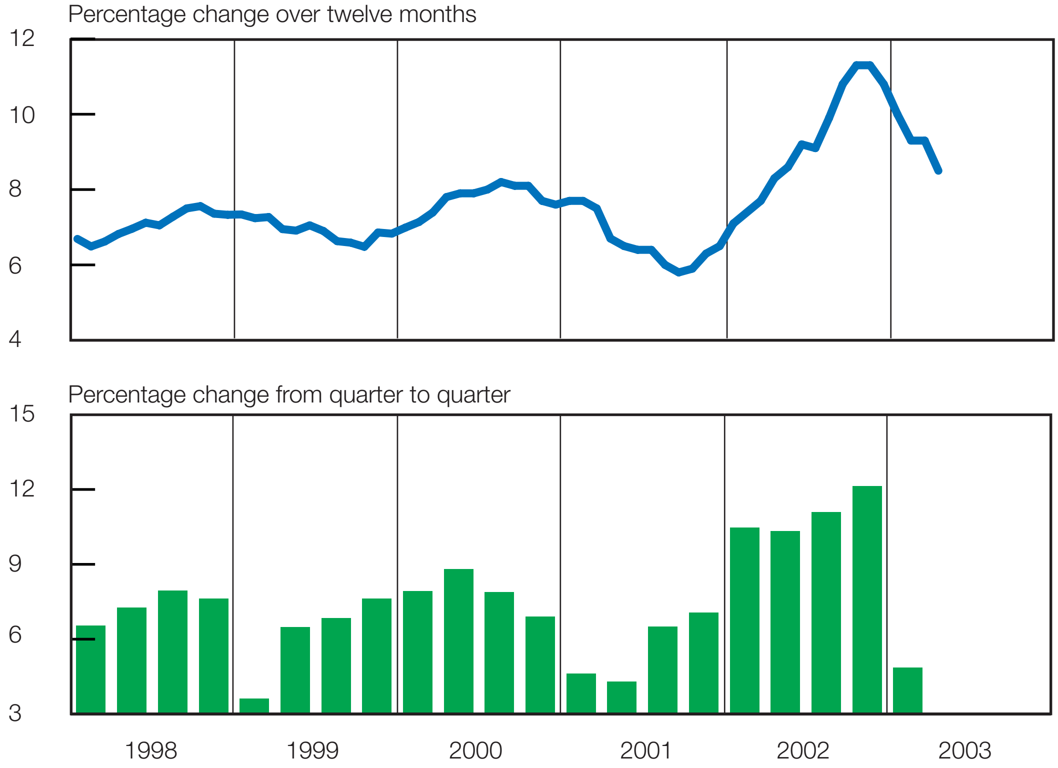
Declines in services price inflation generally lag declines in goods inflation because the prices of non-tradable services do not benefit directly from imported disinflation. A number of service providers also face little competition domestically, causing prices to be sticky in the downward direction.

Consumer services price inflation has exceeded consumer goods price inflation since November 2002, and recorded a twelve-month rate of 9,9 per cent in April 2003. The prices of housing and transport services contributed significantly to the high rate of services price inflation. An improved methodology for calculating inflation in rental values was introduced by Statistics South Africa along with the release of the April 2003 consumer price index; the new methodology led to significantly lower levels of overall inflation, backdated to January 2002. Based on the revised data, inflation in the prices of consumer services moderated from an annualised rate of 15,7 per cent in the fourth quarter of 2002 to 5,8 per cent in the first quarter of 2003. Decelerating housing services price inflation was the main contributor to this slowdown.

CPIX inflation (i.e. changes in the overall consumer price index for metropolitan and other urban areas, excluding the interest cost of mortgage bonds) rose steeply from a most recent low rate of 5,8 per cent in September 2001 to a high of 11,3 per cent in November 2002. Mainly on account of a slowdown in food price inflation, CPIX inflation then moderated to 8,5 per cent in April 2003.

Decelerating CPIX inflation in recent months is not only substantiated by a slower pace of year-on-year increases in the index, but more so by a substantial waning in its short-term pace of increase. In fact, annualised CPIX inflation slowed down from 12,1 per cent in the fourth quarter of 2002 to 4,8 per cent in the first quarter of 2003. The latter value was the first below-six-per-cent rate recorded since early 2001. The slowdown in the first quarter of 2003 was broadly based, as inflation in all CPIX categories moderated. In particular, food price inflation fell steeply from an annualised rate of 22,2 per cent in the third quarter of 2002 to only 3,2 per cent in the first quarter of 2003.

CPIX



Seasonally adjusted and annualised

In general, the following factors may contribute to a continuation of waning inflation in the coming months:

- low inflation rates in the advanced economies, and even deflation in some of them;
- indications of a slowdown in the growth in domestic economic activity;
- considerable surplus production capacity in the domestic economy;
- lower international crude oil price levels;
- a better performance of the exchange value of the rand;
- falling prices of certain foodstuffs;
- corrected lower inflation rates feeding into inflation expectations;
- subdued money supply growth; and
- prudent fiscal policy.

Paramount to the outcome of future price inflation will be the extent to which inflation expectations conform to the lower trend in inflation. Of concern is the upward drift in the growth in unit labour cost, not only as a result of slightly higher wage increases but also of smaller gains in productivity. The relative inflexibility of administered prices may also delay the further slowdown in the pace of consumer price inflation.

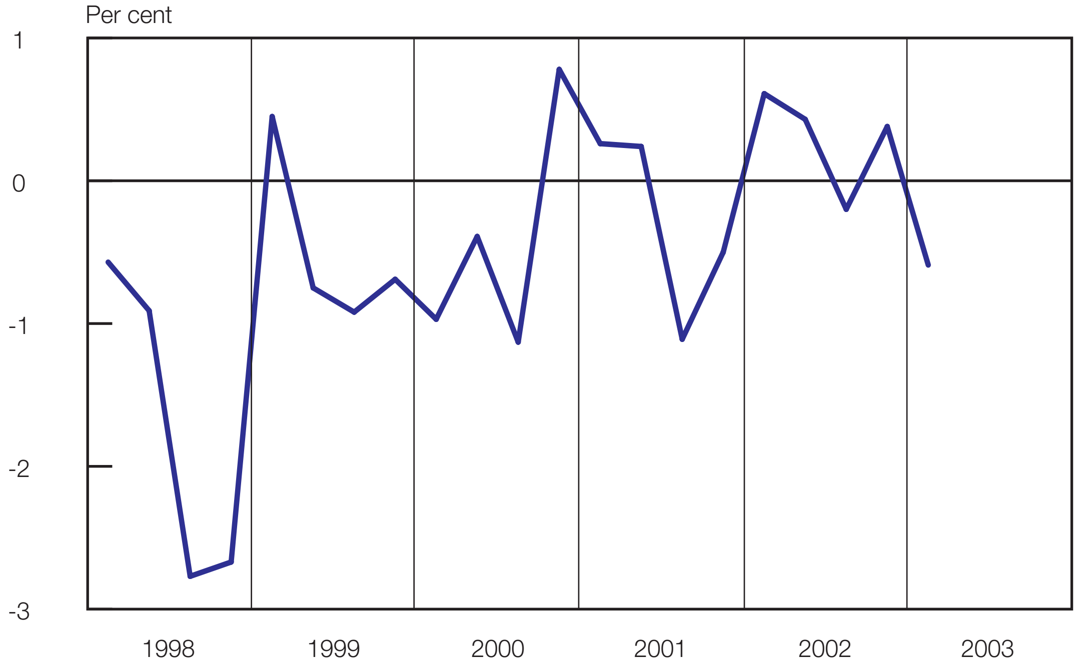
Foreign trade and payments

Current account[3]

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

The balance on current account changed from a surplus of R4,3 billion in the fourth quarter of 2002 to a deficit of R6,8 billion in the first quarter of 2003. This turnabout reflected the weakness of the world economy and the recovery of the exchange rate of the rand. As a percentage of gross domestic product, the current-account deficit amounted to 0,6 per cent in the first quarter of 2003, compared with a surplus of 0,4 per cent in the fourth quarter of 2002.

Ratio of current-account balance to gross domestic product



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

	2002					2003
	1st qr	2nd qr	3rd qr	4th qr	Year	1st qr
Merchandise exports	277,1	288,5	272,1	295,9	283,4	257,8
Net gold exports	39,6	43,5	46,9	40,2	42,6	35,6
Merchandise imports	-273,5	-276,0	-276,8	-293,0	-279,8	-261,4
Trade balance	**43,2**	**56,0**	**42,2**	**43,1**	**46,2**	**32,0**
Net service, income and current transfer payments	-36,8	-51,4	-44,4	-38,8	-42,9	-38,8
Balance on current account	**6,4**	**4,6**	**-2,2**	**4,3**	**3,3**	**-6,8**

Relatively subdued external demand for domestically produced goods contributed to the narrowing of the trade surplus from R43,1 billion in the fourth quarter of 2002 to R32,0 billion in the first quarter of 2003. The contraction in total export earnings was only partially offset by a contraction in the value of imported goods.

The deficit on the country's services and income account with the rest of the world remained broadly unchanged from the fourth quarter of 2002 to the first quarter of 2003, thus precluding a further deterioration in the current account.

Merchandise exports lost some vigour and declined by about 12,9 per cent from R295,9 billion in the fourth quarter of 2002 to R257,8 billion in the first quarter of 2003. This decline in the value of merchandise exports was mainly due to a substantial decrease in the average rand price of exports, but the physical quantity of merchandise exports also fell back.

Although the US dollar prices of South Africa's export commodities edged higher in the first quarter of 2003, the external value of the rand strengthened to such an extent that the unit value of exported goods declined. The average rand price of exported merchandise fell by 8,0 per cent in the first quarter of 2003. The physical volume of merchandise exports declined by 5,3 per cent in the first quarter of 2003, after having increased by 12,0 per cent in the fourth quarter of 2002. Exporters of manufactured goods – especially of vehicles, transport equipment, machinery and electrical equipment and chemical products – suffered most from the contraction in the international demand for South African-produced goods. As a percentage of gross domestic product, merchandise exports fell from 18,7 per cent in the second quarter of 2002 to 17,6 per cent in the first quarter of 2003.

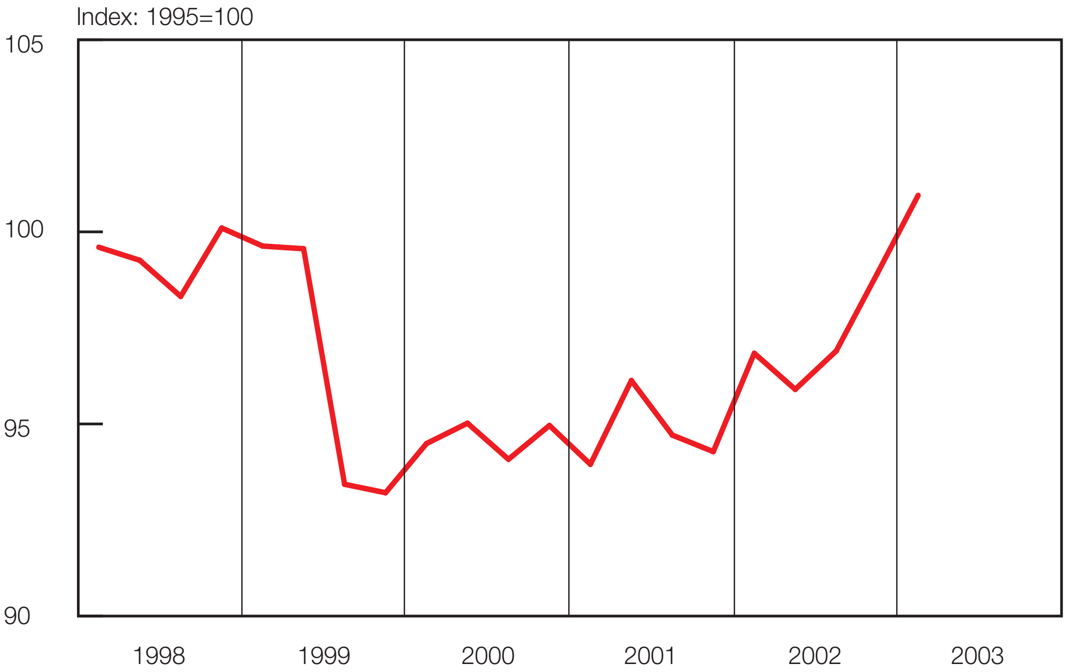
The gold price rallied strongly against the background of heightened international tension and the Iraqi war. On the London market the average fixing price of gold rose from US$323 per fine ounce in the fourth quarter of 2002 to US$352 per fine ounce in the first quarter of 2003. This increase was countered by the appreciation of the rand, which resulted in a lower gold price in rand. The average realised rand price of gold exports decreased by 2,1 per cent from R3 045 per fine ounce in the fourth quarter of 2002 to R2 982 per fine ounce in the first quarter of 2003. The combined impact of this decline in the average realised price of gold exports and a 9,4 per cent decline in its volume caused the value of net gold exports to decline from R40,2 billion in the fourth quarter of 2002 to R35,6 billion in the first quarter of 2003 – its lowest level since the fourth quarter of 2001.

After having risen unabatedly since the first quarter of 2002, the value of merchandise imports declined by 10,8 per cent to R261,4 billion in the first quarter of 2003. An analysis by product category indicates that sizeable declines were recorded in the categories for mineral products (including crude oil), machinery and electrical equipment, vehicles and transport equipment, and chemical products.

The volume of merchandise imports decreased by 3,5 per cent in the first quarter of 2003. Despite this decline, the volume in the first quarter of 2003 was still 3,4 per cent higher than the average level for the year 2002. The fall in the value of merchandise imports was reinforced by a decline of 7,5 per cent in the rand prices of imported goods, essentially as a consequence of the appreciation of the rand and low inflation or even deflation in trading-partner countries.

The higher gold price and stronger prices of other export commodities led to an improvement in South Africa’s terms of trade which rose by 2,1 per cent from the fourth quarter of 2002 to the first quarter of 2003.

Terms of trade including gold



Net dividend payments to non-resident investors increased notably in the first quarter of 2003. This increase in income payments was partially offset by a decline in government’s interest payments to foreign investors, preserving the shortfall on the services and income account of the balance of payments at a more or less unchanged level. Lower payments for transportation services rendered by non-resident carriers and an increase in tourism expenditure by foreign visitors to South Africa also helped to curb the shortfall on the “services account” in the first quarter of 2003.

Financial account

The small surplus on the financial account of the balance of payments in the fourth quarter of 2002 was reversed during the first quarter of 2003 when financial outflows were recorded on a net basis. Net financial outflows to the value of R4,2 billion were recorded in the first quarter of 2003, compared to a net inflow of R0,6 billion in the fourth quarter of 2002. The outflow of capital in the first quarter of 2003 could mainly be attributed to a decline in portfolio and other investment liabilities. This was the third consecutive quarter during which a net outflow of portfolio investment capital was recorded.

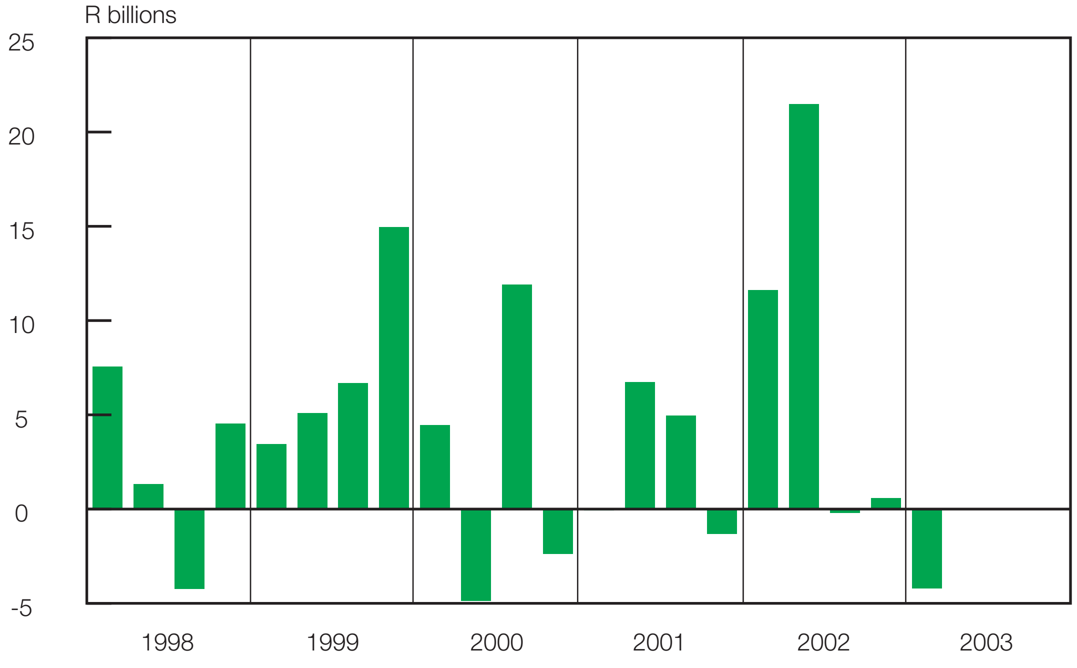
Regarding *foreign-owned assets in South Africa,* a *foreign direct investment* inflow of R0,2 billion was recorded in the first quarter of 2003, compared with a R0,7 billion outflow in the final quarter of 2002. The inflow in the first quarter of 2003 was mainly related to an increase in foreign shareholding in a South African-listed steel company. *Foreign portfolio investors* reduced their holdings of both South African equity and debt securities during the first quarter of 2003. Profit-taking following the significant appreciation of the rand presumably motivated international portfolio investors to reduce their investments in South Africa. With the Telkom Initial Public Offering, non-residents acquired Telkom shares to the value of R0,3 billion (i.e. an inflow of portfolio capital), but this could not prevent a net portfolio capital outflow to the amount of R6,5 billion in the first quarter. *Other foreign investment* recorded an outflow of R5,8 billion in the first quarter of 2003 compared to an outflow of R7,7 billion in the fourth quarter of 2002. The first-quarter outflow occurred mainly as a result of a decline in foreign loan liabilities of the banking sector, while the inflow of non-resident rand deposits into the South African banking sector was fully countered by an outflow of non-resident foreign currency deposits from South African banks.

Net financial transactions not related to reserves
R billions

	2002					2003
	1st qr	2nd qr	3rd qr	4th qr	Year	1st qr
Change in liabilities						
Direct investment	1,7	4,8	2,1	-0,7	7,9	0,2
Portfolio investment	4,4	15,7	-12,9	-1,8	5,4	-6,5
Other investment	14,1	-3,6	-3,9	-7,7	-1,1	-5,8
Change in assets						
Direct investment	-1,2	5,3	2,3	-2,2	4,2	-0,1
Portfolio investment	-6,1	-1,6	-0,8	-1,2	-9,7	-0,4
Other investment	-0,5	-1,0	3,2	10,3	12,0	2,4
Total financial transactions*	**11,6**	**21,5**	**-0,2**	**0,6**	**33,5**	**-4,2**

* Including unrecorded transactions

Balance of payments: Financial account



Regarding *South African-owned assets abroad*, a net increase in *foreign direct investment* assets of R0,1 billion was recorded in the first quarter of 2003 – far less than the R2,2 billion increase recorded in the fourth quarter of 2002. *Portfolio investment* abroad, which has recorded subdued outflows since the second quarter of 2002, recorded an outflow of R0,4 billion in the first quarter of 2003 compared with an outflow of R1,2 billion in the fourth quarter of 2002. The slowdown in these capital outflows could be attributed to the lacklustre performance of global equity markets and the non-renewal of the cashflow-linked avenue through which institutional investors could previously transfer funds abroad. *Other foreign investment* from South Africa recorded a flow-back of capital to an amount of R2,4 billion in the first quarter of 2003 compared with an inflow of R10,3 billion recorded in the fourth quarter of 2002. The inflow of other investment capital was related to the repatriation of foreign-trade finance assets, which is consistent with interest rates in South Africa, exceeding those in most other countries, and the appreciation of the rand.

Foreign debt

South Africa's total outstanding foreign debt increased by US$1,9 billion during 2002, from a level of US$30,8 billion at the end of June 2002 to a level of US$32,7 billion at the end of December 2002. This increase in South Africa's foreign debt was about equally distributed between increases in foreign-currency denominated debt and rand-denominated debt.

