Quarterly Bulletin

March 2005

South African Reserve Bank

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Quarterly Economic Review

Introduction

Early estimates show that real world output expanded by almost 5 per cent in 2004 – a full percentage point higher than in 2003. Indications are that economic growth in Africa south of the Sahara amounted to around 4½ per cent in 2004, with the oil-producing countries in this region recording growth of approximately 8 per cent as export earnings were raised by a combination of increased oil production volumes and higher crude oil prices.

With global output growth probably at its highest since 1976, international commodity prices recorded buoyant levels in 2004. This benefited most commodity-exporting countries, including South Africa – not only by directly raising export revenue, but also through its secondary effects on expenditure and income and through increasing the attractiveness of investment to residents and non-residents alike.

While the relatively high international prices of commodity exports supported South Africa's terms of trade and balance of payments position, it was the buoyancy of real domestic expenditure in particular that propelled growth in 2004. Within an environment characterised by rising income and the lowest inflation and nominal interest rate levels encountered in more than twenty years, all the major components of real domestic final demand rose strongly in 2004. Households' real final consumption expenditure increased by 6 per cent in 2004 as real household disposable income registered a broadly similar rate of increase, supported by increases in employment and wage settlements which remained above the contemporaneous inflation rate. Consumer confidence was also lifted by wealth effects stemming from rising real-estate and financial asset prices and by more affordable interest rates. Real final consumption expenditure by government rose by 7 per cent in 2004 as the focus on public service delivery sharpened and the South African Navy took delivery of three maritime vessels. Real fixed capital formation increased by 9½ per cent during 2004, as firm growth in real capital outlays by private-sector enterprises offset slower growth in investment expenditure by public corporations and general government.

As may be expected with consistently rising economic activity and sales volumes, real inventory levels rose further throughout 2004. Together with the increase in final demand, this brought the rate of increase in real gross domestic expenditure to 6½ per cent in 2004.

Real domestic production responded positively to the growth in real expenditure and registered a growth rate of 3,7 per cent in 2004. This compares favourably with the growth in real gross domestic production of 2,8 per cent which was recorded in 2003.

For 2004 as a whole the tertiary sector experienced the strongest growth among the major production sectors. Within the tertiary sector, the commerce sector registered the highest rate of increase in real value added, consistent with the brisk pace of expenditure in the economy. In the primary sector agricultural output recovered somewhat in 2004 following a contraction in 2003, while real value added in mining rose significantly in 2004 in the wake of strong world demand for commodities. Real value added by the secondary sector recorded the slowest rate of increase among the major output sectors in 2004, but still expanded by roughly 3 per cent during the year. Manufacturing output increased significantly, partly in response to the strong domestic expenditure growth and the strong international demand for certain types of manufactured goods in the current global upswing.

On a quarter-to-quarter basis the annualised rate of growth in real gross domestic product accelerated for five consecutive quarters to a recent maximum of 5½ per cent in the third quarter of 2004. Growth decelerated somewhat to 4 per cent in the final quarter of 2004, primarily on account of the weaker performance of the mining and manufacturing sectors.

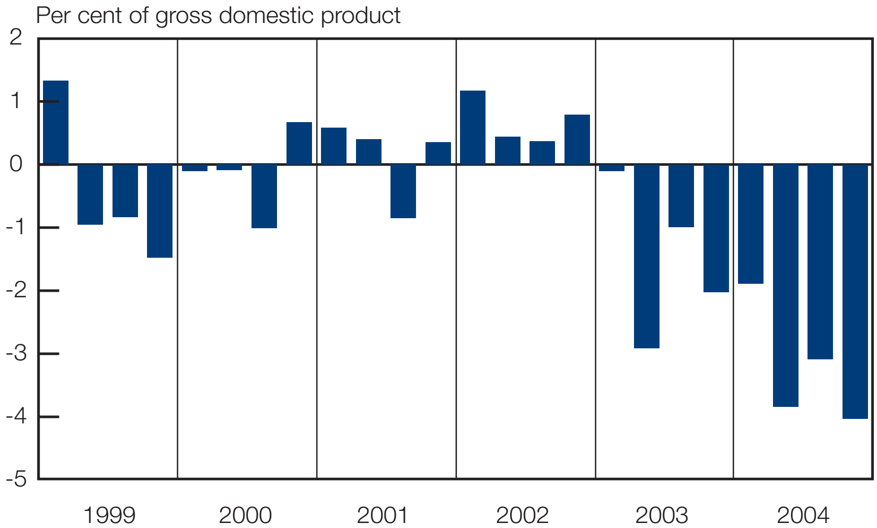
The firm increases in economic activity were accompanied by significant gains in employment. Enterprise-surveyed employment numbers rose by approximately 215 000 over the five quarters to September 2004, with 58 000 employment opportunities created in the third quarter of 2004 alone. The major part of the increase in employment was recorded in the private sector. Wage increases moderated further in 2004, with the average level of wage settlements in collective bargaining agreements receding from 8,9 per cent in 2003 to 6,8 per cent in 2004.

