Quarterly Bulletin

June 2004

South African Reserve Bank

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Introduction

The world economy gained momentum since around mid-2003, with the acceleration in activity spreading to Japan and to some extent even to the euro area – regions previously suffering protracted periods of lacklustre growth. Growth in China and elsewhere in Asia was particularly strong. While these circumstances were favourable for commodity prices in general, consumer price inflation remained subdued in most parts of the world. A handful of central banks pre-emptively started raising interest rates moderately in order to contain future inflation, but levels of short-term interest rates remained fairly low.

Inflation fears were fuelled by the upward trend in the price of crude oil. While the oil price was supported by the strengthening of the world economy and geopolitical tensions and concerns, it gave up some of its earlier gains in early June as OPEC announced an increase in production quotas and as market participants started to pay more attention to the sustained above-quota oil output of most OPEC member countries and the likely impact of the high level of the oil prices on quantities supplied and demanded.

Assisted by favourable export prices, lower interest rates and a growth-supportive fiscal policy, growth in South Africa's real gross domestic product picked up decisively during the first quarter of 2004 to reach an annualised rate of 3,1 per cent – more than double the pace attained in any of the four quarters of 2003, and sufficient to signify an increase in real production *per capita*.

All the main sectors of economic activity registered increases in real production in the first quarter of 2004. Real manufacturing and agricultural output, which had contracted throughout 2003, rose significantly in the first quarter of 2004. In the manufacturing sector this was achieved mainly on account of higher production for the domestic market, since export volumes receded further in early 2004. Mining production also rose in the first quarter, with platinum group metal producers leading the way. Similarly, construction activity expanded briskly, while the tertiary sector continued its perennial solid growth performance.

Whereas domestic production growth accelerated, the pace of expansion in real gross domestic expenditure lost some of its earlier momentum in the first quarter of 2004. This was largely due to a much slower pace of inventory accumulation in the first quarter of 2004 than in the fourth quarter of 2003. Manufacturing, wholesale, retail and motor trade inventories in fact declined in the first quarter.

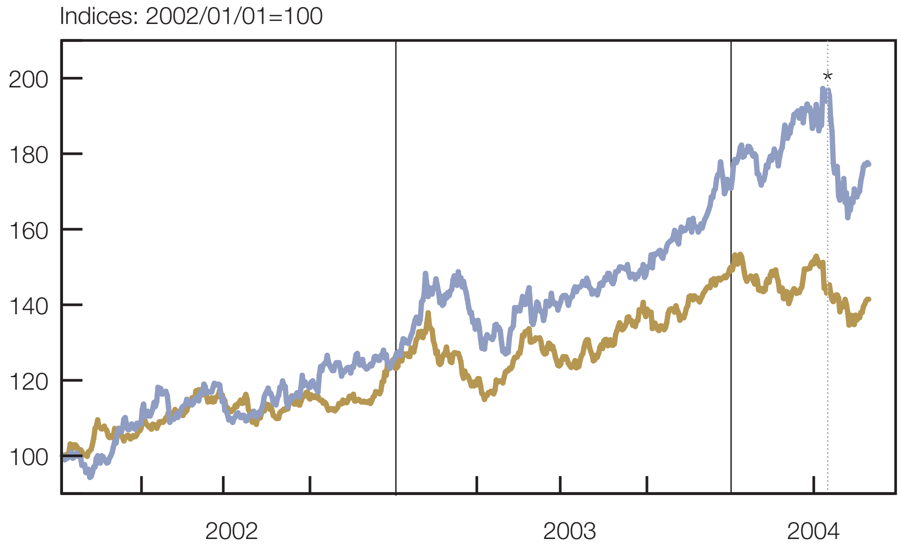
Nevertheless, real expenditure growth continued to exceed the pace of growth in real production. Real fixed capital formation recorded an exceptionally high rate of increase in the first quarter of 2004 as several aircraft were acquired by South African Airways. Private business enterprises in the agricultural, mining and manufacturing sectors also stepped up their fixed capital outlays.

Growth in real household consumption expenditure also gained further momentum in the first quarter, supported by solid increases in households' real disposable income and lower interest rates. Expenditure on durable and semi-durable goods recorded particularly brisk rates of increase. Real government consumption rose further, as another corvette was acquired by the South African Navy – the second in as many quarters – while other government consumption was also stepped up.

Despite the recovery in the world economy, the volume of South African exports contracted further in the first quarter of 2004. However, the value of exports was raised by the significant improvement in the prices of South African export commodities. Import volumes also declined somewhat in the first quarter of 2004. As a result of these developments, the deficit on current account of South Africa's balance of payments edged down slightly to 1,6 per cent of gross domestic product in the first quarter. At this level it was easily financed by inflows of direct and portfolio investment. The Reserve Bank continued its accumulation of foreign exchange reserves and strengthening of its international liquidity position, sterilising the potential impact on domestic money-market liquidity of its acquisition of foreign exchange reserves.

The exchange rate of the rand against a basket of currencies recovered by 16 per cent in the year to the end of December 2003 and, on balance, appreciated by a further 3½ per cent in the five-month period to the end of May 2004, despite the setback to the international prices of commodity exports in the second quarter following indications that steps would be taken to cool down the buoyant economic growth in China. While these movements of the exchange rate of the rand reduced the international competitiveness of South African producers, it also caused the prices of imported goods to record twelve-month declines over the past 13 months, notwithstanding a significant increase in the international price of crude oil over this period. Goods price inflation was accordingly moderated, both at the production and consumer level, contributing to a reduction in twelve-month CPIX inflation – the official target variable – to below 6 per cent from September 2003. By April 2004 CPIX inflation had been maintained within the 3-to-6 per cent target range for eight months in succession. The Reserve Bank's repurchase rate has been maintained at 8 per cent since early December 2003.

Spot prices in US dollar of gold and platinum



* Indications that steps would be taken to restrain overheating sectors of the Chinese economy

Growth in the monetary aggregates accelerated over the February 2004 month-end when bond redemption and interest payments flowed from government accounts to private-sector deposit accounts with the banks. In time, portfolios were adjusted and monetary growth decelerated in March and April. As might be expected under conditions of lower interest rates, brisk domestic expenditure and rising house prices, banks' mortgage, instalment sale and leasing advances to the domestic private sector maintained strong growth in the first four months of 2004. The banks' other loans and advances were more subdued, *inter alia* reflecting disintermediation as some corporate borrowers issued corporate bonds rather than making use of bank credit.

Turnover in the property market reached exceptionally high levels while house prices continued to rise briskly, recording twelve-month rates of increase of around 24 per cent in the first five months of 2004. Yields on bonds rose somewhat from April 2004, both in the international and domestic markets, as investors became less sanguine about prospects for inflation. Share prices on the JSE Securities Exchange SA displayed a dull performance from February 2004, in contrast to the bull rally of the preceding ten months.

The authorities continued to pursue a cautiously expansionary fiscal policy, recording a public-sector borrowing requirement of 3,2 per cent of gross domestic product in the 2003/04 fiscal year – higher than before, but nevertheless in accordance with widely accepted principles of fiscal prudence. Rising capital expenditure by the public sector will not only contribute towards the more efficient functioning of the economy but through certain public works programmes also to the enhancement of skills and creation of employment.

Domestic economic developments

Domestic output[1]

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

After four quarters of lustreless growth which not even matched the rate of population expansion, the rate of increase in South Africa's *real gross domestic product* firmed appreciably in the first quarter of 2004. Real economic growth accelerated from an annualised rate of 1½ per cent in the fourth quarter of 2003 to 3 per cent in the first quarter of 2004. The buoyancy of real output in the first quarter was spread throughout all the major sectors of the economy, with the primary and secondary sectors recording increases in real value added against contractions in the final quarter of 2003. However, the level of real gross domestic product in the first quarter of 2004 was only about 2 per cent higher than in the first quarter of 2003.

Growth in real gross domestic product excluding agriculture accelerated from an annualised rate of 1½ per cent in the fourth quarter of 2003 to 3½ per cent in the first quarter of 2004. When compared with the first quarter of 2003, growth in *non-agricultural gross domestic product* amounted to 2 per cent, roughly the same rate as was attained in 2003 as a whole.

Following four consecutive quarters of decline in 2003 at annualised rates ranging between 2½ and 6½ per cent, the real value added by the *primary sector* increased at an annualised rate of 3 per cent in the first quarter of 2004. The growth in the first quarter could be attributed to increases in the real value added by both the agricultural and the mining sectors.

Real gross domestic product

Percentage change at seasonally adjusted annualised rates

	2002					2003					2004
Sectors	1st qr	2nd qr	3rd qr	4th qr	Year	1st qr	2nd qr	3rd qr	4th qr	Year	1st qr
Primary sector	7	7½	5½	3	3	-2½	-6½	-6½	-4	-1	3
Agriculture	13½	14	9½	5½	6½	-5½	-19½	-22	-9½	-6	2½
Mining	2	3	2½	1½	½	½	5	6	0	2½	3½
Secondary sector	4½	8½	6	1½	4½	-3	-3	-½	-1½	0	3
Manufacturing	5	10	7½	0	5½	-4½	-4½	-1½	-3½	-1	2½
Tertiary sector	3	3½	3	3	3½	3	3	3	3	3	3½
Non-agricultural sector	*3½*	*5*	*4*	*2½*	*3½*	*1*	*1½*	*2*	*1½*	*2*	*3½*
Total	4	5	4	2½	3½	1	½	1	1½	2	3

Subsequent to a decline at an annualised rate of 9½ per cent in the fourth quarter of 2003, the real value added by the *agricultural sector* increased at a rate of 2½ per cent in the first quarter of 2004. The improved conditions in the agricultural sector can partly be attributed to the firm output growth in the horticultural sector. Part of the 2003 wheat crop was harvested in the first quarter of 2004. In addition, the late summer rains that fell over most of the country changed agricultural prospects for the better. Estimates of the 2003/04 maize crop were accordingly revised upwards.

Following strong quarter-to-quarter increases in the second and third quarters, real *mining production* stagnated in the fourth quarter of 2003. This setback was nevertheless short-lived and output subsequently increased at an annualised rate of 3½ per cent in the first quarter of 2004. Mining production volumes increased partly in response to booming international commodity prices, which were boosted by strong global demand, particularly from China. Though the relative strength of the exchange rate of the rand eroded some of the benefits of the favourable international commodity prices, further capacity that had taken a considerable period to develop was brought into production in early 2004. This was especially evident in platinum mining, where real output surged in the first quarter of 2004.

The increase in platinum production was partially counteracted by output declines in gold and diamond mining. Gold mines responded to sustained cost pressure by curbing production further in the first quarter of 2004. In addition, coal production remained unchanged. However, real output of subsectors such as nickel and manganese rose impressively.

Following a decline at a rate of 1½ per cent in the fourth quarter of 2003, the real value added by the *secondary sector* grew at an annualised rate of 3 per cent in the first quarter of 2004. This was mainly on account of a recovery in real manufacturing output. In addition, sustained growth in the real value added by the construction sector as well as the sector supplying electricity, gas and water further boosted growth in the secondary sector.

The real value added by the *manufacturing sector* increased in the first quarter of 2004 after having declined significantly for four successive quarters. The resurgence in real manufacturing output was evident in the increased production volumes of several subsectors. It was nevertheless more pronounced in the manufacturing of food and food products, clothing and textile products, basic metals, radio, television and communication equipment as well as transport equipment. Although there were declines recorded in real production volumes of wood and wood products and electrical machinery and apparatus, these were more than neutralised by solid advances in the other subsectors.

Robust domestic consumer demand for food and food products, clothing and textiles as well as for transport equipment, furniture and recreational goods boosted output in the related manufacturing subsectors. Firm global demand for metals (with the Asian economies playing a major role) underpinned the higher real output of the basic metals subsector. Accordingly, the real value added by the manufacturing sector increased at a rate of 2½ per cent in the first quarter of 2004, after an annualised decline of 3½ per cent had been recorded in the fourth quarter of 2003. This was achieved despite the pressures arising from the relative strength of the exchange value of the rand which made South African manufactured goods less price competitive, and may to some extent be related to the brisk increases in consumption expenditure on items with a generally lower import content, such as food and furniture.

Growth in the real value added by the sector that supplies *electricity, gas and water* was sustained at a sturdy pace of 3 per cent in the first quarter of 2004 – similar to the rate recorded in the fourth quarter of 2003. This can partly be attributed to increased volumes of electricity exported to neighbouring countries, some of which was related to the introduction of the Mozal Port line-2 in Mozambique in the second half of 2003. This has been partially counteracted by imports of electricity from the Cahora Bassa project since the beginning of 2004.

The real output of the *construction sector* continued to increase strongly in the first quarter of 2004. Its annualised quarter-to-quarter growth rate amounted to 6½ per cent in the first quarter of 2004, the same rate as was attained in the fourth quarter of 2003.

This can be ascribed to sustained demand for private residential as well as non-residential buildings, partly reflecting the lower interest rate environment. In addition, infrastructural development by general government supported growth in this sector.

The perennial solid performance of the *tertiary sector* continued into the first quarter of 2004. This was essentially a reflection of lively activity in the real value added by the commerce and the financial intermediation, insurance, real-estate and business services sectors. The quarter-to-quarter growth in the real value added by the transport, storage and communication sector edged down somewhat but output remained at a high level in the first quarter of 2004.

The real value added by the *commerce sector* increased at an annualised rate of 3½ per cent in the first quarter of 2004, the same rate attained in the fourth quarter of 2003. This was mainly due to the robust performance of the real output by the motor trade subsector, which benefited from a sustained high level of consumption and investment demand for new vehicles. The value added by the retail sector benefited from the consistently high demand for durable and semi-durable goods. By contrast, growth in the real value added by the catering and accommodation sector decelerated from the fourth quarter of 2003 to the first quarter of 2004 as the volume of tourist activity receded somewhat.

Real economic activity by the transport subsector of the economy slowed down noticeably in the first quarter of 2004. This slowdown was particularly evident in rail and air transport and was broadly in line with reduced import and export volumes and subdued tourist activity. However, growth in the real value added by the communication subsector remained solid in the first quarter of 2004 and counteracted the weaker performance of the transport sector. This was mostly confined to the continued expansion of the cellular telephone industry. South Africa's advanced telecommunications infrastructure also made it possible for international call-centre activity to expand. As a result of these developments, the growth in real value added by the *transport, storage and communication sector* slowed down from quarterly growth rates of roughly 6 per cent throughout 2003 to an annualised rate of 5½ per cent in the first quarter of 2004.

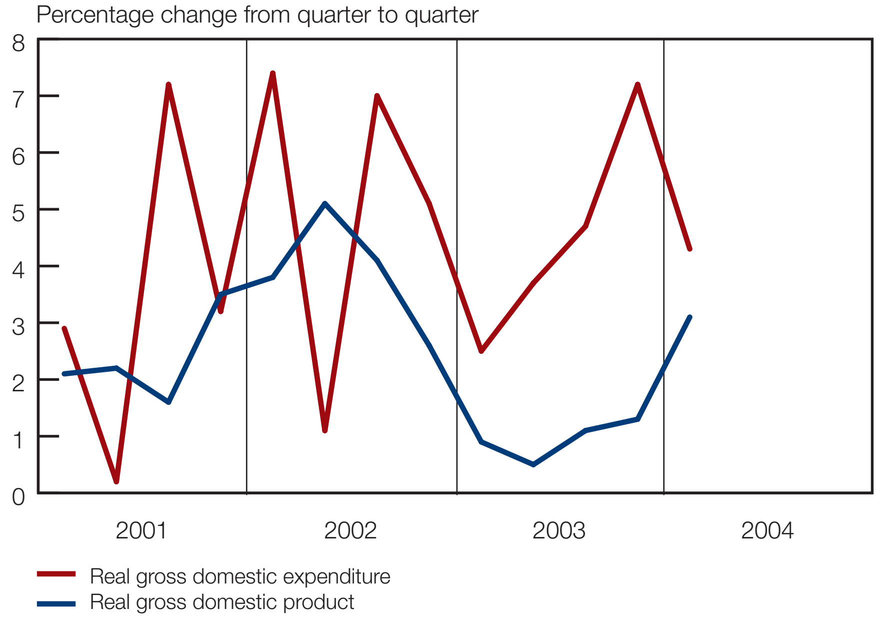
The real value added by the *financial intermediation, insurance, real-estate and business services sector* advanced at an annualised rate of 3½ per cent in the first quarter of 2004, slightly higher than the 3-per-cent growth rate recorded in the fourth quarter of 2003. This was mainly a result of an increase in the banking sector's real value added, which was in turn supported by an increase in the demand for financial services. The real value added by securities dealers continued to increase solidly as trading volumes on the JSE Securities Exchange SA remained strong compared with the same period in 2003. Lively activity was also recorded in the real-estate sector.

Growth in the real value added by *general government* accelerated from ½ a per cent in the fourth quarter of 2003 to an annualised rate of 1 per cent in the first quarter of 2004. This could partly be attributed to the employment of temporary workers to assist with the administration of the general election.

Domestic expenditure

In the first quarter of 2004 the growth in *aggregate real gross domestic expenditure* exceeded growth in real gross domestic production for the seventh quarter in succession. Nevertheless, the divergence between the two growth rates was reduced as expenditure growth tapered off while production growth accelerated. The deceleration in real gross domestic expenditure growth to 4½ per cent, from 7 per cent in the fourth quarter of 2003, can mainly be attributed to a slower pace of inventory accumulation and a slowdown in the growth of real final consumption expenditure by general government. Real final consumption expenditure by households advanced sturdily from the fourth quarter of 2003 to the first quarter of 2004, while the growth in real gross fixed capital formation accelerated sharply.

Real gross domestic product and expenditure



Seasonally adjusted annualised rates

Growth in *real final consumption expenditure by households* increased from an annualised rate of 4 per cent in the fourth quarter of 2003 to 5 per cent in the first quarter of 2004. The solid expansion in real outlays by households was observed throughout all the spending categories but manifested prominently in durable goods and services, where quarter-to-quarter growth accelerated. Household expenditure appears to have been positively influenced by several factors, including

- an acceleration in the growth rate of real disposable income from an annualised rate of 4 per cent in the fourth quarter of 2003 to 4½ per cent in the first quarter of 2004. This was in part due to limited tax relief to households and wage settlements which remained quite high when compared with the contemporary inflation level;
- the reduced cost of obtaining credit as a result of lower interest rates; and
- the improvement in households' perceptions of their net wealth as real-estate values continued to rise.

Household debt as a percentage of disposable income increased in the first quarter of 2004, rising from 52½ per cent in the fourth quarter of 2003 to 54 per cent in the first quarter of 2004. This was consistent with the robust increase in durable goods expenditure which appears to have been partly financed by credit. The acquisition of fixed property also played an important role in raising the level of household debt, as indicated by the brisk increase in mortgage advances.

Growth in real household spending on *durable goods* surged from an annualised 3½ per cent in the fourth quarter of 2003 to 11½ per cent in the first quarter of 2004. This can mainly be attributed to buoyant expenditure on personal transport equipment, notably new cars, recreational and entertainment goods as well as furniture and household appliances. While the relatively stronger exchange rate of the rand might have been an impediment to real output, it has been a boon to household spending. Prices of goods with a high import content in many instances became very competitive and in some cases even declined. In other cases dealers structured attractive packages with extended guarantees and maintenance plans to entice buyers. In addition, the cost of financing durable goods declined in an environment of lower interest rates.

Real gross domestic expenditure

Percentage change at seasonally adjusted annualised rates

	2002					2003					2004
Components	1st qr	2nd qr	3rd qr	4th qr	Year	1st qr	2nd qr	3rd qr	4th qr	Year	1st qr
Final consumption expenditure by households	3½	3½	3	2½	3	2½	3	4	4	3	5
Final consumption expenditure by general government	3½	3½	4	4	3½	4	4½	4½	13	4½	5½
Gross fixed capital formation	6	9	13½	16	6	5	3	7½	8½	8½	21
Change in inventories (R billions)*	8,8	0,2	7,3	6,6	5,7	6,3	9,2	7,9	7,9	7,8	2,1
Gross domestic expenditure	**7½**	**1**	**7**	**5**	**4½**	**2½**	**3½**	**4½**	**7**	**4**	**4½**

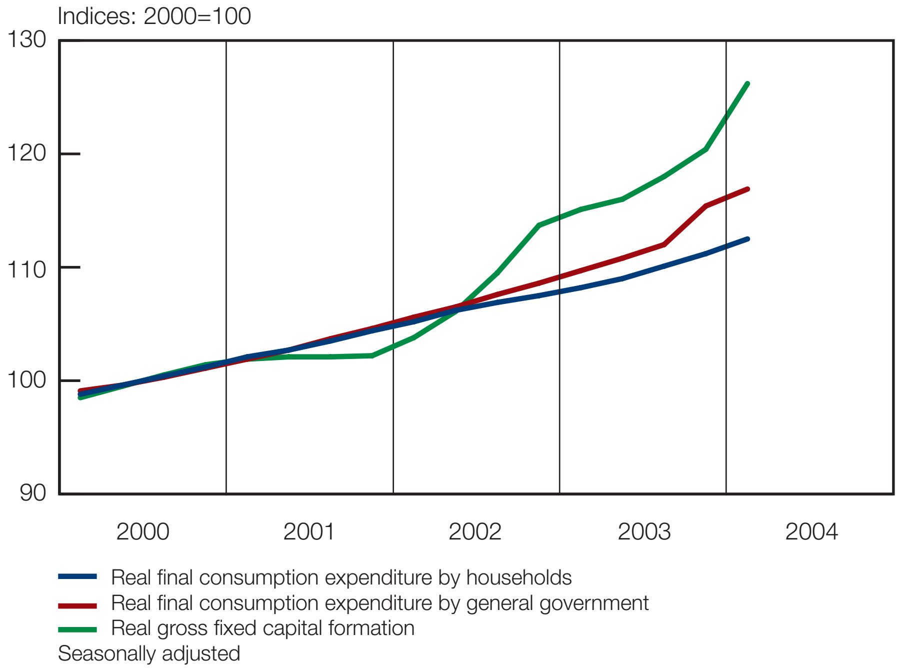
* At constant 1995 prices

Though household expenditure on *semi-durable goods* remained firm, growth edged down somewhat from an annualised rate of 13 per cent in the fourth quarter of 2003 to 11½ per cent in the first quarter of 2004. The lower prices of clothing and footwear and household textiles kept real expenditure on these items at relatively high levels.

Real outlays on food and beverages increased strongly in the first quarter of 2004. This more than offset a decline in real household outlays on petroleum products as well as on medical and pharmaceutical products. The prices of medical products increased at a pace much higher than the overall inflation rate, suppressing quantities demanded. As a result, growth in expenditure on *non-durable goods* slowed down from 4 per cent in the fourth quarter of 2003 to 3½ per cent in the first quarter of 2004. Real outlays on *services* advanced steadily at a rate of 2½ per cent in the first quarter of 2004.

Although growth in *real final consumption expenditure by general government* slowed down from an annualised rate of 13 per cent in the fourth quarter of 2003 to 5½ per cent in the first quarter of 2004, the level of spending remained high. The level of real outlays by general government was supported by the acquisition of a vessel by the South African Navy, the second in as many quarters. However, the government maintained its commitment to fiscal prudence; the growth in government compensation of employees remained quite restrained, even allowing for the cost of employing temporary workers for the election. Consequently, the ratio of final consumption expenditure by general government to gross domestic product remained at 19½ per cent in the fourth quarter of 2003 and in the first quarter of 2004.