Foreign-currency denominated debt increased from US$24,0 billion at the end of December 2001 to US$25,0 billion at the end of December 2002. The national government accessed the foreign capital markets through bond issues and an increase in its foreign-currency denominated loans. This increase in government debt was partially countered by a decline in non-resident foreign-currency deposits with the domestic banking sector.

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

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

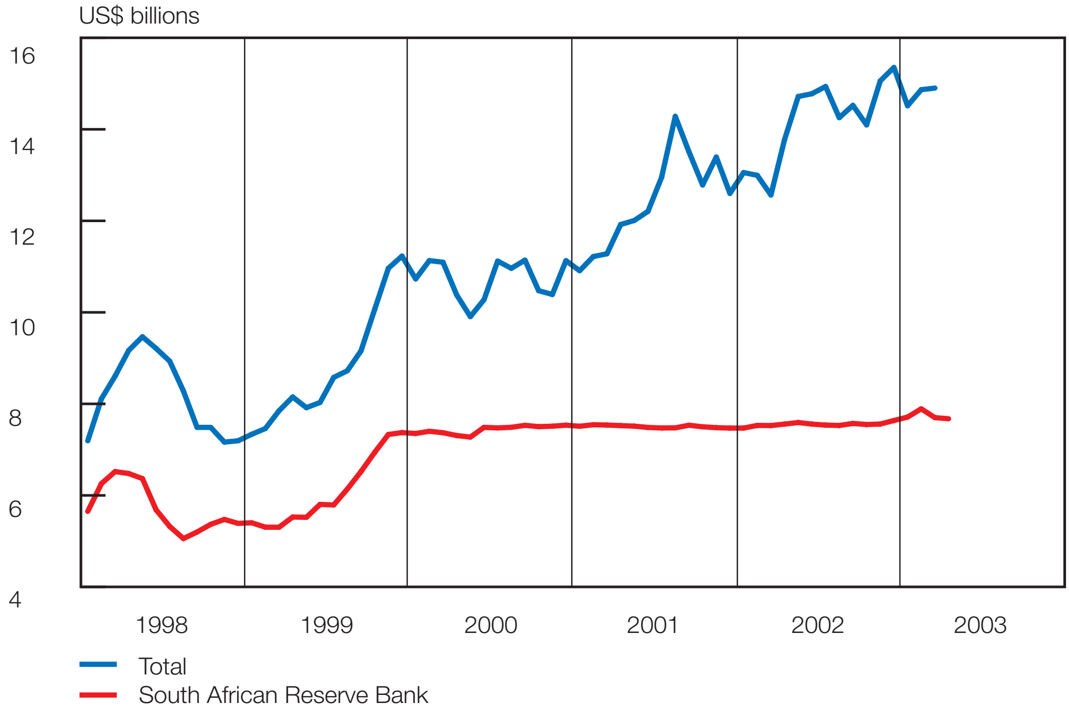
Measured in rand, South Africa's total foreign debt declined from R372,5 billion at the end of 2001 to R283,4 billion at the end of 2002, essentially as a result of the appreciation of the exchange rate of the rand. Expressed as a ratio of annual export earnings, total foreign debt increased from 82,7 per cent to 87,8 per cent over the same period.

Foreign reserves

The deficits on both the current and financial accounts of the balance of payments in the first quarter of 2003 resulted in a decline in South Africa's international reserve holdings of R5,4 billion, compared to an increase of R1,9 billion in the fourth quarter of 2002. For the whole of 2002 the country's net international reserves increased by R36,6 billion.

The value of the country's gross gold and foreign reserves (i.e. international reserves before accounting for reserve-related loans) decreased from R132,6 billion (US$15,4 billion) at the end of December 2002 to R118,3 billion (US$14,9 billion) at the end of March 2003. This decline in gross gold and other foreign reserves coincided with a decline in the value of imports. Consequently, the level of import cover (i.e. the value of gross international reserves relative to the value of imports of goods and services) remained unchanged at 17½ weeks' worth of imports from the end of December 2002 to the end of March 2003.

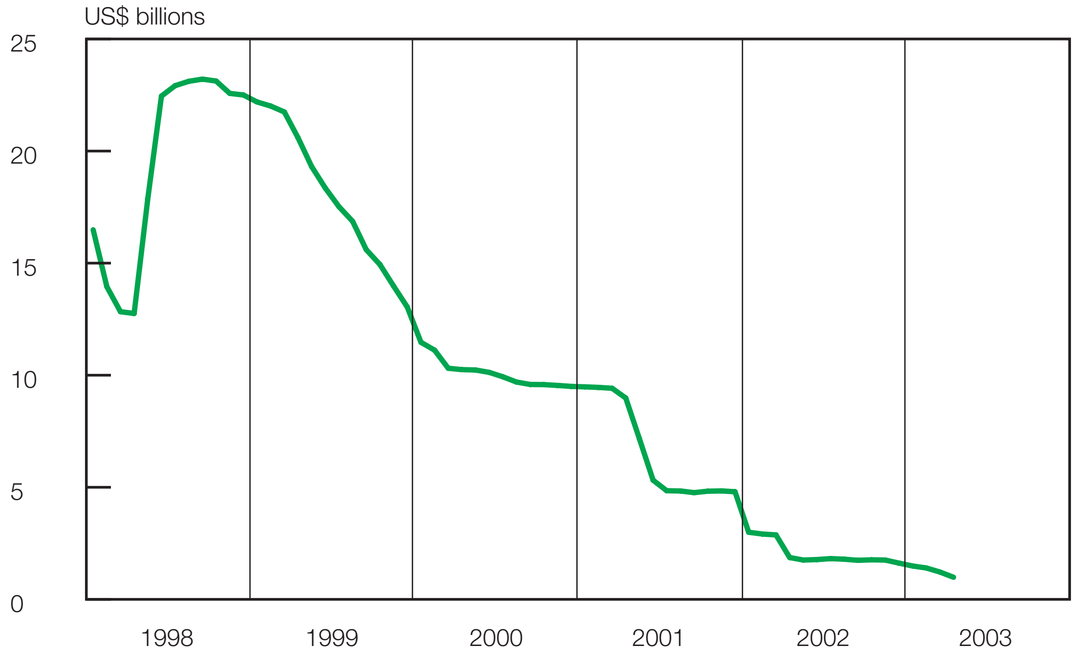
Gross gold and other foreign reserves



The gross gold and other foreign reserves of the Reserve Bank rose from US$7,6 billion at the end of December 2002 to US$7,7 billion at the end of both March and April 2003. The Bank's liabilities related to reserves remained unchanged at US$2,5 billion over the same period. Solely as a result of the appreciation of the rand's exchange value during the first four months of 2003, the rand value of the gross reserves and liabilities related to reserves declined notably over the corresponding period.

The net open foreign-currency position of the Reserve Bank, calculated as the oversold forward position in foreign currency adjusted for net holdings of international reserves, declined from US$1,6 billion at the end of December 2002 to US$1,0 billion at the end of April 2003. On 9 May 2003 the National Treasury announced the launch of a €1,25 billion 10-year global bond. The proceeds from this bond were utilised to close the net open foreign currency position of the Reserve Bank, thereby removing what used to be perceived as an important cause of vulnerability in the South African economy.

Net open position in foreign currency



Oversold position of the Reserve Bank

Exchange rates

After having depreciated by 1,0 per cent during January 2003 on a weighted average basis, the rand appreciated by 8,6 per cent during the following two months, resulting in an increase of 7,5 per cent from the end of December 2002 to the end of March 2003. This followed a 26,0 per cent increase for the year up to the end of December 2002. The rand appreciated by nearly 9 per cent against the US dollar and by about 5 per cent against the euro from the end of December 2002 to the end of March 2003. The nominal effective exchange rate of the rand improved by a further 10,2 per cent from the end of March to the end of April 2003, but depreciated by 14,8 per cent from the end of April to 31 May 2003.

Exchange rates of the rand
Percentage change

	31 Dec 2001 to 28 Jun 2002	28 Jun 2002 to 30 Sep 2002	30 Sep 2002 to 31 Dec 2002	31 Dec 2002 to 31 Mar 2003	31 Mar 2003 to 31 May 2003
Weighted average	**8,4**	**-1,3**	**17,8**	**7,5**	**-6,1**
Euro	3,8	-0,9	14,7	4,8	-9,6
US dollar	16,5	-1,8	22,1	8,9	-1,5
British pound	10,3	-3,8	18,8	11,0	-5,9
Japanese yen............	5,7	0,2	19,0	9,0	-1,7

Revision of the weights used in the calculation of the effective exchange rate of the rand

With the introduction of the euro in January 1999, the South African Reserve Bank revised the weighting structure of the nominal and real effective exchange rates of the rand. In accordance with international practice the weights were based on trade in and consumption of manufactured goods, and were calculated with reference to a basket of the currencies of the country's fourteen most important trading partners.

Owing to the wide margins between the official and parallel market exchange rates of the Zimbabwe dollar and difficulties encountered in obtaining a representative exchange rate for this currency, the Zimbabwe dollar was excluded from the basket of currencies with effect from 1 January 2003. A note in this regard has been available on the Bank's internet website since 31 December 2002.

The process of establishing the revised weighting structure was similar to that described in the article "An indicator of South Africa's external competitiveness" in the September 1999 edition of the *Quarterly Bulletin*, except for the exclusion of the Zimbabwe dollar. The weights are indicated in the table below.

Currencies	Weights prior to January 2003	Weights from January 2003
Euro	35,70	36,38
US dollar	15,15	15,47
British pound	14,91	15,37
Japanese yen	10,26	10,43
Swiss franc	5,28	5,54
China yuan	3,11	3,14
Hong Kong dollar	2,62	2,70
Korean won	2,57	2,64
Zimbabwe dollar	2,27	-
Canadian dollar	1,93	1,96
Swedish krona	1,79	1,81
Australian dollar	1,62	1,68
Singapore dollar	1,62	1,66
Israel shekel	1,17	1,22
Total	100,00	100,00

The strong performance of the rand during the first four months of 2003 could be attributed, among other factors, to:

- the continued weakness of the US dollar;
- the large positive interest rate differential between South Africa and its main trading partners;
- sound monetary and fiscal policies; and
- a further decline in the net oversold open position of the SA Reserve Bank.

During early May 2003 Standard & Poor's and Fitch Ratings, two of the more important international ratings agencies, upgraded South Africa's foreign and local currency sovereign debt ratings and assigned a stable outlook to the country. This further indicates that South Africa is distinguishing itself as a consistent and stable emerging-market country. (See the box on sovereign credit ratings on page 30.)

The net *average daily turnover* in the domestic market for foreign exchange, which had increased to US$8,2 billion in the fourth quarter of 2002, rose further to US$8,4 billion in the first quarter of 2003. The value of transactions in which non-residents participated increased from US$5,0 billion per day to US$5,2 billion per

Sovereign credit ratings

Sovereign credit ratings indicate the creditworthiness of a government, and are an assessment of the capacity and willingness of that government to repay sovereign debt. They are assigned after a thorough assessment of indicators such as national and domestic income, economic structure, economic growth prospects, fiscal flexibility, the public debt burden, price stability, balance of payments flexibility and external debt and liquidity. An investment grade denotes a low level of credit risk, and is in general associated with sound economic fundamentals.

In the recent past, South Africa was afforded favourable credit ratings by three prominent international credit ratings agencies. The accompanying table shows the increasingly favourable rating of the long-term foreign-currency denominated debt of the South African government. The rating of this particular type of debt is important for a country wishing to access the international financial markets. An investment grade rating allows the country access to a wider range of potential investors, and usually contributes to a lower interest rate on the country's foreign debt.

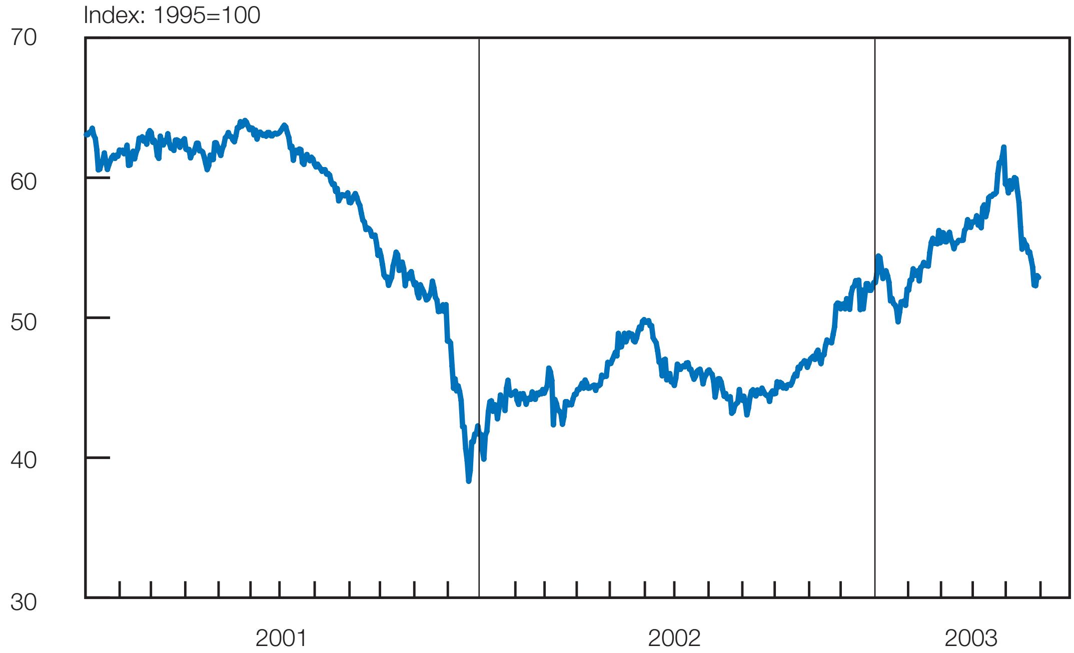
The recent credit rating upgrades have put South Africa in the same category as countries such as Lithuania, Latvia and Tunisia.

Sovereign credit ratings of South Africa's long-term foreign-currency denominated debt

		Moody's		Standard and Poor's		Fitch	
		Rating	Date	Rating	Date	Rating	Date
← Lower risk	Investment grade	Aaa		AAA		AAA	
		Aa1		AA+		AA+	
		Aa2		AA		AA	
		Aa3		AA-		AA-	
		A1		A+		A+	
		A2		A		A	
		A3		A-		A-	
		Baa1		BBB+		BBB+	
		Baa2	29 Nov 2001	BBB	07 May 2003	BBB	02 May 2003
		Baa3	30 May 1995	BBB-	25 Feb 2000	BBB-	27 Jun 2000
Higher risk →	Speculative grade	Ba1		BB+	20 Nov 1995	BB+	19 May 2000
		Ba2		BB	03 Oct 1994	BB	22 Sep 1994
		Ba3		BB-		BB-	
		B1		B+		B+	
		B2		B		B	
		B3		B-		B-	
		Caa1		CCC+		CCC+	
		Caa2		CCC		CCC	
		Caa3		CCC-		CCC-	
		Ca		CC		CC	
		C		C		C	
		-		D		D	

Note: South Africa's current ratings are highlighted

Nominal effective exchange rate of the rand



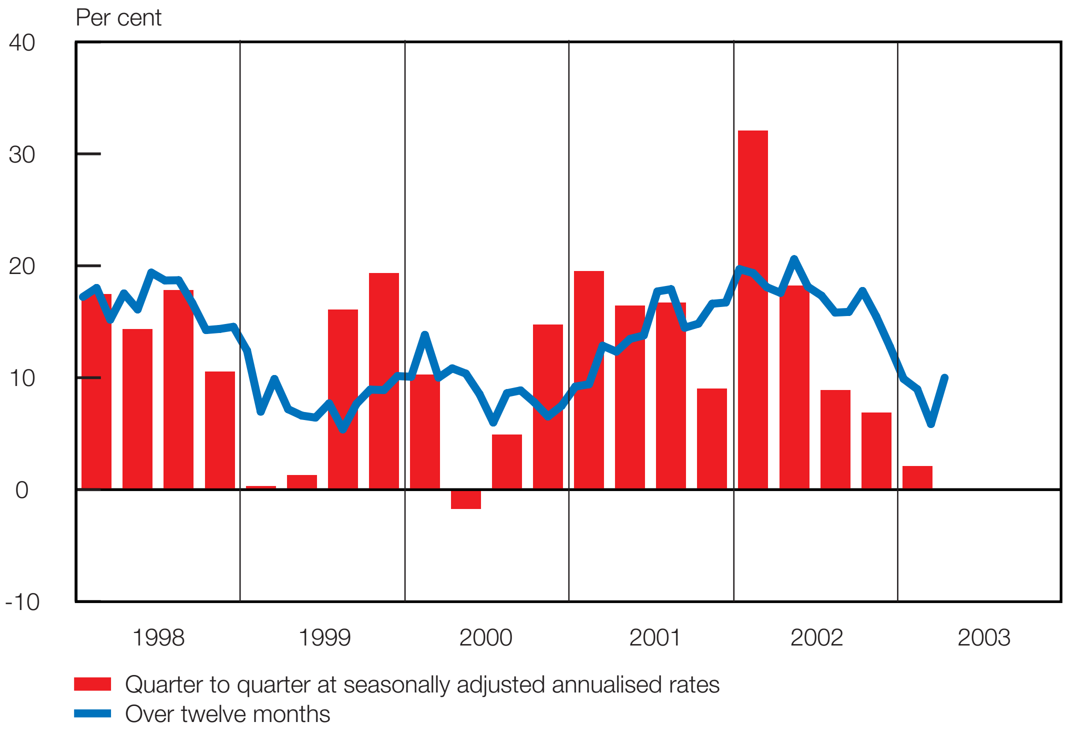
day over the same period. Participation by resident parties remained unchanged at an average of US$3,2 billion per day in the fourth quarter of 2002 and in the first quarter of 2003. In April and May 2003, net daily turnover averaged US$9,2 billion. While the *real effective exchange rate* of the rand appreciated by 21,5 per cent from December 2001 to December 2002, its average level in 2002 was still 17,2 per cent below the average for 2001.

Monetary developments, interest rates and financial markets

Money supply

Against the background of a tightening monetary policy stance, the growth in the average quarterly value of the broadly defined money supply (M3) decelerated markedly from the second half of 2002 to very low levels during the first quarter of 2003. The seasonally adjusted and annualised quarter-to-quarter growth in M3 slowed down from 18,2 per cent in the second quarter of 2002 to 6,9 per cent in the fourth quarter, and was sharply lower at 2,1 per cent in the first quarter of 2003. The slower pace of monetary expansion from the second half of 2002 was also reflected in lower year-on-year growth in M3. The growth over twelve months in M3 decelerated from 20,6 per cent in May 2002 to 5,9 per cent in March 2003. It then rose to 10,0 per cent in April, partly due to a low base value recorded a year earlier.

Growth in M3



The marked slowdown in M3 growth reflected the weakening of the transactions demand for money as real expenditure growth slowed down and inflation receded – at the production level, prices in fact declined in absolute terms during the first quarter of 2003. Furthermore, consumers and businesses faced negative wealth effects as the value of their financial assets declined; share prices fell back, while the rand value of offshore assets declined due to the strengthening of the exchange rate. A build-up in government deposits and the discontinuation of losses on foreign exchange forward cover by the Reserve Bank also contributed to the deceleration in money supply growth.

The growth pattern in all the other monetary aggregates broadly resembled that of M3. For instance, the quarter-to-quarter seasonally adjusted and annualised growth rate in M1A decelerated rapidly from 22,5 per cent in the third quarter of 2002 to a negative growth rate of 2,1 per cent in the fourth quarter, recovering slightly to a positive growth rate of 0,9 per cent in the first quarter of 2003. The annualised growth rate in M1 receded from 0,3 per cent in the fourth quarter of 2002 to a negative 1,5 per cent in the first quarter of 2003, while growth in M2 also decelerated from 11,2 per cent in the fourth quarter of 2002 to 7,0 per cent in the first quarter of 2003. As shown in the accompanying table, the downward trend was also evident in the twelve-month growth rates registered by these monetary aggregates. In March 2003, exceptionally low annual growth rates were recorded mainly on account of a high base for year-on-year growth calculations set in March 2002 when the Easter long weekend coincided with the month-end, raising the demand for money.