Lower historical inflation contributed to the moderation in wage settlements. Year-on-year CPIX inflation slowed down to 4,3 per cent in 2004 as a whole, and amounted to 3,6 per cent in January 2005 – its lowest level since the first calculations of CPIX in 1997. By January 2005 CPIX inflation had been in the target range of 3 to 6 per cent for seventeen consecutive months, thereby contributing to the moderation of inflation expectations. Inflation at the production level also remained low, with the strengthening in the exchange rate of the rand contributing to the containment of the prices of both imported and domestically produced goods.

South Africa's sound economic performance was recognised by two international credit ratings agencies and rewarded with improved ratings which were announced in October 2004 and January 2005. These announcements, together with the acceleration in economic growth, decelerating inflation, a generalised depreciation of the US dollar and favourable international prices of South African export commodities, contributed to an increase of 11,7 per cent in the trade-weighted exchange rate of the rand during the course of 2004. This increase in the trade-weighted exchange rate was followed by a small decline in the first 2½ months of 2005.

The high level of domestic expenditure and the appreciation in the exchange rate of the rand resulted in buoyant imports, raising the deficit on the current account of the balance of payments in 2004 to 3,2 per cent of gross domestic product. This was the

Balance of payments: Balance on current account



Seasonally adjusted

highest annual deficit ratio since 1982, when the current-account deficit amounted to 4,5 per cent of gross domestic product. However, net financial inflows more than neutralised the deficit on the current account in 2004 and enabled the Reserve Bank to accumulate international reserves. Net inflows of portfolio capital – especially into the share market, which was made attractive by relatively favourable yields and expectations of further strong growth in economic activity and profits – constituted the most significant component of the financial inflows in 2004.

Growth in the broadly defined money supply, M3, maintained a robust pace in 2004, consistent with firm increases in nominal income, expenditure and wealth. The accumulation of government deposits in late 2004 and early 2005, in preparation for sizeable coupon interest and capital redemption payments on government bonds at the end of February 2005, contributed to a slowdown in M3 growth as government deposits with the banking system are not included in M3.

Banks' loans and advances to the domestic private sector recorded brisk growth in 2004 and early 2005. Rising property prices gave support to both the demand for and supply of mortgage advances, while the expansion of mortgage finance, in turn, helped to underpin the increases in property prices. However, some moderation in the pace of increase in house prices was observed in recent months. Strong sales of vehicles and other durable items underpinned the brisk increases in instalment sale and leasing finance in 2004 and early 2005.

Against the background of an unchanged Reserve Bank repurchase rate, short-term interest rates were fairly stable from mid-August 2004 to mid-March 2005. On occasion, usually prompted by episodes of rand exchange rate appreciation or the release of favourable inflation data, some money-market rates tended to reflect expectations of an imminent decrease in the Bank's repurchase rate. Long-term bond yields declined further during 2004 and the early part of 2005, signalling expectations of lower inflation and the continued pursuit of sound policies. In the second half of 2004 and early months of 2005 both nominal long-term and short-term interest rates receded to levels last observed more than a quarter of a century ago.

Higher economic growth, rising corporate profitability, lower interest rates and improving business confidence led to further increases in domestic share prices in 2004 and early 2005. From a recent low point reached on 18 May 2004, the all-share price index, on balance, rose by 41 per cent to an all-time high on 17 March 2005. More generally, shares and bonds as well as residential real-estate all displayed vigorous price increases during the past year, creating significant positive wealth effects.

There was a significant acceleration in tax collections during the second half of the 2004/05 fiscal year. Strong domestic expenditure was reflected in high rates of increase in import duty, company tax and value-added tax collections, while the buoyant conditions in the real-estate market continued to boost revenue from transfer duty. Given the high tax collections, the Minister of Finance in the 2005 Budget revised the estimated 2004/05 deficit downward by R9,8 billion to R32,2 billion or 2,3 per cent of gross domestic product. For fiscal 2005/06 the Budget provided for a deficit of 3,1 per cent of gross domestic product and an increase of 12,9 per cent in expenditure as public service delivery, infrastructure provision and access to social services are improved. The rate of taxation on corporate profits was lowered from 30 to 29 per cent as part of a fiscal policy that supports economic growth, but within limits of sustainability.