Components of real domestic final demand



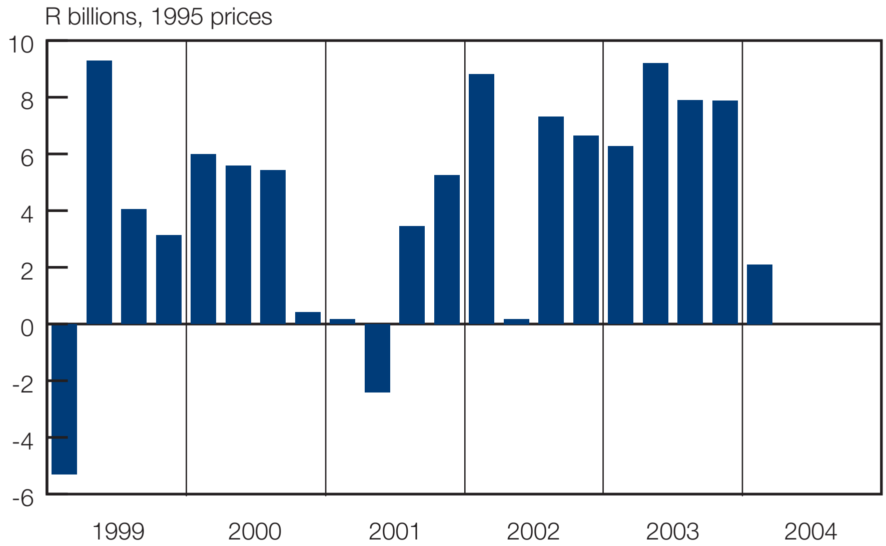
Growth in *real gross fixed capital formation* accelerated considerably from an annualised rate of 8½ per cent in the fourth quarter of 2003 to 21 per cent in the first quarter of 2004. This can be attributed to higher growth in real gross fixed capital formation by both public corporations and the private sector. Simultaneously, real gross fixed capital formation by the general government continued to expand.

Following an increase of 5½ per cent in the fourth quarter of 2003, growth in real fixed capital expenditure by private business enterprises accelerated to 9½ per cent in the first quarter of 2004. This can mainly be ascribed to an increase in real fixed capital outlays by the agricultural, mining and manufacturing sectors. The relative strength of the exchange rate of the rand enhanced the attractiveness of importing machinery and equipment for the agricultural sector. In addition, the turnaround in the output of the manufacturing sector contributed to increased capital expenditure in this sector. While real capital outlays by the mining sector remained strong, it seemed to be originating more from the continuation of existing projects than from new ones.

Real capital outlays by public corporations expanded strongly in the first quarter of 2004 as a result of the acquisition of additional aircraft by South African Airways. This was further supported by the expansion of the Coega development project. Growth in real gross fixed capital formation by general government tapered off somewhat in the first quarter of 2004.

The pace of *real inventory investment* slowed down sharply from R7,9 billion in the fourth quarter of 2003 to about R2,1 billion in the first quarter of 2004. This subtracted 3½ percentage points from the growth in gross domestic expenditure in the first quarter of 2004. The lower rate of inventory accumulation can partly be attributed to a decline in manufacturing inventories. As a result of the rebound in manufacturing production, manufacturers made inroads into their inventories, especially raw materials and intermediate goods.

Change in inventories



Seasonally adjusted annualised rates

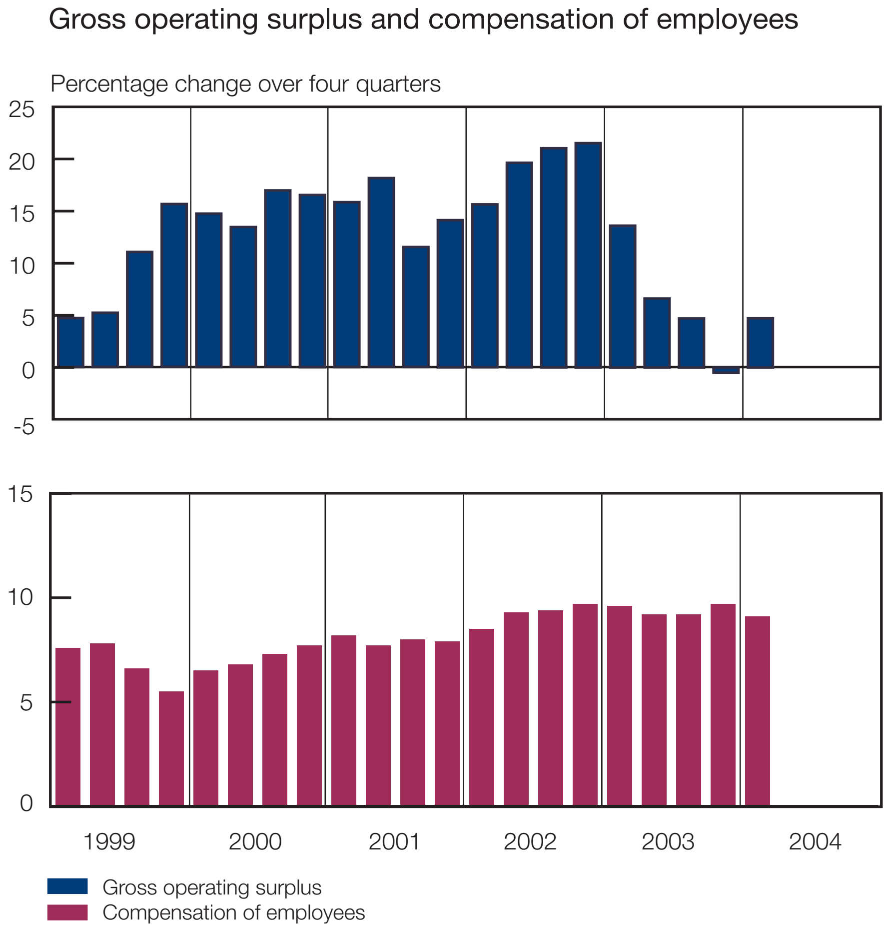
In sharp contrast to the decline in manufacturing inventories, mining inventories increased substantially in the first quarter of 2004. In the commerce sector there was an accumulation of agricultural stock-in-trade. Wholesale, retail and motor trade inventories fell back in the first quarter, probably related to the strong surge in durable consumption expenditure. As a result of these developments, the ratio of industrial and commercial inventories to non-agricultural gross domestic product amounted to 15½ per cent in the first quarter of 2004, compared with a ratio of 16 per cent attained in the fourth quarter of 2003.

Factor income

The growth over one year in *total nominal factor income* accelerated from 4½ per cent in the fourth quarter of 2003 to 7 per cent in the first quarter of 2004. The firmer increase in total factor income was the net result of a considerable improvement in the growth of gross operating surpluses of business enterprises which was underpinned by sustained increases in nominal compensation of employees.

The growth over four quarters in total *compensation of employees* edged down from 9½ per cent in the fourth quarter of 2003 to 9 per cent in the first quarter of 2004. The rate of increase in compensation of employees remained high throughout most sectors of the economy but has started to recede in the mining, manufacturing and trade sectors. This might be an indication that high wage settlements were less easily accommodated against a background of lower inflation in 2003. Notwithstanding these developments, the employees' share in total factor income increased from 51 per cent in the fourth quarter of 2003 to 51½ per cent in the first quarter of 2004.

Measured over four quarters, total *gross operating surpluses* of business enterprises declined by ½ a per cent in the fourth quarter of 2003. This setback was of short duration as growth subsequently rebounded to 4½ per cent in the first quarter of 2004. The lower interest rate environment, lower cost of intermediate goods used in the production process, and the stabilisation of business pricing power contributed to improved operating margins, while the mining and manufacturing sectors also benefited from the commodity price boom induced by favourable global demand.



Gross saving

The ratio of gross domestic saving to gross domestic product increased from 15 per cent in the fourth quarter of 2003 to 15½ per cent in the first quarter of 2004. An analysis of the saving ratio per institutional sector indicates that the major contributor to the firmer saving was the corporate sector.

The stronger growth in the gross operating surpluses of business enterprises provided an impetus for an improvement in *corporate saving* as percentage of gross domestic product. This was particularly evident in the primary and manufacturing sectors of the economy. In addition, dividends paid by the corporate sector were lower in the first quarter of 2004 than in the fourth quarter of 2003. Accordingly, the ratio of corporate saving to gross domestic product increased from just under 11 per cent in the fourth quarter of 2003 to 12 per cent in the first quarter of 2004.

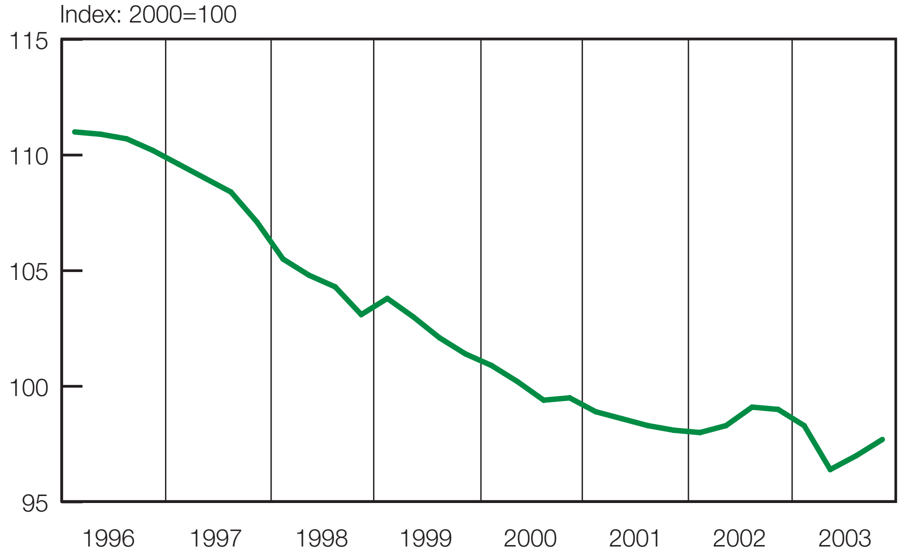
The ratio of *gross household saving* to gross domestic product amounted to 3 per cent in the first quarter of 2004, the same rate attained in the fourth quarter of 2003. Although there was strong growth in household disposable income, household spending increased at a faster pace, leaving household saving growing at a rather weak rate.

General government's rising consumption expenditure and transfer payments to the household sector were not fully matched by increases in tax income in the first quarter of 2004. Accordingly, the ratio of *gross government saving* to gross domestic product declined from 1 per cent in the fourth quarter of 2003 to just ½ a per cent in the first quarter of 2004.

Employment

According to the *Survey of Employment and Earnings* by Statistics South Africa, employment in the formal non-agricultural sector picked up somewhat in the second half of 2003. The magnitude of these increases were, however, such that the level of employment in the second half of 2003 still fell below that in the same period of the preceding year. The employment gains in the second half of 2003 followed an extended period of continuous decline in formal non-agricultural employment, apart from the brief interlude of rising employment in the second and third quarters of 2002. Increases in employment during the second half of 2003 occurred in both the private and public sectors.

Formal non-agricultural employment



When account is taken of seasonal variation, formal non-agricultural employment increased by around 34 000 persons in the third quarter of 2003 and by a further 49 000 in the fourth quarter. Notwithstanding these quarterly gains, the average level of employment in 2003 *declined* by 1,3 per cent compared with the preceding year. On average, private-sector employment decreased by 2,2 per cent in 2003 while public-sector employment increased by 1,7 per cent.

Much of the increase in *non-agricultural private-sector employment* in the closing months of 2003 can be ascribed to the appointment of temporary employees due to an increase in the overall demand for products and services. The sustainability of the increase in aggregate demand will determine the extent to which these temporary workers will be retained in gainful employment, and whether the number of the unemployed will be reduced enduringly.

Encouragingly, the Investec Purchasing Managers Index, representing purchasing managers' expectations in the manufacturing sector, has recorded increases in its employment component since early 2004. According to a survey by Grant Thornton (a private-sector business advisory company) among 250 medium-sized enterprises in South Africa between September and October 2003, 43 per cent of business owners expect to increase their employee numbers in the next year, while only 7 per cent expect to reduce staff.

South African labour statistics

There are two official sources of labour statistics in South Africa at present, namely the *Survey of Employment and Earnings* (SEE) and the *Labour Force Survey* (LFS). They respectively present establishment-based and household survey information; by extracting data from different labour constituencies, they together provide a more detailed picture of the nature and characteristics of the labour market.

The SEE is an enterprise-based quarterly survey covering a sample of approximately 10 200* employer units – both private and public enterprises and organisations in the formal non-agricultural sector of the South African economy. The information received is used to estimate key economic statistics of employment and gross earnings from employment. The survey was improved in September 2002 with a more comprehensive sample to include some additional areas of formal employment that were previously not surveyed.

Because it is a quarterly release, the SEE is more amenable to time series analyses and is a useful source of information concerning employment, productivity, benefits and labour costs. The survey, however, excludes unregistered or informal enterprises. Among registered non-agricultural businesses, the SEE includes only those with a declared turnover of R300 000 or more per annum. Data from the SEE are published on pages S-136, S-137 and S-156 of this *Bulletin*.

Comparison of SEE and LFS employment numbers, September 2003

	Number
SEE formal non-agricultural employment	6 368 000
LFS persons employed in agriculture	1 197 000
LFS persons employed in domestic service	1 022 000
LFS persons employed in informal sector	1 899 000
LFS persons employed in other sectors and enterprises not covered by SEE	1 136 000
LFS total employment	11 622 000

Source: Statistics South Africa, *Labour Force Survey*, September 2003; Statistics South Africa, *Survey of Employment and Earnings*, September 2003 and December 2003; and own calculations.

Statistics South Africa conducts a rotating panel LFS twice a year using a national sample of 30 000 households. From this sample, various national totals are inferred. The LFS is a relatively recent series, which started in February 2000. So far the results of eight survey rounds are in the public domain. From March 2003 the LFS has been rebased using Census 2001 statistics. The data categorised in the LFS include all public and private-sector workers – employees and self-employed – in the formal and informal sectors across all major groups of industries. The LFS is the only official source of data on unemployment.

M Lehutso-Phooko and T Hlekiso

* Before September 2003 the sample consisted of approximately 8 500 private enterprises and public institutions.

In the mining industry, the increase in employment in recent quarters occurred at non-gold mining enterprises while job-shedding at gold mines continued unabatedly. In the electricity, gas and water supply industry the appointment of contract employees added to employee numbers in the fourth quarter of 2003. Employment in the construction sector picked up slightly due to the appointment of more employees for new projects undertaken. Employment increases in retail trade, hotels and restaurants in the final quarter of 2003 resulted from the appointment of temporary workers as a result of an increase in workload and the expansion of businesses. In the financial intermediation, insurance, real-estate and business services industry employment gains resulted from an expansion of enterprises, an increase in workload and, in business services, also from additional activities in preparing for the general elections.

While employment numbers in the private sector only increased somewhat in recent quarters, *public-sector employment* increased almost continuously since the first quarter of 2002. When measured from quarter to quarter and expressed at an annualised rate, public-sector employment increased by 2,8 per cent and 1,2 per cent in the third and fourth quarter of 2003, respectively. These increases assisted in raising the level of public-sector employment by about 29 000 in the year to the fourth quarter of 2003. Much of the increase in employment in the public sector in the final months of 2003 also resulted from the appointment of temporary employees due to an increase in workload, new contracts that commenced and the appointment of examiners, moderators and markers, mainly by universities and technikons.

Findings from the September 2003 household-based *Labour Force Survey* (LFS) by Statistics South Africa are not conclusive as to whether or not actual employment improved during 2003. Although the survey shows that employment in the formal non-agricultural sector increased by about 103 000 in the six months to September 2003, this increase is not statistically significant and therefore does not conclusively substantiate that a meaningful rise in the level of employment occurred between March and September 2003.

The LFS further indicates that the official unemployment rate declined from 31,2 per cent in March 2003 to 28,2 per cent in September. This decrease in the unemployment rate unfortunately did not result from meaningfully more individuals finding employment during this period, but rather from a substantial number who became discouraged and gave up actively seeking employment. Such discouraged workers could therefore no longer be regarded as part of the unemployed and were accordingly classified as economically inactive. The resulting rise in the number of economically inactive people in the economy explains why the expanded definition of unemployment – which includes discouraged workers – remained relatively stable at a high 41,8 per cent in September 2003 despite the decline in the official unemployment rate.

Long-term agreements and better dispute resolution procedures than before contributed appreciably to the reduction in the number of workdays lost due to strikes and other forms of industrial action in 2003. According to Andrew Levy Employment Publications (a private-sector institution), the number of workdays lost fell from 945 000 in 2002 to 700 000 in 2003.

The coverage and financial base of the Unemployment Insurance Fund (UIF) were broadened by the inclusion of employees from government agencies who are not classified as public servants. From 1 April 2004, these employees also became contributing members of the fund. Only those workers who are legally defined as public servants in terms of the Public Service Act will in future be exempted from contributing to the UIF.

In a recent initiative by government to address the high unemployment in the country, an expanded public works programme was announced. This programme commenced in April 2004 and will endeavour to create more than one million jobs over the next five years through the development of infrastructure. While many of these jobs will be temporary, it is envisaged that the enhancement of skills resulting from this programme will better equip prospective job seekers in future.

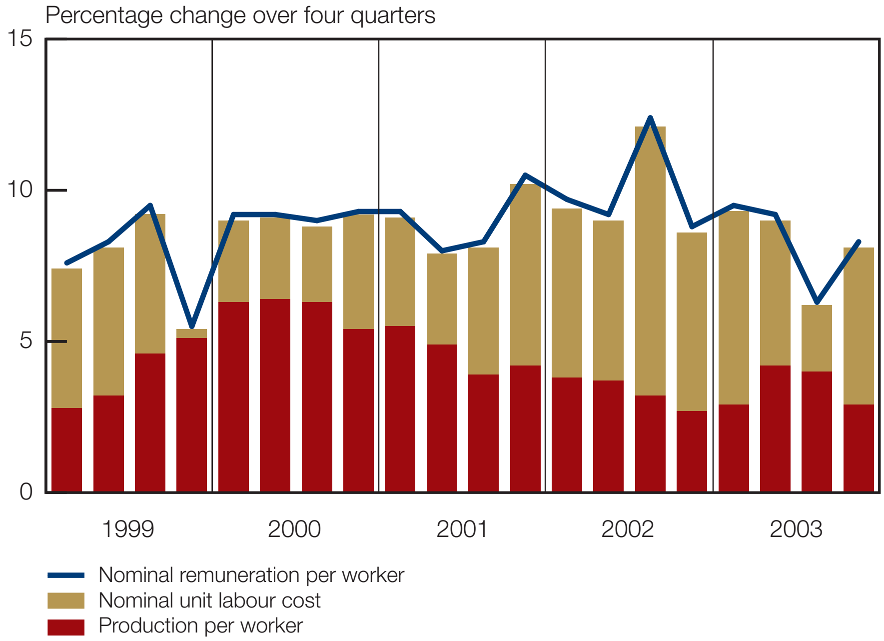
Labour cost and productivity

In accordance with the decline in consumer price inflation in the past year or so, *nominal wage growth per worker* in the formal non-agricultural sector moderated from a year-to-year rate of 9,6 per cent in 2002 to 8,6 per cent in 2003. The slowdown in the rate of increase in average nominal remuneration per worker was fairly pervasive, as employees in both the private and public sector received lower remuneration increases in 2003 than in the preceding three years. When measured over periods of four quarters, nominal wage growth per worker amounted to 8,3 per cent in the fourth quarter of 2003.

The slowdown in nominal wage growth is corroborated by the results of the *Wage Settlement Survey* as released by Andrew Levy Employment Publications. According to this survey, the average level of wage settlements in collective bargaining agreements fell further from 8,9 per cent in 2003 to 7,6 per cent in the first quarter of 2004 and to a predicted average of between 7,5 per cent and 8,5 per cent for the remainder of the year. The average salary or pension payment per recipient paid into recipients' bank accounts, as processed by the Automated Clearing Bureau, rose from R3 210 in April 2003 to R3 320 in April 2004 or by 3,4 per cent. However, when measured over periods of four quarters, the rate of increase in this indicator slowed down appreciably from 9,6 per cent in the first quarter of 2003 to 6,4 per cent in the fourth quarter and further to 3,0 per cent in the first quarter of 2004.

Economy-wide labour productivity growth at average annual rates of around 3,5 per cent in the past two years was more sedate than in preceding years, possibly as further rationalisation and pruning of staff became more difficult in already-lean organisations. Given the renewed rise in the level of employment in the second half of 2003, the growth in the *real output per worker in the non-agricultural sectors* of the economy decelerated from 4,2 per cent in the second quarter of 2003 to 2,9 per cent in the

Nominal remuneration, productivity and unit labour cost in non-agricultural sector



fourth quarter. Changes in labour productivity growth were more profound in the *manufacturing sector* where real production per worker *decreased* by 2,9 per cent in the year to the fourth quarter of 2003. This decrease in production per worker followed a significant reduction in manufacturing production volumes in the course of 2003 without a commensurate fall in employment.

The increase in the *cost of labour per unit of production* in the entire formal non-agricultural sector was contained at a year-to-year rate of 5,0 per cent in 2003, somewhat lower than the 6,0 per cent increase in 2002. Nominal wage growth in excess of the 3-to-6-per-cent inflation target during 2003 would have resulted in a higher increase in nominal unit labour cost, had it not been for the improvement in labour productivity.

Following the decrease in production per worker and an acceleration in nominal wage growth, increases in nominal unit labour cost in the *manufacturing sector*, at a year-to-year rate of 11,3 per cent in 2003, exceeded that for the economy as a whole. Manufacturing output prices were generally rising at a much slower pace over this period, signalling a compression of operating margins in the sector. A continuation of this situation could lead to a reduced ability of industry to expand production and simultaneously contribute towards sustainable employment generation.

Prices

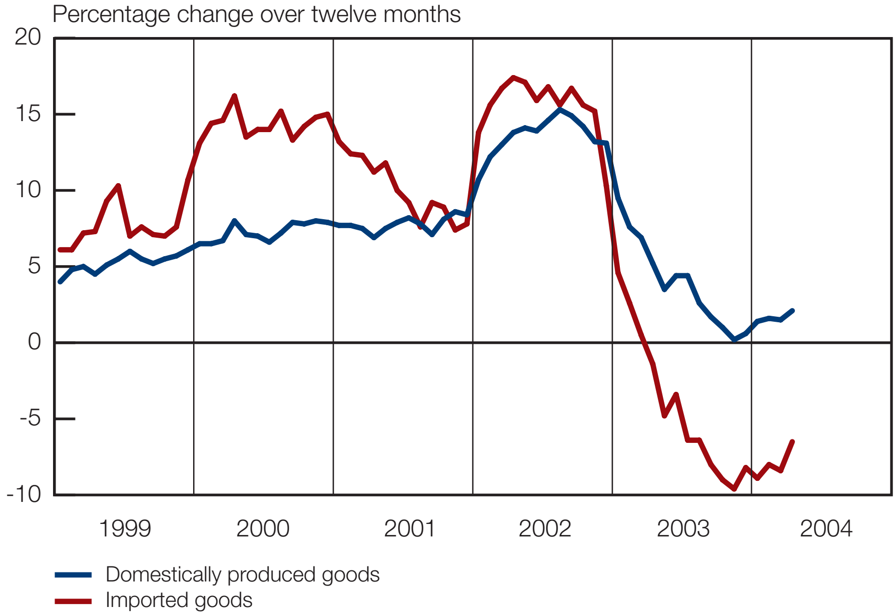
The recovery of the exchange rate of the rand during the past two years significantly influenced price formation processes in the domestic economy, with its cumulative impact driving price inflation down to historically low levels. Meaningful declines were recorded in the prices of goods, especially at the production level. The decline in the prices of goods at the production level was further supported by lower food and oil price inflation. In general, there was a fairly pervasive moderation in inflation pressures. More recently though, the short-term pace of increase in the production prices of domestically produced goods and the consumer prices of goods picked up as petrol and diesel prices rose, and agricultural food price inflation accelerated somewhat.

Consistent with the significant appreciation in the exchange rate of the rand, year-on-year inflation in the *prices* of *imported goods* fell from a high of 17,4 per cent in April 2002 to 0,5 per cent in March 2003 and subsequently became negative. The year-on-year rate of *decline* in the prices of imported goods reached 9,6 per cent in November 2003. Thereafter, this rate of price decline moderated somewhat to 6,5 per cent in April 2004. A subdued international inflationary environment also assisted in restraining increases in the prices of imported goods.

The quarter-to-quarter pace of decline in the prices of imported goods accelerated from an annualised rate of 7,2 per cent in the fourth quarter of 2003 to 8,3 per cent in the first quarter of 2004. Having increased by as much as 15,5 per cent in 2002 as a whole, prices of imported goods declined by 4,2 per cent in 2003.