Growth in monetary aggregates
Percentage change over twelve months

Period		M1A	M1	M2	M3
2002:	Mar	28,1	24,7	17,8	18,1
	Apr	18,5	20,9	16,6	17,6
	May	21,3	25,2	19,6	20,6
	Jun	18,0	21,5	17,1	18,1
	Jul	18,0	18,3	14,6	17,3
	Aug	19,9	17,0	14,1	15,8
	Sep	21,2	20,5	15,7	15,9
	Oct	10,5	17,8	17,3	17,8
	Nov	13,2	14,7	15,6	15,5
	Dec	8,9	11,9	12,2	12,8
2003:	Jan	12,5	6,3	10,1	9,9
	Feb	8,1	2,9	8,9	9,0
	Mar	4,0	2,8	5,2	5,9
	Apr	7,2	2,8	10,6	10,0

The overall decline in M3 deposits during the first quarter of 2003 consisted mainly of a significant decline in cheque and transmission deposits, and could have been partly related to the slowdown in nominal household consumption expenditure. Long-term deposits also declined during the first quarter of 2003.

The M3 deposit holdings of companies changed considerably in the first quarter of 2003 compared with the fourth quarter of 2002. In the fourth quarter of 2002, corporate deposits accounted for 60 per cent of the overall increase in M3: non-financial companies, in particular, *raised* their deposits with the banks in the fourth quarter of 2002. In the first quarter of 2003, non-financial companies *reduced* their deposit holdings by a substantial amount.

The quarter-to-quarter annualised growth in nominal gross domestic product exceeded the growth in M3 by 9,7 percentage points in the fourth quarter of 2002 but only by 1,3 percentage points in the first quarter of 2003 as the gross domestic product deflator rose very little. Having reached a low point of 1,71 in the second quarter of 2002, the income velocity of circulation of M3 accordingly remained broadly unchanged at 1,75 in the fourth quarter of 2002 and the first quarter of 2003.

The M3 money supply increased by R17,2 billion from the end of the third quarter of 2002 to the end of the fourth quarter of 2002 but declined by R6,4 billion from the end of the fourth quarter of 2002 to the end of the first quarter of 2003. The main counterparts of the decline in the first quarter of 2003 were an R18,8 billion decline in banks' net claims on the government sector and a R61,2 billion decrease in "net other assets and liabilities". These were partly offset by an increase of R77,3 billion in the banks' claims on the private sector. It should be noted that in the first quarter of 2003 both claims on the private sector and net other assets and liabilities were significantly influenced by technical changes in the reporting of derivatives which came into effect in January 2003.

Counterparts of change in M3
R billions

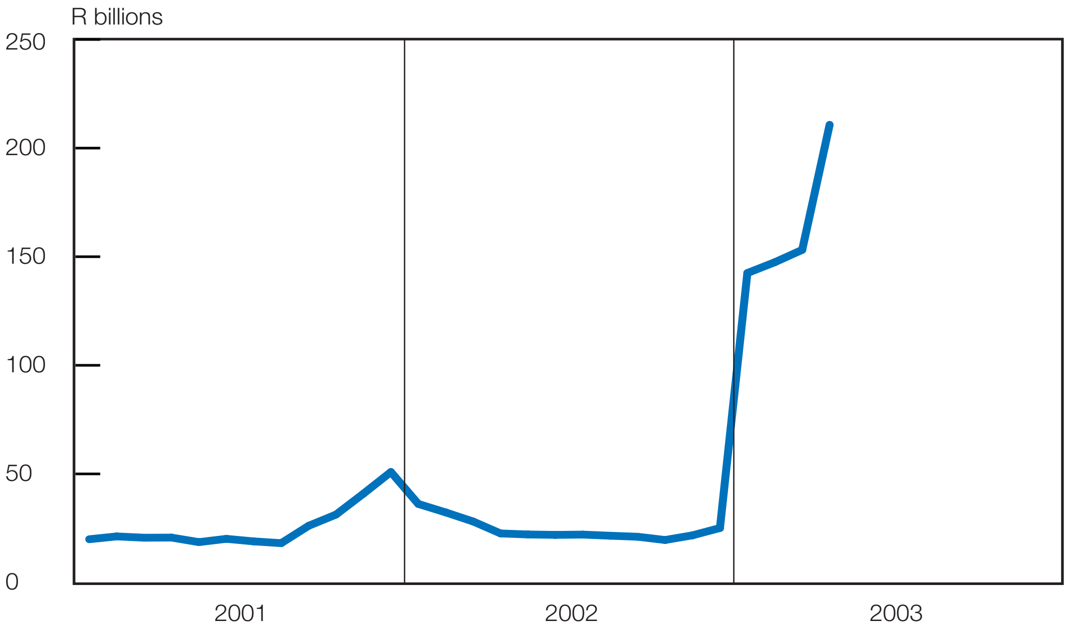
Counterparts	4th qr 2002		1st qr 2003	
Net foreign assets		17,0		-3,7
Net claims on the government sector		13,0		-18,8
Gross claims	7,1		-7,7	
Government deposits (+decrease; -increase)	5,9		-11,1	
Claims on the private sector		12,1		77,3
Net other assets and liabilities		-24,9		-61,2
Total change in M3		17,2		-6,4

Credit extension

The quarter-to-quarter annualised growth in *total domestic credit extension* (i.e. credit extension to the private sector and net claims of banks on the government sector) accelerated from 0,3 per cent in the second quarter of 2002 to 21,1 per cent in the fourth quarter and further to 33,1 per cent in the first quarter of 2003. Technical factors underpinned this steep acceleration.

In the first quarter of 2003 credit extension figures were distorted by the Accounting Statement AC133-related reporting requirement which banks started implementing from January 2003, in terms of which derivative positions must be marked to market and reported on the balance sheet on a gross rather than on a net basis. This affected

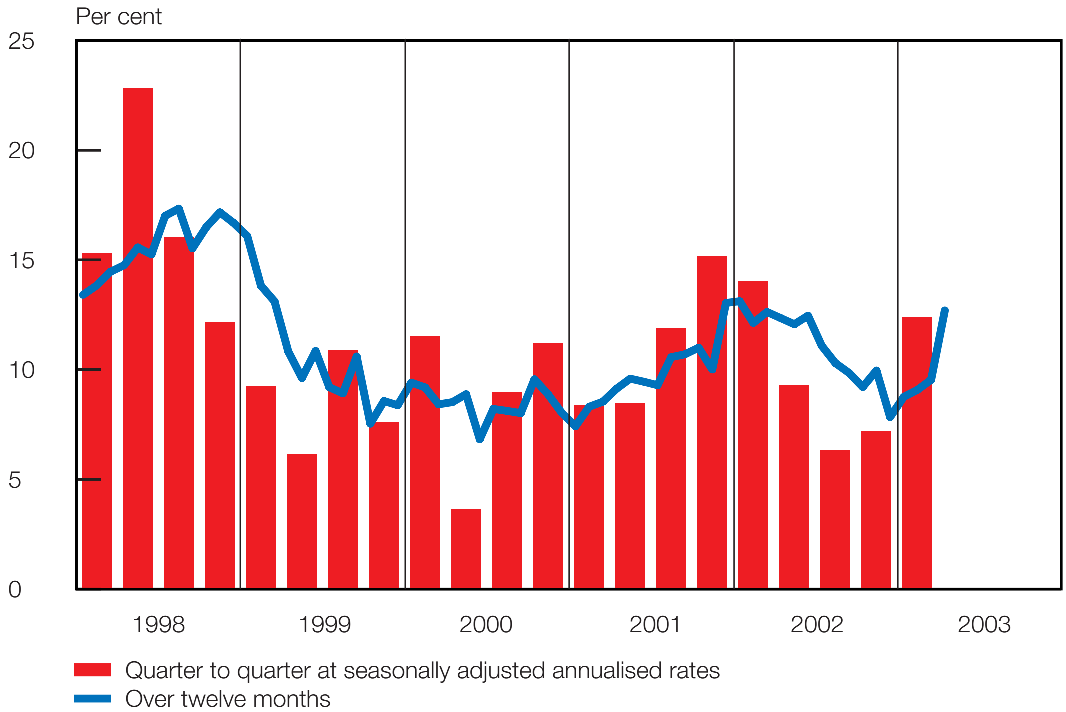
Banks' derivatives assets as reported on their balance sheets



the investment component of credit extended to the private sector, and also spilled over to total domestic credit extension: measured over twelve months, growth in total bank credit extension accelerated from 7,8 per cent in December 2002 to 15,0 per cent in January 2003 and 24,5 per cent in April.

Mainly owing to the changed reporting procedures, annualised growth in credit extended to the *private sector* increased substantially from 6,7 per cent in the fourth quarter of 2002 to 37,1 per cent in the first quarter of 2003. A more accurate indication of the underlying increase in demand for credit by the private sector is obtained by excluding the investments and bills discounted components from the total claims of banks on private-sector entities. The remaining components of banks' claims on the private sector – essentially total loans and advances of all types – rose at modest rates of 6,3 per cent and 7,2 per cent in the third and fourth quarter of 2002 but accelerated to 12,4 per cent in the first quarter of 2003. *Growth over twelve months* in banks' claims on the domestic private sector, excluding investments and bills discounted, decelerated from 9,8 per cent in September 2002 to 8,8 per cent in January 2003. It then picked up, reaching 12,7 per cent in April.

Growth in loans and advances extended to the private sector



An analysis of credit extended to the private sector by type of credit indicates that the twelve-month growth rate in *mortgage advances* decelerated from 12,8 per cent in July 2002 to around 10 per cent in early 2003 and amounted to 11,2 per cent in April. The absolute increase in mortgage advances in the first quarter of 2003 was still considerable, amounting to R9 billion compared with R6 billion in the fourth quarter of 2002. This firm growth in mortgage financing could largely be a reflection of fairly buoyant trading conditions in the real-estate market since the second half of 2000. Testimony to buoyant real-estate market conditions is provided by a significant increase in the number of mortgage finance applications received and those approved, coupled with the fact that house prices increased in real terms, making investment in the property market relatively attractive.

Growth in *instalment sale credit and leasing finance* lost some momentum over the past year, but remained firm at twelve-month rates of around 14 per cent since mid-2002. Most recently there was a shift towards the financing of used rather than new vehicles. New motor vehicle finance contributed 22 per cent and used motor vehicle finance 32 per cent to the increase in instalment sale credit in the first quarter of 2003, in contrast with 22 and 31 per cent, respectively, in the fourth quarter of 2002.

Credit extended to the private sector by type of credit
Percentage change over twelve months

Period		Instalment sale and leasing finance	Investments and bills discounted	Mortgage advances	Other loans and advances	Total	Total (excluding investments and bills discounted)
2002:	Jan	17,5	55,0	12,1	12,6	15,6	13,1
	Feb	16,0	36,8	12,5	10,4	13,7	12,1
	Mar	15,9	28,3	11,8	12,3	13,6	12,6
	Apr	15,6	32,4	11,7	11,8	13,5	12,4
	May	17,5	26,3	12,1	10,0	12,9	12,1
	Jun	16,5	10,2	12,7	10,7	12,3	12,5
	Jul	14,5	7,3	12,8	8,0	10,9	11,1
	Aug	14,3	17,5	12,6	6,5	10,7	10,3
	Sep	13,0	8,2	11,7	6,8	9,7	9,8
	Oct	13,4	1,9	11,0	5,8	8,7	9,2
	Nov	15,2	-1,4	11,2	6,7	9,2	10,0
	Dec	13,7	-31,1	10,4	3,2	4,4	7,8
2003:	Jan	14,0	51,0	10,2	5,4	12,1	8,8
	Feb	14,7	69,7	9,9	6,1	13,8	9,1
	Mar	13,4	116,8	10,7	6,9	16,8	9,5
	Apr	14,8	115,9	11,2	13,5	21,9	12,7

The rate of increase over twelve months in *other loans and advances* has moderated to below 10 per cent since July 2002. Although the *other loans and advances* category is still an important asset on the banks' balance sheets and a source of corporate borrowing activity, its contribution to total credit extended to the private sector decreased from an average of 38 per cent in 2002 to 36 per cent in April 2003. This is consistent with leads in the repatriation of export proceeds and lags in foreign payments.

The monetary sector's *total advances* to the private sector rose by R19,3 billion in the first quarter of 2003. The household sector absorbed the larger part of this amount – R15,3 billion, against only R3,0 billion absorbed by the corporate sector. This measure of private-sector credit extension also shows that the household sector's total share of private-sector credit increased from 51,0 per cent in the fourth quarter of 2002 to 52,0 per cent in the first quarter of 2003.

Interest rates and yields

The prices of fixed-interest securities continued to be buoyed by the strengthening of the exchange value of the rand. Together with the conservative monetary policy stance, the appreciated value of the rand served to reinforce expectations of a moderation in inflation.

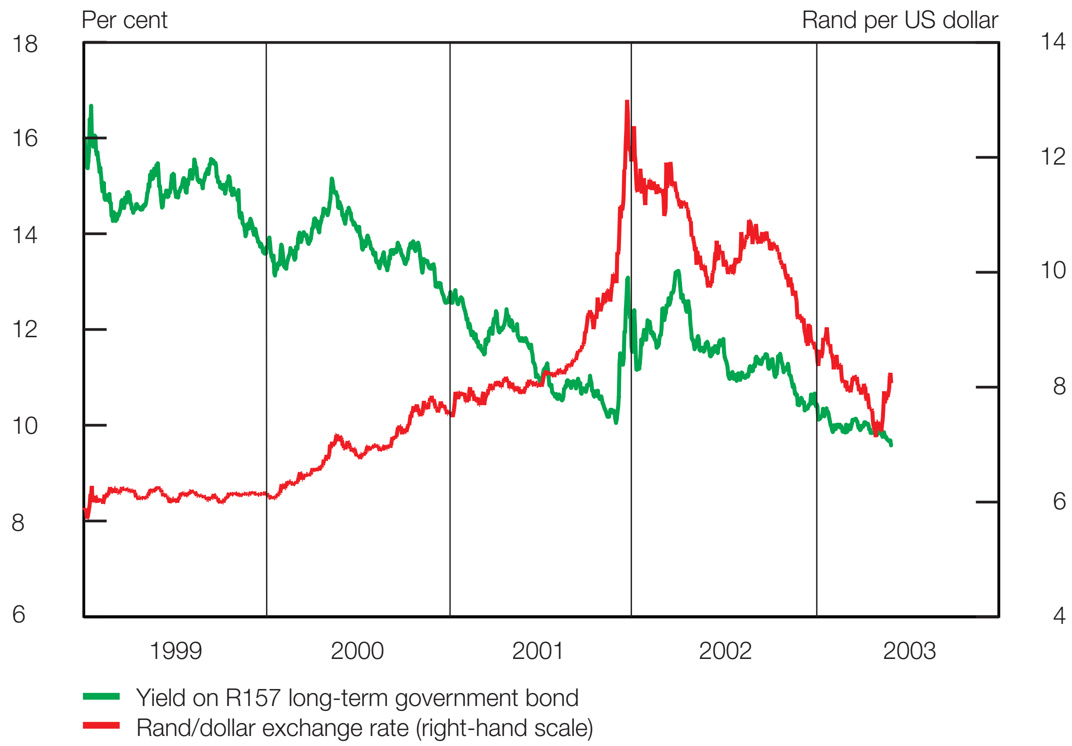
The *monthly average yield on long-term government bonds* in the eleven-to-thirteen-year maturity range declined from 12,6 per cent in March 2002 to a historic low of 9,9 per cent in February 2003 when it breached the 10 per cent level for the first time since 1980. The bond market rally then temporarily lost momentum and the monthly average bond yield increased to 10,0 per cent in March in response to, among other things:

- the uncertainties created by the US-led invasion of Iraq;
- a somewhat slower than expected moderation of inflation;
- the unchanged level of the repurchase rate at 13,5 per cent per annum; and
- increased recourse to funding in the domestic bond market as announced in the Budget of national government for fiscal 2003/04.

Subsequently, the monthly average bond yield again receded to 9,9 per cent in April 2003 and edged even lower to 9,8 per cent in May.

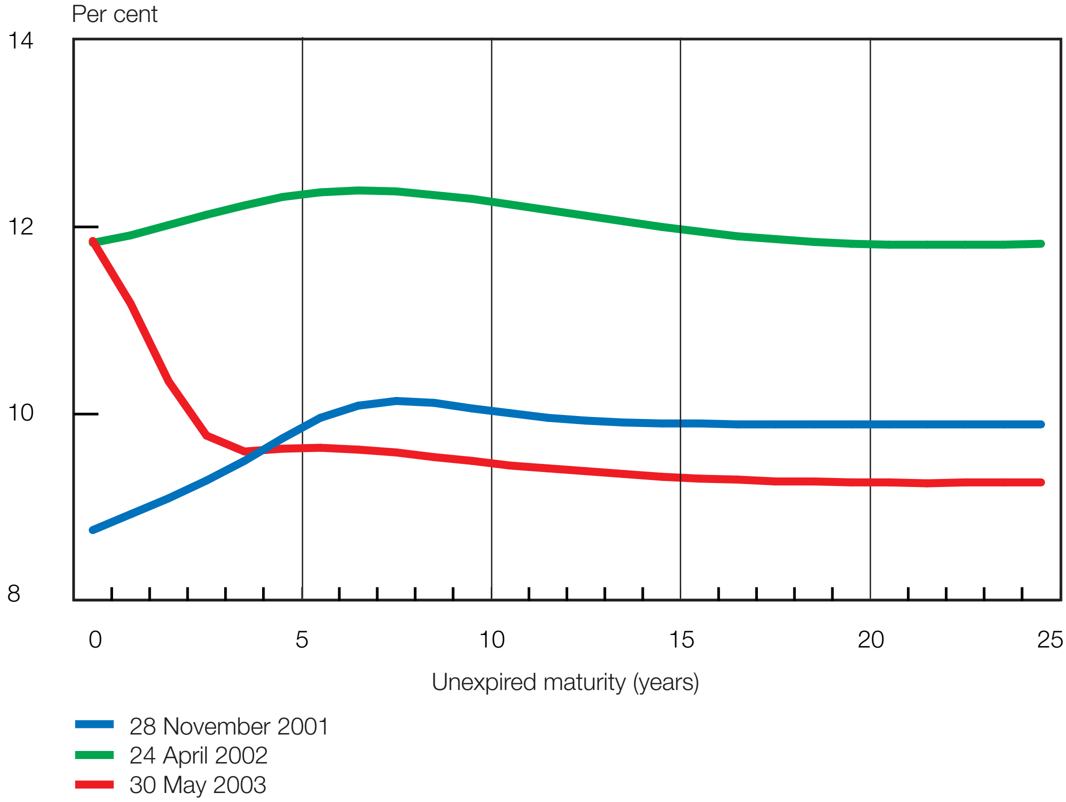
The *daily average yield* on R157 government bonds (with redemption dates ranging from 2014 to 2016) fluctuated downward from 11,49 per cent on 22 October 2002 to 9,85 per cent on 28 February 2003. The daily average bond yield then increased to 10,13 per cent on 20 March 2003 before drifting lower to a level of 9,79 per cent on 30 April 2003, i.e. to a level lower than in November 2001. Subsequently, long-bond yields fluctuated downward to 9,58 per cent at the end of May 2003. Bearish sentiment arising from the somewhat unexpected depreciation of the rand in May was largely offset by expectations of lower inflation, the latter reinforced first by the announcement by Statistics South Africa that the methodology used to calculate the rapidly rising rent component of the consumer price index was under review and then by the release on 30 May of corrected inflation numbers that were significantly lower than before.

Bond yield and exchange rate



The slope of the *yield curve* changed from upwards to downwards in April 2002 and continued to invert further in the early months of 2003. With long-term yields substantially lower than short-term yields, the *inverse yield gap*, i.e. the difference between bond yields at the extreme long and short ends of the yield curve, amounted to 258 basis points on 30 May 2003. In May 2003 yields at the long end of the maturity spectrum were 62 basis points lower than on 28 November 2001 – immediately prior to the sudden sharp depreciation of the exchange value of the rand. By contrast, as short-term yields followed the repurchase rate higher, yields at the extreme short end of the curve in May 2003 were 309 basis points above the yield recorded on 28 November 2001. On balance, the current shape of the yield curve reflects expectations of an easing of monetary policy in the medium term and enduringly lower inflation in the long term.