Domestic economic developments

Domestic output[1]

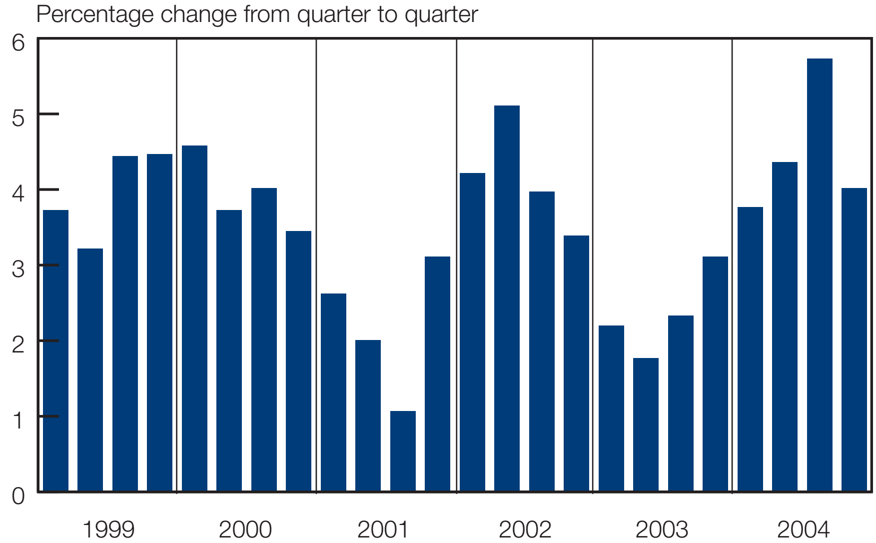
1 The quarter-to-quarter growth rates referred to in this section are based on seasonally adjusted data.

Real economic activity in South Africa improved in 2004, mainly reflecting buoyant conditions in real domestic final demand. Real gross domestic product, which had increased by 2,8 per cent in 2003, increased further by 3,7 per cent in 2004. The enhanced performance was particularly evident in the middle quarters of 2004 when quarter-to-quarter growth accelerated from an annualised rate of 4 per cent in the first quarter to 4½ per cent and 5½ per cent in the second and third quarters, respectively.

In the fourth quarter of 2004, growth in South Africa's real *gross domestic product* slowed down to an annualised rate of 4 per cent. The relative weakness in the real output of the primary and secondary sectors, especially in the mining and manufacturing sectors, was primarily responsible for the slowdown in real gross domestic product growth in the fourth quarter. By contrast, growth in the real value added by the tertiary sector was sustained at the same brisk pace recorded in the third quarter.

Real gross domestic product

Percentage change from quarter to quarter



Seasonally adjusted annualised rates

The growth in the real value added by the *primary sector*, which had accelerated unabatedly in the first three quarters of 2004, slowed down markedly from an annualised rate of 9½ per cent in the third quarter to ½ a per cent in the fourth quarter. This slowdown was visible in the real output of both the agricultural and mining sectors. For 2004 as a whole, the level of real output in the primary sector rose by 3½ per cent compared with an increase of only 1 per cent in 2003, mainly as a result of the recovery in the real value added by the agricultural sector following its substantial contraction in 2003.

Following a decline of 6 per cent in 2003, the real value added by the *agricultural sector* increased by 1 per cent in 2004 mainly on account of higher field crop production, particularly of maize. In addition the output of livestock farmers also increased. Quarter-to quarter growth in real value added was at its strongest in the middle quarters of 2004, but slowed down from an annualised rate of 11½ per cent in the third quarter to 4 per cent in the fourth quarter. Although livestock and horticultural production held up fairly well, the real output in other subsectors of the agricultural sector was weak in the fourth quarter.

The real value added by the *mining sector* increased for eleven consecutive quarters, but production volumes then shrank in the fourth quarter of 2004. The contraction in real output at an annualised rate of 1 per cent in the fourth quarter of 2004 was mainly due to a decline in the real value added by the gold and platinum mining sectors, following exceptionally strong output growth in the third quarter. The strength of the exchange rate left its mark on profitability as export earnings came under pressure. Although coal mining production increased on account of favourable world demand conditions, this could not offset the decline in the real value added by the other mining subsectors in the fourth quarter. For 2004 as a whole, growth in the real value added by the mining sector amounted to 4 per cent, which is comparable to the rate of 4½ per cent recorded in 2003.

Following an increase of 6½ per cent in the third quarter of 2004, growth in the real value added by the *secondary sector* slowed down to an annualised rate of 3 per cent in the fourth quarter. All three subsectors of the secondary sector recorded slower growth. Nonetheless, their real value added performed sturdily on a year-to-year basis, recording a growth rate of 3 per cent in 2004 against stagnant real output in 2003.