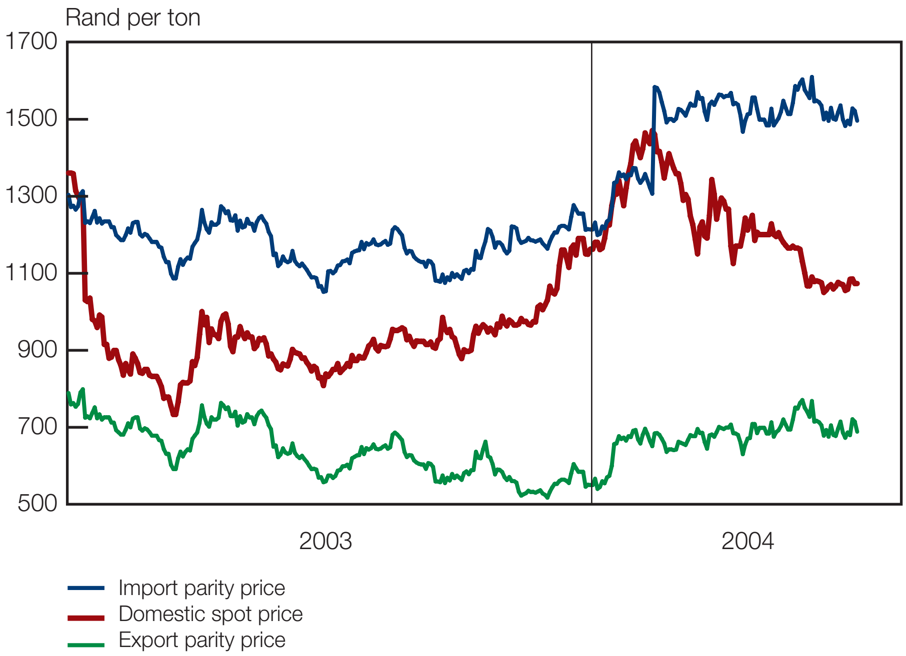
Following the sharp *decline* in imported goods inflation since 2002, *domestically produced goods inflation* receded from a high year-on-year rate of 15,3 per cent in August 2002 to a low of 0,2 per cent in November 2003. More recently, domestically produced goods inflation picked up modestly to 2,1 per cent in April 2004. This pick-up in domestically produced goods inflation resulted mainly from higher prices of agricultural food and petroleum products. Excess capacity in industry has, however, limited the potential acceleration in domestically produced goods inflation in recent months.

Production prices



Initial concerns of drought in 2004 with a resultant adverse effect on food prices were largely allayed by good rainfall in the earlier part of the year. The spot price of yellow maize increased from April 2003 to January 2004 when the impact of the drought exerted upward pressure on prices. It declined thereafter following better-than-expected rainfall in the early part of 2004. The spot price of wheat, while remaining high due to its anchoring to the import parity price level (the price level at which the importation of wheat becomes a viable alternative to buying domestically produced wheat), declined from the first week of February 2004.

Price of yellow maize



Changes in the prices of domestically produced goods moved from declines at an annualised rate of 3,0 per cent in the fourth quarter of 2003 to increases at a rate of 3,1 per cent in the first quarter of 2004. This resulted mainly from an acceleration in the quarter-to-quarter pace of increase in the prices of agricultural, forestry and fishing products. Prices in the categories for electricity, gas, water provision, mining, manufactured food, textiles, clothing and footwear, and basic metals and metal products continued to decline.

Driven by the slowdown in domestically produced goods inflation and *declining* prices of imported goods, the year-on-year rate of increase in the *all-goods production price index* slowed down appreciably from 15,4 per cent in September 2002 to 0,2 per cent in August 2003. Subsequently, all-goods production prices started to decline. When measured over periods of twelve months, all-goods production prices declined by 1,2 per cent in March 2004. Subsequently, this rate of price decline moderated to 0,2 per cent in April 2004. From quarter to quarter, all-goods production prices remained essentially unchanged in the first quarter of 2004, following price declines at an annualised rate of 3,7 per cent in the fourth quarter of 2003.

Production prices

Quarter-to-quarter percentage changes at annualised rates

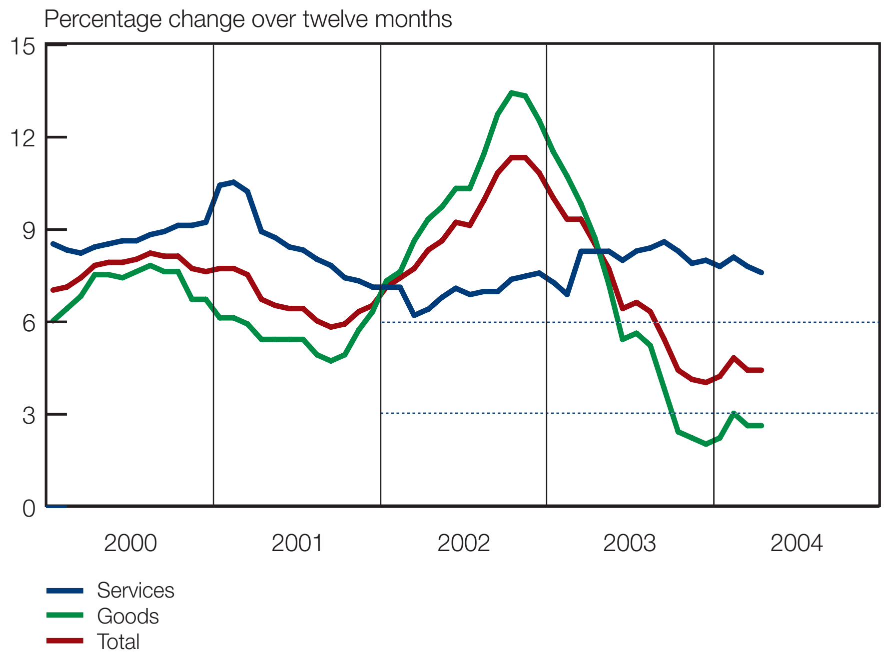
Period		Domestically produced goods	Imported goods	Overall production prices
2002:	1st qr	21,5	37,1	25,8
	2nd qr	15,0	13,0	14,0
	3rd qr	11,9	6,7	10,2
	4th qr	6,3	1,3	5,4
	Year	**13,5**	**15,5**	**14,2**
2003:	1st qr	-0,7	-10,1	-3,1
	2nd qr	0,5	-10,1	-2,9
	3rd qr	5,6	-8,1	1,8
	4th qr	-3,0	-7,2	-3,7
	Year	**3,9**	**-4,2**	**1,7**
2004:	1st qr	3,1	-8,3	0,1

Twelve-month CPIX inflation (i.e. changes in the overall consumer price index for metropolitan and other urban areas, excluding the interest cost of mortgage bonds) fell from a recent peak of 11,3 per cent in November 2002 to 4,0 per cent in December 2003. CPIX inflation, however, picked up to a year-on-year rate of 4,8 per cent in February 2004, but moderated somewhat to 4,4 per cent in both March and April 2004. The deceleration in March 2004 was mainly due to a substantial increase in March 2003, establishing a high base value for year-on-year calculations. The increase in April 2004 was moderated by declines in the prices of recreation and entertainment, and clothing and footwear. Inflation has now remained within the target range of between 3 and 6 per cent for eight months in succession.

The general decline in CPIX inflation since 2002 was most evident in food price inflation, prices of clothing, footwear, petrol, furniture and equipment, and vehicles. All these categories benefited from the favourable effects of a stronger exchange rate. However, more recently when measured from quarter to quarter and expressed at an annualised rate, CPIX inflation accelerated from 1,1 per cent in the fourth quarter of

2003 to 7,2 per cent in the first quarter of 2004. This acceleration was largely the result of steeply rising petrol prices as well as higher prices for alcoholic beverages and tobacco, following the increase in excise duties that was announced in the February 2004 National Budget.

CPIX



While there has been a sharp deceleration in year-on-year *CPIX goods price inflation* from 13,4 per cent in October 2002 to around 2 per cent in recent months – essentially reflecting exchange rate disinflationary effects – *CPIX services price inflation* remained high at around 8 per cent in the past twelve months. The factors that contributed to the high level of services price inflation included relatively high wage increases for domestic workers and increases in certain administered prices. The rate of increase in the wages of domestic workers started moderating from March 2004.

Overall consumer price inflation declined substantially from a year-on-year rate of 13,0 per cent in October 2002 to below 1 per cent during the six successive months to April 2004. Overall consumer price inflation benefited from the steep decline in housing services prices – mainly from the five-and-a-half-percentage-point reduction in interest rates since June 2003. New surveys of domestic worker wages indicate that there may be lower wage increases in the six months from March 2004 than the increases from September 2003 to February 2004.

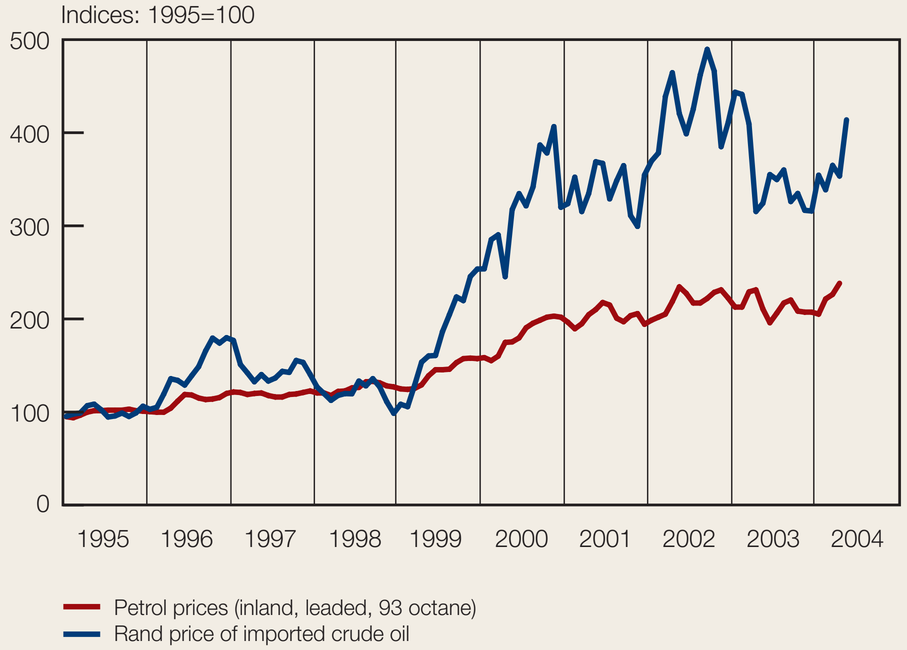
The short-term pace of change in overall consumer prices reverted from prices declining at an annualised rate of 2,1 per cent in the fourth quarter of 2003 to prices increasing at a rate of 1,8 per cent in the first quarter of 2004. While overall services prices continued to decline in the first quarter of 2004, albeit at a reduced rate, consumer goods price inflation increased twofold on account of the increases in petrol, alcoholic beverages and tobacco prices.

The effect of changes in international crude oil prices on the domestic price of petrol and diesel

Changes in international crude oil prices influence the domestic consumer prices of petrol and diesel. The changes in consumer prices of petrol and diesel are, however, not proportionate to the changes in international crude oil prices, as indirect taxes and distribution margins drive a wedge between the price of crude petroleum and the pump price of petrol and diesel. All the taxes and distribution margins levied on petrol and diesel are specified as fixed amounts that do not change in accordance with the changes in the international crude oil price. The higher these taxes and margins as a ratio of the final price of petrol and diesel, the smaller will be the percentage increase in the petrol and diesel price for a given increase in the international oil price. In June 2004, indirect taxes accounted for roughly 33 per cent of the retail price of a litre of petrol. When the wholesale and retail margins are added, roughly 50 per cent of the retail price of a litre of petrol is insulated from direct changes in crude oil prices.

The calculation of domestic fuel prices is based on what is termed the "basic fuel price" (BFP) mechanism. The *international component* of domestic fuel prices is based on the import parity principle and is meant to subject local refineries to the same levels of efficiency as those of their international counterparts. The BFP is an import-parity pricing formula based exclusively on spot (cash) prices reported daily by international fuel price reporting agencies. The basic price of *petrol* is based on the *average* of Platt's (a price reporting agency's) spot price assessment in the Mediterranean refining area and of Platt's spot price assessment in Singapore. The basic price of *diesel* and *illuminating paraffin* is, however, based on the *average* of Platt's spot price assessment in the Arab Gulf and of Platt's spot price assessment in the Mediterranean refining area. The domestic component of the BFP formula includes freight cost, wharfage, ocean loss and insurance costs. In addition, certain costs such as demurrage, coastal storage and stock financing to cover the cost of providing storage and handling are also included in the formula.

Crude oil and domestic petrol prices



The *domestic price* of petrol includes a fuel tax, wholesale and retail margins, zone differentials, delivery costs, road accident fund levy, slate levy, equalisation fund levy and customs and excise duties. As it would be cumbersome to adjust pump prices daily, the average price ruling during a preceding month is used as the price for the following month, with the actual price change taking place on the first Wednesday of each month.

As indicated in the accompanying graph, changes in the prices of crude oil are substantially more volatile than those in the domestic prices of petrol and diesel due to the insulating effect of indirect taxes and other margins which do not change in tandem with oil prices. In fact, during the period January 1996 to April 2004, the average month-to-month rate of *change* in the rand price of crude oil amounted to 7,4 per cent, while the domestic price of petrol changed by only 2,6 per cent. The volatility in the retail price of petrol was therefore only about a third of that of the price of crude oil. Stated differently, if the rand price of crude oil should increase by 10 per cent, the price of petrol and diesel can be expected to increase by around 3,5 per cent. The administered component of the price of petrol and diesel therefore has a stabilising effect on the magnitude of petrol and diesel price changes, even though it raises the absolute level thereof.

Given the typical relationship between crude oil prices and ex-refinery prices of petrol and diesel, an increase of US$10 per barrel in crude oil prices can be expected to raise liquid fuel prices by approximately 60 South African cents per litre. From current levels in June 2004, this would be an increase of roughly 13 per cent. Given the 5,08 per cent weight of petrol in the CPIX basket, it would therefore *directly* add some 0,7 per cent to the level of CPIX through the consumer's own expenditure on liquid fuels. However, indirect effects are likely to be equally important.

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When measured over periods of twelve months, *services price inflation* decelerated markedly from a high of 13,2 per cent in December 2002 to 0,8 per cent in October 2003. Lower home mortgage interest rates lowered the cost of home-ownership, and hence overall services prices. Services prices fell by as much as 2,8 per cent in the year to April 2004. When measured from quarter to quarter and annualised, services prices declined by 1,4 per cent in the first quarter of 2004. The pace of price *increases* of services excluding housing and transport remained at a high annualised rate of 16,9 per cent in the first quarter of 2004 largely due to the rising cost of medical services.

Consumer prices

Quarter-to-quarter changes at seasonally adjusted annualised rates

Period		Goods	Services	Overall CPI	CPIX
2002:	1st qr	12,4	10,4	11,1	9,9
	2nd qr	13,6	10,2	12,8	12,7
	3rd qr	11,0	15,3	12,4	10,4
	4th qr	12,9	15,8	14,2	8,6
	Year	**10,2**	**7,8**	**9,2**	**9,3**
2003:	1st qr	2,7	5,6	3,6	6,5
	2nd qr	-0,4	3,2	1,8	4,6
	3rd qr	3,7	-2,6	0,6	4,7
	4th qr	2,5	-8,4	-2,1	1,1
	Year	**5,7**	**6,2**	**5,8**	**6,8**
2004:	1st qr	5,2	-1,4	1,8	7,2

Quarter-to-quarter changes in the *prices of consumer goods* more than doubled from an annualised rate of increase of 2,5 per cent in the fourth quarter of 2003 to 5,2 per cent in the first quarter of 2004. Price declines in all the major consumer goods categories during the first quarter of 2004 were counteracted by the sharp increase in transport running cost caused by higher petrol prices. Other categories that experienced increases in prices were food, alcoholic beverages and tobacco.

New medicine pricing regulations came into effect on 2 May 2004 with the intention of reducing the retail cost of medicine. Some teething problems were experienced with the implementation of these new regulations. Furthermore, the recent surge in the international price of crude petroleum and the associated increases in domestic petrol and diesel prices represent risks to the inflation process in coming months.

Foreign trade and payments

International economic developments

The global economic recovery gained momentum during the course of 2003 and continued in the first quarter of 2004. Although the recovery in the euro area remained hesitant, economic growth in the United States, Japan and China was brisk.

Growth on the African continent also picked up from 3,5 per cent in 2002 to 4,1 per cent in 2003. While this was below the levels required to achieve the Millennium Development Goals, it was nonetheless encouraging to note that real growth in economic activity on the continent as a whole remained above 3,5 per cent per annum during the past three years.

The strengthening and broadening of the global recovery in recent months has resulted in a significant upward revision in the IMF's growth projections in April 2004. Global growth is expected to accelerate from 3,9 per cent in 2003 to 4,6 per cent in 2004, before slowing moderately to 4,4 per cent in 2005.

This pick-up in economic conditions was accompanied by a strong rebound in global trade, but has also put upward pressure on commodity prices. Brent crude oil prices have increased substantially since the end of the war in Iraq due to the delays in restoring Iraq's oil production to pre-war levels, the higher-than-expected oil demand (especially from the United States and China), low commercial oil inventories and geopolitical developments. Brent crude oil prices increased to levels around US$39 per barrel due to concerns about the security of oil supplies from the Middle East and about the adequacy of fuel inventories in the United States, given the approaching summer holiday. Oil prices declined late in May and in early June after Saudi Arabia indicated its preparedness to raise output and OPEC announced an increase in production quotas.

International oil price

Source: Bloomberg

Non-oil commodity prices strengthened during early 2004, but suffered a setback following indications that the Chinese authorities would take steps to cool down their buoyant economy.

Global inflationary pressures and fears are fairly well-contained. In most countries policy interest rates remained low and most recent adjustments were downward. The US Federal Open Market Committee kept the federal funds rate unchanged at 1,0 per cent since the end of June 2003. Markets, however, started to speculate on the likely timing of the first increase in the federal funds rate given the robust domestic economic performance of the United States and the consolidation of the global economic recovery.

In a handful of countries, however, monetary policy assumed a more contractionary stance. The most recent policy moves of the Bank of England, Reserve Bank of Australia and Reserve Bank of New Zealand were to raise their official interest rates.

Current account

The deficit on the current account of the balance of payments, which had deteriorated significantly in the fourth quarter of 2003, contracted moderately to an estimated R20,2 billion in the first quarter of 2004. Expressed as a ratio of the country's gross domestic product, the current-account deficit narrowed from 1,8 per cent in the fourth quarter of 2003 to 1,6 per cent in the first quarter of 2004.

The contraction in the current-account deficit could be attributed to both an improvement in the trade surplus and a reduction in net service, income and current transfer payments to non-residents. The widening of the trade surplus from R14,2 billion in the fourth quarter of 2003 to R15,2 billion in the first quarter of 2004 resulted from a better export performance which was almost offset by a marginal increase in the value of merchandise imports.

Balance of payments on current account

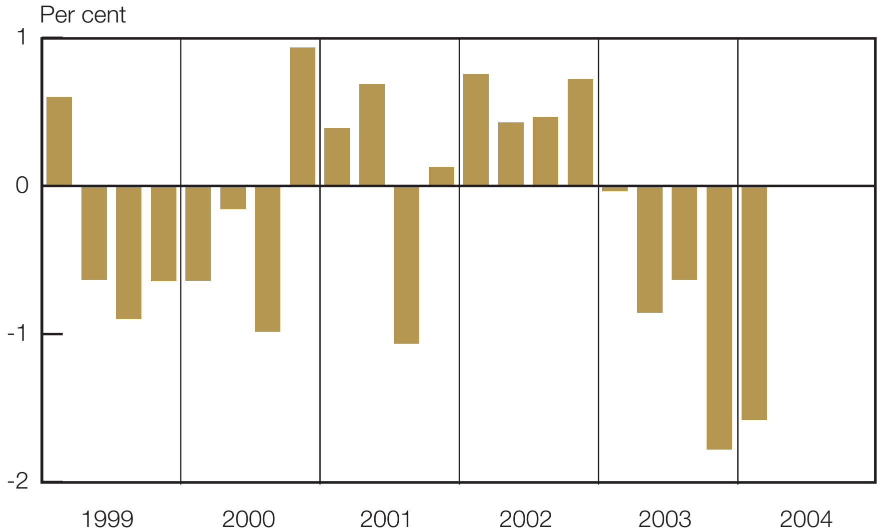
Seasonally adjusted and annualised
R billions

	2003					2004
	1st qr	2nd qr	3rd qr	4th qr	Year	1st qr
Merchandise exports	262,8	258,3	258,5	244,5	256,0	257,0
Net commodity gold exports	36,6	34,2	34,7	35,9	35,3	33,5
Merchandise imports	-262,0	-262,1	-260,9	-266,2	-262,8	-275,3
Trade balance	**37,4**	**30,4**	**32,3**	**14,2**	**28,5**	**15,2**
Net service, income and current transfer payments	-37,8	-40,7	-40,0	-36,3	-38,6	-35,4
Balance on current account	**-0,4**	**-10,3**	**-7,7**	**-22,1**	**-10,1**	**-20,2**

After having declined for five consecutive quarters since the fourth quarter of 2002, the average realised rand price of *exported goods* rose by 9 per cent in the first quarter of 2004, mainly on account of the weaker average external value of the rand alongside rising commodity prices. South Africa's non-gold commodity export prices expressed in rand in fact rose by 16 per cent in the first quarter of 2004 compared with the final quarter of 2003. The rise in the unit price of exports was more than sufficient to counter a decline of 3½ per cent in the volume of exported goods over the period. Consequently, the value of merchandise exports advanced by 5 per cent to R257,0 billion in the first quarter of

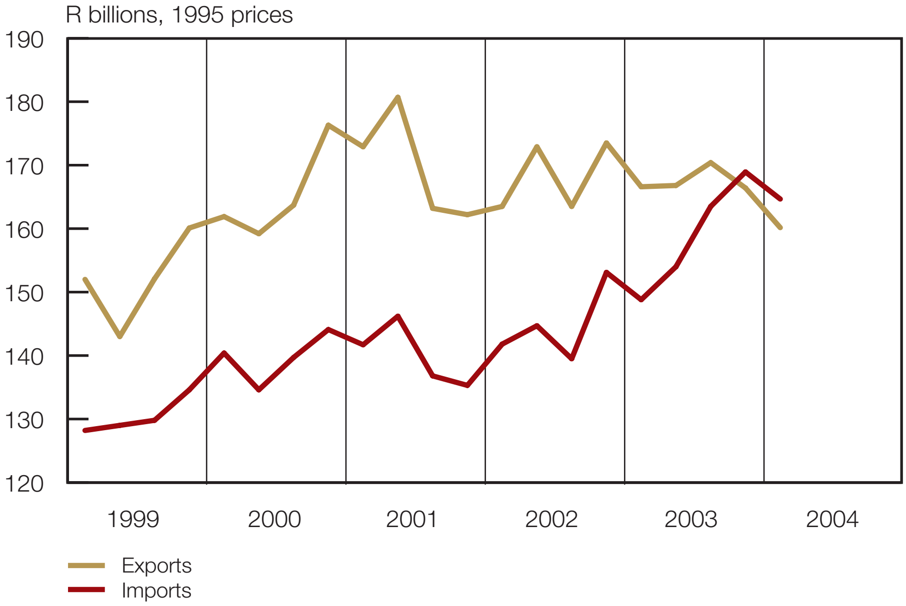
2004 from R244,5 billion in the fourth quarter of 2003. Export proceeds in the subcategories for platinum group metals, and base metals and articles of base metals recorded particularly strong increases. The value of mining exports in the first quarter of 2004 was at its highest since the fourth quarter of 2002.