Yield curves



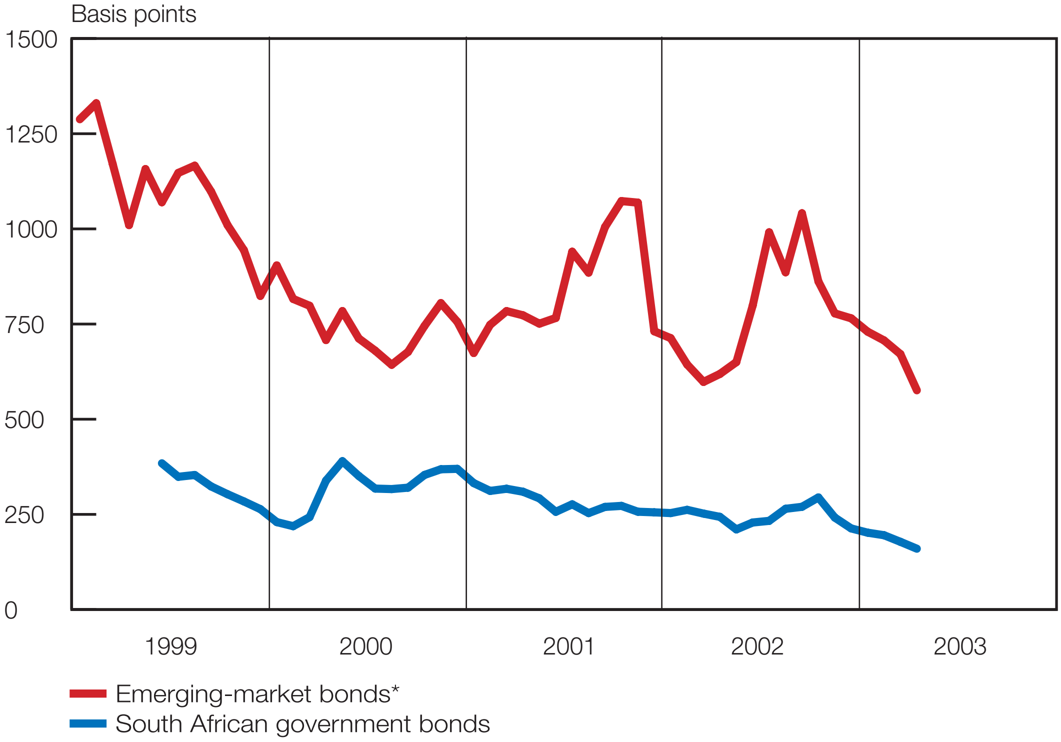
The improvement in longer-term inflation expectations as reflected by the bond market is confirmed by the progressive decline in the *break-even inflation rate.* This approximation of expected long-term inflation is calculated as the difference between the nominal yield on conventional bonds and the real yield on inflation-linked bonds within the six-to-ten-year maturity range. Interrupted briefly in September and October 2002, expected long-term inflation derived in this way nonetheless decreased sharply from a monthly average of 8,0 per cent in April 2002 to 6,1 per cent in February and March 2003, before receding further to below the 6 per cent level in April and May 2003.

Using historical year-on-year increases in CPIX as an indicator of future price changes, the *real* or *inflation-adjusted yield on long-term government bonds* fell from 4,8 per cent in December 2001 to a negative value of 0,4 per cent in November 2002

– the first negative real return since January 1994. However, with the subsequent deceleration of CPIX inflation exceeding the decline in nominal bond yields, the real yield improved somewhat to 0,6 per cent in March 2003 and 1,3 per cent in April.

The yield spread of emerging markets' sovereign debt over benchmark United States Treasury Bonds (as measured by the JP Morgan Emerging Markets Bond Index or EMBI+) narrowed significantly by 488 basis points from September 2002 to May 2003. In absolute terms, the *sovereign risk premium* of South African government foreign-currency denominated debt is far less than that of typical emerging-market debt. With the series of six ratings agency upgrades in the eighteen months to May 2003, including the upgrades by Fitch Ratings and Standard & Poor's in May 2003, the yield spread on South African government bonds tightened significantly. The yield spread on the South African government dollar-denominated bonds issued in the North American market declined, on average, by about 125 basis points from September 2002 to May 2003.

Sovereign risk premiums



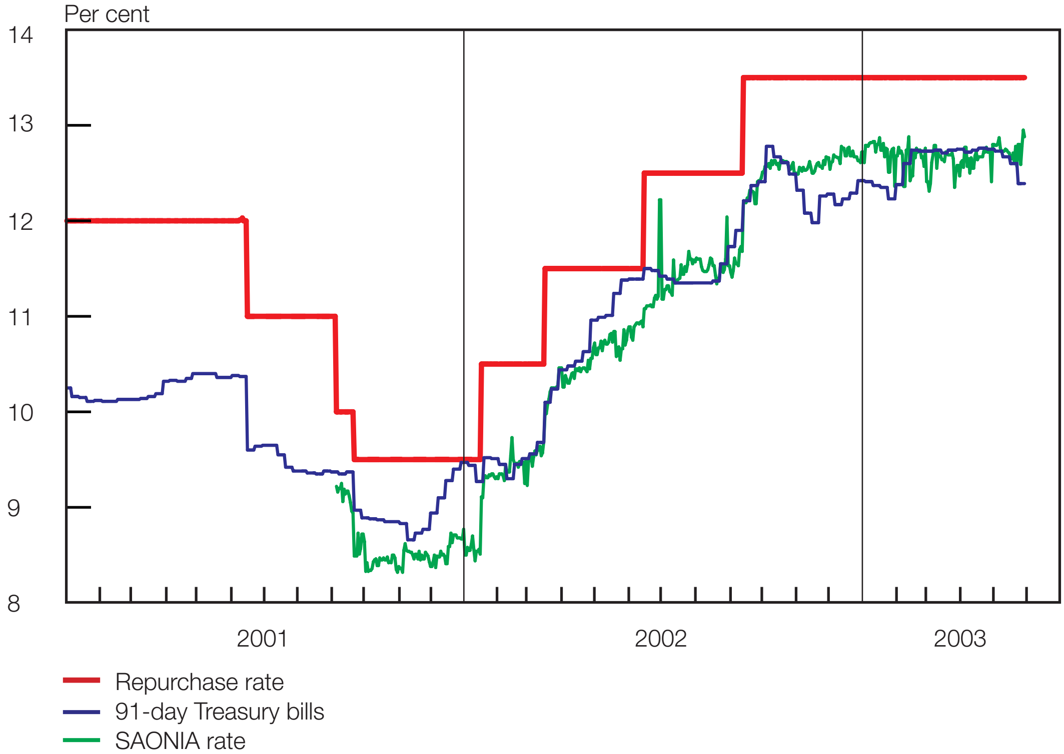
* Source: JP Morgan EMBI+

In a statement concluding the March 2003 meeting of the Monetary Policy Committee (MPC), several factors were outlined which pointed to an improved inflation outlook, but risks to achieving the inflation target were still perceived to be too high to justify a relaxation of monetary policy. The repurchase rate of the Reserve Bank was therefore left unchanged at the level of 13,50 per cent, as established on 13 September 2002.

Against the background of an unchanged repurchase rate, the SAONIA (South African Overnight Interbank Average) rate was fairly stable, fluctuating between 12,31 per cent and 12,88 per cent in the first five months of 2003. This rate typically edges higher whenever liquidity conditions tighten in the money market, as sometimes happens around the start of a new maintenance period when the minimum reserve requirements of the banking system are recalculated, or around the last trading day of the month. The SAONIA rate amounted to 12,78 per cent on 9 June 2003.

Other money-market interest rates also remained fairly stable during the first five months of 2003. For instance, the rate on three-month bankers' acceptances declined by 11 basis points from 13,04 per cent on 2 January 2003 to 12,93 per cent on 19 March, despite the intensification of geopolitical tensions. After the MPC had left the repurchase rate unchanged at its March 2003 meeting, the rate on such acceptances moved higher to reach 12,99 per cent on 12 April, but declined to 12,19 per cent on 9 June amidst strong expectations of an imminent reduction in the Reserve Bank's refinancing rates in mid-June, reinforced by the downward revision of the consumer price inflation rate already referred to earlier.

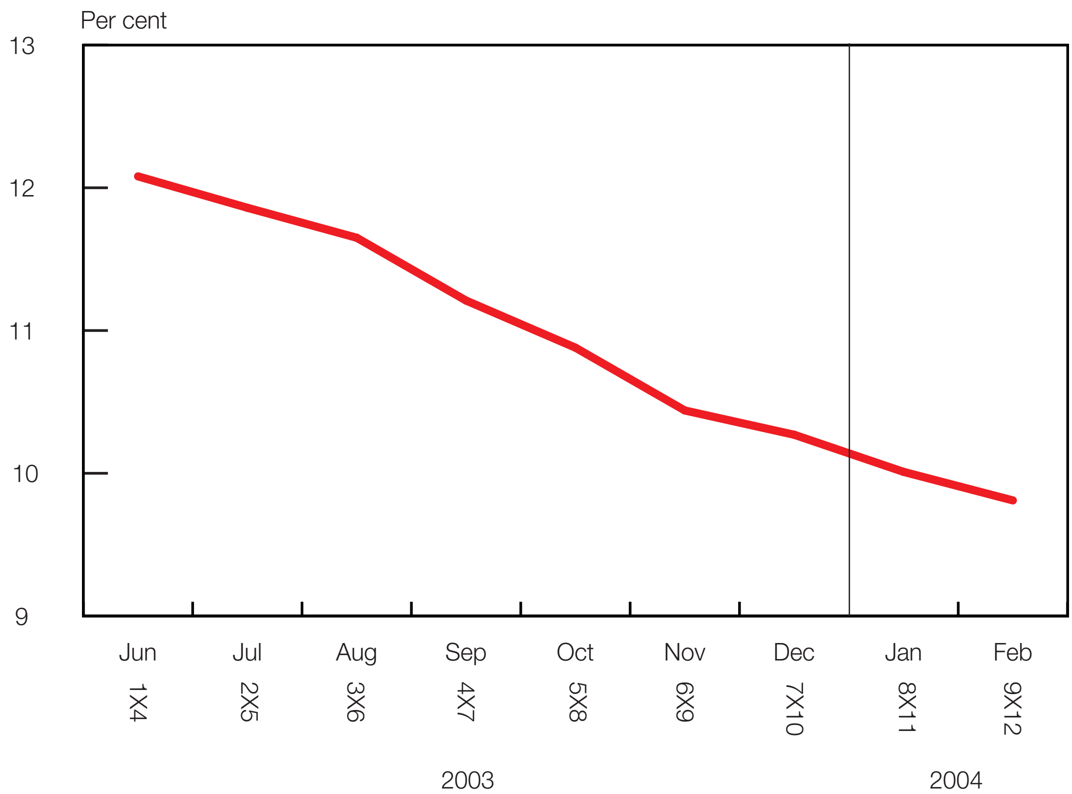
Money-market interest rates



The rate on 91-day Treasury bills was similarly confined to a narrow range. From a level of 12,42 per cent on 2 January 2003, this rate declined to 12,23 per cent on 30 January. However, government raised the amount of such bills offered at the weekly tender by R500 million to R1,5 billion from 31 January 2003. With an increased supply of Treasury bills and with geopolitical tensions gripping the market, the Treasury bill rate increased to 12,74 per cent on 14 February and then fluctuated around that level. The weekly tender amount was reduced to its earlier level of R1 billion from the end of March and the rate resumed its downward movement to reach 11,57 per cent on 6 June.

The rate on 9x12-month forward rate agreements (FRAs) receded from 11,15 per cent on 2 January 2003 to 10,65 per cent on 13 January. This rate suddenly rose to 11,25 per cent on 25 February as mounting geopolitical tensions heightened perceived risks in financial markets around the world. During the first week of March, the increase was reversed as sentiment changed somewhat and the market concentrated on the interest rate implications of the stronger performance of the rand. Fuelled by market reaction to the lower level of measured inflation, the rate on 9x12-month FRAs declined to 9,15 per cent on 9 June. As shown in the accompanying graph, the shape of the entire FRA curve at the end of May 2003 also indicates expectations of declining money-market interest rates.

Rates on forward rate agreements at end May 2003



Since September 2002, the private banks have kept their *prime overdraft* and *predominant mortgage rates* unchanged at 17 per cent. This followed four increases in 2002 coinciding with increases in the repurchase rate. Similarly, the *predominant rate on twelve-month fixed deposits with banks* remained unchanged at 12 per cent from September 2002 to April 2003 – its highest level since June 1999. In May 2003 the rate was lowered to 11 per cent as banks anticipated a lowering of the repurchase rate.

Money market

The average daily liquidity requirement of the private-sector banks increased from R10,6 billion in January 2003 to R11,1 billion in May.

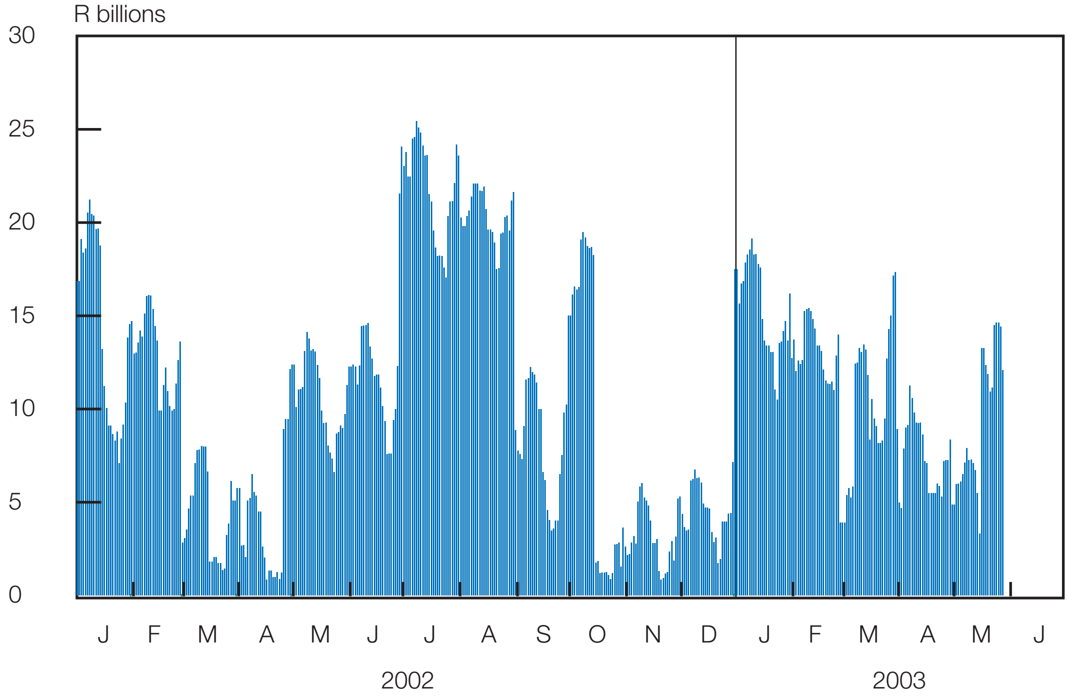
In order to keep the private banks dependent on the Reserve Bank for the provision of liquidity, the Bank engaged in various liquidity-draining operations, as illustrated in the accompanying table. It increased the outstanding amount of its own debentures from R7,7 billion at the end of December 2002 to R8,0 billion at the end of May 2003. On balance, outstanding reverse repurchase transactions in government securities with private-sector parties were raised from R7,6 billion at the end of December 2002 to R10,3 billion at the end of March and maintained at that level in April and May.

Outstanding balances of selected money-market intervention instruments
R billion

End of	Foreign-currency swaps with deposits	Reserve Bank debentures	Reverse repurchase agreements
2002: Aug	54,8	7,3	7,0
Sep	53,4	7,3	6,8
Oct	51,6	7,5	8,0
Nov	49,6	7,5	8,6
Dec	45,3	7,7	7,6
2003: Jan	45,3	7,6	10,5
Feb	42,9	8,0	10,0
Mar	34,9	7,9	10,3
Apr	30,1	8,0	10,3
May	27,3	8,0	10,3

Since September 2002, the Reserve Bank has curtailed the use of foreign-currency swap transactions with private-sector parties as a liquidity-draining instrument. The outstanding amount of these transactions was gradually reduced from a high of R54,8 billion at the end of August 2002 to R30,1 billion

Daily Tax and Loan account balances of government with private-sector banks



at the end of April 2003. Government had previously issued zero-coupon bonds to the Bank in partial compensation for losses previously incurred on forward foreign-currency transactions. In March R4 billion in such bonds were converted to cash, which helped to reduce the outstanding amount of foreign-currency swaps. Repayments received by the Reserve Bank in respect of temporary liquidity assistance which had been provided to troubled banks during 2002, and profits on foreign reserve transactions arising from the appreciated value of the rand in 2003, also facilitated the unwinding of some of these foreign-currency swaps.

Following a relatively small increase of R0,4 billion in notes and coin in circulation outside the Reserve Bank during February and March 2003, a further increase of R1,2 billion was recorded in April on account of the public's higher demand for cash around a number of public holidays. This was partly reversed in May when note flows on balance eased money-market liquidity by R0,6 billion.

Government sold the foreign-currency proceeds of a eurobond issue to the Reserve Bank on 16 May 2003. Accordingly, the Bank transferred around R10,6 billion to government's Tax and Loan accounts with the private-sector banks, thereby expanding money-market liquidity. This effect was neutralised as the Reserve Bank immediately delivered a similar amount in foreign currency to counterparties in terms of forward contracts previously entered into. The Bank's forward book and net open position in foreign currency were simultaneously reduced.

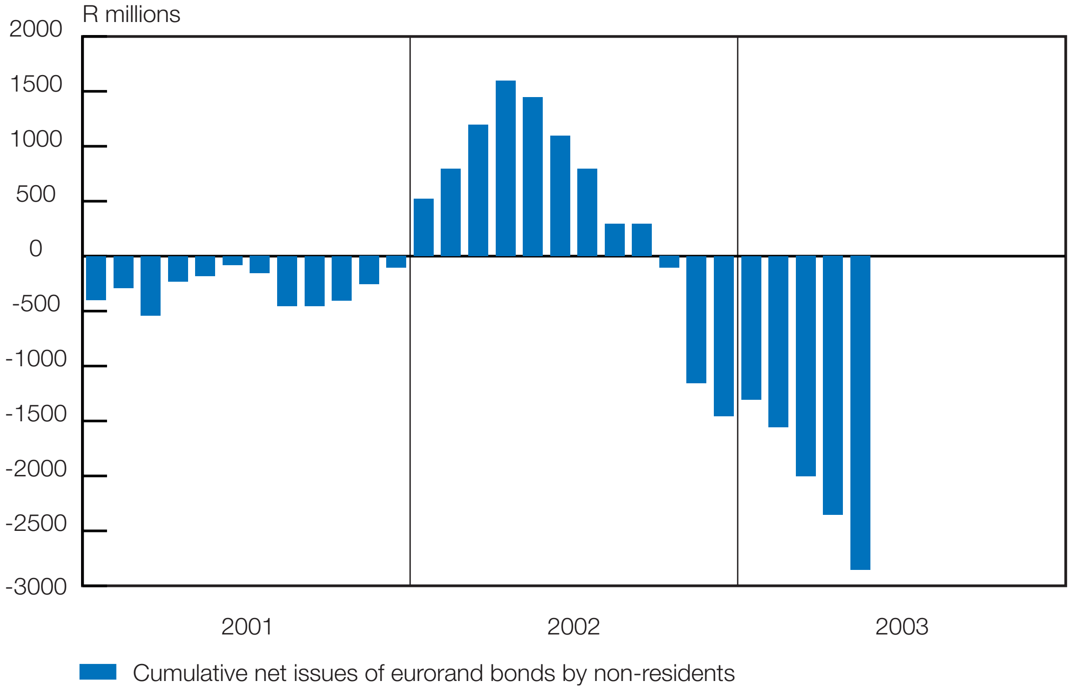
Bond market

Public-sector borrowers reduced their outstanding domestic marketable bond debt in fiscal 2002/03 by R9,8 billion compared with net redemptions of R10,3 billion in the previous fiscal year. A net amount of R6,9 billion was raised in the first half of fiscal 2002/03, including the zero-coupon bond issued by the national government to the Reserve Bank. Public-sector borrowers then repaid fixed-interest securities to the net amount of R16,8 billion in the second half of the fiscal year. A budgeted domestic funding requirement of just over R9 billion for fiscal 2003/04 was announced in the 2003 Budget of national government.