Real gross domestic product

Percentage change at seasonally adjusted annualised rates

	2003					2004				
Sectors	1st qr	2nd qr	3rd qr	4th qr	Year	1st qr	2nd qr	3rd qr	4th qr	Year
Primary sector	-0	-2	-2	0	1	5	7	9½	½	3½
Agriculture.................	-6½	-19½	-21	-5½	-6	8½	17½	11½	4	1
Mining.......................	3½	6½	7	2	4½	3½	3	9	-1	4
Secondary sector	-2	-3	-1	0	0	5	6	6½	3	3
Manufacturing...........	-3	-4	-2	-1	-1	5	6	6½	2½	2½
Tertiary sector................	4	4	4	4½	4	3½	4	5	5	4
Non-agricultural sector ..	*2½*	*2½*	*3*	*3*	*3*	*4*	*4*	*5½*	*4*	*4*
Total	**2**	**2**	**2½**	**3**	**3**	**4**	**4½**	**5½**	**4**	**3½**

Growth in the real value added by the *manufacturing sector* slowed down from an annualised rate of 6½ per cent in the third quarter of 2004 to 2½ per cent in the fourth quarter. This can mainly be attributed to declines in the real output of several subsectors including food and beverages; petroleum, chemical, rubber and plastic products; and glass and non-metallic mineral products. However, solid performances were recorded by several other subsectors of the manufacturing sector which counteracted these declines to some extent. Firm growth in real output was recorded by the subsectors textiles, clothing and leather, wood and wood products as well as basic iron and steel.

Manufacturing output volumes contracted by 1 per cent in 2003 as a whole, but subsequently rebounded strongly and increased by 2½ per cent in 2004. Factors contributing to the improvement included:
- the continued strength of domestic demand;
- local manufacturers' proximity to and flexibility in dealing with the domestic market;
- well-contained and even declining input costs in certain sectors; and
- strong international demand for certain types of manufactured goods in the current global upswing.

Under these circumstances capacity utilisation in manufacturing increased considerably, while business confidence reached its highest level in more than two decades in 2004.

The real value added by the sector supplying *electricity, gas and water* slowed down from an annualised rate of 3½ per cent in the third quarter of 2004 to 3 per cent in the fourth quarter. This modest slowdown was mainly evident in the growth in real value added by the electricity subsector. Higher volumes of electricity exported in 2004 boosted growth in the real value added by the sector supplying electricity, gas and water from ½ a per cent in 2003 to 2 per cent in 2004.

The real value added by the *construction sector* increased further in the fourth quarter of 2004, albeit at a marginally slower pace than in the third quarter. The firm performance was underpinned by robust activity in the residential building sector. The relatively low interest rates and rising household incomes provided impetus to the demand for new residential buildings. Building conditions in the non-residential sector also showed a substantial improvement, particularly as the demand for retail and entertainment space increased. By contrast, building activity in the civil engineering sector remained unimpressive. Annual growth in real construction output accelerated from 5 per cent in 2003 to 6½ per cent in 2004 – the highest annual growth rate since 1989.

The services sector continued its sterling performance. Growth in the real value added by the *tertiary sector* was sustained at an annualised rate of 5 per cent in the third and fourth quarters of 2004. This can mainly be ascribed to lively activity in the commerce, transport, storage and communication as well as the finance, insurance, real-estate and business services sectors. For 2004 as a whole, the real value added by the tertiary sector grew by 4 per cent – the same rate attained in 2003.

The growth in the real value added by the *commerce sector* accelerated from an annualised rate of 5½ per cent in the third quarter of 2004 to about 7 per cent in the fourth quarter. The buoyant levels of domestic demand enhanced activity in the wholesale and retail trade subsectors in the fourth quarter of 2004. Retailers, in particular, benefited from lively consumption demand, especially for durable goods. Prices remained well-contained and even came down in the case of certain items with a high import content, providing a stimulus for consumer demand. The real value added by the motor trade subsector also rose further in the fourth quarter of 2004. Compared to the other sectors of the economy, the commerce sector has registered the highest annual growth rate in both 2003 and 2004.

The ongoing expansion of the communication subsector, specifically that of cellular telephone and internet activity, boosted the quarter-to-quarter growth in the real value added by the *transport, storage and communication sector* to an annualised rate of about 7 per cent in the fourth quarter of 2004, slightly higher than the rate of 6½ per cent recorded in the third quarter. In addition, the increased volume of imports and exports added a fillip to the real value added by land transport. Growth in the real value added by the transport, storage and communication sector accelerated from 5 per cent in 2003 to 5½ per cent in 2004.

Following an increase of 5½ per cent in the third quarter of 2004, growth in the real value added by the *financial intermediation, insurance, real-estate and business services sector* accelerated to an annualised rate of 6 per cent during the fourth quarter of 2004. This could mainly be ascribed to higher trading volumes on the JSE Securities Exchange South Africa (JSE) and robust growth recorded in the real-estate subsector. Banks' real output remained high as the demand for financial services continued to increase. The annual growth in the financial intermediation, insurance, real-estate and business services sector in 2004 amounted to about 4 per cent, roughly the same rate as attained in 2003.