Ratio of current-account balance to gross domestic product



The value of South Africa's *gold exports* decreased from R35,9 billion in the fourth quarter of 2003 to R33,5 billion in the first quarter of 2004. A decrease of 9½ per cent in the physical quantity of gold exported was partly neutralised by an increase of 3 per cent in the average realised price in rand per fine ounce of gold. In dollar terms, the fixing price of gold rose from US$392 per fine ounce in the fourth quarter of 2003 to US$409 per fine ounce in the first quarter of 2004.

Real imports and exports of goods* and services



* Including gold

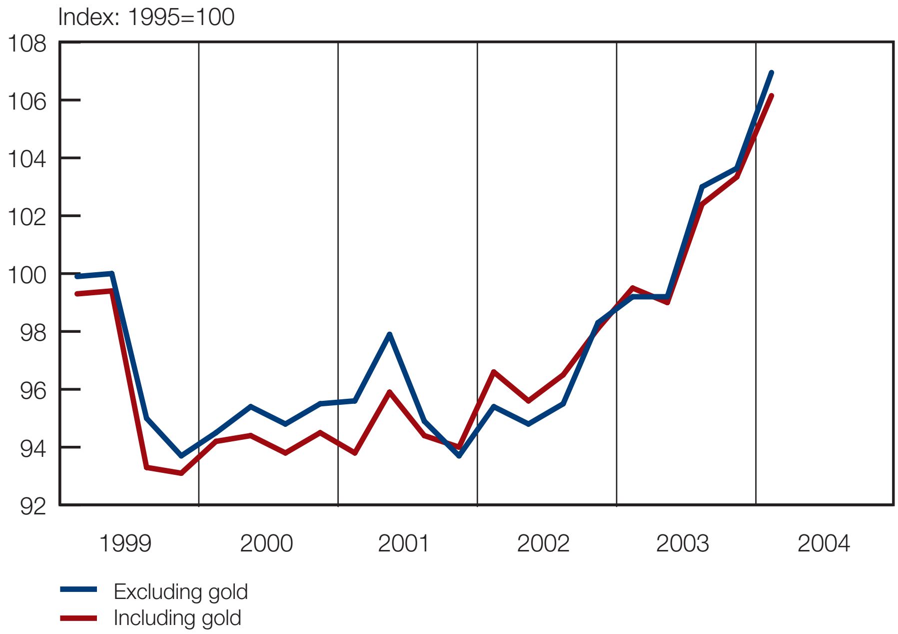
Notwithstanding a sharp decline in the value of crude oil imports, which partially neutralised increases in the value of agricultural and manufactured imports, the value of *merchandise imports* rose by 3½ per cent in the first quarter of 2004. The increase in merchandise imports was noticeable mainly in manufactured goods such as machinery and electrical equipment, vehicles and transport equipment, textiles, and chemical products.

Although the overall physical quantity of imported goods fell by about ½ a per cent in the first quarter of 2004, the volume of non-oil imports increased by almost 3 per cent, consistent with rising real domestic final demand. A moderate decline in the quarterly average nominal effective exchange rate of the rand caused the rand prices of imported goods to rise by 4 per cent from the fourth quarter of 2003 to the first quarter of 2004.

Preliminary estimates indicate that net service, income and current transfer payments to the rest of the world narrowed from a seasonally adjusted and annualised value of R36,3 billion in the fourth quarter of 2003 to an estimated R35,4 billion in the first quarter of 2004. The somewhat smaller shortfall could largely be attributed to a reduction in local companies' dividend payments to non-resident investors. Travel receipts from foreign visitors touring South Africa increased, but local shareholders experienced a reduction in dividend receipts from non-residents.

South Africa's terms of trade (including gold) improved by a further 2½ per cent in the first quarter of 2004 as export prices rose more than import prices.

Terms of trade: Export prices relative to import prices



Financial account

The surplus on the financial account of the balance of payments (including unrecorded transactions) more than halved from R34,5 billion in the fourth quarter of 2003 to R15,5 billion in the first quarter of 2004. The inflow of capital in the first quarter of 2004 could be attributed to net inflows of direct and portfolio investment.

Net financial transactions not related to reserves

R billions

	2003					2004
	1st qr	2nd qr	3rd qr	4th qr	Year	1st qr
Change in liabilities						
Direct investment	0,1	0,4	1,8	3,4	5,7	7,8
Portfolio investment	-4,0	22,4	-4,3	-6,2	7,9	5,1
Other investment	-1,2	4,8	-1,7	11,6	13,5	4,5
Change in assets						
Direct investment	-2,8	0,7	-1,5	-1,8	-5,4	1,0
Portfolio investment	-0,4	0,2	-0,3	-0,5	-1,0	0,0
Other investment	5,2	1,7	5,8	10,8	23,5	-3,8
Total financial transactions*......	**-7,5**	**26,0**	**10,4**	**34,5**	**63,4**	**15,5**

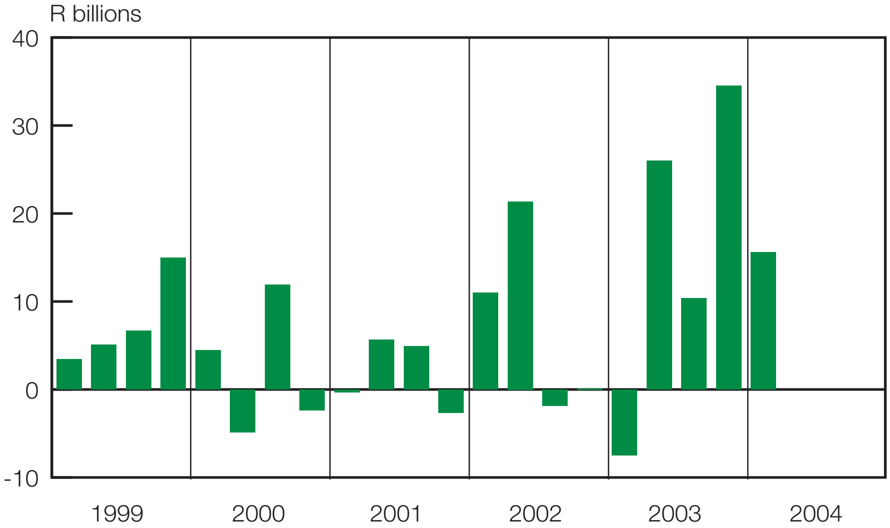
* Including unrecorded transactions

Foreign-owned assets in South Africa

Foreign direct investment inflows into South Africa increased from R3,4 billion in the fourth quarter of 2003 to R7,8 billion in the first quarter of 2004. The inflow in the first quarter of 2004 was mainly related to the acquisition of a significant interest in a listed South African mining company by a non-resident direct investor as well as to the recapitalisation of a domestic bank by its non-resident majority shareholder. This increase in foreign direct investment liabilities was, however, partly negated by an outflow of other long and short-term loan capital over the same period.

Foreign portfolio investors increased their holdings of both South African equity and, to a lesser extent, debt securities during the first quarter of 2004. Positive sentiment regarding South Africa on account of rising commodity prices and relatively low price-earnings ratios compared with shares listed on other leading exchanges may have encouraged foreign portfolio investors to increase their holdings of portfolio assets issued in South Africa. Whereas portfolio investment liabilities recorded an outflow of R6,2 billion in the fourth quarter of 2003, this was reversed to an inflow of R5,1 billion in the first quarter of 2004.

Balance of payments: Financial account



Balance on financial and capital transfer account, including unrecorded transactions

Other foreign investment into South Africa recorded an inflow of R4,5 billion in the first quarter of 2004 compared with an inflow of R11,6 billion in the fourth quarter of 2003. The sustained inflow of other investment capital resulted mainly from a substantial increase in the foreign deposit liabilities of the domestic banking sector, which was only partly countered by the redemption of foreign borrowing by the South African banking and government sector. The outflow from the government sector resulted from the early repayment of the National Treasury's US$750 million syndicated loan. The Reserve Bank, as co-borrower under the syndicated loan agreement, subsequently drew down the US$750 million prepaid by National Treasury.

South African-owned assets abroad

Direct investment flows changed from an outflow (i.e. an increase in foreign direct investment assets) of R1,8 billion in the fourth quarter of 2003 to an inflow of R1,0 billion in the first quarter of 2004. While South African resident companies acquired dominant interests in the equity capital of foreign companies, these outflows were more than offset as a result of the sale by a South African retailer of a dominant interest in a foreign company, as well as repatriation of loan capital provided to foreign subsidiaries.

Portfolio investment abroad changed to a marginal inflow in the first quarter of 2004 compared with an outflow of R0,5 billion in the fourth quarter of 2003. The small first-quarter inflow occurred as a result of repatriation of foreign debt securities by the domestic banking sector.

Other investment in foreign assets changed from an inflow of capital of R10,8 billion in the fourth quarter of 2003 to an outflow of R3,8 billion in the first quarter of 2004. The increase in other investment capital was related to a delay in the repatriation of part of the proceeds of the sale of an interest in the South African mining company referred to earlier.

Foreign debt

South Africa's total outstanding foreign debt increased by US$0,7 billion from the end of September 2003 to the end of December, from a level of US$36,5 billion to a level of US$37,2 billion. This increase in South Africa's foreign debt was the result of an increase in foreign-currency denominated debt, which was only partly countered by a small decline in rand-denominated debt.

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

Period	2001	2002	2003 3rd qr	2003 4th qr
Foreign-currency denominated debt...	**24,0**	**25,0**	**26,2**	**27,4**
Bearer bonds.................................	6,0	7,8	9,6	9,7
Converted long-term loans.............	0,1	0,0	0,0	0,0
Public sector..................................	3,0	4,9	4,6	4,9
Monetary sector.............................	8,9	6,2	5,4	5,9
Non-monetary private sector...........	6,0	6,1	6,6	6,9
Rand-denominated debt	**6,8**	**7,7**	**10,3**	**9,8**
Bonds..	4,3	4,5	5,0	4,2
Other	2,5	3,2	5,3	5,6
Total foreign debt................................	**30,8**	**32,7**	**36,5**	**37,2**

Foreign-currency denominated debt increased from US$26,2 billion at the end of September 2003 to US$27,4 billion at the end of December. This increase can be attributed to an increase in non-residents' foreign-currency loans to and deposits with South African banks, as well as smaller increases in public and non-monetary private-sector debt.

Dominated by exchange rate movements, South Africa's total foreign debt measured in rand declined from R255,4 billion at the end of September 2003 to R247,2 billion at the end of December. Total foreign debt as a ratio of gross domestic product accordingly declined considerably from 30,7 per cent to 23,2 per cent from the end of December 2002 to the end of December 2003.

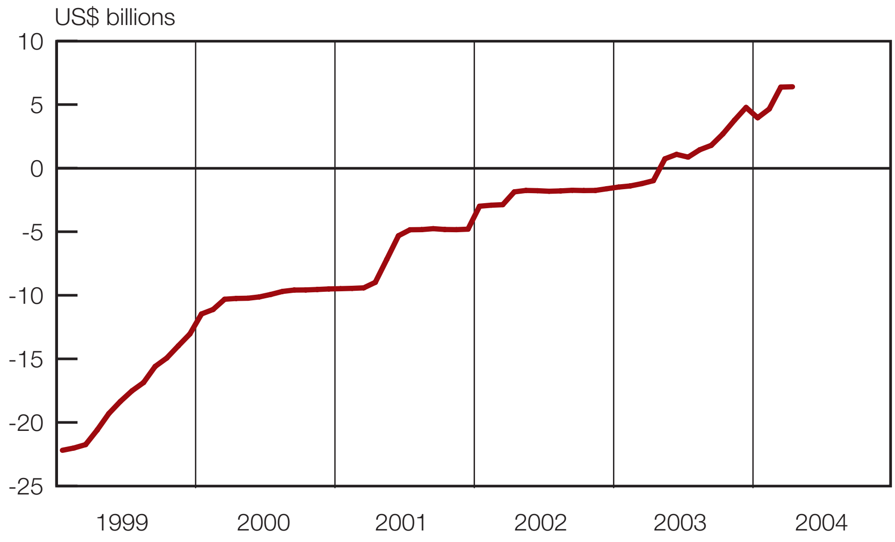
Foreign reserves

During the first quarter of 2004, the deficit on the current account of the balance of payments was again more than fully financed by a surplus on the financial account. South Africa's net international reserves accordingly improved by R13,4 billion in the first quarter of 2004 compared with a record increase of R28,7 billion in the fourth quarter of 2003. For the whole of 2003 the country's net reserves increased by R53,3 billion.

The value of the country's gross gold and foreign reserves (i.e. international reserves before accounting for reserve-related loans) increased from US$24,9 billion (R165,3 billion) at the end of December 2003 to US$26,1 billion (R166,1 billion) at the end of March 2004. The value of gross international reserves relative to the value of imports of goods and services remained roughly unchanged at 23½ weeks' worth from the end of December 2003 to the end of March 2004.

The gross gold and other foreign reserves of the Reserve Bank increased from US$8,0 billion at the end of December 2003 to US$9,8 billion at the end of March 2004 and further to US$10,3 billion at the end of May. This increase was the result of purchases of foreign currency by the Reserve Bank in order to gradually increase its foreign reserves. The Bank's liabilities related to reserves increased from US$3,0 billion at the end of December 2003 to US$3,7 billion at the end of March 2004 following the drawing down by the Bank of the US$750 million facility repaid by National Treasury as mentioned above. Liabilities related to reserves of the Bank still amounted to US$3,7 billion at the end of May.

International liquidity position of the South African Reserve Bank



The international liquidity position of the Reserve Bank improved from US$4,8 billion at the end of December 2003 to US$6,4 billion at the end of March 2004 and US$8,0 billion at the end of May. During this period a significant milestone was also reached when the oversold forward book was closed out during February 2004.

Exchange rates

On a weighted-average basis, the exchange rate of the rand, on balance, declined by 5,9 per cent in January 2004, before strengthening by 6,9 per cent and 5,1 per cent, respectively, during February and March as the strong rise in international commodity prices supported confidence in the rand. The weighted average exchange rate of the

Exchange rates of the rand

Percentage change

	31 Mar 2003 to 30 Jun 2003	30 Jun 2003 to 30 Sep 2003	30 Sep 2003 to 31 Dec 2003	31 Dec 2003 to 31 Mar 2004	31 Mar 2004 to 31 May 2004
Weighted average*.....	4,4	3,2	0,3	5,7	-2,0
Euro	2,3	3,5	-2,7	8,3	-2,7
US dollar	7,6	5,5	5,2	5,1	-2,7
British pound.............	2,9	3,9	-1,2	2,1	-2,8
Japanese yen............	8,6	-2,9	2,0	1,8	2,8

* Against a basket of 13 currencies

rand consequently increased by 5,7 per cent from the end of December 2003 to the end of March 2004. This increase in the nominal effective exchange rate of the rand followed the 24,2 per cent and 16,2 per cent increase in the years up to the end of December 2002 and the end of December 2003, respectively. The nominal effective exchange rate of the rand declined by 5,2 per cent from the end of March to the end of April 2004, partly due to a decline in some commodity prices and expectations that American interest rates

Daily nominal effective exchange rate of the rand

would be raised sooner than previously thought, thereby eroding the interest differential favouring investment in South Africa. This was partly reversed when the rand again appreciated by 3,4 per cent from the end of April to 31 May 2004.

The continued prudent economic policies and the improvement in the Bank's foreign reserve position caused market participants to increasingly attach two-way currency risk to the rand, instead of the earlier perception of the rand as a currency of which the depreciation is assured over the longer term.

The real effective exchange rate of the rand declined by 3 per cent from December 2003 to March 2004 but, on balance, increased by 9 per cent over the twelve months to March 2004.

The average net daily turnover in the domestic market for foreign exchange, which had increased to US$11,3 billion in the fourth quarter of 2003, declined slightly to US$11,0 billion in the first quarter of 2004. The value of transactions in which non-residents participated decreased marginally from US$7,6 billion per day to US$7,5 billion per day over the same period. Participation by resident parties also declined from an average of US$3,6 billion per day in the fourth quarter of 2003 to US$3,5 billion in the first quarter of 2004.

Monetary developments, interest rates and financial markets

Money supply[2]

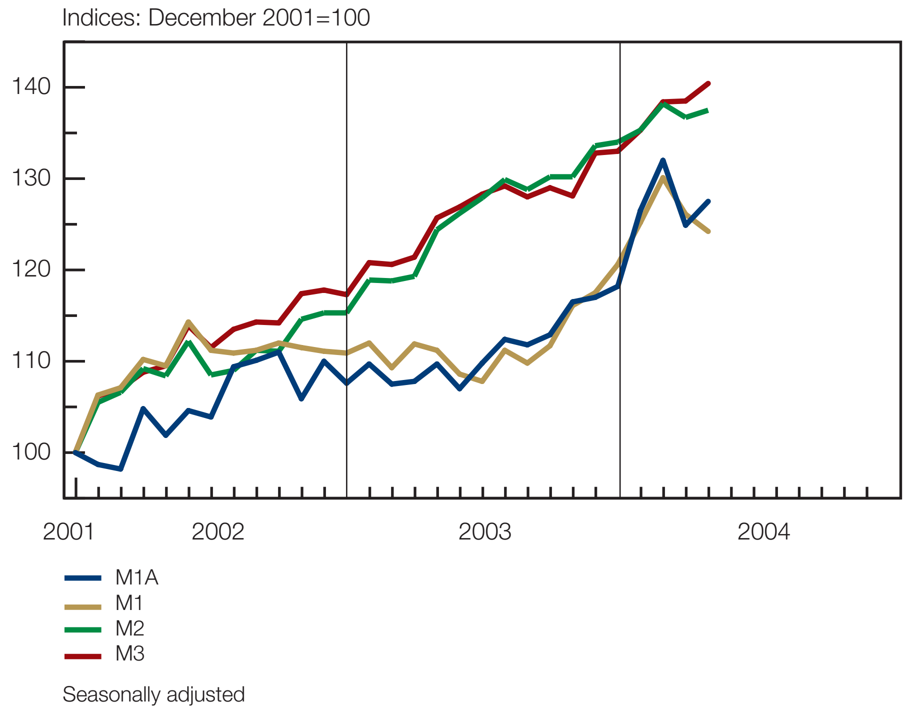
2 *Annualised growth rates referred to in this section are based on seasonally adjusted data.*

Growth in the broadly defined money supply (M3) decelerated somewhat in the second half of 2003, consistent with developments in nominal expenditure and prices. Lower deposit interest rates also reduced the relative attractiveness of holding monetary deposits. However, during the first quarter of 2004 growth in M3 reaccelerated significantly as domestic final demand, prices and domestic production recorded brisk increases. Cash received by non-bank domestic parties from coupon interest payments on government bonds and the redemption of the first tranche of the R150 bond also temporarily raised the level of M3 at the end of February.

Measured over twelve months, growth in M3 accelerated from 9 per cent in October 2003 to 14,9 per cent in February 2004 but decelerated marginally to 12,4 per cent in April. The quarter-to-quarter annualised growth in M3 accelerated from 6,5 per cent in the fourth quarter of 2003 to 19,2 per cent in the first quarter of 2004.

In contrast to the broader aggregates (M2 and M3), growth in the narrowest monetary aggregates (M1A and M1) started to accelerate in the second half of 2003. This was not surprising, given that M1A and M1 are the most liquid and least interest-bearing of the monetary aggregates and consequently the most favoured by reductions in the level of interest rates, as had occurred from mid-2003. Transactions balances may also have been raised by above-inflation wage settlements concluded during the second half of 2003.

Monetary aggregates



The upward momentum in the narrow monetary aggregates intensified during the first quarter of 2004, as shown in the table on the following page. Month-to-month movements are illustrated in the accompanying graph, from which it seems that the government bond redemption and interest payments at the end of February 2004 were deposited into the cheque accounts of private-sector parties, but subsequently were converted into other financial instruments. Nevertheless, the increase in M1A amounted to R17,3 billion during the first quarter of 2004 – a record increase in this narrow aggregate. Brisk growth in domestic final demand, rising real disposable income and a low interest rate environment underpinned this strong increase.

Growth in monetary aggregates

Per cent at seasonally adjusted annualised rates

	2003				2004
	1st qr	2nd qr	3rd qr	4th qr	1st qr
Notes and coin in circulation	12,1	7,9	16,7	24,1	25,2
Cheque and transmission deposits	-5,9	-9,6	12,5	32,9	36,0
M1A	**-0,4**	**0,8**	**12,9**	**17,1**	**40,6**
Other demand deposits	-2,8	-7,1	-11,1	30,7	41,4
M1	**-1,4**	**-3,7**	**1,3**	**25,1**	**37,3**
Other short and medium-term deposits	40,4	63,2	28,5	-3,7	-7,8
M2	**14,7**	**23,5**	**15,1**	**8,7**	**13,7**
Long-term deposits	-4,4	-11,3	-24,6	-15,6	73,6
M3	**11,6**	**19,8**	**9,2**	**6,5**	**19,2**

While deposits with unexpired maturities ranging from 2 days to 6 months ("other short and medium-term deposits" in the table) declined in the first quarter of 2004, long-term deposits rose during this period. The steep acceleration in the growth rate displayed by long-term deposits contrasted with the preceding quarters, when such deposits maintained a downward trend. It was partly related to the movements in longer-term deposit rates offered by the banks; such rates receded during 2003 but increased in early 2004.

While the corporate sector's M3 deposits rose by R30,5 billion in the first quarter of 2004, the household sector's M3 deposit holdings at the same time increased by only R2,9 billion, mainly on account of funds deposited by unincorporated businesses.

Annualised quarter-to-quarter growth in M3 exceeded growth in nominal gross domestic product by 7,2 percentage points in the first quarter of 2004. As a result, the income velocity of circulation of M3 declined from 1,63 in the fourth quarter of 2003 to a record low of 1,60 in the first quarter of 2004.

The M3 money supply increased by R33,4 billion from the end of the fourth quarter of 2003 to the end of the first quarter of 2004. The accounting counterparts of the change in M3 are reflected in the table on the following page.

As reflected in the table, a substantial part of the increase in M3 in the first quarter of 2004 was on account of the increase in *net other assets and liabilities.* The increase in this statistical counterpart was mainly due to the requirement that banks report derivatives instruments and other financial instruments at market value and on a gross basis. Banks' claims on the private sector also continued to be affected by the same practice.

Counterparts of change in M3

R billions

Counterparts	4th qr 2003		1st qr 2004	
Net foreign assets		21,4		9,4
Net claims on the government sector		3,8		9,2
Gross claims	8,5		-9,9	
Government deposits (decrease +; increase -)	-4,7		19,1	
Claims on the private sector		21,2		-1,8
Net other assets and liabilities		-13,9		16,6
Total change in M3		**32,5**		**33,4**

Net claims on the government sector were influenced by a sharp decline in government deposits following the redemption of and coupon interest payments on government bonds during the first quarter of 2004.

The increase in net foreign assets during the first quarter of 2004 can mainly be attributed to the increase in foreign assets of the Reserve Bank, which rose by R9,6 billion during the quarter concerned.

Credit extension

3 *Total loans and advances to the domestic private sector consist of instalment sale credit, leasing finance, mortgage advances, overdrafts, credit card and general advances. The first three categories are referred to as* asset-backed credit, *while the last three categories together are referred to as* other loans and advances.