The *national government* raised R10,7 billion through foreign-currency denominated debt issues in the *international bond markets* in fiscal 2002/03, compared with R12,4 billion in fiscal 2001/02. In the current fiscal year national government raised R10,4 billion in May 2003 through the issuance of a ten-year €1,25 billion global bond at a coupon rate of 5,25 per cent and a spread of 142 basis points over benchmark bonds of the German Federal Government. With this issue, government took advantage of low international interest rates and foreign investor appetite for high-yielding South African securities.

In 2002, new issues of *eurorand bonds* by non-residents in the *European bond markets* tapered off as the strengthening of the exchange rate of the rand discouraged unhedged issues. Net issues of eurorand bonds to the value of R1,3 billion in the first quarter of 2002 were followed by net redemptions of R2,7 billion in the ensuing three quarters, resulting in overall net redemptions of R1,4 billion for 2002 as a whole. Further net redemptions by non-residents amounting to R1,4 billion were recorded in the first five months of 2003.

Eurorand bond market



The *outstanding nominal value of private-sector loan stock* listed on the Bond Exchange of South Africa increased rapidly in 2002. Fuelled by, among other things, the low cost of funding in the bond market relative to the high cost of borrowing in the money market and the dearth of public-sector fixed-interest securities, listed private-sector loan stock increased by R10 billion from R28,9 billion in June 2002 to R38,9 billion in December followed by a modest further increase to R41,1 billion in May 2003.

Turnover in the *domestic secondary bond market* declined by almost 2 per cent from a record R12,4 trillion in 2001 to R12,2 trillion in 2002. The quarterly value of bonds traded declined from R3,5 trillion in the fourth quarter of 2001 to R2,6 trillion in the first quarter of 2003 – its lowest quarterly value since the last quarter of 2000. The decline occurred alongside tightening monetary conditions and the appreciating exchange value of the rand. In April 2003 turnover on the Bond Exchange of South Africa amounted to R0,9 trillion followed by R1,0 trillion in May 2003.

Non-residents' transactions in the secondary bond market changed from net sales of R25,6 billion in 2001 to small net purchases of R0,2 billion in 2002. Non-residents' net sales of bonds of R8,3 billion in the third quarter of 2002 – a period when the exchange rate of the rand depreciated – largely eroded net purchases recorded during the remainder of the year. Non-residents once more reduced their holdings of South African debt securities by R5,6 billion in the first quarter of 2003. Subsequently, non-residents' net purchases of bonds amounted to R5,8 billion in April followed by net sales of R0,4 billion in May 2003. From the beginning of 2003 to the end of May, non-residents' net cumulative sales of bonds amounted to R0,1 billion.

Non-resident participation in trading on the Bond Exchange of South Africa, measured as purchases and sales as a percentage of total purchases and sales of bonds, accounted for 12,7 per cent of the total turnover in May 2003. Their participation in 2002 fluctuated between levels just below 9 per cent and 13 per cent.

Share market

The total value of equity capital raised in the domestic and international *primary share markets* by companies listed on the JSE Securities Exchange SA increased strongly during 2002 and reached R28,1 billion in the third quarter of 2002 – its highest value since the third quarter of 2000. The quarterly value of share capital raised then decreased to R10,9 billion in the fourth quarter and R8,0 billion in the first quarter of 2003. Equity financing amounted to only R0,6 billion in April 2003.

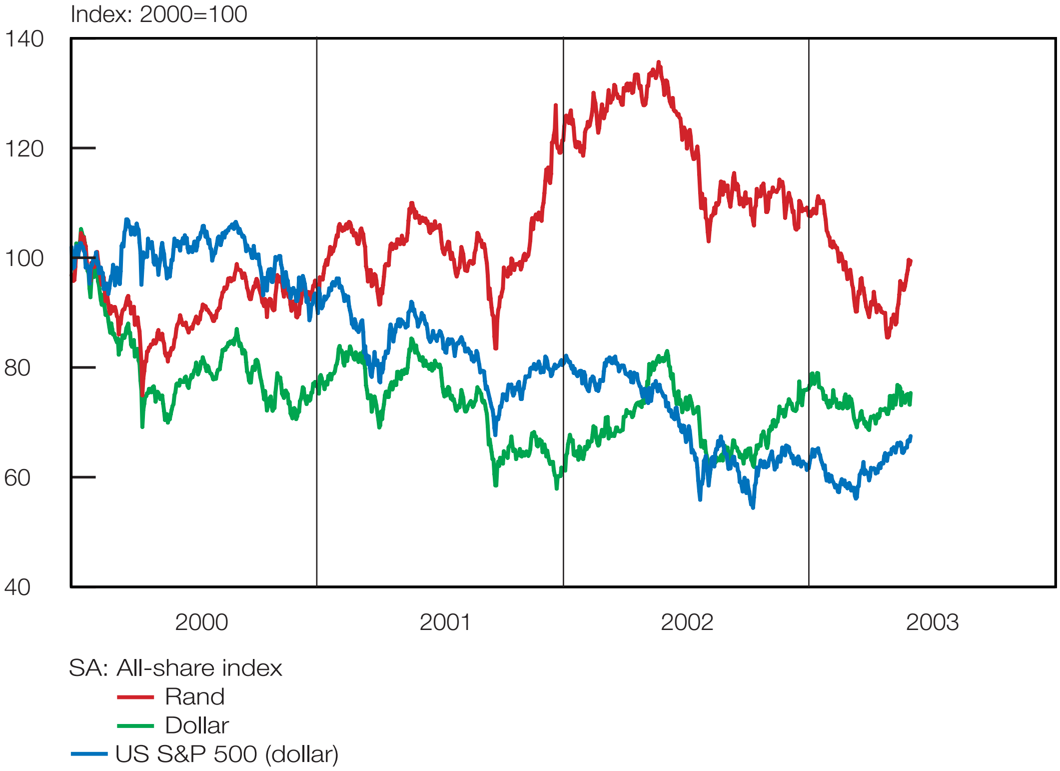
Turnover in the *secondary share market* was buoyant in 2002 and the value of listed shares traded on the JSE Securities Exchange SA amounted to a record R808 billion. However, the quarterly value of shares traded fell back from a record R236 billion in the second quarter of 2002 to R178 billion in the fourth quarter as the appreciation of the rand and the associated decline in share prices dampened trading activity. Turnover subsequently increased to R186 billion in the first quarter of 2003. However, as a result of the sustained sharp decline in share prices, trading activity contracted to only R47 billion in April – its lowest level since October 2001. Turnover recovered somewhat to R64 billion in May 2003.

Non-resident portfolio investment in the *secondary share market* switched from a net inflow of foreign portfolio capital to the value of R5,4 billion in the first half of 2002 to a net outflow of R11,0 billion in the second half of the year. A net outflow of R5,6 billion was therefore recorded in 2002 as a whole, followed by net sales of R2,0 billion in the first quarter of 2003, due to large net sales in January. Non-resident share market activity, measured as purchases and sales as a percentage of the total value of shares traded on the JSE Securities Exchange SA, moderated from 26 per cent in 2002 to less than 24 per cent in the first quarter of 2003. In April and May 2003, non-residents on balance increased their holdings of shares by R1,4 billion, resulting in annual cumulative net sales of R0,6 billion from the beginning of 2003 to the end of May.

The *monthly average price level of all classes of shares* listed on the JSE Securities Exchange SA on balance fell by 29 per cent in rand terms over twelve months from an all-time high in May 2002 to May 2003. There were two downward corrections: one of 18 per cent from May 2002 to August and one of 19 per cent from November 2002 to April 2003. In April 2003, in the wake of the conclusion of the war on Iraq, world bourses recovered, as reflected by the 5 per cent gain in the S&P 500 composite index in dollar terms, while the South African share market in rand terms continued to decline by 4 per cent. However, in dollar terms the all-share price index improved by 9 per cent in April 2003 due to the stronger exchange rate of the rand. The dollar value of the all-share price index declined by only 8 per cent over the twelve months to May 2003, compared to a decline of 13 per cent in the S&P 500 composite index.

The general decline in domestic share prices was primarily driven by the strength of the exchange rate of the rand, weak global economic growth and, more recently, the war in Iraq and the SARS virus. Worst affected were rand-hedge shares and companies with exposure to foreign earnings, as the strength of the exchange value of the rand translated into lower earnings. A number of profit warnings have subsequently been issued. In addition, the proposed Mineral and Petroleum Royalty Bill introduced in the National Assembly on 10 March 2003, setting out the government's planned charge on mining companies for the extraction and transfer of mineral resources, contributed to concern about the

Share prices



future profitability of the mining industry. The monthly average share price level of the *resources* sector fell by 36 per cent in the twelve months to May 2003 and the monthly average *gold-mining share price index* by 33 per cent over the same period. On average, the rand price of gold per fine ounce declined despite an increase in the dollar price of gold, thereby contributing to the fall in the prices of gold-mining shares.

Proposed royalty rates on selected minerals

Substance	Royalty rate Per cent
Salt, sand, gravel, granite, phosphate rock, offshore oil and gas at depths deeper than 500 meters	1
Coal, copper, iron, manganese	2
Gold, silver, vanadium, onshore oil and gas and offshore oil and gas at depths shallower than 500 meters	3
Platinum group metals	4
Amethyst, quartz, tiger's eye, topaz	5
Diamonds	8

Source: Minerals and Petroleum Royalty Bill, 2002, as published for comments

In contrast, *financial share prices* registered a more muted decline over the twelve months to May 2003. Financial shares declined by 24 per cent from May 2002 to April 2003 followed by an increase of 3 per cent in May 2003, supported by the life assurance sector which benefited from the lower tax rate announced in the 2003 Budget and banking shares which are discounting a future easing of monetary conditions.

The *daily closing level of the all-share price index* fell by 36,8 per cent from a record high on 22 May 2002 to its lowest level in nineteen months on 29 April 2003, before posting a gain of 16,0 per cent to 30 May.

Mirroring the decline in share prices, the *dividend yield* on all classes of shares increased from 3,0 per cent in May 2002 to 4,6 per cent in April 2003, the highest level since 1990. The dividend yield receded to 4,3 per cent in May.

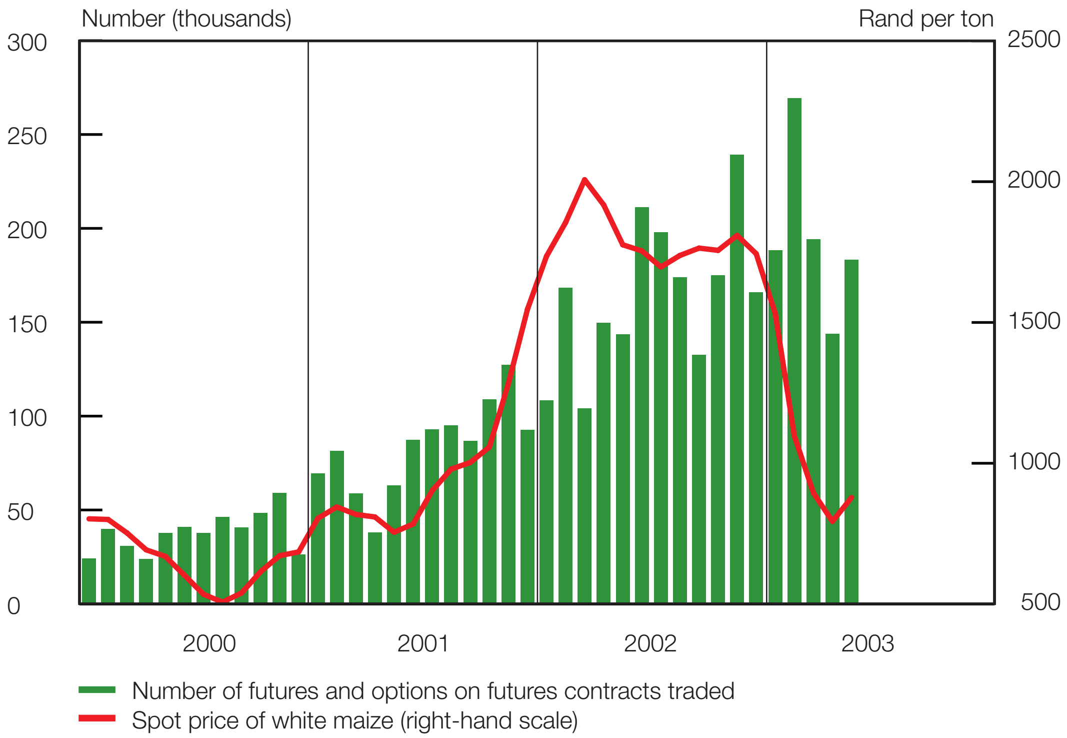
The *price-earnings ratio* of all classes of shares fell from 13,7 in May 2002 to 9,7 in April 2003 – its lowest level since September 2001 – before increasing slightly to 10,0 in May. Levels below 10 were last recorded in September and October 2001, and before that in 1991.

Market for derivatives

Share index and individual equity derivatives constitute almost all of the *futures and options on futures contracts* traded on the Financial Derivatives Division of the JSE Securities Exchange SA. The combined number of futures and options on futures contracts traded declined by 18 per cent from 35,6 million in 2001 to 29,4 million in 2002, coinciding with the general decline in share market activity. The annualised number of contracts traded fell further to 25,6 million in the first quarter of 2003 and 20,3 million in April 2003, before improving to 27,4 million in May.

Price movements of agricultural products caused by supply and demand imbalances as well as changes in the exchange value of the rand underpinned the increase in the number of *commodity futures contracts and options* on such contracts traded on the Agricultural Products Division of the JSE Securities Exchange SA throughout 2002 and the beginning of 2003. Consecutive record turnovers of 580 000 contracts in the

Derivatives market: Agricultural products



fourth quarter of 2002 and 652 000 contracts in the first quarter of 2003 were recorded. Trading then receded to a quarterly rate of 430 000 contracts in April and 549 000 in May.

Reflecting the decline in the equities market, the number of *warrants* traded on the JSE Securities Exchange SA decreased from a quarterly average of 5,5 billion contracts in the first three quarters of 2002 to 3,2 billion in the fourth quarter and further to 1,9 billion contracts in the first quarter of 2003. Highly skewed towards call warrants on account of expectations of price increases, trading decreased to 0,3 billion contracts in April 2003 – its lowest monthly level since December 1999 – before increasing to 0,4 billion contracts in May, which translates into an estimated quarterly rate of 1,2 billion contracts.

Real-estate market

The *real-estate market* remained buoyant despite the increase in the cost of mortgage finance in the first nine months of 2002. The overall seasonally adjusted value of turnover, measured by *transfer duty paid*, slowed only marginally from an average monthly level of R277 million in the first half of 2002 to R276 million in the second half before increasing to an average of R310 million in the first quarter of 2003. In 2003 the first four months' average level of transfer duty paid represented an increase of 10,4 per cent when compared to the same period of 2002. This increase is more or less comparable to the growth in mortgage advances of 11,2 per cent from April 2002 to April 2003.

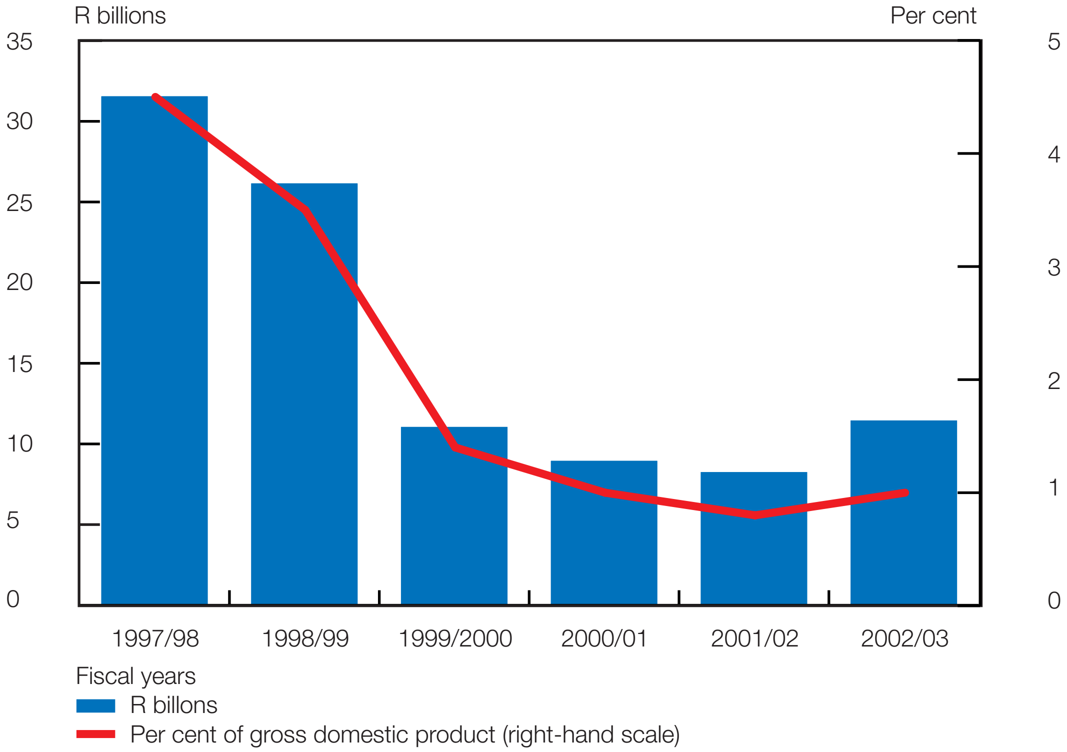
The rate of increase in residential property prices, calculated over twelve months, amounted to 16,6 per cent in April 2003 compared to average increases of 14,3 per cent in 2002. This may be due to, among other things, purchases in anticipation of lower interest rates.

Public finance

Non-financial public-sector borrowing requirement

The activities of the *non-financial public sector* (i.e. the consolidated central government, provincial governments, local authorities and non-financial public enterprises and corporations) resulted in a deficit of R11,5 billion in fiscal 2002/03 which was R3,3 billion more than in the previous fiscal year. As a ratio of gross domestic product, this borrowing requirement amounted to 1,0 per cent in fiscal 2002/03 compared with 0,8 per cent in the previous fiscal year.

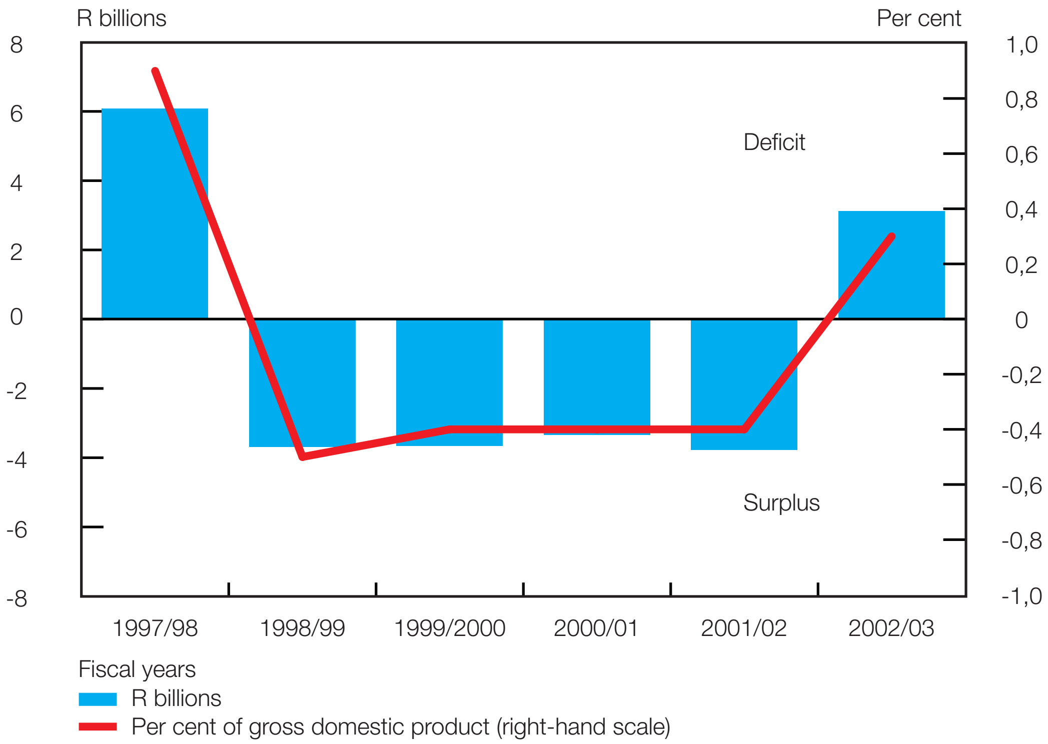
Non-financial public-sector borrowing requirement



The increase in the borrowing requirement of the non-financial public sector can mainly be attributed to a turnaround from a surplus to a deficit in the financial position of provincial governments. The surpluses of non-financial public enterprises also decreased from R1,8 billion in fiscal 2001/02 to R0,3 billion in fiscal 2002/03, essentially because of higher capital expenditure.