The real value added by the *general government* increased at an annualised rate of 1½ per cent in the fourth quarter of 2004 – similar to the growth in the first three quarters of the year. This stable rate of output growth was largely due to continued moderate increases in general government employment.

The improvement in South Africa's international terms of trade and the lower net primary income payments to the rest of the world, particularly dividend payments, strengthened the level of real gross national income in 2004. As a result, growth in real gross national income accelerated from 3 per cent in 2003 to 5 per cent in 2004. This translated into increases in gross national income per capita of 1 per cent in 2003 and 3 per cent in 2004.

Domestic expenditure

Growth in *aggregate real gross domestic expenditure* accelerated from an annualised rate of 2½ per cent in the third quarter of 2004 to 4½ per cent in the fourth quarter. This acceleration was observed in all three components of domestic final demand – real final consumption expenditure by households and by general government, and real gross fixed capital formation. The slowdown in real inventory investment in the fourth quarter was more than neutralised by the robust increase in the other major spending categories. The level of real gross domestic expenditure was 6½ per cent higher in 2004 than in 2003.

Real gross domestic expenditure

Percentage change at seasonally adjusted annualised rates

	2003					2004				
Components	1st qr	2nd qr	3rd qr	4th qr	Year	1st qr	2nd qr	3rd qr	4th qr	Year
Final consumption expenditure by households	3	3½	5½	6	3½	6	6½	6½	7	6
Final consumption expenditure by general government	6	6½	6½	14	6½	6	6	0	13	7
Gross fixed capital formation	8	4½	7	10	9	11½	10	7½	9	9½
Change in inventories (R billions)*	7,6	10,5	9,2	9,2	9,2	9,6	14,9	13,6	7,6	11,4
Gross domestic expenditure	**7**	**5½**	**6**	**8½**	**5½**	**5½**	**9**	**2½**	**4½**	**6½**

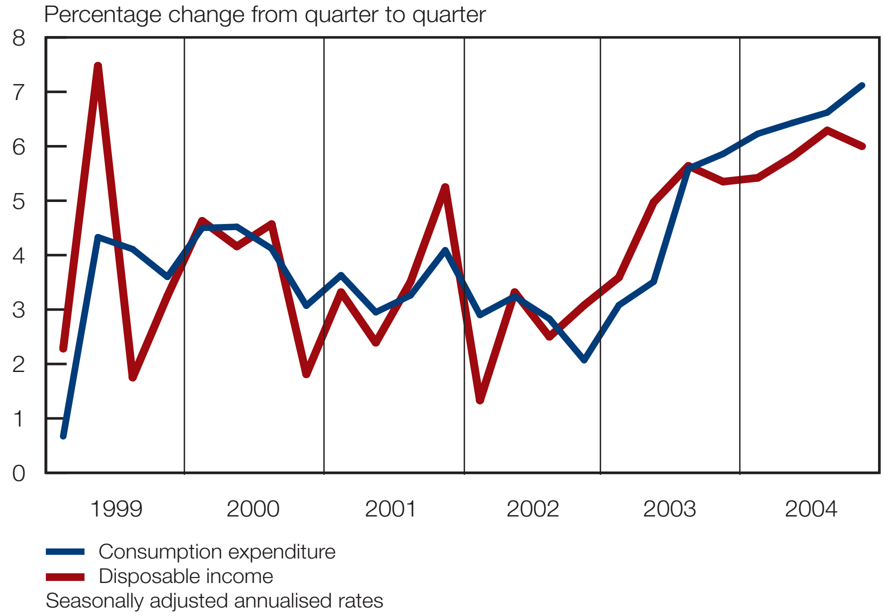
* At constant 2000 prices

Growth in *real final consumption expenditure by households* accelerated from 6½ per cent in the third quarter of 2004 to an annualised rate of 7 per cent in the fourth quarter. The buoyancy in consumer spending was also reflected in a year-on-year growth rate of 6 per cent in 2004 compared to a growth rate of 3½ per cent recorded in 2003.

The strong household spending in 2004 was underpinned by several factors, including:
- an increase of 5½ per cent in real household disposable income in 2004, partly due to wage settlements which remained above the contemporaneous inflation rate and income tax rates which were lowered marginally;
- the steady decline in bank lending rates in 2003 and 2004, culminating in the lowest nominal short-term interest rates since 1980; this reduced the debt servicing cost of households as a percentage of disposable income from 8 per cent in 2003 to 6 per cent in 2004;

- the high levels of consumer confidence recorded in 2004, previously observed in 1997; and
- the wealth effects arising from the exceptional increase in property and other asset prices.