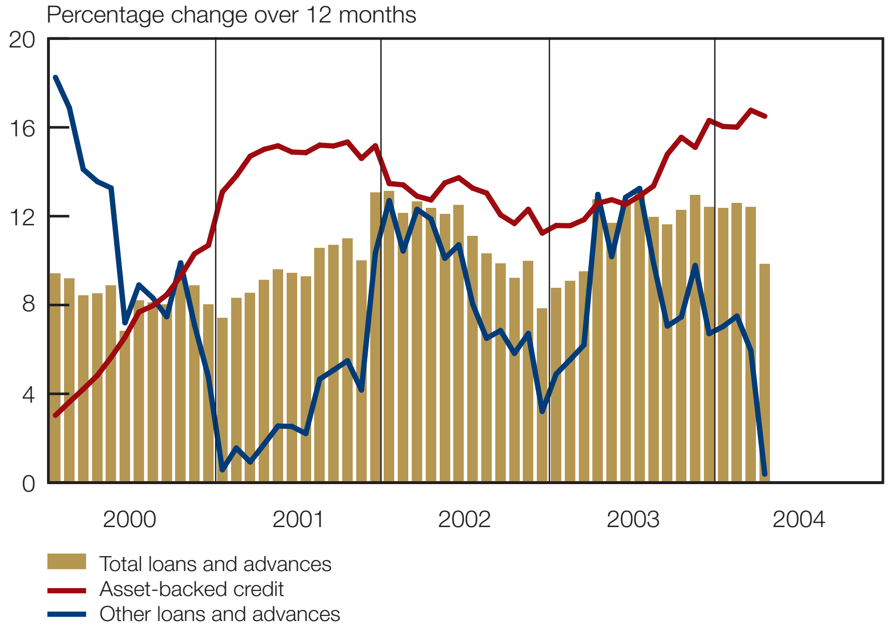
The reduction in interest rates since mid-2003, rising real disposable income, strong growth in domestic expenditure and the wealth effects associated with buoyant conditions in the property market continued to support firm growth in total loans and advances[3] extended to the private sector. However, growth in total loans and advances was restrained to some extent by disintermediation, evidenced by the funding of part of the corporate sector's financial deficits outside the banking sector.

Twelve-month growth in banks' total loans and advances to the private sector remained firm, fluctuating around 12 per cent from April 2003 to March 2004. It decelerated to 9,9 per cent in April, largely due to a high base value a year earlier. The quarter-to-quarter growth in loans and advances accelerated from 7,2 per cent in the fourth quarter of 2003 to 12,8 per cent in the first quarter of 2004. Brisk demand for the asset-backed credit categories was the main driver of robust growth in total loans and advances. Of the overall increase of R22,0 billion in total loans and advances in the first quarter of 2004, asset-backed credit accounted for R18,3 billion.

Measured over twelve months, growth in asset-backed credit accelerated from 12,6 per cent in April 2003 to 16,3 per cent in December and remained around 16 per cent in the first four months of 2004. However, the quarter-to-quarter growth rate in asset-backed loans decelerated somewhat from 17,5 per cent in the fourth quarter of 2003 to 15,3 per cent in the first quarter of 2004.

A disaggregated analysis of total loans and advances by type of credit indicates that a large part of the increase in asset-backed credit was in the form of *mortgage advances* extended to the household sector. Mortgage advances contributed R13,1 billion to the overall increase in asset-backed credit during the first quarter of 2004, of which the household sector accounted for R11,5 billion with the remainder being taken up by the corporate sector. The brisk increase in mortgage advances was partly a cause and partly an effect of the buoyant trading conditions in the real-estate market, with the strong demand for residential property supported by a lower interest rate environment and sustained increases in fixed property prices.

Loans and advances to the private sector



Instalment sale credit and leasing finance remained relatively firm in the first quarter of 2004, reflecting strong demand for motor vehicles and other durable goods. The list prices of most types of vehicles remained stable in early 2004, while significant discounts were given by some dealers. The financing of new and used motor vehicles contributed 56 per cent to the total increase in instalment sale credit and leasing finance during the first quarter. Buoyancy was also visible in the banks' new business payouts of such finance during the first quarter of 2004.

Other loans and advances contributed R3,7 billion to the overall increase in total loans and advances extended to the private sector in the first quarter of 2004 with both the corporate and household sectors fairly equally represented. This was in contrast with the fourth quarter of 2003 when the corporate sector was responsible for the bulk of the increase in other loans and advances.

The *other loans and advances* category is mainly dominated by the corporate sector's use of overdrafts on current account and general advances. Historical data indicate that the growth trend in this category is influenced by a combination of factors such as

- the direction of leads and lags in foreign payments and receipts depending on the performance of the exchange rate and the corporate sector's expectations;
- the financing requirements associated with inventory accumulation and expansion of gross fixed capital formation; and
- the cost of bank credit relative to other sources of funding.

Recently, disintermediation through the issuing of bonds by non-bank corporate entities contributed to subdued growth in other loans and advances.

The household sector accounted for a significant increase in total loans and advances extended to the private sector during the first quarter of 2004. This sector's use of loans and advances increased by R19,0 billion in the first quarter of 2004 compared with R3,7 billion in the fourth quarter of 2003. Conversely, the corporate sector's use of bank credit declined by R3,0 billion during the first quarter of 2004 compared with an increase of R16,8 billion in the fourth quarter of 2003.

The continued strong growth in asset-backed credit categories that started in the fourth quarter of 1999 indicates prolonged favourable bank lending conditions. However, the modest level of and downward trend displayed by banks' non-performing loans suggest that banks have not been expanding their lending imprudently.

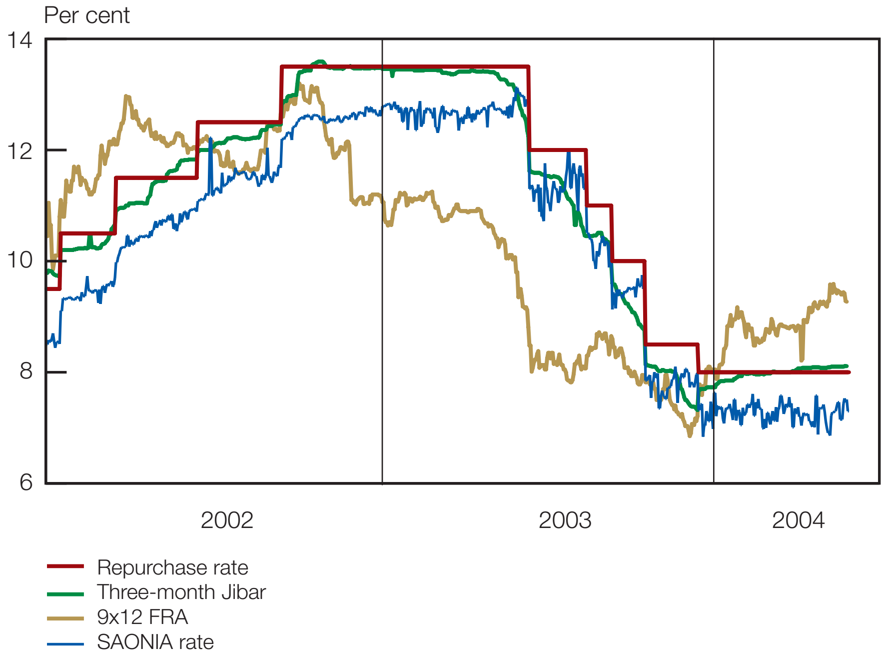
Interest rates and yields

The Monetary Policy Committee (MPC) at its meetings held in February, April and June 2004 left the repurchase rate unchanged at 8,00 per cent. (The April and June 2004 MPC statements discussing developments underlying the respective decisions are reproduced in full elsewhere in this *Quarterly Bulletin.*)

With the repurchase rate stable at 8,00 per cent since mid-December 2003, the South African Overnight Interbank Average (SAONIA) rate fluctuated in a fairly narrow range between 6,86 per cent and 7,63 per cent.

Rates on forward rate agreements (FRAs) and surveys among analysts conducted by the media pointed towards expectations that the repurchase rate would be left unchanged at the April and June 2004 MPC meetings. These expectations were fulfilled. However, as far as the second half of 2004 and the year 2005 are concerned, expectations of increases in the policy rate seem to dominate, with however differing views on the timing of such increases.

Money-market interest rates



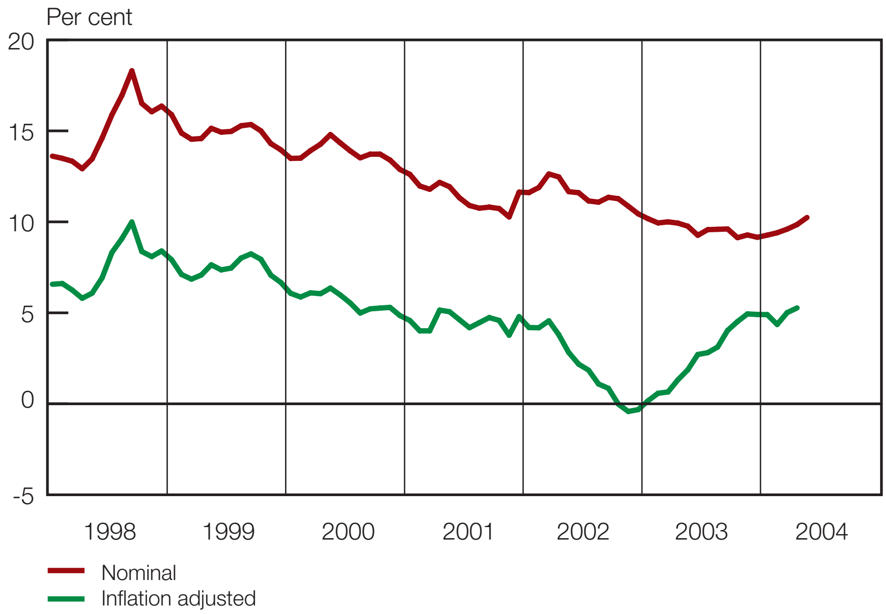
Interest rates on three-month paper maintained the upward trend which started after the less-than-expected cut in the repurchase rate in mid-December 2003. For instance, the three-month Johannesburg Interbank Agreed Rate (Jibar) gradually increased by a total of 36 basis points from 7,73 per cent on 2 January 2004 to 8,11 per cent on 11 June 2004. The rate on 91-day Treasury bills, on balance, rose very little during the first two months of 2004, probably mainly due to the increased replacement demand for liquid assets ahead of and following the maturity of major government bonds.

With the repurchase rate of the South African Reserve Bank unchanged in the first half of 2004, private-sector banks maintained their *prime lending rates* at 11½ per cent. Similarly, the private banks' *predominant rate on mortgage loans* remained unchanged at 11½ per cent since December 2003, the lowest level since February 1980. As the expectations of further reductions in short-term interest rates waned and rising money-market interest rates became more widely expected, the private banks raised the *average rate on twelve-month fixed deposits* from 6,1 per cent in December 2003 to 7,1 per cent in May 2004. In 2003 a total reduction of 590 basis points was recorded in these deposit rates.

The *monthly average yield on long-term government bonds* in the ten-to-twelve-year maturity range edged upward from 9,1 per cent in October 2003 – its lowest level since 1979 – to 9,3 per cent in November. It initially remained close to this level, reaching 9,4 per cent in February 2004 before rising more forcefully to 10,2 per cent in May. The bottoming out and upward bias in bond yields from the end of 2003 can be ascribed to the sensitivity of the bond market to, among other things

- the spill-over effect of higher bond yields in developed markets as market participants responded to signs of improving global growth;
- growing expectations of a tightening of the monetary policy stance in the second half of 2004 following indications that the downward trend in inflation has bottomed out;
- net sales of bonds by non-residents from July 2003 to January 2004, and again in April and May;
- national government's increased recourse to funding in the domestic bond market from 2003, after two years of net redemptions; and
- a sharp increase in the issuance of corporate bonds by the private sector from the second half of 2003.

Nominal and inflation-adjusted yields on long-term domestic government bonds

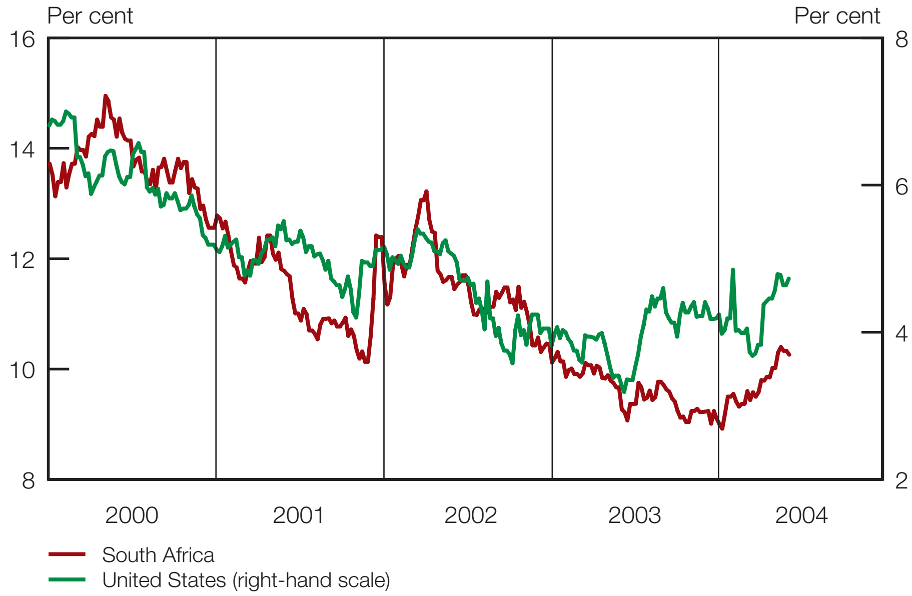


The *real* or *inflation-adjusted yield on long-term government bonds* (using historical year-on-year increases in CPIX as an indicator of expected future price changes) improved markedly from a negative value of 0,4 per cent in November 2002 to 4,9 per cent in

December 2003 as the fall in CPIX inflation exceeded the decline in long-term bond yields. Interrupted briefly by a decline in February 2004, the real yield increased to 5,3 per cent in April – its highest level since November 2000.

The decline in the *daily average yield* on long-term government bonds from 9,82 per cent on 4 September 2003 to a recent low of 8,88 per cent on 12 January 2004 *inter alia* reflected the then quite positive sentiment and benign inflation expectations in the wake of the recovery of the exchange rate of the rand. Bond yields subsequently increased sharply to 9,60 per cent at the end of January in response to a weaker exchange rate of the rand but again retreated to 9,25 per cent on 18 February when the exchange value of the rand improved. Long-term bond yields then accelerated to 10,01 per cent at the end of April and increased further to 10,21 per cent on 31 May 2004 as the market increased its focus on the risks to domestic inflation. The upward bias in global bond yields, driven by inflation concerns arising from stronger real economic activity and the higher oil price, contributed to the bearish sentiment in the domestic market.

Yields on long-term government bonds

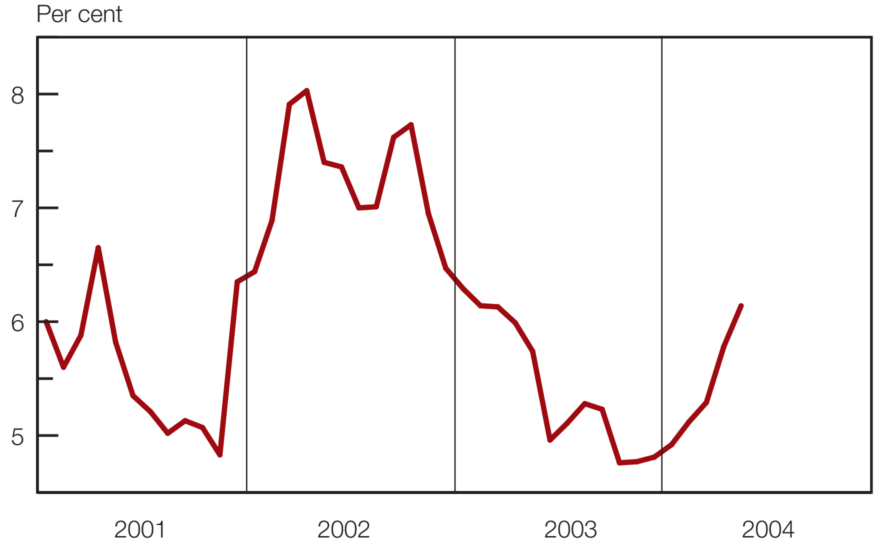


After bond yields across the maturity spectrum reached a low point on 12 January 2004 the slope of the *yield curve* steepened significantly in the months that followed. From January 2004 to the end of May yields on short-dated bonds remained anchored to the repurchase rate of the Reserve Bank, while bond yields across the rest of the maturity spectrum moved upwards in response to a steady supply of bonds and the prospect of somewhat higher inflation during the latter part of 2004. At the end of May bond yields beyond the two-year maturity interval were above the levels recorded at the end of August 2003 – when the yield curve flattened out – with a slight downward bias beyond the ten-year maturity interval.

Shifting expectations in the bond market, as reflected by the yield curve, are also evidenced by the *yield gap*, i.e. the difference between bond yields at the extreme long and short ends of the yield curve. After becoming positive on 9 September 2003 the yield gap progressively increased to 214 basis points on 3 December, before narrowing to 55 basis points on 13 February 2004. It again widened to 145 basis points on 31 May 2004.

The *break-even inflation rate* also increased noticeably. 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 five-to-nine-year maturity range. After progressively declining from a monthly average of 6,3 per cent in January 2003 to a recent low of 4,8 per cent in December, expected long-term inflation derived in this way increased sharply to 5,8 per cent in April 2004 and 6,1 per cent in May.

Break-even inflation rate



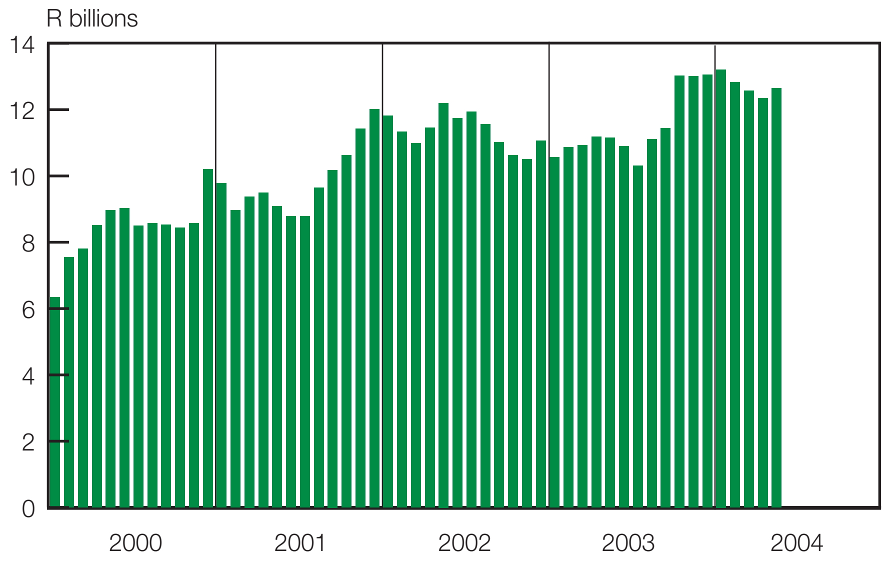
Difference between the nominal yield on conventional R153 (2010) and real yield on inflation-linked R189 (2013) bonds

The *currency risk premium* on South African government bonds (measured as the differential between yields on rand-denominated South African government bonds in the five-to-six-year maturity range issued in the domestic market and those issued in the United States market and denominated in dollar) narrowed by 128 basis points from December 2002 to October 2003. The currency risk premium then widened by 55 basis points to May 2004 as international investors reassessed their exposure to emerging-market sovereign debt. Foreign investor sentiment changed concomitant with the rise in bond yields in the United States as robust economic growth led to concerns regarding an earlier-than-expected tightening of monetary policy by the Federal Reserve.

Money market

The amount of liquidity which the Reserve Bank was ready to supply at the weekly main repurchase tender had been maintained at around R13 billion during the first five months of 2004. Allowing for instances where the banks tendered for less than R13 billion, together with other transitory events such as supplementary repurchase activity, the total average daily liquidity requirement of the private-sector banks came to R12,8 billion in February 2004 and receded further to R12,6 billion in May.

Total liquidity requirement



The Bank's operations in the money market during this period were structured and managed in such a way that liquidity always remained at levels deemed appropriate. Fluctuations in liquidity were smoothed successfully. For instance, to alleviate liquidity pressures associated with the redemption of the R006 government bond (the first tranche of the R150 bond) at the end of February 2004, the Bank allotted reverse repurchase agreements and debentures which matured concurrently with these bonds. A special roll-over auction by National Treasury towards the end of February 2004 resulted in an amount of R4,5 billion in R006 bonds being converted to R153 and R194 bonds.

Bond redemption and interest payments by national government on 28 February 2004

	Redemption	Interest
Total domestic bonds	R26,5 billion	R13,7 billion

Other important events with a bearing on money-market liquidity in the first five months of 2004 included
- the squaring off of the Reserve Bank's forward book in February, thereby removing an important source of liquidity creation or contraction;
- following this squaring off, the resumption of foreign reserve accumulation by the Bank; its foreign currency reserves rose by R12,8 billion in the three months to the end of May; and
- the repayment of lender-of-last-resort assistance that had been provided to certain banks early in 2002.

The use of various money-market intervention instruments by the Bank is reflected in the accompanying table. Apart from a notable reduction in the overall use of such instruments, there has been a shortening in the maturities of both reverse repurchase transactions in government bonds and Reserve Bank debentures utilised to drain liquidity.

Foreign exchange reserve accumulation by the Reserve Bank expands money-market liquidity. Cash received by the Bank from National Treasury upon the maturity of and coupon interest payments on major government bonds in the Bank's portfolio helped to sterilise such liquidity at the end of February 2004.

Outstanding balances of selected money-market intervention instruments

R billions

End of		Forreign-currency swaps with deposits	Reserve Bank debentures			Reverse repurchase agreements			Total instruments outstanding
			28 days	91 days	Total	28 days	91 days	Total	
2003:	Jan	45,3	3,9	3,7	7,6	6,4	4,1	10,5	62,8
	Feb	42,9	3,4	4,6	8,0	6,4	3,6	10,0	60,4
	Mar	34,9	4,7	3,2	7,9	5,8	4,5	10,3	52,8
	Apr	30,1	4,4	3,6	8,0	6,3	4,0	10,3	48,4
	May	27,3	5,2	2,8	8,0	7,0	3,3	10,3	45,6
	Jun	20,6	5,0	3,0	8,0	5,0	4,0	9,0	37,7
	Jul	17,6	2,4	5,6	8,0	0,5	9,8	10,3	36,3
	Aug	15,3	2,8	5,2	8,0	0,6	9,7	10,3	34,0
	Sep	11,0	2,6	5,1	7,8	2,1	7,6	9,7	29,1
	Oct	3,6	4,0	3,0	7,0	5,7	2,9	8,6	19,2
	Nov	0,0	3,0	3,7	6,7	5,8	2,8	8,6	15,8
	Dec	0,0	0,5	2,8	3,2	2,8	2,5	5,2	8,5
2004:	Jan	0,0	5,4	1,5	6,9	3,1	0,3	3,4	10,3
	Feb	0,0	4,4	0,7	5,1	1,8	0,0	1,8	6,9
	Mar	0,0	6,0	0,3	6,3	3,5	0,0	3,5	9,8
	Apr	0,0	4,5	0,3	4,8	6,0	0,0	6,0	10,8
	May	0,0	5,6	0,3	5,9	8,5	0,0	8,5	14,4

On 1 April 2004, the National Treasury paid the third of four instalments of R7 billion each in terms of the Gold and Foreign Exchange Reserve Account Defrayal Act (No 4 of 2003) to the Bank, as first announced in the 2002/03 Budget. The bond received from the Treasury was exchanged for marketable bonds which were used in the Bank's open-market operations.

Liquidity was also drained by the R1,6 billion increase in notes and coin in circulation outside the Bank from the end of February to the end of May 2004.

In order to shorten the average maturity of government bonds in its portfolio, the Bank has conducted seven switch auctions in government stock since 27 November 2003 with the latest switch conducted on 20 May 2004 to the value of R1 billion.