An analysis of the *Statement of revenue, expenditure and borrowing* of the *provincial governments* indicates that the provincial governments recorded a deficit of R3,1 billion in fiscal 2002/03 compared with a surplus of R3,8 billion in fiscal 2001/02. Total grants received by the provincial governments from the national government – the main source of revenue of the provincial governments – amounted to R136,9 billion during fiscal 2002/03 or 12,8 per cent more than in the preceding fiscal year. Provincial government expenditure growth, however, surpassed this, recording an increase of 19,0 per cent.

Provincial governments' surplus or deficit



Capital spending by provincial governments amounted to R13,8 billion during fiscal 2002/03, representing an increase of 21,8 per cent over the rather low level of such spending in the previous fiscal year. Although capital expenditure increased quite substantially in the past fiscal year, it still represented only 9,5 per cent of the total expenditure by provincial governments.

Provincial governments utilised their bank balances to defray part of their expenditure, leading to a decrease in their deposits with private-sector banks from R9,6 billion at the end of March 2002 to R8,3 billion at the end of March 2003. Their overall indebtedness with banks remained unchanged at R0,5 billion on both these dates.

Preliminary *local government* statistics indicate an improvement from a financial deficit of R4,4 billion recorded in fiscal 2001/02 to a deficit of R1,5 billion in fiscal 2002/03. The financial position of some local governments was adversely affected by the large-scale non-payment for services.

The surplus position of both the *extra-budgetary institutions* and *social security funds* strengthened considerably in fiscal 2002/03 compared with their results reported for the previous fiscal year. At the level of social security funds, the improvement in their financial position was essentially brought about by new legislation which resulted in workers at all remuneration levels contributing to the Unemployment Insurance Fund. Apart from this, National Treasury also made additional transfers to finance the restructuring of the fund.

The Intergovernmental Fiscal Review 2003

The *Intergovernmental Fiscal Review 2003* was released in the National Council of Provinces on 26 February 2003. The review assesses the financial position of provincial and local governments, the relationships between different levels of government and whether certain objectives for the delivery of services are met. It emphasises that accountability for service delivery is a fundamental objective in achieving budgeted outcomes.

Over the medium term, provinces are projecting small deficits, which will be financed through cash balances accumulated from past surpluses. Consistent with the priorities set out in the *Medium Term Budget Policy Statement 2002* (MTBPS), provincial governments' budgets accorded high priority to increased spending on social services.

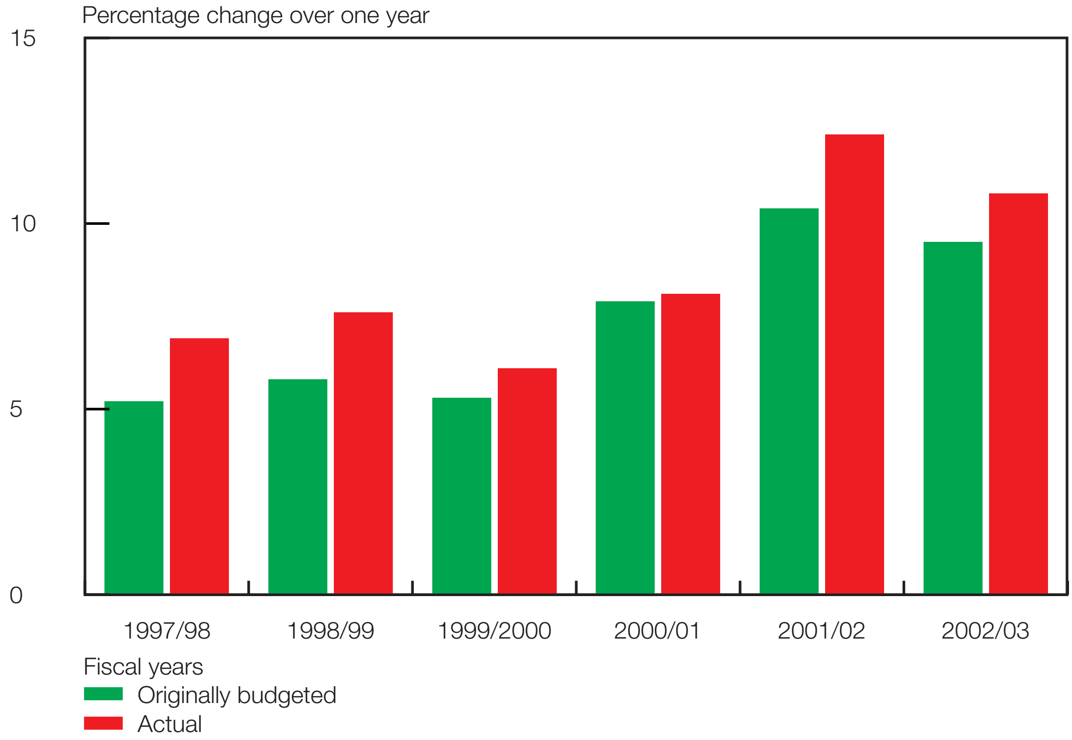
Provincial governments are succeeding in curtailing growth in personnel expenditure. The downward trend, which started in fiscal 2000/01, is set to continue over the medium term, resulting in a further decline in the share of personnel expenditure as a percentage of total expenditure from 51,6 per cent in 2002/03 to 46,4 per cent in 2005/06. This will release more resources for service delivery, with non-personnel expenditure expected to increase over the medium term.

By contrast, personnel expenditure at the level of local government increased in the past few years, and amounted to some 32 per cent of local governments' operating budgets in fiscal 2002/03. This ratio was nevertheless still considerably smaller than that of the provincial governments. It was stated by government in the *Intergovernmental Fiscal Review* that local governments should improve the collection of revenue and reduce the arrears in the payment of water and electricity bills.

National government finance

Preliminary data indicate that national government expenditure in fiscal 2002/03 amounted to R291,2 billion – R3,3 billion more than the originally budgeted provision, but close to the revised estimate presented to Parliament by the Minister

Expenditure by national government



of Finance in February 2003. This resulted in a year-on-year rate of increase in government expenditure of 10,8 per cent in fiscal 2002/03, which exceeded the original Budget target of 9,5 per cent.

The year-on-year rate of increase in national government expenditure in fiscal 2002/03 was lower than the increase of 12,4 per cent recorded in the previous fiscal year, but exceeded the average year-on-year rate of increase of 8,5 per cent in the preceding five fiscal years.

Interest paid on the national government debt was well-contained and in fact *decreased* by 1,6 per cent to R46,6 billion in fiscal 2002/03 – the first time since fiscal 1974/75 that government recorded a decrease in its interest bill. This amount also fell slightly below the original budget estimate of state debt costs. Lower interest rates, appropriate borrowing strategies, the restructuring of the composition of government debt and the steady decline in the borrowing requirement of national government in recent years, jointly contributed to the decline in the interest burden. In fiscal 2002/03, interest payments as a ratio of gross domestic product amounted to 4,1 per cent which is well below the 5,4 per cent level recorded as recently as 1999/2000. In his presentation of the 2003/04 Budget to Parliament, the Minister of Finance indicated that debt service cost as a share of government expenditure will continue to fall over the medium term, releasing resources for expenditure on service delivery.

National government transferred R123,5 billion, equivalent to 42,4 per cent of its total expenditure, to provincial governments as their equitable shares of the revenue pool. Although only 6,5 per cent of the spending by national government was of a capital nature, the capital expenditure in fiscal 2002/03 represented an increase of almost 23,9 per cent from the previous fiscal year.

National government expenditure as a ratio of gross domestic product amounted to 25,9 per cent in fiscal 2002/03, slightly down from the 26,1 per cent recorded in the preceding fiscal year. After allowing for cash-flow adjustments (i.e. transactions recorded as a result of timing differences between the recording of transactions and bank clearances, and late departmental requests for funds), government's cash expenditure amounted to R289,4 billion in fiscal 2002/03, which was 11,8 per cent higher than in the previous fiscal year.

The *Statement of national government revenue, expenditure and borrowing* indicates that unaudited national government revenue increased by 12,1 per cent to amount to R278,2 billion in fiscal 2002/03 – R13,0 billion more than the original budget estimate, and also more than the revised estimate of R275,7 billion presented to Parliament in February 2003. This rate of increase was substantially higher than the rate of increase of 6,9 per cent originally envisaged in the Budget for fiscal 2002/03.

The rate of increase in national government revenue in fiscal 2002/03 was lower than the rate of increase of 15,1 per cent recorded in the previous fiscal year, but marginally above the average year-on-year rate of increase of 11,2 per cent in the preceding five fiscal years.

As shown in the accompanying table, the increase in national government revenue was primarily due to stronger-than-envisaged growth in taxes on goods and services and on income and profits, especially by companies. In turn, this was related to continued improvements in the efficiency of tax collections, a higher-than-expected inflation rate and favourable terms-of-trade developments. Collection of secondary tax on companies also increased from R4,0 billion in fiscal 2000/01 to R6,1 billion in fiscal 2002/03 as a result of the step-up in the distribution of dividends by companies.

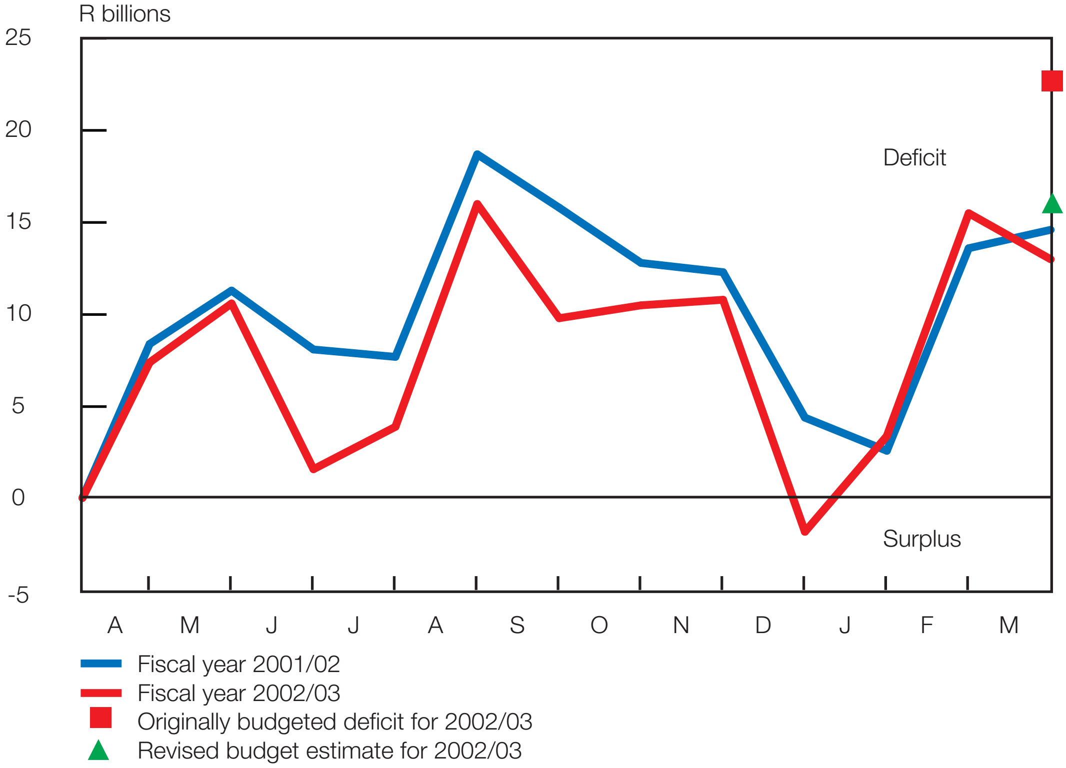
National government revenue in fiscal 2002/03

Revenue source	R billions		
	Originally budgeted	Actual	Percentage change*
Taxes on income and profits	155,7	159,7	8,4
Payroll taxes	3,0	3,3	22,7
Taxes on property	4,6	5,1	9,8
Domestic taxes on goods and services	92,8	96,9	11,5
Taxes on international trade and transactions	10,6	9,7	12,2
Other revenue**	6,8	11,8	92,0
Less: SACU*** payments	8,3	8,3	0,7
Total revenue	265,2	278,2	12,1

* Fiscal 2001/02 to fiscal 2002/03
** High values are partly due to the inclusion of an amount of R5,7 billion of unallocated revenue which is currently not allocated to a specific revenue source
*** Southern African Customs Union

National government revenue as a ratio of gross domestic product amounted to 24,8 per cent in fiscal 2002/03, compared with 24,6 per cent in the previous fiscal year. National government's cash revenue (revenue adjusted for timing differences between the recording of transactions and bank clearances) also amounted to R278,2 billion, representing an increase of 12,2 per cent in fiscal 2002/03 compared with the previous fiscal year.

Cumulative deficit of national government



The net result of the higher-than-budgeted revenue and expenditure was a national government deficit before borrowing and debt repayment of R13,0 billion in fiscal 2002/03. This deficit was much lower than both the originally budgeted deficit of R22,7 billion and the revised estimate of R16,1 billion presented to Parliament in February 2003. The national government deficit before borrowing and debt repayment as a ratio of gross domestic product amounted to 1,2 per cent in fiscal 2002/03 compared with a ratio of 1,5 per cent in the previous fiscal year.

The *primary balance* (i.e. the deficit recalculated by excluding interest payments from total expenditure) reached a surplus of 3,0 per cent of gross domestic product in fiscal 2002/03, slightly lower than the 3,2 per cent recorded in the previous fiscal year.

The fiscal 2002/03 cash deficit amounted to R11,1 billion. Apart from financing this deficit, national government had to pay a premium on debt portfolio restructuring to the amount of R0,3 billion and also made a payment of R7,0 billion to the South African Reserve Bank as part payment of the outstanding balance on the Gold and Foreign Exchange Contingency Reserve Account. An extraordinary entry to the amount of R0,6 billion provided for the debt of the former Regional Authorities and the South African Housing Trust assumed by national government in terms of the Disestablishment of the South African Housing Trust Limited Act, Act No. 26 of 2002.

Although the proceeds from the restructuring of state assets contributed less than originally anticipated, extraordinary revenue nevertheless made a significant contribution towards reducing the net borrowing requirement of national government in fiscal 2002/03. Receipts from this source included R4,2 billion from the Telkom Initial Public Offering (IPO) and R1,6 billion from the monetisation of Transnet's interest of 20 per cent in M-Cell by means of an innovative structured financial mechanism. Receipts were also bolstered by the restructuring of the Central Energy Fund and profits on the revaluation of maturing foreign loans amounting to R2,2 billion and R1,0 billion, respectively. After taking these extraordinary receipts and payments into account, the net borrowing requirement of national government amounted to R10,1 billion.

National government financing in fiscal 2002/03

R billions

Instrument	Originally budgeted	Actual
Deficit	**22,7**	**11,1***
Plus: Extraordinary payments	1,6	8,0
Cost/profit on revaluation of maturing foreign loans**	...	-1,0
Less: Extraordinary receipts	12,0	8,0
Net borrowing requirement	**12,3**	**10,1**
Domestic government bonds	-10,9	-4,2
Treasury bills	4,0	4,2
Foreign loans	16,3	13,3
Change in available cash balances***	2,9	-3,2
Total net financing	**12,3**	**10,1**

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

Treatment of extraordinary revenue and expenditure in the analysis of government finances

The *Statement of national government revenue, expenditure and borrowing* records some flow of funds as extraordinary transactions. Extraordinary items are exceptional in the sense that they are usually of a large value, occur irregularly and are not part of the general operations of government.

The analysis of government finances in the *Statement of national government revenue, expenditure and borrowing*, the *Budget Review* and in Tables S-55 and S-56 of the *Quarterly Bulletin* excludes these extraordinary transactions from revenue and expenditure. It is therefore also excluded from the calculation of the budget deficit of national government. This calculated deficit is then increased with extraordinary payments and decreased with extraordinary receipts to derive the net borrowing requirement of government. The presentation of national government finances in this way facilitates the comparison of actual outcomes with the budgeted estimates and allows for the analysis of long-term trends in government operations without the distortions created by the inclusion of extraordinary items.

The analysis of the finances of the general government (as presented in Tables S-71 to S-77 of the *Quarterly Bulletin*) adheres to the guidelines provided in *A Manual on Government Finance Statistics,* 1986 (GFS) of the International Monetary Fund. This analysis facilitates international comparability of the *overall financial position* of government. All transactions of government are classified according to the underlying economic nature of the transactions, and recorded accordingly. The GFS framework does not allow any transaction to be recorded as extraordinary. As indicated in the accompanying schematic presentation, the economic nature of each extraordinary transaction is determined and the transactions are re-routed to be included in either revenue and grants, or expenditure and net lending, or in financing activities.

Re-routing between budget comparable analysis and GFS analysis

Budget comparable analysis	GFS Analysis
Revenue	Revenue and grants
Less: Expenditure	Expenditure and net lending
Deficit	**Deficit**
Less: Extraordinary receipts	
Plus: Extraordinary payments	
Net borrowing requirement	
Financing	**Financing**

The classification of extraordinary items according to their economic nature in the GFS framework usually leads to differences in the deficit as calculated in the budget comparable analysis and the GFS analysis. In 2002/03, for example, the budget comparable deficit amounted to R13,0 billion and the GFS deficit to R11,7 billion. Although the total value of extraordinary receipts and payments during the fiscal year came to R17,0 billion, the effect on the GFS deficit was only a net decrease of R1,3 billion due to offsetting transactions.

The re-routing principle may be illustrated by considering the treatment of two recent transactions resulting from the restructuring of state assets. The proceeds from the initial public offering of Telkom shares and the proceeds from the disposal of Transnet's shares in M-Cell were both recorded as extraordinary revenue in fiscal 2002/03. The disposal of some of government's shares in Telkom reduced government's equity holding (direct ownership) in this public corporation and as such it was recorded as negative net lending in the GFS framework. However, Transnet's disposal of its M-Cell shares did not change the ownership relationship between government and the public corporation, Transnet. Transnet merely cashed in on an investment (its equity holding in M-Cell) which provided Transnet with increased cash reserves from which a larger than usual dividend to its owner (national government) was declared. The GFS framework therefore records this transaction as *revenue*, more specifically, non-tax revenue.

When a user of statistics considers the deficit of national government, care should be taken in the choice of deficit measure used. If the user wants to consider the overall financial position of government or when making international comparisons, the all-inclusive GFS deficit should take preference. When comparing government's performance with the Budget, the budget comparable deficit, excluding extraordinary items, should take preference.