Real household consumption expenditure and disposable income



In the fourth quarter of 2004, most major categories of household spending participated in the spending boom. Annualised growth in real spending on *durable goods* accelerated from 19½ per cent in the third quarter of 2004 to 25½ per cent in the fourth quarter. This was mainly a result of households stepping up real outlays on furniture, household appliances and motor cars. Purchases of recreational and entertainment goods also gathered momentum in the fourth quarter.

Growth in real outlays on *semi-durable goods* accelerated in the fourth quarter of 2004 as spending on household textiles and furnishings and on clothing and footwear picked up substantially. By contrast, real outlays on *non-durable goods* lost some momentum as households curtailed their purchases of petroleum products in response to the steep rise in petrol and diesel prices during the fourth quarter. Spending on *services* increased at the same pace as in the third quarter of 2004.

Households financed part of their expenditure by incurring more debt. Household debt as percentage of disposable income accordingly increased from 55 per cent in the third quarter of 2004 to 57 per cent in the fourth quarter. On an annual basis, the ratio increased from 51½ per cent in 2003 to 54½ per cent in 2004.

After stagnating in the third quarter of 2004, growth in *real final consumption expenditure by general government* accelerated to 13 per cent in the fourth quarter of 2004. This can partly be attributed to the acquisition of a maritime vessel, the last of four to arrive as part of the current defence procurement programme. Real government consumption expenditure on other non-wage goods and services increased at a steady pace from the third to the fourth quarter of 2004. Growth in real compensation of employees was also maintained at the same pace as in the third quarter. The higher level of government expenditure in the fourth quarter lifted the ratio of final consumption expenditure by general government to gross domestic product to 20 per cent, approximating levels previously observed during the period 1992 to 1994.

Armaments purchases in the national accounts

National accounts data are recorded on the basis of the set of internationally-agreed concepts, definitions, classifications and accounting rules contained in the 1993 *System of National Accounts* (SNA). This framework provides for national accounts statistics being recorded on an accrual and not a cash basis. Accrual accounting implies that transactions are recorded at the time that economic value is created, transferred or exchanged. The 1993 SNA also advises that expenditure by the military on weapons of destruction and the equipment needed to deliver them should be classified as final consumption expenditure by general government and not as fixed capital formation. The construction of buildings for use by military personnel and the construction of roads, airfields and docks for use by the military should, however, form part of fixed capital formation.

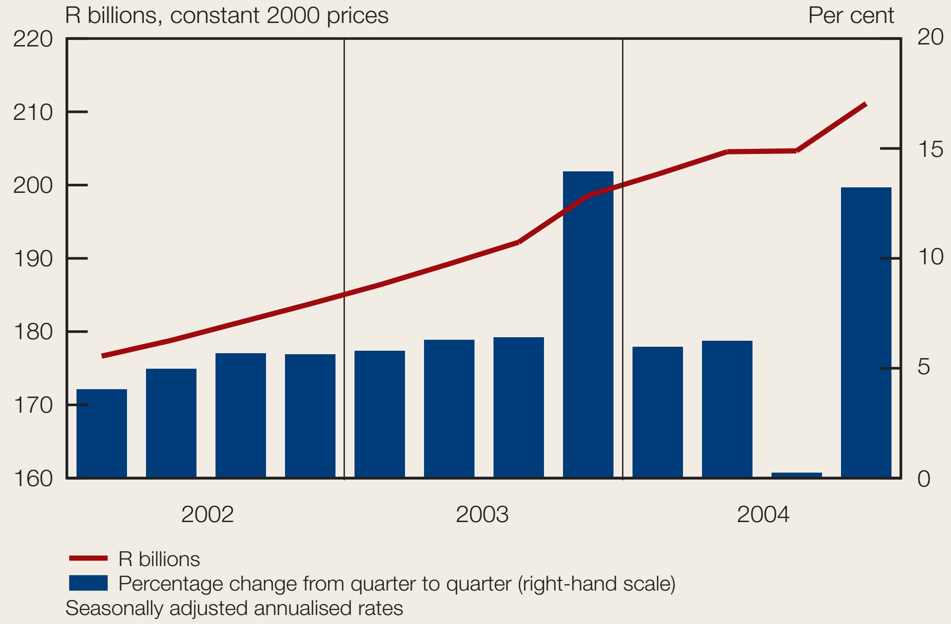
Part of government's expenditure on collective goods and services includes defence expenditure in ensuring safety for all in the country. A strategic armaments procurement programme, which forms part of the Special Defence Account of the Department of Defence, was approved by Cabinet in September 1999. This arms procurement programme provides for four corvettes, four maritime helicopters, three submarines, thirty utility helicopters, twenty-four trainer aircraft and twenty-eight fighter aircraft to be delivered from abroad.