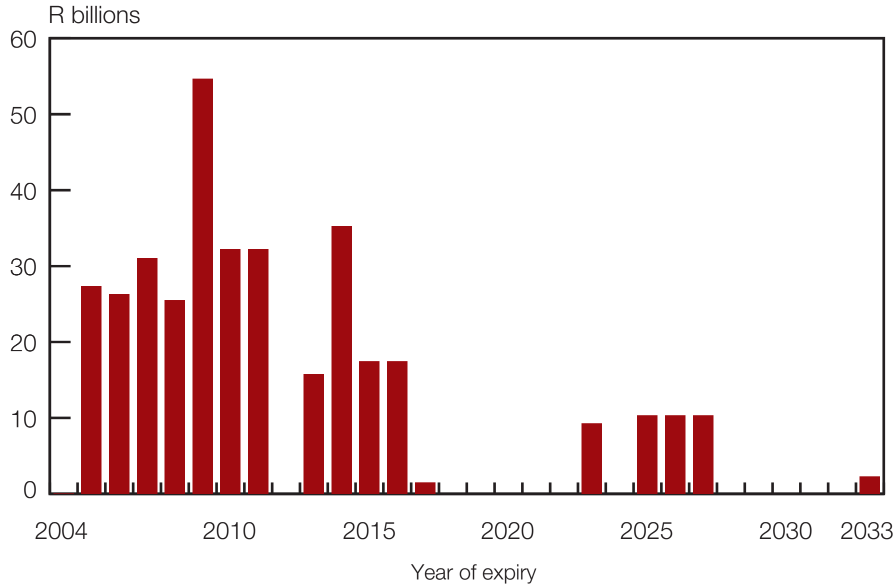
On 28 May 2004 National Treasury successfully issued a US$1 billion ten-year Global bond. The Bank purchased the foreign-currency proceeds of this transaction, which settled on 2 June when the rand equivalent was deposited into government's tax and loan accounts with the commercial banks. Its liquidity impact was neutralised through a combination of foreign-currency swap, Reserve Bank debenture and reverse repurchase transactions.

Bond market

Public-sector borrowers increased their outstanding domestic marketable bond debt in fiscal 2003/04 by R31,5 billion compared with net redemptions of R9,7 billion in the previous fiscal year. A net amount of R42,3 billion was raised in the first nine months of fiscal 2003/04, followed by net redemptions of R10,8 billion in the first quarter of 2004 which included national government's repayment of the first of three tranches of the R150 government bond on 28 February 2004. In the Budget of national government, presented to Parliament in February 2004, an amount of R34,3 billion was projected to be raised during 2004/05 through net domestic bond issues.

Thus far in the 2004/05 fiscal year the national government has funded itself through a wide spectrum of domestic bond issues, including the raising of R1,0 billion through inflation-linked bonds during April 2004. Since the introduction of inflation-linked bonds by the government in March 2000, the nominal value of the amount in issue has increased to R30 billion at the end of May 2004, comprising approximately 8,2 per cent of total outstanding marketable domestic government bonds. Currently, the four inflation-linked bonds in issue have outstanding maturities of four, nine, nineteen and twenty-nine years.

Domestic government bonds outstanding on 31 May 2004 by expiry date



National Treasury also raised R1,5 billion through the issue of a new conventional government bond, the R203 bond, maturing in 2017. This was the first of two new bond issues announced in the February 2004 Budget. The R204 bond, maturing in 2018, is still to be issued. The coupon interest on the two bonds will be paid semi-annually with the R203 carrying an 8,25 per cent coupon rate and the R204 an 8,00 per cent coupon rate. The new bonds will fall between the R157 bond (maturing in 2014/15/16) and the R186 bond (maturing in 2025/26/27). The R203 bond was well received by the market as indicated by a tendered amount of more than four times the amount offered at the initial auction on 4 May 2004.

In an effort to diversify its funding sources and simultaneously promote a savings culture among citizens, the National Treasury launched the RSA Government Retail Bonds on 24 May 2004. The two-year retail bond currently holds a fixed interest rate until maturity of 9,25 per cent, the three-year bond 9,50 per cent and the five-year bond 10,0 per cent. Interest will be paid on 31 March and 30 September, and the minimum investment amount is R1 000. National Treasury raised R50 million through the new retail bonds in May.

On 6 April 2004 the City of Johannesburg raised R1 billion by issuing a bond with a coupon rate of 11,95 per cent and maturing in 2010. This was the first municipal bond issue since 1990. The issue was oversubscribed by 50 per cent by the end of bidding, indicating that it was well received by the market. The bond is not guaranteed by the national government nor secured by city assets, and part of the funds raised will be used to finance infrastructural and capital expenditure while the bulk will be used to refinance debt. The bond adheres to the requirements of the new Municipal Finance Management Act, No 56 of 2003, which becomes effective on 1 July 2004, allowing municipalities to borrow without national or provincial government guarantees.

After raising R10,6 billion through a foreign-currency denominated debt issue in the *international bond market* during May 2003, the *national government* refrained from further foreign issues in fiscal 2003/04. In total, foreign debt was reduced by R2,4 billion in fiscal 2003/04. This included the premature repayment of a dual-currency loan on account of favourable exchange rate considerations. On 6 May 2004 National Treasury announced the mandated lead managers for its 2004/05 foreign funding, and on 25 May announced the successful issue of a 6½ per cent US$1 billion ten-year Global bond. This translated to an amount of R6,4 billion, compared with a net amount of R5,9 billion that was projected to be raised through foreign loans in the 2004/05 Budget. *Public corporations* steered clear of the international bond markets in 2003 and the first five months of 2004.

In the *European bond markets* non-resident issuer interest in rand-denominated bonds rebounded during the early months of 2004. In 2003 non-resident issuer interest waned and scheduled redemptions exceeded new issues by R2,5 billion. Net issues by non-residents in these markets rebounded to R2,4 billion in the first quarter of 2004, with non-resident interest captured by the combination of attractive nominal interest rates and the possibility of rand appreciation. Net redemptions of R0,8 billion in April were again followed by net issues of R0,5 billion in May 2004.

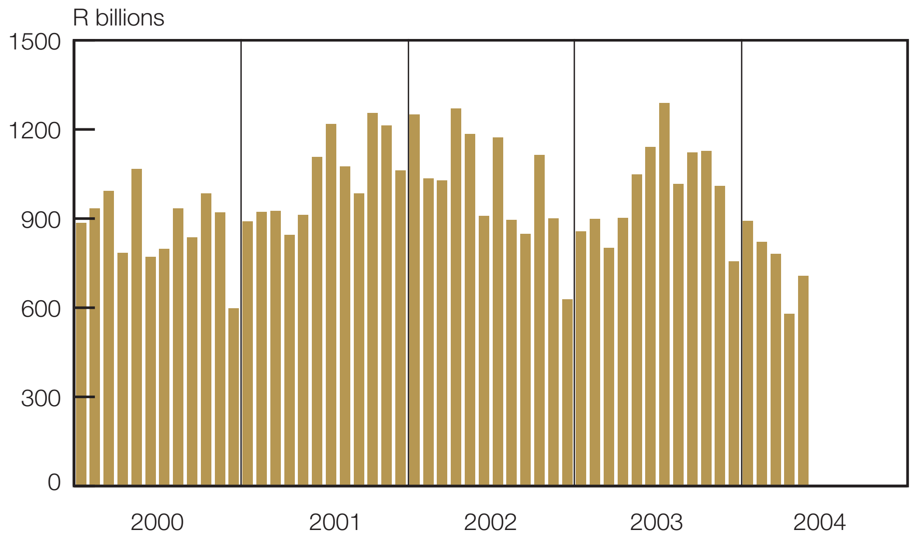
The *outstanding nominal value of private-sector loan stock* listed on the Bond Exchange of South Africa increased from R58,4 billion in December 2003 to R63,9 billion in May 2004. The increase of R5,5 billion followed an increase of R19,6 billion in 2003 which occurred mostly in the second half of that year. Investor appetite for high-yielding securities reportedly continued to support new issues.

Short-term funding through the issuance of commercial paper further supplemented private-sector corporate bond issuance. The value of *commercial paper* listed on the Bond Exchange increased by R1,4 billion in the first five months of 2004 to reach R11,2 billion in May.

Trading activity in the *domestic secondary bond market* slowed markedly from October 2003 when bond yields edged upwards. This followed brisk trade in the second and third quarter of 2003 as investor interest in especially short-dated bonds was driven by the expected and actual lowering of the repurchase rate as from June 2003. Turnover on the Bond Exchange of South Africa declined from R3,4 trillion in the third quarter of 2003 to R2,5 trillion in the first quarter of 2004 and a quarterly rate of R1,9 trillion during April and May.

Non-residents' interest in South African debt securities declined markedly from the second half of 2003. Net purchases of R2,7 billion in the first half of 2003 were followed by net sales of R10,8 billion in the second half of the year, resulting in a reduction in their holdings of debt securities of R8,1 billion in 2003 as a whole. Small net purchases of R0,1 billion in the first quarter of 2004 were followed by net sales of R4,3 billion in April and May 2004 resulting in total net sales of bonds amounting to R4,2 billion in the year to date. The recent selling of bonds occurred alongside fluctuations in the exchange value of the rand and generally weaker global demand for fixed-interest securities in the wake of expected increases in interest rates in major international financial centres.

Turnover in the secondary bond market



Share market

The total value of equity capital raised in the domestic and international *primary share markets* by companies listed on the JSE increased from a low R2,2 billion in the second quarter of 2003 to R7,4 billion in the fourth quarter, before slowing to R3,9 billion in the first quarter of 2004. Equity financing accelerated to R12,6 billion in April, mostly in the form of increased dual listings, when the Ghanaian mining company Ashanti Goldfields Company Limited merged with AngloGold Limited and with Anglo American plc acquiring the remaining 30 per cent minority interest in the European paper and packaging company Frantschach AG. In May 2004 equity financing increased further to R14,3 billion, including large rights issues by Nedcor Limited and an issue of convertible perpetual cumulative preference shares by Anglo Platinum.

By May 2004 four companies had listed on the AltX alternative exchange, launched by the JSE on 27 October 2003. The value of turnover on AltX for the first five months of 2004 amounted to R5 million compared with R6 million on the development capital board and R10 million on the venture capital board. In May shares listed on AltX offered an average earnings yield of 14,3 per cent, significantly higher than the earnings yields offered by the development and venture capital boards. AltX will ultimately replace the development and venture capital markets established by the JSE in the late eighties.

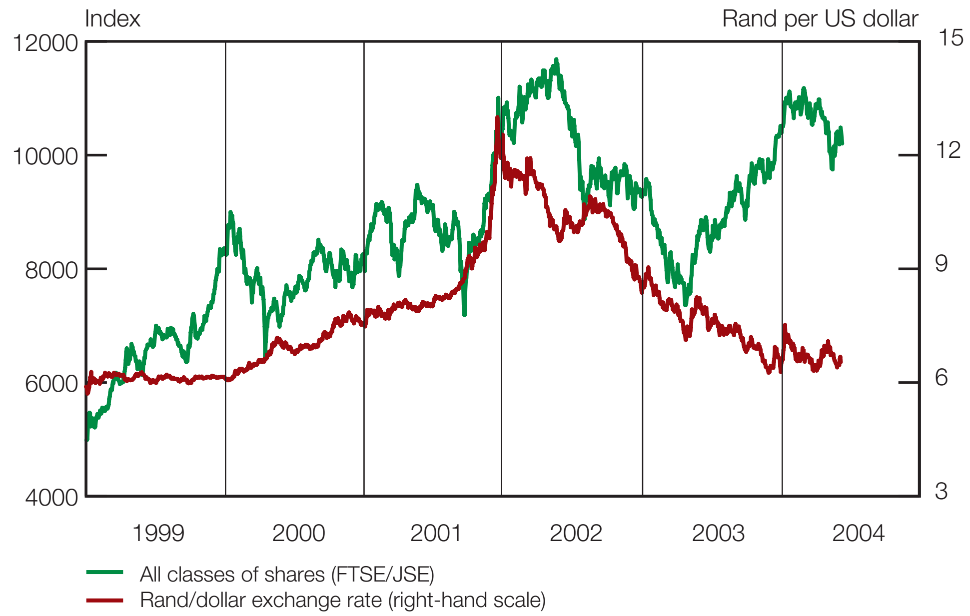
The JSE launched a number of new indices in the first five months of 2004. On 20 May the Social Responsibility Investment Index was launched, highlighting corporate social and environmental responsibility. Two new property indices were also launched on 1 June, namely the SA Listed Property Index and the Capped Property Index. Both these indices consist of the top twenty companies, by market capitalisation, in the real-estate sector of the JSE. The SA Listed Property Index consists of companies with primary listings on the JSE, while the Capped Property Index allows for companies with either primary or secondary listings.

The value of shares traded in the *secondary share market* of R752 billion in 2003 was 7 per cent less than the high turnover of R809 billion in 2002. The recovery in share prices from April 2003, however, buoyed trading activity from R176 billion in the second quarter of 2003 to a record high of R254 billion in the first quarter of 2004. Turnover subsequently decreased slightly to a quarterly rate of R246 billion in May when domestic share prices declined along with weaker world markets.

Despite the recovery in the domestic share market during 2003, *non-residents* sold shares to the value of R1,1 billion in the second half of the year. Their total net sales of R0,4 billion in 2003 were, however, far lower than the net sales of R5,6 billion recorded in 2002. Non-residents subsequently increased their holdings of South African shares by R5,0 billion in the first quarter of 2004. Further net purchases of R3,9 billion followed in April and May 2004. From the beginning of 2004 to the end of May, non-residents' net purchases of shares amounted to R8,9 billion.

The continued improvement of international share markets, high commodity prices and declining domestic interest rates contributed to the recovery in the domestic share market during 2003. The *monthly average price level of all classes of shares* listed on the JSE increased by 37 per cent from a recent low in April 2003 to February 2004. This was followed by a decline of 7 per cent from February to May, partly on account of a set-back in international commodity prices. In dollar terms, the all-share price index increased by 46 per cent from April 2003 to May 2004, supported by the appreciation of the exchange value of the rand. This may be compared with a more subdued increase of 24 per cent in the S&P 500 composite index over the same period.

Share prices and the exchange rate



The *daily closing level of the all-share price index* posted a gain of 52 per cent from a recent low on 25 April 2003 to 3 March 2004. Since then the all-share index has declined by 7 per cent to the end of May, following the downward trend of international equity markets resulting from weaker commodity prices, the sharply higher oil price and the prospect of rising international interest rates.

The monthly average price level of the *resources sector* increased by 36 per cent from April 2003 to January 2004, benefiting from the improved global economic outlook, rising commodity prices and also the depreciation of the exchange value of the rand from December 2003. Speculation that the US Federal Reserve System will raise interest rates sooner than expected and indications that China planned to take measures to curb its robust economic growth, contributed to a sharp turnaround in commodity prices. As a result the monthly average price level of resources shares declined by 17 per cent from January 2004 to May, led by a sharp fall of 28 per cent in the prices of gold-mining shares. By contrast, the monthly average price of non-gold mining shares in the metals and minerals category declined by only 11 per cent over the same period as demand for large diversified offshore listed mining companies remained strong.

During the first five months of 2004 the prices of both *financial and industrial shares* continued to increase in contrast to the declines recorded by the rest of the share market. Companies in both of these categories rely mostly on the earnings of their South African operations and have benefited from the lower interest rate environment since June 2003. The prices of financial shares increased by 5 per cent in the first five months of 2004 after they had increased by 17 per cent from April 2003 to December. Similarly, the prices of industrial shares registered an increase of 9 per cent in the first five months of 2004 following an increase of 41 per cent from April 2003 to December.

The *dividend yield* on all classes of shares receded from 4,6 per cent in April 2003, its highest level since 1990, to 2,8 per cent in February and 3,1 per cent in May 2004. The *earnings yield* on all classes of shares receded from 10,3 per cent in April 2003 to 6,7 per cent in February 2004 before increasing to 7,3 per cent in May. Conversely, the *price-earnings ratio* of all classes of shares reached 13,7 in May 2004, from a recent low of 9,7 in April 2003.

Market for derivatives

The total number of *futures and options on futures contracts* traded on the Financial Derivatives Division of the JSE increased from 7,9 million contracts in the fourth quarter of 2003 to a recent high of 10,0 million contracts in the first quarter of 2004. In April and May 2004 trade slowed to a quarterly rate of 6,7 million contracts, coinciding with the uncertainty in the underlying share market. Index and individual equity derivative products, on average, accounted for almost all of the overall trade in financial derivatives.

The number of *commodity futures contracts and options* on such contracts traded on the Agricultural Products Division of the JSE declined from a record turnover of 652 000 contracts in the first quarter of 2003 to 499 000 contracts in the third quarter, before improving to 593 000 contracts in the first quarter of 2004. Trade decreased to a quarterly rate of only 273 000 contracts in April and May 2004, influenced by improved supply prospects and a sharp decline in the spot prices of maize products from March 2004.

The number of *warrants* traded on the JSE gradually increased from a low of 1,1 billion contracts in the second quarter of 2003 to 1,6 billion contracts in the fourth quarter. Trade volumes decreased moderately to 1,5 billion contracts in the first quarter of 2004. In April and May 2004 trade at a quarterly rate came to 1,5 billion contracts. The waning of investor interest in this market, notwithstanding the steadily rising share prices, is evident from the decline in the number of listed warrants from 410 in March 2003 to 305 in May 2004.

Real-estate market

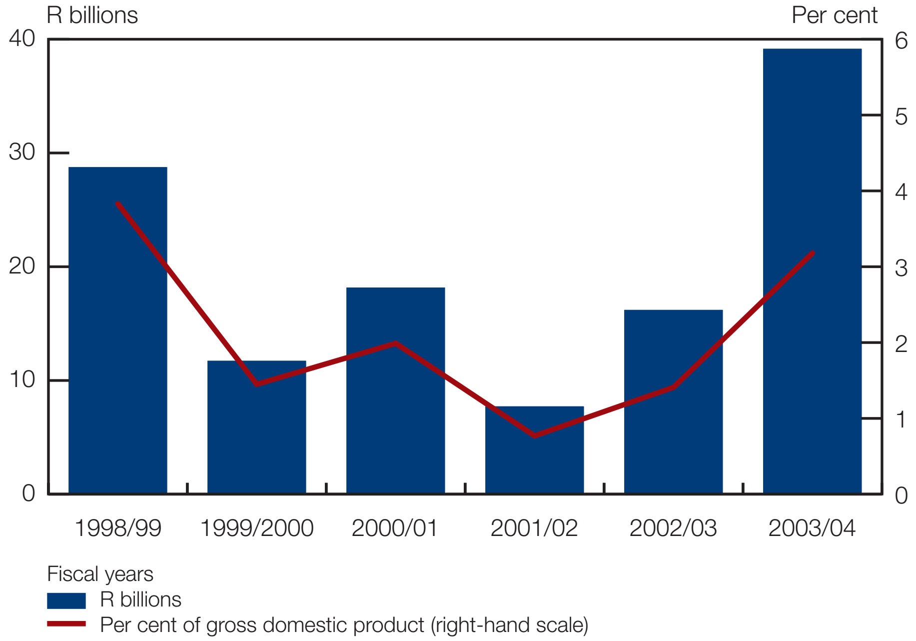
The *real-estate market* remained buoyant during 2003, aided by the prospect of and subsequent lowering of the cost of mortgage finance from June to December. The overall seasonally adjusted value of turnover, measured by *transfer duty paid*, increased sharply from an average monthly level of R320 million in the first half of 2003 to R395 million in the second half before accelerating even further to an average of R474 million in the first quarter of 2004. In 2004 the first four months' average level of transfer duty paid represented an increase of 52 per cent when compared with the same period of 2003. Simultaneously, the rate of increase in residential property prices, as measured by Absa, recorded twelve-month rates of increase of around 24 per cent in the first five months of 2004.

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 governments and the non-financial public enterprises and corporations) resulted in a cash *deficit* of R39,2 billion in fiscal 2003/04 which was R23,0 billion more than in the previous fiscal year. As a ratio of gross domestic product, the non-financial public-sector cash deficit amounted to 3,2 per cent in fiscal 2003/04 compared with 1,4 per cent in fiscal 2002/03.

Non-financial public-sector borrowing requirement

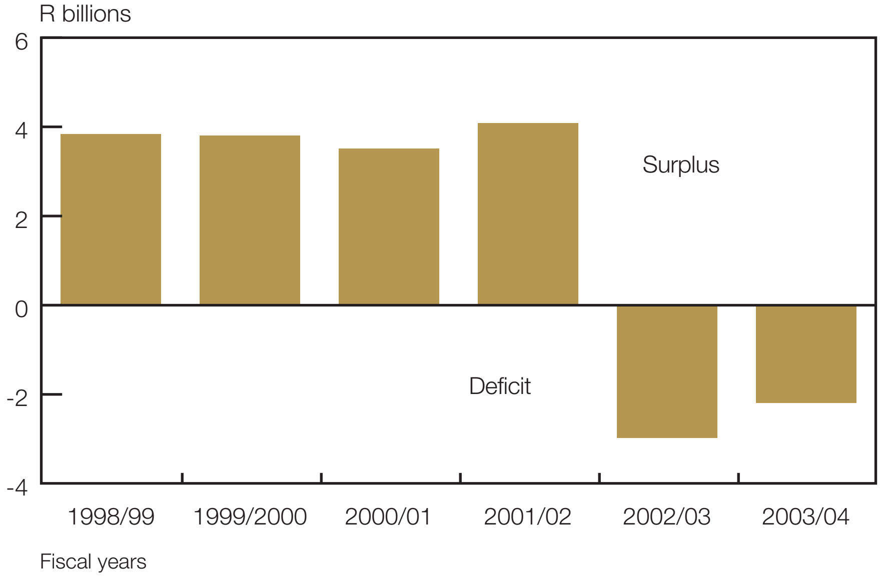


The increase in the cash deficit of the non-financial public sector can mainly be attributed to an increase in the cash deficit of *national government* from R15,1 billion in fiscal 2002/03 to R34,2 billion in fiscal 2003/04. The cash surplus of *non-financial public enterprises* declined from R5,0 billion in fiscal 2002/03 to R2,5 billion in fiscal 2003/04. Investment in non-financial assets picked up during both 2002/03 and 2003/04, due to, *inter alia,* the purchase of new aircraft by South African Airways and progress with the Coega harbour project in the Eastern Cape.

An analysis of the *Statement of revenue, expenditure and borrowing* of the *provincial governments* indicates that the provincial governments recorded a cash deficit of R5,2 billion in the January-March quarter of 2004, bringing the provincial cash deficit for the full fiscal year 2003/04 to R2,2 billion compared with a cash deficit of R3,0 billion in the previous fiscal year. Total grants received by the provincial governments from the national government – the main source of provincial governments' cash receipts – amounted to R161,5 billion during fiscal 2003/04 or 18,0 per cent more than in the preceding fiscal year. Cash payments for the operating activities of provincial governments recorded an increase of 13,3 per cent, which is consistent with government's stated objective of increasing the role of provinces in service delivery.

On a cash-flow basis investment in non-financial assets by provincial governments increased by R5,6 billion in fiscal 2003/04 to an amount of R9,6 billion, confirming the improvement in provincial spending on infrastructure.

Cash balance of provincial governments



Provincial governments' bank deposits stayed broadly unchanged at around R8,4 billion between the end of March 2003 and the end of March 2004, while their indebtedness to banks increased from R0,5 billion to R3,2 billion over the same period.

Preliminary data for local governments indicate a rising cash deficit. The estimated cash deficit of local governments amounted to R9,4 billion in fiscal 2003/04, compared with R7,6 billion in fiscal 2002/03. More capital expenditure accounted for the higher deficit; preliminary data show that capital investment in infrastructure amounted to R16,8 billion in fiscal 2003/04, R3,7 billion more than in the previous fiscal year.

Preliminary indications are that the financial position of the *extra-budgetary institutions* deteriorated in fiscal 2003/04, recording a cash surplus of R1,2 billion compared with a cash surplus of R2,3 billion in fiscal 2002/03. *Social security funds* recorded a cash surplus of R2,8 billion in fiscal 2003/04 compared with a cash surplus of R2,1 billion in fiscal 2002/03.