The greater part of national government's net borrowing requirement in fiscal 2002/03 was financed through the issuance of bonds in the foreign capital market. Total foreign loans arranged during fiscal 2002/03 amounted to R13,3 billion compared with the R16,3 billion originally envisaged in the Budget for 2002/03. Foreign funding comprised of:

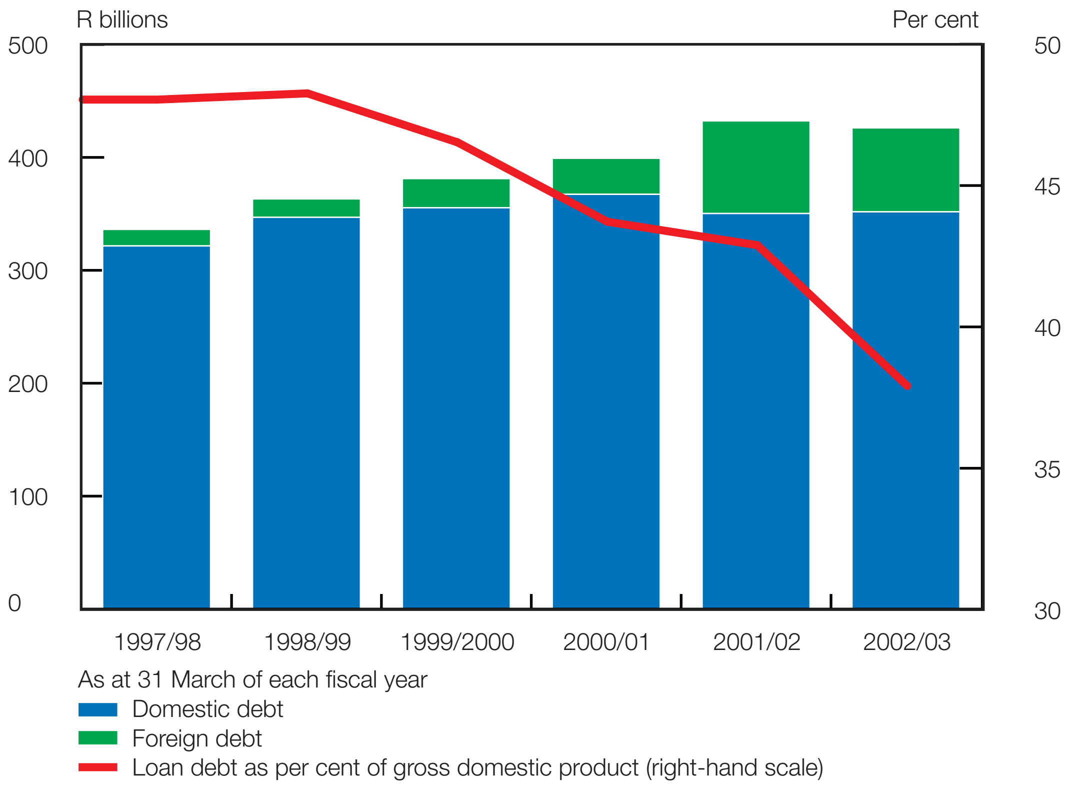
- amounts drawn on the export credit facility which had been arranged specifically for the Special Defence Procurement Programme to the amount of R4,9 billion; and
- the issuance of a ten-year dollar-denominated bond to the amount of US$1 billion with a coupon rate of 7,375 per cent which yielded R10,8 billion.

As envisaged in the *Budget Review 2002*, government primarily made use of foreign funding to finance the borrowing requirement and concluded the bulk of its foreign funding requirement in the first quarter of fiscal 2002/03.

In May 2003 the National Treasury issued a new €1,25 billion global benchmark bond which carries an annual coupon rate of 5,250 per cent with a maturity of 10 years and yielded R10,6 billion to the National Revenue Fund.

Gross funding by means of issuing long-term domestic bonds in fiscal 2002/03 was obtained at an average rate of 11,6 per cent per annum and short-term instruments were sold at an average rate of 8,2 per cent per annum. These rates can be compared with budgetary assumptions of 11,4 per cent and 9,7 per cent, respectively.

Loan debt of national government



The issuance of debt instruments, the discount on new government bond issues and the revaluation of foreign debt at a stronger exchange value of the rand, led to a decrease in the loan debt of national government. Foreign funding further allowed the National Treasury to redeem on a net basis some domestic government bonds during fiscal 2002/03. The loan debt of national government accordingly declined from R432,3 billion at the end of March 2002 to R426,1 billion at the end of March 2003. As a ratio of gross domestic product, the national government's *loan debt* decreased from 42,9 per cent at the end of March 2002 to 37,9 per cent at the end of March 2003. The contribution of foreign loans to this ratio decreased from 8,1 per cent at the end of March 2002 to 6,6 per cent at the end of March 2003. This was mainly due to the effect of the improvement in the exchange value of the rand on the revaluation of foreign loans.

The *total debt* of national government increased from R460,3 billion at the end of March 2002 to R462,6 billion at the end of March 2003. Also included in this aggregate is the unaudited outstanding balance on the Gold and Foreign Exchange Contingency Reserve Account which increased from R28,0 billion at the end of March 2002 to R36,6 billion at the end of March 2003. However, as a ratio of gross domestic product, total debt of national government decreased from 45,7 per cent at the end of March 2002 to 41,2 per cent at the end of March 2003.

Statement of the Monetary Policy Committee

20 March 2003

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

Introduction

In February 2000 an announcement was made by government that an inflation targeting framework had been adopted for monetary policy purposes. This change was made to improve the co-ordination between monetary policy and other macro-economic policies, as well as to make monetary policy more transparent and accountable. Under this framework the Reserve Bank and more specifically the Monetary Policy Committee was given the task to achieve an average rate of increase in the overall consumer price index for metropolitan and other urban areas excluding mortgage interest costs (the CPIX) of between 3 and 6 per cent for the year 2002. The CPIX measure of inflation was chosen to ensure a wide coverage of consumer items, but without the mortgage interest cost component that would perversely fall as monetary policy was relaxed, and vice versa.

In 2002 the rate of increase in the CPIX averaged 10 per cent, or 4 percentage points above the upper limit of the target range. In the light of this outcome the Reserve Bank wishes to inform the public in general why the actual inflation rate deviated from the target. The Bank would also like to spell out what measures have been taken to bring the inflation rate within the target band in due course.

The inflation outcome for 2002

The Monetary Policy Committee is of the opinion that four factors were mainly responsible for the acceleration in the rate of increase in the general price level in 2002. First and foremost the rapid rise in the prices of consumer goods and services was related to the sharp depreciation in the external value of the rand in the second half of 2001. The nominal value of the rand on a trade-weighted basis declined by 34,3 per cent from the end of June 2001 to the end of that year. Initially the weakness of the rand was mainly linked to the contagion effects of the political situation in Zimbabwe and financial stability problems experienced in emerging-market economies such as Argentina and Turkey. Later developments in the exchange rate of the rand were characterised by typical financial market behaviour under the circumstances which prevailed at the time where further declines in the exchange rate of the rand became a self-fulfilling prophecy based on market expectations.

The increased risk aversion of international investors caused asset fund managers to withdraw portfolio investments from South Africa. These sales of South African securities increased the demand for dollars in the domestic currency market, which put downward pressure on the exchange rate of the rand. At the same time, importers made advance payments to avoid paying more in rand for foreign currency denominated purchases of goods abroad at a later stage, while exporters delayed the repatriation of foreign-currency earnings to obtain expected higher rand proceeds from a depreciating currency. The effects of the leads and lags in foreign payments and receipts on the exchange rate of the rand were aggravated by the appearance of a deficit on the current account of the balance of payments during the second half of 2001.

A second factor leading to the acceleration in inflation during 2002 was the rise in domestic food prices which had already started from the middle of the preceding year. The prices of food increased by no less than 16,7 per cent in 2002. If the increases in food prices are excluded from the overall CPIX, the rate of increase in the prices of other goods and services averaged 7,8 per cent in 2002.

Food prices are generally a highly volatile component in consumer expenditure and can have a significant impact on other price developments in South Africa. The substantial rise in food prices during 2002 can to a large extent be attributed to the depreciated value of the rand. After the liberalisation of agricultural pricing, export and import parity prices have generally set the lower and upper bounds to the prices of domestically produced agricultural goods. The rise in international prices of grain products together with the depreciation of the rand caused the prices of food in South Africa to rise considerably. Moreover, the regional demand and supply of crops in southern Africa shifted the prices of agricultural goods higher owing to a movement away from export parity pricing to import parity pricing.

Thirdly, the acceleration in the prices of consumer goods and services was the result of increases in international oil prices during 2002. After the Brent price of oil had stabilised around US$20 per barrel in January and February 2002, it started to move higher and reached an average of approximately US$28 per barrel in December 2002. This increase was mainly related to concerns about a possible US-led attack on Iraq and disruptions in the supply of oil due to general strikes in Venezuela.

Fourthly, the inflation outcome in 2002 was affected by large increases in some administered prices. In particular, the prices of medical and education services and water rates continued to increase at very high rates of approximately 10 per cent or more in 2002, following on even higher increases in 2001. Assessment rates and fees for sanitary services and refuse removal also rose at a high rate in 2002. As a result, the increase in the prices of all administered goods and services averaged 8,4 per cent in 2002, or was about equal to the increase in the preceding year. High increases in administered prices, which have a weight of almost 25 per cent in the CPIX, continue to make it extremely difficult to bring inflation down to the targets set by government.

This brief exposition of the major reasons why the inflation target was not met in 2002 indicate that it was largely due to extraordinary events that could not be foreseen and which were beyond the control or influence of monetary policy. At the beginning of 2002, when it had already become apparent that the inflation target would not be met, the Reserve Bank considered whether to make use of the escape clause, which recognises circumstances which could temporarily lead to deviations from the target. In the end the Bank decided that it would be unwise to make use of this clause. Continued monetary discipline was regarded as essential for price stability and sustainable high economic growth. It was also argued at the time that the negative effect of higher interest rates on short-term economic growth would be neutralised to a large extent by the very competitive external value of the rand.

Rather than opting for a temporary increase in the inflation target, the Monetary Policy Committee decided that corrective measures should be applied. The committee affirmed that it was highly unlikely that any measures would bring the inflation rate to within the target range for 2002 because of the long lags between interest rate increases and a slowdown in inflation. The objective of the committee accordingly became focused on bringing the rate of increase in CPIX within the target range as soon as possible with the least short-term cost to economic growth and employment creation.

The first corrective step was already taken at a special meeting of the Monetary Policy Committee early in January 2002. At this meeting the committee decided to increase the repurchase rate of the Bank by 100 basis points to counter rising inflation expectations. Monetary policy was tightened further at the subsequent three scheduled meetings of the Monetary Policy Committee. At all three meetings the repurchase rate was increased by 100 basis points to bring the level to 13,5 per cent in September 2002. On the basis of expected inflation, this led to a significant increase in real short-term interest rates in South Africa and therefore a tightening in monetary policy.

At the November meeting of the Monetary Policy Committee it was decided that the right dose of monetary discipline had been applied and that there were some signs that inflation pressures were abating. The committee therefore kept the repurchase rate unchanged because this level of the rate was regarded as appropriate to bring the inflation rate within the target range in due course.

Current inflation outlook

Since the last meeting of the Monetary Policy Committee the inflation outlook has improved further. This is specifically confirmed by a slowdown in the prices of production goods, which generally precedes similar changes in consumer price inflation. The recent recovery of the rand and a lower rate of increase in food prices have curbed the rise in the prices of both imported and domestic goods. As a result, the year-on-year rate of increase in the all-goods production price index declined from 15,4 per cent in September 2002 to 8,1 per cent in January 2003. An even more impressive reduction in the seasonally adjusted and annualised quarter-to-quarter production price inflation has been recorded from 25,8 per cent in the first quarter of 2002 to 5,0 per cent in the fourth quarter.

Other factors pointing to an improved inflation outlook, include the following:

- A recovery in the exchange rate of the rand. The weighted exchange rate of the rand increased by 26,0 per cent from the end of December 2001 to the end of December 2002 and by a further 5,9 per cent up to 20 March 2003. This brought the level of the nominal effective exchange rate of the rand close to its level at the end of 2000, i.e. just before the weakening of the rand in 2001. Sound macro-economic policies, relatively high domestic interest rates in comparison to developed countries, a reduction in risk aversion towards emerging market economies, improved international credit ratings of South Africa and the weakness of the dollar were possibly responsible for this recovery of the rand.

- Slowdown in food price increases. Food price inflation moderated somewhat from a year-on-year increase of 19,3 per cent in October 2002 to 15,4 per cent in January 2003. Although this latter rate of increase is still very high, the recovery of the rand, the decline in international grain prices and expected good summer crops should bring food price increases to significantly lower levels.

- Slower momentum in the growth of money supply. The seasonally adjusted and annualised quarter-to-quarter growth in the broadly defined money supply (M3) declined sharply from 32,1 per cent in the first quarter of 2002 to 7,1 per cent in the fourth quarter. Measured over a period of twelve months, the growth in M3 came down from 17,8 per cent in October 2002 to 9,9 per cent in January 2003.

- Continued moderate growth in bank credit extension. Growth over twelve months in bank credit extension to the private sector declined from 15,6 per cent in January 2002 to only 4,7 per cent in December, but then rose again to 12,7 per cent in January 2003. The January 2003 figure, however, was distorted by regulatory and accounting changes specifying that certain transactions must be reported on a gross rather than a net basis. These changes particularly affected the investments of banks in private sector entities. If these items are excluded, the rate of increase in the loans and advances of banks to the private sector, measured over a period of twelve months, declined from 10,3 per cent in August 2002 to 7,9 per cent in December, and then increased moderately to 8,9 per cent in January 2003.

- Excess production capacity. The utilisation of production capacity in manufacturing, which had amounted to 81,1 per cent in the third quarter of 2002, declined to 80,1 per cent in the fourth quarter. The increase in excess production capacity was the combined result of increased capital outlays by manufacturing enterprises and a slowdown in the growth of manufacturing output. It also seems unlikely that capacity constraints will arise in the near future because of an apparent weakening in the demand for manufactured goods as signalled by a recent decline in unfilled orders.

- Surplus on the current account of the balance of payments. The current account of the balance of payments turned around from a seasonally adjusted and annualised deficit of R2,2 billion in the third quarter of 2002 to a surplus of R4,3 billion in the fourth quarter. The current account was also in surplus to the amount of R3,3 billion for the year as a whole, clearly indicating that there are no signs of excess spending in the South African economy. The improvement in the current account balance was largely the result of the higher gold price leading to a higher value of net gold exports. This development, together with an increase in the prices of exported goods and services, neutralised a decline in the volume of merchandise exports and a rise in merchandise imports. Projections of current account aggregates show that future excess spending also seems unlikely.

- Continued fiscal discipline. Although government adopted a more expansionary fiscal policy stance from 2001/02, fiscal discipline continued to be applied. It is estimated that the deficit before borrowing and debt repayment will reach 2,4 per cent of gross domestic product in the fiscal year 2003/04, and that it will be maintained more or less at this level in the next two years. At these levels, the finances of government should not present any difficulties for monetary policy.

The above-mentioned promising developments will need to be maintained if a meaningful reduction in CPIX inflation is to be achieved. After the year-on-year rate of increase in the CPIX had accelerated from a low level of 5,8 per cent in September 2001 to 12,7 per cent in November 2002, it retraced only modestly to 11,3 per cent in February 2003. Moreover, the seasonally adjusted and annualised quarter-to-quarter increase in CPIX inflation rose from 11,1 per cent in the second quarter of 2002 to 14,5 per cent in the fourth quarter. These high levels of CPIX inflation leave little room for complacency on the part of monetary policy.

Considerable risks still exist that could prevent the rate of increase in the CPIX from moving into the target range during the course of 2003. Among these risks the recent high rates of increase in the average nominal remuneration per worker in the formal non-agricultural sectors of the economy combined with a slowdown in labour productivity growth, are probably the most disconcerting. As a result, average year-on-year growth in nominal unit labour cost reached 7,4 in the first nine months of 2002, which could bring about considerable upward pressure on future price inflation. It has been found in the past that high rates of increase in unit labour costs invariably lead to an acceleration in domestic inflation.

In the current circumstances, the insecure international economic environment is a further risk factor to take into consideration when determining monetary policy. Considerable uncertainty exists regarding the economic impact of the war in Iraq and about the pace of the underlying recovery in the world economy.

Another major risk factor for monetary policy is that prices of goods and services determined by government agencies have continued to increase rapidly and there are still few signs that these increases are tapering off. As already indicated, these administered prices form a large part of the CPIX. In addition, they also affect other prices indirectly. It is therefore of the utmost importance that macroeconomic and microeconomic policies be co-ordinated closely to achieve optimum results with overall economic policy.

Monetary policy stance

Although there are still important risks prevalent that could have a negative effect on the inflation outcome, conditions have become generally more favourable for a decline in domestic inflation. This is confirmed by projections using the Reserve Bank's forecasting models, which indicate that there is a strong likelihood that CPIX inflation will move within the target band during the course of the year. However, the forecasts also indicate that the average rate of increase in the CPIX may only be slightly below the upper band of the inflation target in 2004. Taking this into consideration, as well as the risks identified above, the Monetary Policy Committee has decided to maintain the repurchase rate at its current level of 13,5 per cent per annum.

In addition, the Reserve Bank wants to confirm that, consistent with our inflation-targeting monetary policy framework, we have no intermediate policy targets or guidelines and we are committed to allowing the value of the rand to be determined by the market. Recently, with the recovery of the rand, the Reserve Bank has on occasion taken the opportunity to purchase dollars for our reserves on a moderate scale. These operations have helped to reduce the Bank's net open position in foreign currency from US$1,8 billion at the end of November 2002 to US$1,3 billion on 13 March 2003. Such operations purely represent normal prudent management of the Reserve Bank's balance sheet as is ordinarily the case in central banking. They are in no way directed at seeking to influence a particular level of the rand, whose value will continue to be set by the market.

Statement of the Monetary Policy Committee

12 June 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 rate of inflation has declined further since the last meeting of the Monetary Policy Committee. In particular production price inflation slowed down to low levels. Changes in production prices, which generally precede similar changes in consumer prices, fell back from a peak year-on-year rate of increase of 15,4 per cent in September 2002 to 8,1 per cent in January 2003 and to 3,3 per cent in April. In fact the all-goods production price index measured from quarter to quarter declined at a seasonally adjusted and annualised rate of 3,2 per cent in the first quarter of 2003, while it had increased by 5,3 per cent in the fourth quarter of 2002 and by 25,8 per cent in the first quarter of 2002. The recovery of the rand, moderating food price inflation and a disciplined monetary policy stance eased price pressures.

Even more significant is that the decline in production prices was not only confined to lower prices of imported goods related to the recovery in the external value of the rand, but the prices of domestically produced goods also declined at an annualised quarter-to-quarter rate of 0,9 per cent in the first quarter of 2003. Moreover, all the categories of domestically produced goods experienced disinflation in the first quarter of 2003. Prices of imported goods declined at an annualised rate of 10,0 per cent in the first quarter of 2003.

The revised consumer price index for metropolitan and other urban areas excluding the interest cost of mortgage bonds (the CPIX) also improved significantly. The year-on-year rate of increase in the CPIX decelerated from a peak of 11,3 per cent in November 2002 to 9,3 per cent in February 2003 and 8,5 per cent in April. CPIX inflation declined at a faster pace from a seasonally adjusted and annualised rate of 12,1 per cent in the fourth quarter of 2002 to 4,8 per cent in the first quarter of 2003.

Had the figures not been revised, the quarter to quarter annualised rate of growth in the CPIX would have amounted to 6,3 per cent in the first quarter of 2003. Measured over a period of twelve months the revision of the CPIX was also significant. However, the turning point and pattern of change between the previous and revised monthly series coincide fairly closely.

Factors favouring lower inflation

A number of developments favour a reduction in the inflation rate:

- Low inflation in the rest of the world. Global inflation is generally expected to remain low and consumer prices in advanced economies could even reach an average rate below 2 per cent in 2003. The sluggish world economic performance and weak household demand could promote continuing disinflationary pressures.

- The recovery in the external value of the rand. The nominal value of the effective exchange rate of the rand increased by 26,0 per cent during the year up to the end of December 2002 and by a further 0,9 per cent in the first five months of 2003. Although the pass-through effect of the recovery of the rand is usually much smaller than in the case of a depreciation, the current available information indicates that some of the direct and indirect effects of the changed external value of the rand have already benefited disinflation in the CPIX.

- The ending of the war in Iraq. The end of the war in Iraq and the fact that oil supplies were not materially affected, has removed some of the uncertainties about the international economic environment. However, tensions in the Middle East persist. The surge in the average oil price per barrel from US$24,50 in November 2002 to US$32,65 in February 2003, came to an abrupt end at the beginning of the Iraqi war. Brent crude oil prices then dropped to an average of US$25,76 per barrel in May. Together with the recovering rand, this decline in oil prices led to a considerable reduction in domestic fuel prices in May and June 2003, which should also assist in bringing the rate of inflation down to lower levels.