In financing these military goods, pre-payments may be made for some of the goods to be delivered at a later point in time, or financing may be arranged allowing the government to pay for an item some time after acquiring it. However, because of the accrual accounting basis of compiling national accounts information, these pre-payments and loan repayments are not taken into account in compiling general government final consumption expenditure. Only when these goods are delivered and ownership is transferred to the South African government, the total amount for the goods delivered is recorded as general government final consumption expenditure.

As military vessels, aircraft and submarines are expensive, the level of and growth in general government final consumption expenditure are often visibly affected in the specific quarter when ownership of such an item is taken by the government.

The accompanying graph shows both the level of and annualised growth in real general government final consumption expenditure on a quarterly basis. The first of the four corvettes that form part of the arms procurement programme was delivered to the South African Defence Force in the fourth quarter of 2003, which resulted in a higher level of real general government final consumption expenditure and a distinctly higher growth rate in such expenditure. The following two corvettes were received during the first and second quarters of 2004. No corvette changed ownership in the third quarter, but the fourth corvette was received during the final quarter of 2004.

Real final consumption expenditure by general government

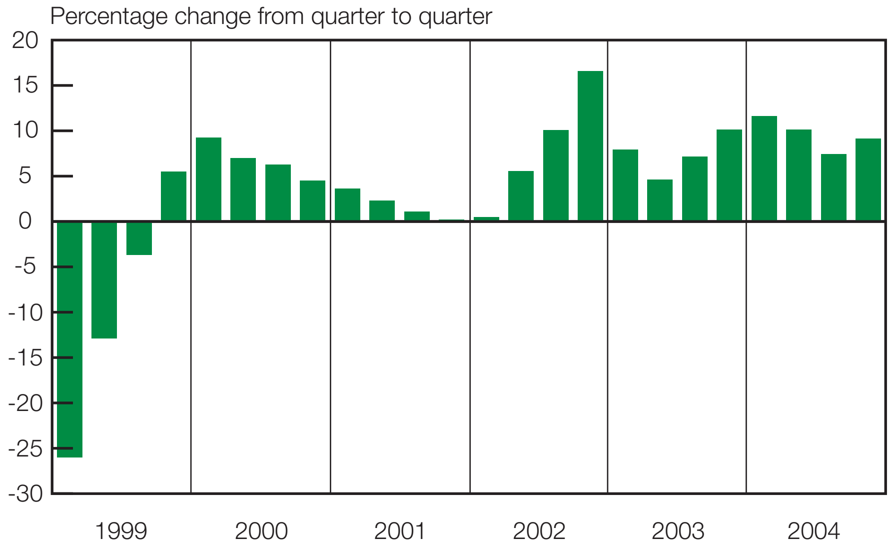


by M E Swanepoel

Growth in *real gross fixed capital formation* picked up from an annualised rate of 7½ per cent in the third quarter of 2004 to 9 per cent in the fourth quarter. The buoyant quarter-to-quarter increases throughout 2004 resulted in an annual growth rate of 9½ per cent, higher than the 9-per-cent growth rate recorded in 2003. Firm annual growth in real capital outlays by the private business enterprises in 2004 offset slower growth in spending by public corporations and general government.

During the fourth quarter of 2004 growth in real capital outlays by the *private sector* faltered somewhat while that of public corporations and general government picked up substantially. Growth in real gross fixed capital formation by the private sector slowed down from an annualised rate of 20 per cent in the third quarter of 2004 to 4½ per cent in the fourth quarter as enterprises in agriculture and mining pruned back their capital outlays. The agricultural sector's investment expenditure was adversely affected by a decline in the rand prices of key agricultural products. The platinum mines, whose projects formed the mainstay of mining investment in recent years, postponed several projects given the lustreless rand prices of their key products. The decline in gross fixed capital formation in the primary sector of the economy was countered by ongoing investment in retail and entertainment space, which benefited from the strong consumer spending.