National government finance

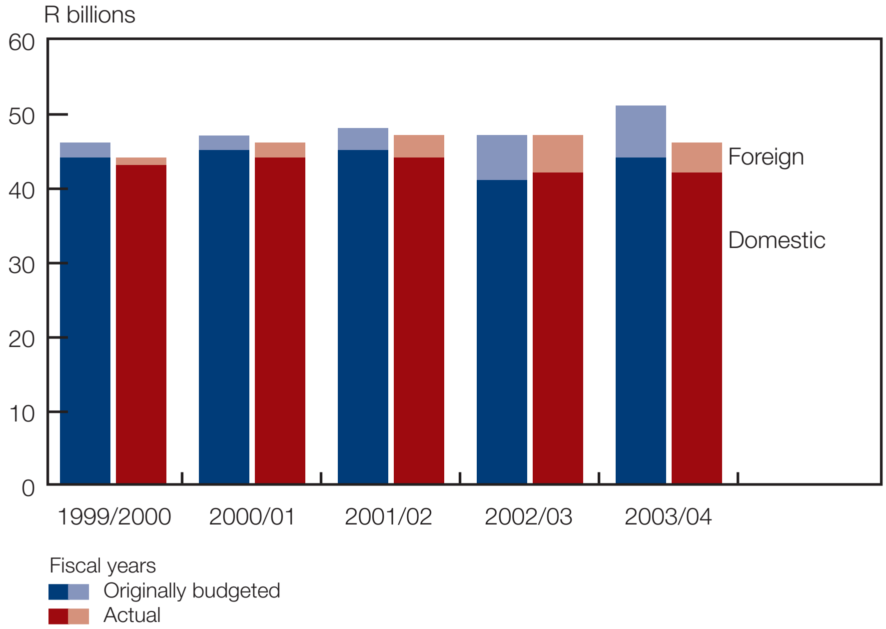
Unaudited data show that national government expenditure in fiscal 2003/04 amounted to R329,0 billion – R4,9 billion less than the originally budgeted provision and R2,7 billion less than the revised estimate presented to Parliament by the Minister of Finance in February 2004. Although this resulted in a year-on-year rate of increase in national government expenditure of 12,9 per cent in fiscal 2003/04, which was less than the original budget target of 14,6 per cent, it still represented a real increase of 7,3 per cent.

The year-on-year rate of increase in national government expenditure in fiscal 2003/04 was higher than the increase of 10,9 per cent recorded in the previous fiscal year and also exceeded the average year-on-year rate of increase of 8,2 per cent in the preceding five fiscal years.

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), national government's cash expenditure amounted to R327,7 billion in fiscal 2003/04, which was 13,2 per cent higher than in the previous fiscal year.

Interest paid on national government debt was well-contained and in fact *decreased* by 1,1 per cent to R46,1 billion in fiscal 2003/04. Interest payments were originally budgeted to increase at a rate of 8,9 per cent in fiscal 2003/04. 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 2003/04 interest payments as a ratio of gross domestic product amounted to 3,7 per cent, compared with 4,1 per cent in fiscal 2002/03. Such a low ratio had previously been recorded in fiscal 1990/91. For the period under review, interest paid on domestic government debt rose slightly – by 1 per cent – from the previous fiscal year, while interest paid on foreign government debt decreased by 18,4 per cent during fiscal 2003/04 from the previous fiscal year. This decrease could partly be attributed to the strengthening of the domestic currency, but also to the early redemption of some foreign liabilities.

National government interest payments

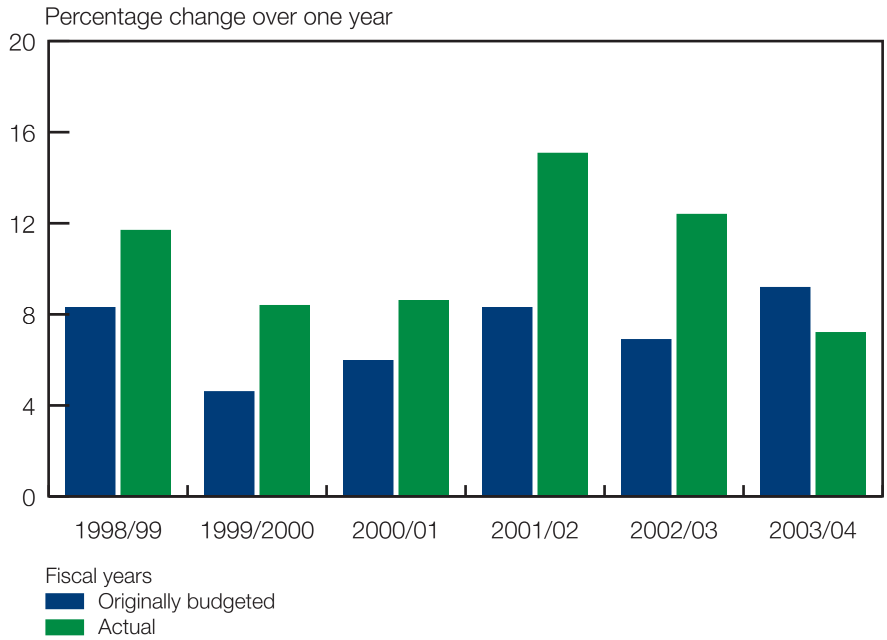


National government transferred R144,7 billion, equivalent to 44,0 per cent of its total expenditure, to provincial governments as their equitable share of nationally raised revenue. Capital expenditure amounted to R20,4 billion, or only 6,2 per cent of national government spending in fiscal 2003/04. This represented an increase of 7,4 per cent from the previous fiscal year, compared with an increase of 23,6 per cent recorded in fiscal 2002/03. This rate of increase was much lower than the rate of increase of 19,5 per cent originally envisaged in the Budget for fiscal 2003/04.

National government expenditure as a ratio of gross domestic product amounted to 26,7 per cent in fiscal 2003/04, higher than the 25,4 per cent recorded in the preceding fiscal year.

The *Statement of national government revenue, expenditure and borrowing* indicates that unaudited national government revenue increased by 7,2 per cent to amount to R298,9 billion in fiscal 2003/04 – R5,6 billion less than the original budget estimate and R1,4 billion less than the revised estimate of R300,3 billion presented to Parliament in February 2004. This rate of increase was much lower than the rate of increase of 9,2 per cent originally envisaged in the Budget for fiscal 2003/04 and also fell slightly short of the revised increase of 7,7 per cent printed in the *Budget Review 2004.* It also fell well below the rate of increase of 12,4 per cent recorded in the previous fiscal year, and below the average year-on-year rate of increase of 11,2 per cent in the preceding five fiscal years.

Revenue of national government



National government's cash revenue (revenue adjusted for timing differences between the recording of transactions and bank clearances) amounted to R299,2 billion, representing an increase of 7,4 per cent in fiscal 2003/04 compared with the previous fiscal year.

National government revenue in fiscal 2003/04

Revenue source	R billions Originally budgeted	R billions Actual	Percentage change*
Taxes on income and profits	177,9	170,6	3,7
Payroll taxes	3,6	3,9	17,4
Taxes on property	5,9	6,7	31,1
Domestic taxes on goods and services	109,6	109,9	12,7
Taxes on international trade and transactions	11,3	8,5	-11,1
Other revenue**	5,9	8,9	28,1
Less: SACU*** payments	9,7	9,7	17,7
Total revenue	304,5	298,9	7,2

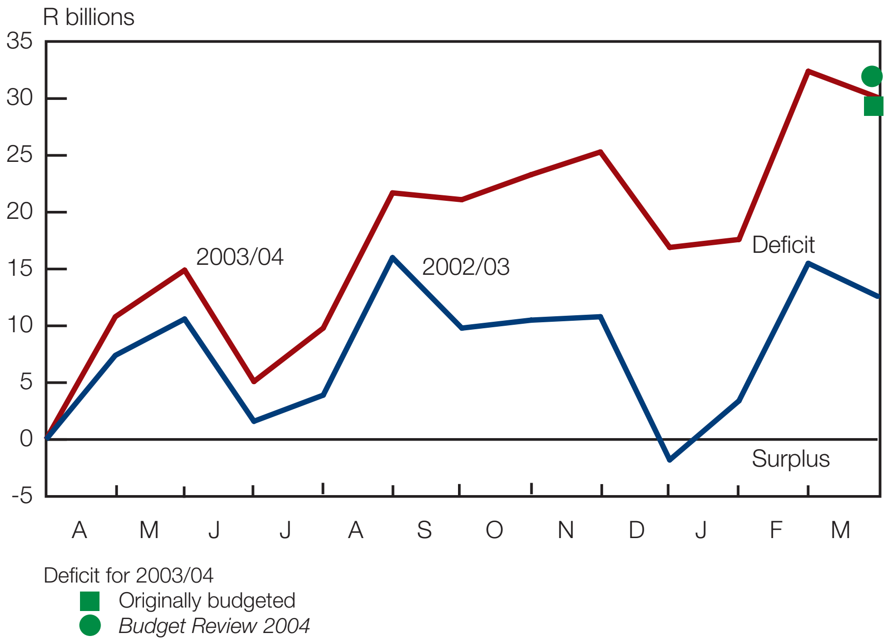
* Fiscal 2002/03 to fiscal 2003/04
** High values are partly due to the inclusion of an amount of R1,4 billion of unallocated revenue which is currently not allocated to a specific revenue source
*** Southern African Customs Union

As shown in the table on the previous page, the lower rate of increase in national government revenue was primarily due to the under-performance of taxes on income and profits, especially by companies, and of taxes on international trade and transactions. This was partially related to the continued strengthening of the rand in 2003, which resulted in less revenue than expected from corporate income tax and customs duties. As companies in the manufacturing and mining sector were affected by the recovery of the rand and weak foreign demand, their profit margins were eroded and their tax payments therefore reduced. The buoyancy in the property market as a result of lower interest rate levels, coupled with real increases in remuneration and real tax relief for individuals in the past few years, resulted in a higher rate of increase in taxes on property than originally projected.

National government revenue as a ratio of gross domestic product amounted to 24,3 per cent in fiscal 2003/04, identical to the ratio recorded in the previous fiscal year.

The net result of revenue and expenditure was an unaudited national government deficit before borrowing and debt repayment of R30,1 billion in fiscal 2003/04. This deficit was higher than the originally budgeted deficit of R29,5 billion, but lower than the revised estimate of R31,4 billion presented to Parliament in February 2004. The national government deficit before borrowing and debt repayment as a ratio of gross domestic product amounted to 2,4 per cent in fiscal 2003/04 compared with a ratio of 1,1 per cent in the previous fiscal year. The originally budgeted deficit relative to gross domestic product was also estimated at 2,4 per cent.

Cumulative balance of national government



The *primary balance* (i.e. the deficit recalculated by excluding interest payments from total expenditure) reached a surplus of 1,3 per cent of gross domestic product in fiscal 2003/04, lower than the 3,0 per cent recorded in the previous fiscal year.

The cash deficit for fiscal 2003/04 amounted to R28,4 billion compared with a cash deficit of R10,6 billion in the previous fiscal year. In addition to financing this deficit, national government paid a premium on debt restructuring to the amount of R0,2 billion. National government also paid an amount of R7,0 billion in zero-coupon bonds to the South African Reserve Bank as partial settlement of the outstanding balance on the Gold and Foreign Exchange Contingency Reserve Account. These bonds were converted into interest-bearing R194 bonds in October 2003. Government also made a profit of R3,5 billion on the revaluation of foreign loans at redemption in fiscal 2003/04.

Proceeds from the restructuring of state-owned entities were originally projected to amount to R5,0 billion in 2003/04 but eventually amounted to only R9 million, primarily emanating from overflows from Telkom's Initial Public Offering in 2002/03.

The greater part of the borrowing requirement of national government in fiscal 2003/04 was financed through the issuance of bonds in the domestic capital market, as indicated in the accompanying table. Domestic long-term funding in the full fiscal year 2003/04 was obtained at an average rate of 9,9 per cent per annum. Domestic short-term instruments were sold at an average rate of 9,6 per cent per annum. These yields can be compared with the budget assumptions of 10,2 per cent and 12,1 per cent, respectively. Net redemptions of foreign loans during fiscal 2003/04 amounted to R2,5 billion.

National government financing in fiscal 2003/04

R billions

Instrument	Originally budgeted	Actual
Deficit	**29,5**	**28,4***
Plus: Extraordinary payments	7,0	7,4
Cost/profit on revaluation of foreign loans at redemption **	1,8	-3,5
Less: Extraordinary receipts	6,3	0,0
Net borrowing requirement	**32,0**	**32,3**
Treasury bills	6,0	6,7
Domestic government bonds	9,3	31,0
Foreign loans	13,6	-2,5
Change in available cash balances ***	3,1	-2,9
Total net financing	**32,0**	**32,3**

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

Net foreign funding included amounts drawn on the export credit facility which had been arranged for the financing of the Strategic Defence Procurement Programme to the amount of R3,8 billion, a euro global benchmark bond which yielded R10,6 billion and redemptions of a euro-denominated Deutsche Mark bond and a syndicated dual currency loan in January 2004.

The average maturity of national government's domestic marketable bonds decreased from 101 months at the end of March 2003 to 98 months at the end of March 2004. The average maturity of the foreign marketable debt of national government also decreased from 81 months at the end of March 2003 to 79 months at the end of March 2004.

The financial activities of national government resulted in an increase in government's bank balances from R9,7 billion at the end of March 2003 to R12,7 billion at the end of March 2004.

The net borrowing requirement of national government, together with the discount on new government bonds issued, led to an increase in the total loan debt of national government from R426,1 billion at the end of March 2003 to R455,1 billion at the end of March 2004. The appreciation in the exchange rate of the rand and the net redemption of foreign loans during fiscal 2003/04 have led to a decrease in the share of foreign loans in the total loan debt from 17,4 per cent at the end of March 2003, to 14,2 per cent at the end of March 2004. Helped by foreign loan revaluation profits during 2003/04, total loan debt decreased from 37,1 per cent of gross domestic product at the end of March 2003 to 36,9 per cent at the end of March 2004.

It was also announced that the unaudited balance on the Gold and Foreign Exchange Contingency Reserve Account amounted to R18,0 billion on 31 March 2004 compared with R36,6 billion a year earlier. The reduction was due to the net profits of R11,6 billion on this account which were realised in the 2003/04 fiscal year, and the R7,0 billion repayment made to the SA Reserve Bank. These transactions brought the total debt of national government to R473,0 billion at the end of March 2004 compared with R462,6 billion at the end of March 2003. As a ratio of gross domestic product, total national government debt decreased from 40,2 per cent at the end of March 2003 to 38,4 per cent at the end of March 2004.

It was announced in the Budget for fiscal 2004/05 that National Treasury would introduce new securities for the retail savings market during the first quarter of the 2004/05 fiscal year. National Treasury started issuing such bonds on 24 May 2004 as discussed above in the “Bond market” section of this *Review*.

Statement of the Monetary Policy Committee

22 April 2004

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 the first two months of 2004 the rate of CPIX inflation has risen moderately but remains well within the target range of 3-6 per cent. This increase in the inflation rate was nevertheless slightly less than the forecast of the Reserve Bank. The Reserve Bank's projections for the inflation rate in the first two months of the year were higher than the actual figures. These results are therefore still within our projections indicating that the rate of inflation is likely to remain in the inflation target range over the next two years.

The inflation outcome

The twelve-month rate of increase in the consumer price index for metropolitan and other urban areas excluding the interest cost of mortgage bonds (the CPIX) rose from 4,0 per cent in December 2003 to 4,2 per cent in January and 4,8 per cent in February 2004. If energy and food prices are excluded, the year-on-year rate of increase in the prices of other goods and services included in the CPIX has fluctuated around a level of about 5,7 per cent over the four months up to February 2004.

The higher level of CPIX inflation excluding energy and food prices was due to continued high increases in the prices of services. The twelve-month rate of increase in the prices of services included in the CPIX measured around 8 per cent during the first two months of 2004. In particular, high rates of increase were recorded in the rent of fixed property, medical costs and educational fees and the wages of domestic workers were adjusted upwards by the Minister of Labour's determination. The consumer prices of goods on a year-on-year basis rose from 2,0 per cent in December 2003 to 3,0 per cent in February 2004 largely due to increases in the running cost of motor vehicles.

Measured from month to month and adjusted for seasonal factors, CPIX inflation rose from low rates of increase in the last three months of 2003, to levels of 1,0 per cent in January 2004 and 0,8 per cent in February. These monthly rates were the result of increases in the prices of petrol and diesel, food, alcoholic drinks and medical expenses. The prices of goods and services for most other categories continued to decline in the first two months of 2004.

The inflation outlook

Despite these increases in the CPIX, the inflation outlook over the coming months as well as over the longer term continues to be favourable. Recent developments in the production price index, which affect the CPIX with a short lag, should continue to restrain consumer price inflation over the short term. From the second half of 2003, the all-goods production price index has generally declined from month to month. The seasonally adjusted percentage change over one month in the production price index in January 2004 was again negative, followed by an increase of 0,1 per cent in February. Measured over a period of twelve months, the all-goods production price index has declined in every month since September 2003, but the rate of decline has moderated somewhat from 2,5 per cent in November 2003 to 1,0 per cent in February 2004.

This decline in production price inflation can mainly be ascribed to the recovery in the external value of the rand. The year-on-year change in the prices of imported goods became negative in April 2003, and in February 2004 this rate of decline amounted to 8,0 per cent. The decline in the prices of imported goods affected the inflation in domestically produced goods, which slowed down considerably during the course of 2003. The twelve-month rate of increase in the prices of domestically produced goods picked up somewhat from 0,2 per cent in November 2003 to 1,6 per cent in January 2004.

These developments clearly indicate that production prices should exert hardly any pressure on consumer prices over the short term. The expected developments in the CPIX over the coming months will mainly be related to exogenous developments, such as changes in energy prices, indirect taxes and food. As the second-round effects of these increases are expected to be small and because a number of other factors are still favouring low increases in prices, the long-term inflation outlook is still promising.

The expected acceleration in global economic growth noted in previous statements of the Monetary Policy Committee, has now been confirmed by recent international statistical releases. In the USA, the UK, Japan, China and other countries in Asia, economic growth was quite strong in the second half of 2003. A moderate economic recovery also became discernible in the production figures of the euro area. The growth in the world economy has been accompanied by a steep increase in international commodity prices. Despite this rise in commodity prices, world inflation has remained at low levels and is expected to remain so for the rest of 2004.

Some pressure has been exerted on domestic prices by the increase in oil prices in 2004 due to output restrictions by OPEC, political tensions in the Middle East and Venezuela, and concerns about oil stocks in the United States. Although this may give rise to short-term increases in consumer prices, oil prices should, however, not be a major threat to inflation over the long term because oil demand and supply are expected to be more or less in balance.

Domestically, most conditions seem to endorse the containment of inflation within the target range. Domestic demand conditions are not at present a source of inflationary pressure, with the growth in real gross domestic product at an annualised rate of 1½ per cent in the fourth quarter of 2003 being well below the growth potential of the economy. This is confirmed by the ample spare capacity in manufacturing where the utilisation of production capacity amounted to 79,6 per cent in the fourth quarter of 2003. It is particularly noteworthy that inflation expectations have continued to decline as evidenced in the latest Bureau for Economic Research (Stellenbosch University) inflation expectations survey, commissioned by the South African Reserve Bank, published today.

The widespread rains in the first three months of 2004 have improved the agricultural outlook considerably. Most crop estimates have been revised upwards and shortages of agricultural produce should not have a serious impact on food prices. This is also reflected in the recent decline in the maize price. Over the short term, the improved weather conditions could lead to higher meat prices as farmers will now probably be inclined to build up their herds of livestock.

Another important factor that should contribute to price stability is the continued fiscal discipline applied by government. The fiscal policy announced in the Budget for the fiscal year 2004/05 is being pursued in a prudent manner which should not place pressure on domestic prices.

As with any prognosis about likely future developments, there are a number of uncertainties that could impact on this outlook and which the MPC will continue to monitor closely. Strong domestic demand has had a big impact on the volume of imports, which rose sharply in the second half of 2003. Over this same period exports did not perform well. Fortunately, these developments were offset to some extent by a substantial improvement in South Africa's terms of trade, reflecting the increases in international commodity prices. The deficit on the current account of the balance of payments nevertheless amounted to 1,8 per cent of gross domestic product in the fourth quarter of 2003. Trade statistics for the first two months of 2004 indicate that the current-account deficit probably increased further over these two months. The surplus on the trade account of the balance of payments declined from a seasonally adjusted annualised level of R14,3 billion in the fourth quarter of 2003 to R7,6 billion in the first two months of 2004.

The deficits on the current account of the balance of payments have been comfortably financed by inflows of capital. Moreover, the rand has demonstrated greater stability in recent months with the nominal effective exchange rate of the rand currently at around the same level that it was at in the latter part of 2003. It is impossible to predict what the external value of the rand will be over the coming months, but a widening in the deficit on current account does increase the risk of accelerating inflation.

A further factor when considering the inflation outlook is the continued strong growth in nominal unit labour cost. Although the rate of increase in these costs has declined from 6 per cent in 2002 to 5 per cent in 2003, the salaries and wages per worker still increased at a rate of 8,6 per cent in 2003.

The recent growth in money supply may also be an early indicator of potential inflationary pressures in the longer term. Measured over twelve months, growth in M3 remained around 12 per cent from September 2003 to January 2004 and then accelerated to just above 15 per cent in February. This latest month's increase in M3 was to a large extent due to a decline in government deposits reflecting the redemption and coupon interest payments on government bonds.

The increase in money supply growth was not accompanied by an acceleration in bank credit extension to the private sector. The twelve-month growth rate in total loans and advances of banks to the private sector remained stable at levels of around 12,5 per cent in the first two months of 2004, i.e. at about the same rate as during the last half of 2003.

The process of adjustment of global economic imbalances, and the risk of continuing geopolitical tensions, could be a source of increased international instability which could impede the present recovery in the world economy and pose threats to low inflation and growth in emerging-market economies. In the short term, a particular concern in this context is the risk of pressure on domestic fuel costs arising from the prevailing higher oil prices.

Monetary policy stance

Taking these factors into consideration, the central expectation of the Monetary Policy Committee is that CPIX inflation will remain within the target range during the forecast period while the economy should pick up momentum. This momentum could be greatly assisted by appropriate sustainable supply-side measures. Accordingly the Monetary Policy Committee has decided to maintain the current monetary policy stance and keep the repo rate unchanged at 8,0 per cent per annum. The Monetary Policy Committee will continue to monitor all the factors affecting the inflation outlook. If the outlook changes, the Committee will not hesitate to change the monetary policy stance.

Statement of the Monetary Policy Committee

10 June 2004

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 CPIX inflation has remained well within the target range of 3 – 6 per cent for the past eight months, i.e. from September 2003 to April 2004, despite increases in international oil prices. In general most factors favour a continuation of inflation within this range and inflation expectations have generally improved. Recent evidence indicates that there has been an acceleration in economic growth. South Africa has now experienced eighteen (18) consecutive quarters of economic expansion, this being the longest upward phase of the business cycle on record.

The inflation outcome

The twelve-month rate of increase in the consumer price index for metropolitan and other urban areas excluding the interest cost of mortgage bonds (the CPIX) decreased from 11,3 per cent in October and November 2002 to 4,4 per cent in both March and April 2004. Although these latest rates of inflation are marginally above the year-on-year rate of 4,0 per cent in December 2003, they have remained well within the inflation target range.

The rates of increase over twelve months in the prices of consumer goods have been below the lower limit of the inflation target range since October 2003 and amounted to 2,6 per cent in April 2004. By contrast, prices of consumer services continued to increase at year-on-year rates of around 8 per cent over this same period and only recently came down to 7,6 per cent in April 2004. Increases in administered prices were mainly responsible for the continued high increases in the prices of services.

Measured from quarter to quarter and adjusted for seasonal factors, CPIX inflation accelerated from an annualised rate of 1,1 per cent in the fourth quarter of 2003 to 7,2 per cent in the first quarter of 2004. Seasonally adjusted and annualised, the month-to-month increase in the CPIX amounted to 5,8 per cent in April. These higher rates could mainly be attributed to increases in the prices of petrol, alcoholic beverages and tobacco, and were related to increases in international oil prices and excise duties.

In addition to the monetary and fiscal discipline applied by the authorities, the steadier performance of the exchange rate of the rand has continued to contribute to the maintenance of price stability. Improved agricultural conditions from the beginning of 2004 also assisted in moderating consumer food price increases.