- Improvement in inflation expectations. The recent survey by the Bureau of Economic Research of the University of Stellenbosch clearly indicates that inflation expectations of analysts, business, labour and households are subsiding. A decline in long-term inflation expectations is also indicated by a 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 just below 6 per cent from April 2003. Inflation expectations play an important role in the inflation containment process.

- Surplus production capacity in manufacturing. The utilisation of production capacity in manufacturing declined to 80,3 per cent in the first quarter of 2003, or to a level considerably below what would normally be regarded as full capacity utilisation. A clear downward trend is also discernible in total unfilled orders at constant prices from the middle of 2002, which makes any capacity constraints unlikely in the near future.

- Prudent fiscal policy. The government remains fully committed to pursuing sound fiscal policies. This is demonstrated by the low level of the non-financial public-sector borrowing requirement of 1,0 per cent of gross domestic product in the fiscal year 2002/03 and by the planning of the fiscus as presented in the Medium Term Budget Policy Statement of the year 2002. Although the borrowing requirement ratio is slightly higher than the ratio of 0,8 per cent recorded in the fiscal year 2001/02, it is very low by any international comparison. Government has also succeeded in reducing its debt as a ratio of gross domestic product from 45,7 per cent at the end of March 2002 to 41,2 per cent at the end of March 2003.

- Slower monetary growth. The rate of increase in the broadly defined money supply (M3) declined from a peak of 20,6 per cent in May 2002 to 5,9 per cent in March 2003. However, it rose to 10 per cent in April. The growth over twelve months in the banks' claims on the domestic private sector, excluding investments and bills, accelerated from 9,1 per cent in February 2003 to 12,7 per cent in April. The household sector was mainly responsible for this rise in bank credit extension.

Inflation risks

Large pay increases continue to be a major risk factor for the containment of inflation. This risk becomes even more crucial if it is accompanied by a slowdown in labour productivity growth. In 2002 the average nominal remuneration per worker in the formal non-agricultural sectors of the economy amounted to 9,9 per cent, compared with an already high 9,1 per cent in 2001. Over the same period, the growth in total labour productivity in the economy declined from 4,8 per cent to 2,8 per cent. As a result, nominal unit labour costs in the formal non-agricultural sectors increased at a rate of 7,0 per cent in 2002. Increases at these levels, if sustained going forward, could jeopardise the positive inflation outlook.

Despite the relatively tight monetary stance, the growth in final domestic demand was sustained. Having increased at an average rate of 4 per cent in 2002, the quarter-to-quarter annualised rate of increase in final domestic demand amounted to 3½ per cent in the first quarter of 2003.

Real final consumption expenditure by households increased at an annualised rate of 2½ per cent in the first quarter of 2003, or at roughly the rate attained in the preceding quarter. The steady growth in real consumption expenditure by households was possibly underpinned by the tax cuts announced in the Budget of February 2003. Consumers incurred debt to maintain consumption expenditure and to acquire assets, which led to an increase in the ratio of household debt to disposable income from 51 per cent in the fourth quarter of 2002 to 53 per cent in the first quarter of 2003.

Real government consumption expenditure also increased at the same pace as that recorded in the fourth quarter of 2002. In addition, the increase in real fixed capital formation amounted to 8½ per cent in the first quarter of 2003. The growth in capital formation continued in all the sectors of the economy, with the exception of the agricultural sector which was affected adversely by the recovering rand and in some instances by weather conditions.

The high growth in domestic final demand was accompanied by a marked slowdown in economic activity. The growth in South Africa's real gross domestic product declined from an annualised rate of 2½ per cent in the fourth quarter of 2002 to 1½ per cent in the first quarter of 2003. The further slowdown in domestic output growth was evident in all the sectors of the economy, with a decline in the real value added of the primary and manufacturing sectors. This downward movement in economic activity can mainly be attributed to a decline in the volume of exports related to a depressed global economy and the recovery in the external value of the rand. The level of the real effective exchange rate of the rand in the first quarter of 2003 was, nevertheless, still well below the average level in 2000, i.e. before the recent sharp fluctuations in the exchange rate of the rand.

In the first quarter of 2003 the current account of the balance of payments moved into a deficit, albeit to the still low level of ½ a per cent of gross domestic product. If the current account deficit continues to widen it could lead to pressures on domestic inflation.

Inflation projections

Projections of the likely rate of inflation for 2004, calculated by using the Reserve Bank's core and other forecasting models, indicate that on the policy stance to date, the average rate of increase in the CPIX will be close to the midpoint of the inflation target band in 2004.

Monetary policy stance

Taking these factors into consideration as well as the widening of the differential between South African interest rates and those of our major trading partners owing to a general decline in international interest rates, the Monetary Policy Committee has decided to reduce the repo rate by 150 basis points to a level of 12 per cent per year effective from 13 June 2003.

In taking this decision, the committee recognises the progress achieved so far in reducing inflation and the prospect that inflation may fall within the target range later this year. But the committee will remain vigilant to the risks going forward, particularly those relating to wage settlements, administered prices and the uncertain outlook for the global economy. The committee will be ready to take whatever actions are necessary in either direction in the light of the way future risks materialise.

A note on the recent flight to cash in South Africa

by Michael A Kock [1]

Introduction

This note briefly reviews the impact of changes in share prices on the preference for liquid assets of South African investors. Changes in investor sentiment are reflected in reallocations of assets between equity, fixed-interest securities, cash and bank deposits and money-market instruments, and by the ebb and flow of funds to the unit trust industry.

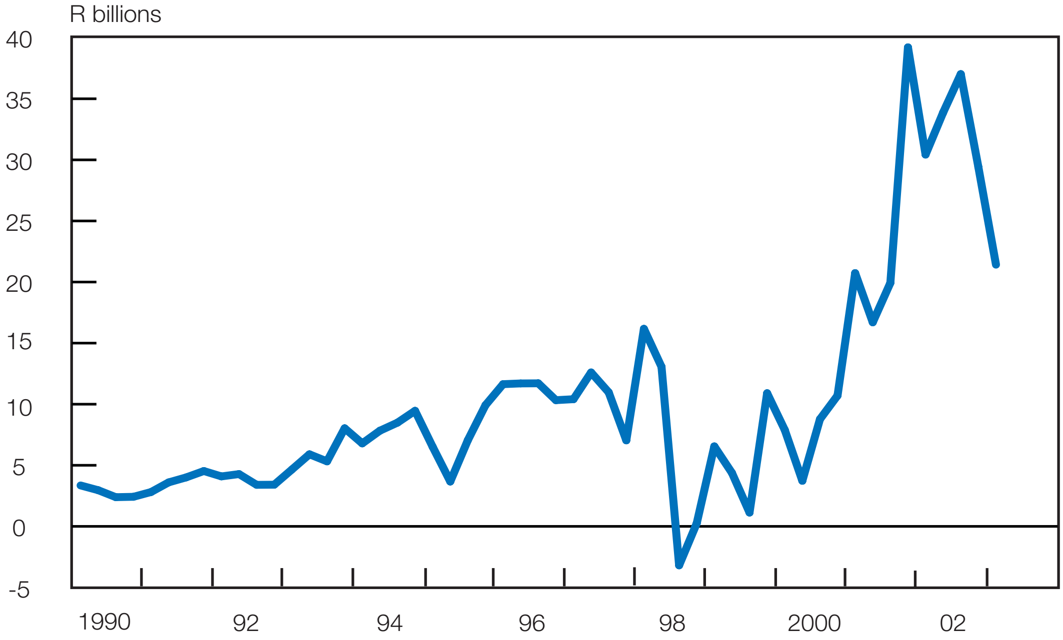
1 The views expressed are those of the author and do not necessarily reflect the views of the South African Reserve Bank.

Changes in the asset composition of unit trusts

Cash holdings amounted to approximately 42 per cent of the total market value of assets managed by the unit trust industry in March 2003. Cash holdings by all non-bank financial intermediaries (i.e. long-term insurers, private and official pension and provident funds and unit trusts) amounted to about 12 per cent of their total assets in December 2002. Non-bank financial intermediaries' cash holdings as a percentage of the market capitalisation of the JSE Securities Exchange SA also amounted to 12 per cent in the fourth quarter of 2002 and as a percentage of the M3 money supply to almost 30 per cent on occasion during 2001 and 2002. This strengthening in the demand for liquid assets contributed to an acceleration in M3 growth from a year-on-year rate of 7 per cent in the fourth quarter of 2000 to 19 per cent in the second quarter of 2002.

The unit trust industry performed fairly well when assessed in terms of the *valuation gap* between the market and the book value of assets under management (see Graph 1). The market value of assets adjusted for current liabilities and domestic intra-industry assets exceeded the book value of assets managed by unit trusts almost

Graph 1 Valuation gap*



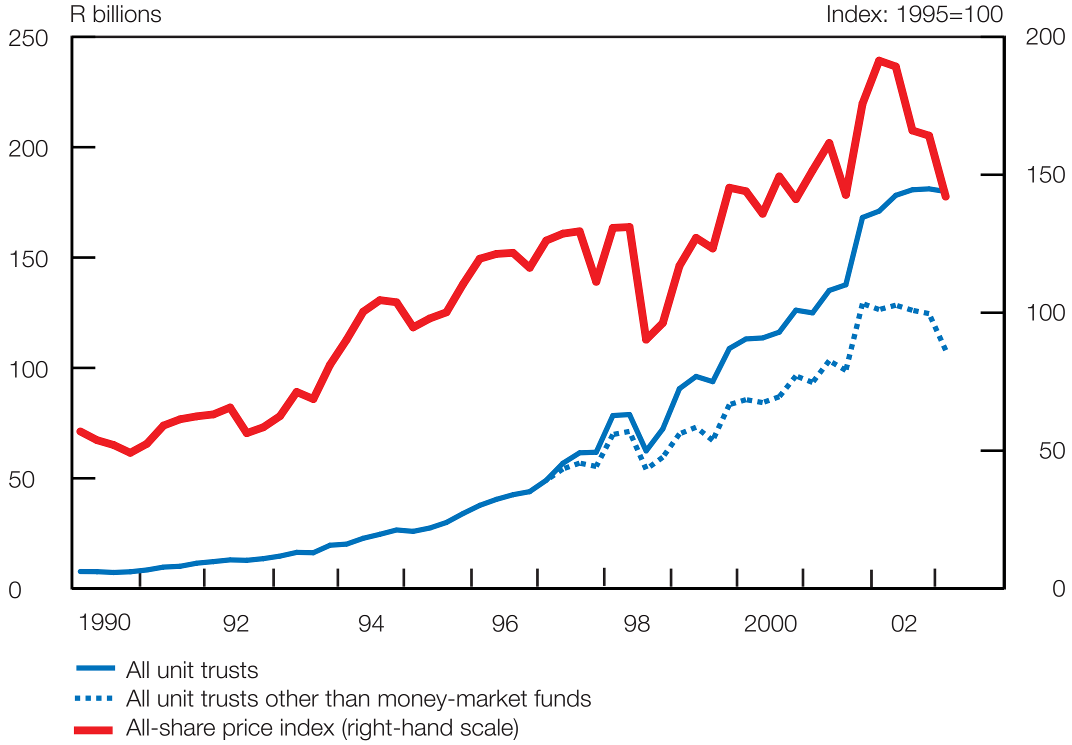
* Market value minus book value of total assets under management

uninterruptedly since 1990, except in 1998 when share prices declined sharply. After the correction of 1998, the market value of assets under management increased in the fourth quarter of 2001 to a level that was well in excess of total book value.

The valuation gap between market and book values narrowed in 2002 when share prices declined again. In 1998 the monthly average level of the all-share price index declined by 39 per cent from May to September and contributed to an absolute change of almost R20 billion in the valuation gap from the first to the third quarter. The monthly average level of the all-share price index declined by 28 per cent from May 2002 to March 2003. On balance, the valuation gap shrank by R18 billion from the fourth quarter of 2001 to the first quarter of 2003, i.e. by about the same amount as in 1998 despite the value of funds under management in 2002 being more than twice as high as in 1998.

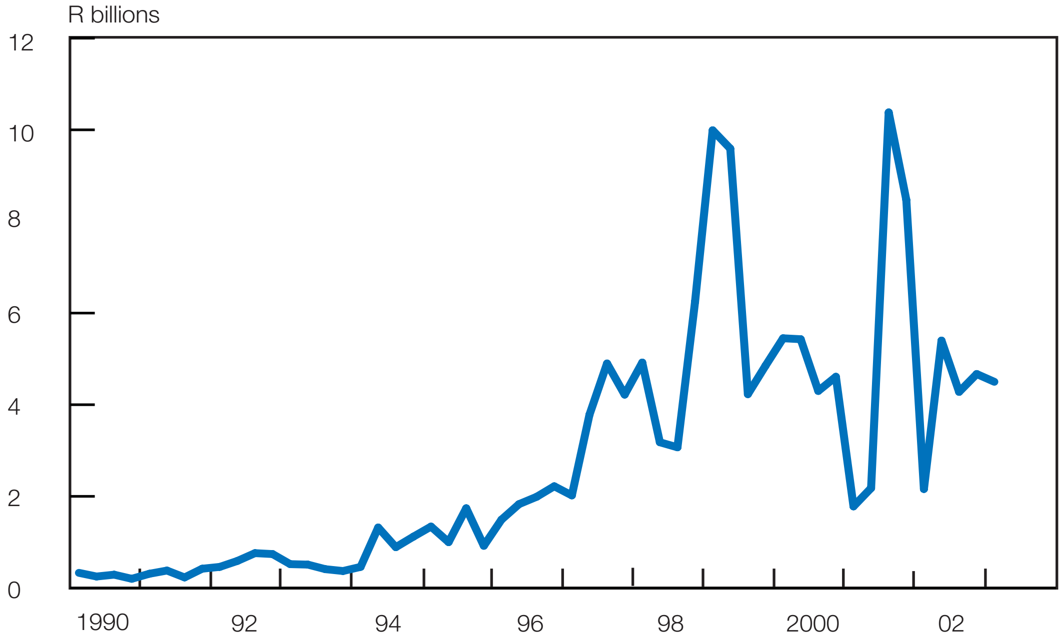
A significant change in the response of the *market value of assets under management* to the fluctuations of share prices is evident from Graph 2. The smaller negative effect of a downward correction in share prices in 2002/03 compared with 1998 may largely be attributed to investors' strong accumulation of highly liquid assets.

Graph 2 Changes in share prices and the market value of assets managed by unit trusts



As shown in Graph 3, investors' *net transactions* (i.e. sales less repurchases) in units of unit trusts were far more volatile in the period after 1998 than in the preceding years. Since 1998 investors apparently attempted to synchronise their net purchases of units with share price movements. With the benefit of hindsight, they erred somewhat with the timing of their investments and failed to capitalise on the recovery in share prices after 1998. In 2001, however, the increased acquisition of units and increased exposure to assets other than cash paid off temporarily, but part of these gains were forfeited during the slump in the share market in 2002.

Graph 3 Net sales of units by unit trusts*

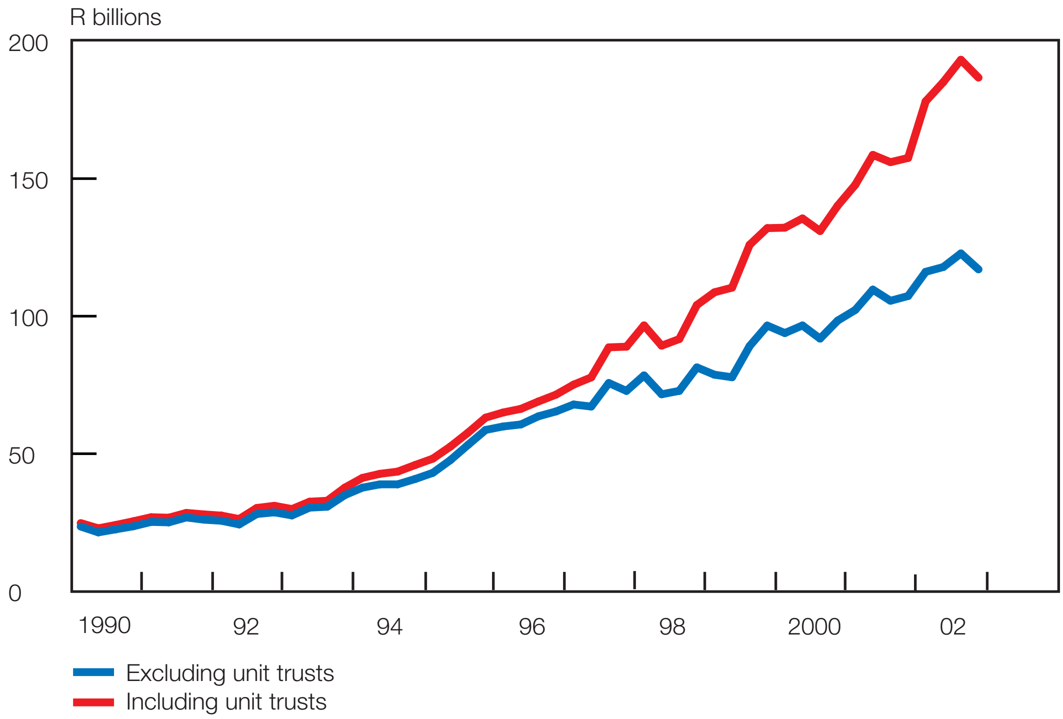


* Sales minus repurchases

Non-bank financial intermediaries

The flight to cash by investors in the unit trust industry contributed significantly to the increase in the *overall holdings of cash, bank deposits and money-market instruments by non-bank financial intermediaries* as indicated in Graph 4. The increased

Graph 4 Holdings of cash, bank deposits and money-market instruments by non-bank financial intermediaries



preference for cash was facilitated by the introduction of money-market funds in 1997. In 1998, the holdings of cash and bank deposits of unit trusts, including money-market funds, accounted for some 21 per cent of cash and bank deposits held by non-bank financial intermediaries. Since then, holdings of cash and other cash-like assets by unit trusts rose exponentially and accounted for 37 per cent of the total cash and other equivalent assets held by non-bank financial intermediaries in the fourth quarter of 2002.

Summary

The current high cash component of the asset portfolios of unit trusts clearly provides some cover or hedge against possible adverse share price movements. Losses suffered on their share investments certainly enhanced investors' precautionary and speculative demand for cash as an asset class. This also partly explains the strong growth in the monetary aggregates up to the middle of 2002. However, if share prices were to recover in the near term a portion of the cash holdings of unit trusts is likely to be redirected to equity investments.

Notes to tables

General note applicable to all statistical tables

The sector classification of Telkom SA Limited, the South African telecommunications company, was extensively investigated subsequent to the public offering of a portion of government's shares in Telkom. Although government owns less than 51 per cent of the shares after the privatisation transaction early in March 2003, government has maintained an adequate degree of control over the company, through certain reserved rights negotiated in agreements entered into prior to the listing of the company, to warrant the continued classification of Telkom as a *public corporation* rather than a private company. Its classification will be reviewed from time to time as the shareholding and agreements governing Telkom's control change.

Share prices – Table S-32

The share price indices as calculated by the Reserve Bank were revised in accordance with the new sector classification introduced by the FTSE/JSE in June 2002. All JSE Securities Exchange of South Africa indices now meet the specifications of the FTSE global classification system, enabling comparison with similar indices elsewhere in the world.

The resources sector replaces the mining category and is the overarching index for mining, together with oil and gas. The mining sector consists of gold, metals and minerals (companies primarily engaged in the extraction and/or refining of copper, manganese and other metal or mineral bearing ores), mining finance (finance houses engaged in the financing and developing of mining interests) and coal, platinum and diamonds. The financial sector now differentiates between banks, insurers, investment companies and real estate. The cyclical services sector (which consist of general retailers; leisure, entertainment and hotels; media and photography; support services and transport) replaced the commercial index.

All indices have been rebased to the year 2000.

Yields and stock exchange activity – Table S-33

The dividend and earnings yields were revised to conform with the new classification system. The value of shares traded on the stock exchange and unit trust prices were rebased to the year 2000.