However, the prices of fresh meat started to rise rapidly in the first four months of 2004. Together with increases in the rates charged for electricity, gas and water and international oil prices, this contributed to a reversal in the rate of decline in the all-goods production price index. While production prices continued to decrease in the first four months of 2004, the year-on-year rate of decline slowed down from 2,5 per cent in November 2003 to 0,2 per cent in April 2004. This was mainly due to an increase in the year-on-year change in prices of domestically produced goods from 0,2 per cent to 2,1 per cent over the same period. However, the prices of imported goods declined further at relatively high rates in the first four months of 2004.

The inflation outlook

In the short run, developments in international oil prices, through their impact on domestic fuel costs, are likely to be a source of supply-side upwards pressure on inflation. The monthly average spot price of Brent crude oil increased from US$25,0 per barrel in April 2003 to US$37,5 per barrel in May 2004 and on some days exceeded US$40 per barrel. Geopolitical uncertainties together with a strong growth in demand, a curtailment of production and the build-up of strategic stocks were mainly responsible for this price behaviour. Over the short term, the announced intention to increase oil production of OPEC countries in July and August 2004, should hopefully help to reduce prices below recent peak levels. But it is unclear whether prices will fall back fully to the OPEC target band. Over the medium to longer term, oil demand and supply are expected to be more or less in balance which could lead to a correction in international prices.

Against this background and taking all other factors into account, it is possible that year-on-year rates of increase in the CPIX could temporarily breach the upper level of the target band towards the end of 2004 and the early part of 2005. Any such breach is expected to be short-lived, with the likelihood that CPIX inflation will return to within the range shortly thereafter.

Looking further ahead, the inflation outlook generally remains favourable and inflation expectations also support this view.

Despite a sharp rise in international commodity prices, world inflation is expected to remain at low levels. The International Monetary Fund forecasts that the annual percentage change in global consumer prices will decline from 3,7 per cent in 2003 to 3,2 per cent in 2005. This lower inflation is forecast within an environment of continued world economic growth notwithstanding current higher international oil prices.

The rate of increase in domestic production picked up in the first quarter of 2004. Faster growth in output is likely to be sustained throughout this year and 2005 given the strength of domestic demand. For the moment, domestic producers still have considerable excess production capacity, so that at present pressures arising from supply constraints do not appear to be having a marked effect on domestic production price increases. Moreover, the growth rate of total real gross domestic fixed capital formation amounted to 8½ per cent in 2003 and preliminary information indicates that it continued to grow at a high rate in the first quarter of 2004.

Although government in its latest Budget projected the public-sector borrowing requirement as a ratio of gross domestic product to rise somewhat from 2,8 per cent in fiscal 2003/04 to 3,2 per cent in fiscal 2004/05, the budget proposals also indicated that this is intended to be a temporary phenomenon. It is envisaged that this ratio will decline again to 2,7 per cent in fiscal 2006/07, clearly demonstrating the determination of the government to preserve fiscal discipline. Recent announcements by the government indicate a greater determination to take active steps to moderate administered price increases within the context of inflation targeting.

With the exception of meat and deciduous fruit prices, the outlook for most other food prices generally seems to be favourable. Paradoxically, meat prices usually rise with improved agricultural conditions when farmers postpone the marketing of livestock. The prices of deciduous fruit will probably be affected by the current low rainfall in the Western Cape. Favourable agricultural conditions in the rest of the country should help to contain increases in other food prices.

Domestic final demand continued to increase substantially in the first quarter of 2004 as substantiated by indicators such as retail sales, the sales of motor vehicles and credit extension to households. The impact of the increase in domestic expenditure on South Africa's trade balance was moderated somewhat by the acceleration in the growth of domestic production. As a result, the deficit on the current account of the balance of payments is likely to be smaller than was the case in the fourth quarter of 2003.

Preliminary estimates suggest that this deficit was more than fully financed by a surplus on the financial account, including unrecorded transactions. These transactions enabled the Reserve Bank to increase its gross international reserves further from US$8,2 billion at the end of December 2003 to US$10,0 billion at the end of March 2004. At the end of May 2004 these reserves stood at about US$10,5 billion. In view of these developments the external value of the rand has been more stable in the first five months of 2004 than in the preceding three years.

Growth in money supply and total loans and advances of banks remains fairly brisk while the income velocity of circulation was at a historically low level of 1,6 in the first quarter of 2004. The twelve-month growth rate in the broadly defined M3 increased from 12,3 per cent in December 2003 to 14,9 per cent in February 2004, before coming down to 12,4 per cent in April. Twelve-month growth in total loans and advances of around 12 per cent was recorded from April 2003 to March 2004. In April this growth receded to 9,9 per cent, mainly on account of high base effects.

The increase in the average nominal remuneration per worker amounted to 8,6 per cent in 2003 and wage settlements in collective bargaining agreements are predicted to average between 7½ and 8½ per cent for 2004. Although this indicates a declining trend when compared with the year-to-year rate of increase in labour remuneration per worker of about 9½ per cent in 2002, it is still considerably in excess of productivity increases. Nominal unit labour cost accordingly continued to increase at high rates. Particularly disconcerting is the fact that nominal unit labour cost in manufacturing enterprises rose by as much as 11,2 per cent in 2003. This could give rise to inflationary pressures in domestic production prices.

Monetary policy stance

Taking the above-mentioned factors into consideration, in particular the risks to the inflation outlook, together with further increases in domestic demand, the Monetary Policy Committee has nevertheless decided to maintain the current monetary policy stance and keep the repo rate unchanged at 8,0 per cent per annum. The Monetary Policy Committee will continue to monitor all the risk factors to the inflation outlook. If the outlook changes, the Committee will review its stance.

Note on the funding structure of non-financial companies, 1990 – 2003

by Z B Jansen

Introduction

Companies are responsible for generating the major share of output in South Africa, thereby exercising a strong demand for financial resources. The quantity and composition of such financing should ideally be studied within the accounting framework recommended by the *System of National Accounts* 1993 (SNA 93), which provides guidelines for the compilation of consolidated balance sheets for the household sector, the financial and non-financial corporate sector, and the general government.

Although complete balance sheets for these institutional sectors are not currently available in South Africa, it is possible, by making use of selected data sources, to construct an approximation of some key components of the balance sheet for the corporate sector. This note briefly examines some developments in corporate debt financing and other sources of finance during the 1990s and the early years of the new millennium.

The main types of finance that companies may avail themselves of as well as the advantages usually associated with debt financing are summarised in the following section. Thereafter developments in the composition of the funding structure of industrial companies listed on the JSE Securities Exchange SA (JSE) are presented. Special attention is devoted to debt financing. This is followed by a brief analysis of the corporate sector's preference for debt financing, while some concluding comments are presented in the final section.

The main types of financing and advantages of debt

The corporate sector essentially utilises three main types of finance. These are share capital, retained income or reserves, and debt. Collectively, share capital and reserves are referred to as equity. Retained income may be regarded as the near-equivalent of accumulated corporate saving and is an internally generated source of finance. Equity funding is provided by shareholders who expect some return on their investment. This return may either be in the form of dividends paid to shareholders or in the form of internal growth generated by the income retained or saved. Compensation for debt utilisation is typically in the form of interest payments to creditors. The rewards for the provision of finance entail a cost to companies, and the mix of the main types of finance utilised is strongly influenced by availability and relative cost considerations.

Utilising additional debt may, in certain circumstances, improve profitability and returns to shareholders. In essence, productive assets may be acquired through mobilising debt capital, thereby raising the earnings capacity of a firm. This process is generally referred to as leveraging. As long as assets are employed productively, leveraging contributes to the attainment of higher returns on equity. Leveraging, however, is a constrained process. Profitability cannot be raised indefinitely by increasing the debt-to-equity ratio. The debt-to-equity ratio is a reflection of the portion of a firm's funding needs that is satisfied by raising interest-bearing debt. Debt financing has a relative advantage over equity financing that stems from the deductibility of interest payments for purposes of calculating taxable income. Thus, for a specific configuration of interest rates and tax rates, an optimal combination of debt and equity financing can be determined (Bevan and Danbolt, 2002:159).

Changes in the composition of the funding structure of non-financial companies

McGregor BFA developed an information system containing standardised financial information about companies listed on the JSE. Most non-financial companies are classified together under the heading “industrial companies”, encompassing companies in the manufacturing, construction, retail-trade and telecommunications subsectors of the economy. The comprehensiveness of this dataset makes the information adequately representative of the characteristics of the entire non-financial corporate sector of the South African economy and is useful for analysing changes over time in capital structures.

The funding structure of industrial companies for the period 1990 – 2003 is summarised in Table 1. The various sources of funding are expressed as percentages of total funding. Some developments in the more important liability components are highlighted in the paragraphs below.

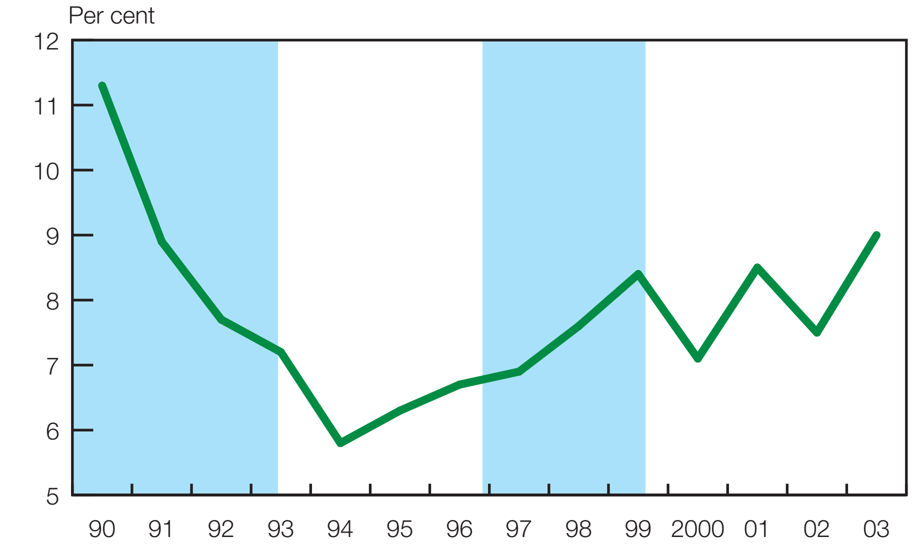
Table 1 The funding structure of industrial companies listed on the JSE Securities Exchange SA as a percentage of total funding

Year	Ordinary share capital	Non-distributable reserves	Distributable reserves	Other equity*	Interest-bearing debt	Trade creditors	Other current liabilities	Total
1990	4,4	15,0	24,1	10,7	19,1	22,1	4,6	100
1991	4,2	12,6	27,4	10,0	20,2	21,7	3,9	100
1992	3,8	14,4	24,7	11,0	20,9	21,6	3,6	100
1993	3,5	14,3	25,1	10,9	20,8	21,8	3,6	100
1994	3,6	15,9	25,5	8,1	20,7	22,5	3,7	100
1995	3,4	16,8	24,6	8,5	19,8	23,4	3,5	100
1996	3,1	17,9	24,0	8,2	19,6	23,4	3,8	100
1997	2,9	19,3	25,3	8,4	18,7	22,2	3,2	100
1998	3,8	19,4	23,0	5,4	25,4	20,3	2,7	100
1999	3,5	18,2	20,9	5,5	28,6	21,1	2,2	100
2000	3,4	16,1	25,1	4,4	28,4	20,6	2,0	100
2001	3,2	16,7	24,2	7,3	26,6	19,7	2,3	100
2002	3,5	15,4	26,3	5,6	26,5	20,2	2,5	100
2003	3,6	18,6	25,2	2,9	25,6	21,1	3,0	100
Averages								
1990 – 1994	3,9	14,4	25,4	10,1	20,3	21,9	4,0	100
1995 – 1999	3,3	18,3	23,6	7,2	22,4	22,1	3,1	100
2000 – 2003	3,4	16,7	25,2	5,1	26,8	20,4	2,4	100

* For example, preference shares
Source: McGregor BFA

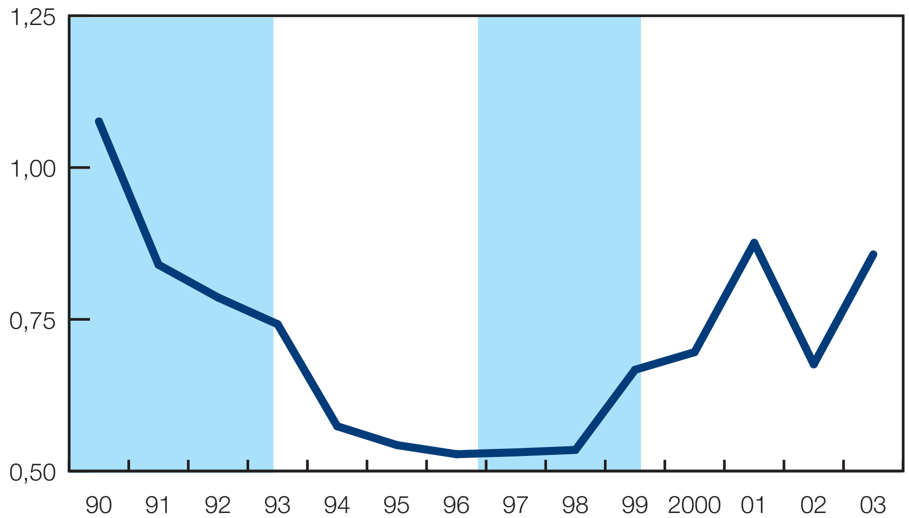
As equity issuance in the form of ordinary share capital is believed to be an easily accessible source of finance for listed companies, ordinary share capital as a percentage of total funding represents a surprisingly small portion of funding. It has declined steadily from 4,4 per cent in 1990 to about 3 per cent in 1996 and 1997. Subsequently, indications of an upward trend emerged. The average earnings-price ratio of industrial companies as calculated by the South African Reserve Bank (i.e. the inverse of the price-earnings ratio), which is generally regarded as an indicator of the cost of share capital, has increased steadily since 1994 from a low of less than 6 per cent to 9 per cent in 2003 (see Graph 1). However, relative to the cost of borrowed funds, the cost of ordinary share capital remained comparatively low during the five-year period from 1994 to 1998, creating favourable circumstances for increasing the relative importance of ordinary share capital (see Graph 2). Evidence of this expected increase emerged when ordinary share capital as a percentage of corporate funding moved from about 3 per cent in 1997 to about 4 per cent in 1998 but faltered again towards 2001, mostly on account of debt substitution. This was subsequently followed by a slight increase in the relative contribution of this type of funding since 2001, supported by the stabilisation of its cost relative to the cost of borrowed funds during 2002 and 2003.

Graph 1 The earnings-price ratio of shares of industrial companies



The shaded areas represent the downward phases of the business cycle

Graph 2 The cost of ordinary share capital relative to the cost of borrowed funds

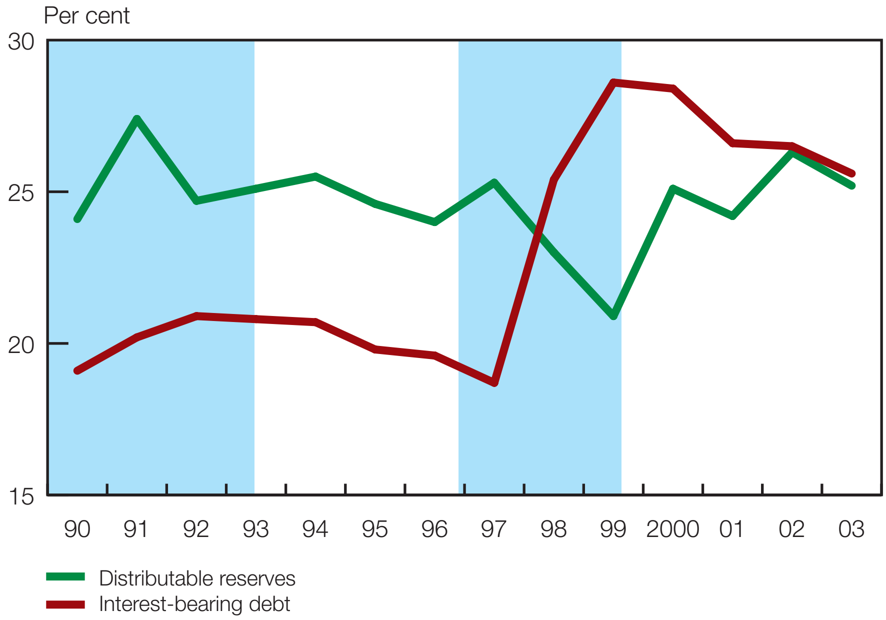


The shaded areas represent the downward phases of the business cycle

Distributable reserves or internally generated funding represents, on average, the largest portion of total funding. As a portion of total funding, *distributable reserves* has fluctuated around 25 per cent since 1990, experiencing an abrupt deterioration around 1998 and 1999 when the financial crisis in Southeast Asia left its mark on the South African economy, but recovered thereafter (see Graph 3).

Interest-bearing debt represents the second largest portion of total funding. A steep increase occurred around 1998 in the relative importance of this kind of funding, partly related to the significantly higher interest rates and concurrent decline in sales volumes experienced by many companies, which temporarily forced them to incur more debt. This ratio receded into 2000 and beyond as financial conditions eased (see Graph 3).

Graph 3 Interest-bearing debt and distributable reserves relative to total funding

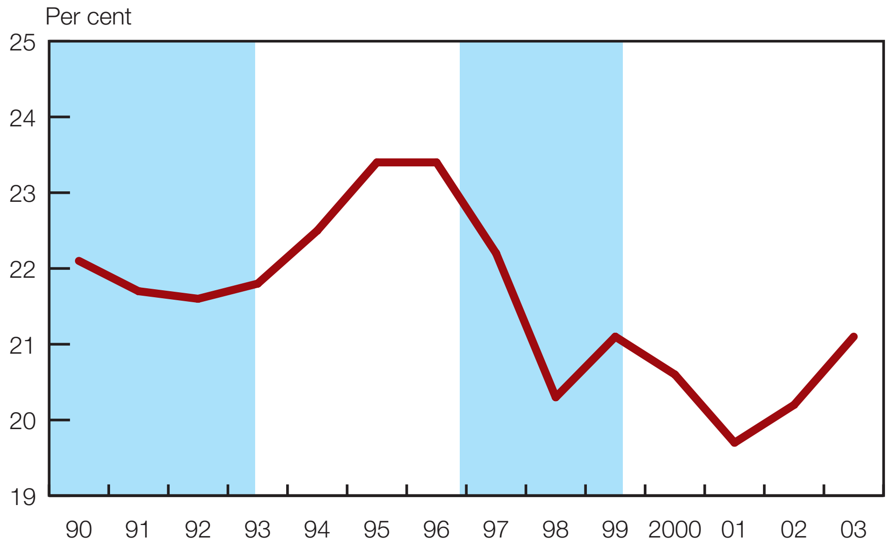


The shaded areas represent the downward phases of the business cycle

Interest-bearing debt tends to increase relative to total funding during periods of economic downswings. During recovery phases of the business cycle, profitability is usually bolstered by heightened economic activity and companies may be inclined to utilise less debt relative to internally generated funds. Interest-bearing debt may be seen as a substitute (though not perfect) for distributable reserves, especially during periods where aggregate income growth slows down. For example, distributable reserves as a percentage of total corporate funding declined sharply in 1998 and 1999, while the proportion of interest-bearing debt rose strongly. During this period, corporate profitability came under severe stress when, following the depreciation of the rand in 1998, the revaluation losses on foreign-currency denominated debt were written off against corporate profits. The sharp rise in the contribution of interest-bearing debt to total funding was also echoed in a strong rise in credit extended by the monetary sector to the corporate sector during 1998, and by a sharp increase in the ratio of such credit extension to gross domestic product.

Currently, *trade creditors* constitutes the third largest source of funding and differs from interest-bearing debt in two important ways. Firstly, it is normally seen as an interest or cost-free source of finance. Secondly, it represents a spontaneous source of finance as it arises from everyday business operations. For example, if sales and consequently purchases were to double on account of an improvement in demand conditions, the amount owed to trade creditors is also likely to double. As such, this type of finance reflects an element of cyclicality (see Graph 4).

Graph 4 Trade creditors relative to total funding



The shaded areas represent the downward phases of the business cycle

Calculations of the duration of the average settlement period of trade creditors during the working capital cycle indicate that the duration increased steadily from 1,74 months in 1989 to a high of 2,43 months in 1999, reflecting the tight financial conditions of 1998 and 1999, but receded during the period 2000 – 2003. This increase in the average settlement period had a supporting effect on corporate profitability since the need for other interest-bearing debt was minimised.

Debt financing and the real cost of debt

The real cost of debt is essentially determined by the interplay of three variables, namely the nominal cost of debt, the corporate tax rate and the inflation rate. This interrelationship is summarised in the following algebraic expression:

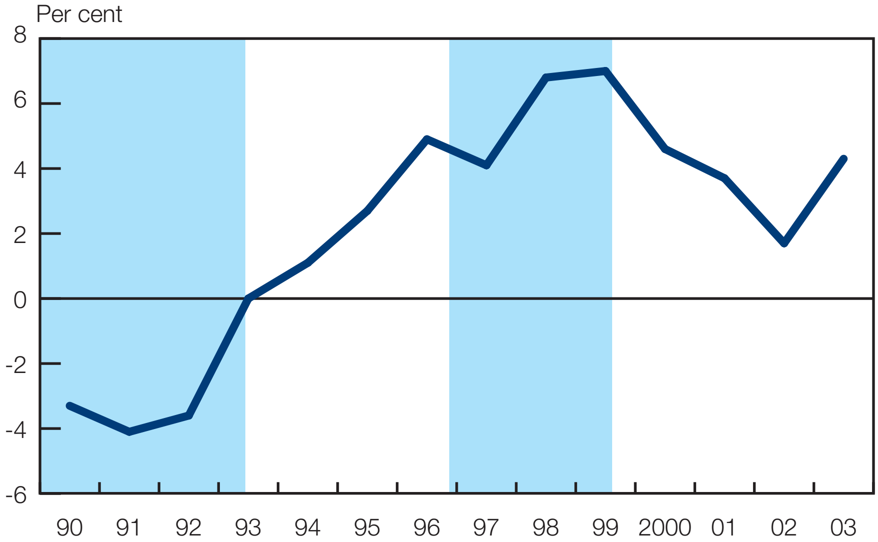
$$K_{dr} = \frac{(1 + (K_{dn}(1 - T)))}{1 + R} - 1,$$

where K_{dr} = real after-tax cost of debt;
K_{dn} = nominal cost of debt or interest rate;
R = inflation rate; and
T = the corporate tax rate.

Using the prime overdraft rate as an approximation of the nominal cost of debt and changes in the consumer price index to represent inflation, estimates of K_{dr} can be obtained.

As shown in Graph 5, the estimated real after-tax cost of debt finance was less than zero until 1992. From 1993 to 1999 the real cost of debt was consistently positive and generally rising. Though still maintaining a positive value, the real after-tax cost of debt declined from 1999 to 2002 but then rose slightly in 2003. For profit-maximising companies, rising debt-financing cost could be seen as an incentive for economising on the use of debt, and relying more heavily on other more affordable sources of finance.

Graph 5 The real after-tax cost of debt



The shaded areas represent the downward phases of the business cycle

The deterioration in overall economic conditions that followed the Southeast Asian financial crisis around 1998 created circumstances in which many companies had to fall back on bank credit to tide them through a difficult period which was seen as temporary and of relatively short duration. The "distress" borrowing at that time led to a sharp rise in the ratio of debt finance to overall corporate financing, despite the positive and rising real after-tax cost of debt finance. The overall recovery in economic conditions since late 1999 assisted companies in gradually working down their debt-financing ratio.

Conclusion

Debt financing is an important source of finance for the non-financial corporate sector and will remain part of the financing mix of companies. The optimal mix of debt and other sources of finance depends on a range of factors of which cost considerations are important. The analysis of empirical evidence indicates that debt levels increased noticeably during the second half of the 1990s before receding slightly after the turn of the century. The intensity of the adverse financial conditions experienced during 1998 and 1999 brought about an unusual environment associated with some distress borrowing. Subsequently, a much more "normal" environment of lower inflation and interest rates has been established. Within such an environment, the prudent utilisation of debt will be conducive to South Africa's future economic development.

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