Real gross fixed capital formation

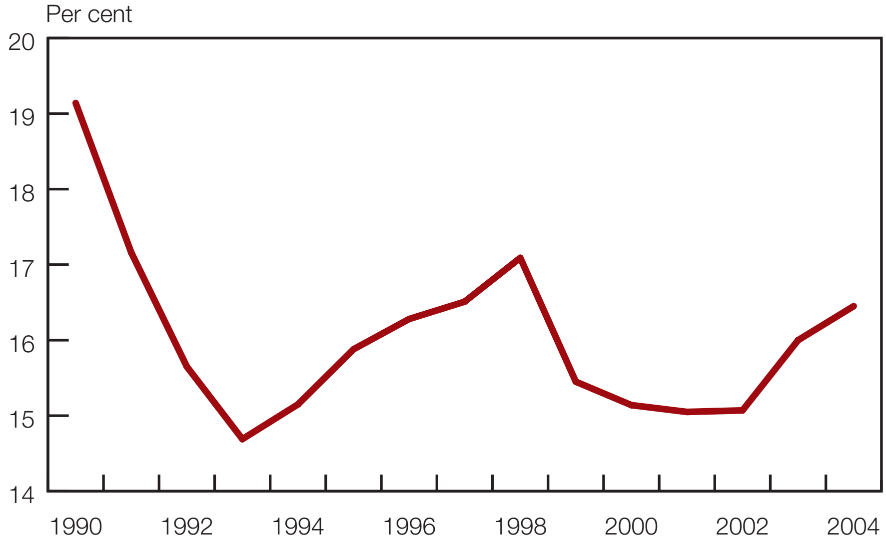


Seasonally adjusted annualised rates

Public corporations stepped up spending considerably in the fourth quarter. The addition of network equipment strengthened investment by the communication sector. In addition, the public utilities supplying electricity, gas and water stepped up their capital investment. Real outlays on road infrastructure and urban renewal projects contributed to growth in real gross fixed capital formation by *general government.*

An analysis of annual growth rates in capital spending by type of asset confirms that the growth rate of capital outlays on residential buildings not only exceeded that of the other asset types during 2004, but that the growth of investment spending on residential buildings was at the highest since the mid-1960s. The ratio of gross fixed capital formation to gross domestic product improved from 16 per cent in 2003 to 16½ per cent in 2004. This compares well with an average ratio of 15½ per cent from 2000 to 2003.

Gross fixed capital formation as percentage of gross domestic product



Following a strong build-up in the first three quarters of 2004, *inventory accumulation* slowed down in the fourth quarter. Most sectors of the economy reported smaller net additions to inventories – possibly unplanned, as final demand increased strongly in the fourth quarter. In the mining sector inventories were actually reduced, particularly in the gold-mining sector. Higher sales of gold were probably encouraged by the stronger performance of the gold price while production continued its secular decline. The slowdown in inventory accumulation compressed real expenditure growth by about 2½ percentage points in the fourth quarter of 2004. As a percentage of non-agricultural gross domestic product, the level of industrial and commercial inventories edged down from 15,7 per cent in the third quarter to 15,5 per cent in the fourth quarter of 2004.

Factor income

The growth over four quarters in *total nominal factor income* slowed down marginally from over 10 per cent in the third quarter of 2004 to just under 10 per cent in the fourth quarter. An analysis of the two major components, i.e. compensation of employees and gross operating surplus, indicates that the rate of growth in gross operating surplus slowed down somewhat while compensation of employees increased at the same rate as in the third quarter. For 2004 as a whole, the strong performance of business operating surpluses was mainly responsible for lifting the level of total nominal factor income by 8½ per cent, considerably higher than the rate of 6½ per cent recorded in 2003.

Growth in *compensation of employees*, measured over one year, was sustained at a rate of 9 per cent in the third and the fourth quarters of 2004. The stabilisation in the rate of increase was evident throughout most sectors of the economy with the exception of the agricultural and mining sectors where growth in compensation of employees slowed down. As a consequence of the comparatively moderate tempo of wage increase, the growth in compensation of employees decelerated from 10 per cent in 2003 to 9 per cent in 2004. While the slowdown in compensation of employees might ultimately reduce its share in factor income, the recent changes have increased the ratio of compensation of employees to total factor income from 51 per cent in 2003 to 51½ per cent in 2004.

The growth in total *gross operating surpluses* of business enterprises measured over four quarters slowed down from 11½ per cent in the third quarter to 11 per cent in the fourth quarter of 2004. The slowdown was spread throughout virtually all sectors of the economy except for the mining sector. It was, however, more pronounced in the agricultural sector where farmers had to cope with rapidly rising input costs relative to output prices. The mining sector benefited from healthy sales, particularly of diamonds. As a result of the deceleration in the year-on-year growth in business operating surpluses during the fourth quarter, the share of total operating surplus in total factor income receded slightly from 49 per cent in the third quarter to 48½ per cent in the final quarter of 2004. Nominal gross operating surpluses of businesses rose by 8 per cent in 2004 as a whole, substantially higher than the 3½ per cent increase in 2003.

Gross saving

The national saving ratio or *gross saving as a percentage of gross domestic product* declined from 15 per cent in the third quarter of 2004 to 13½ per cent in the fourth quarter. The weakness in gross saving was confined to the household and corporate sectors, while gross saving by general government remained broadly unchanged from the third quarter of 2004. The weaker saving in the fourth quarter implied that the sizeable increase in gross capital formation could not be financed from domestic resources only – some R44,4 billion of the financing of gross capital formation in 2004 was obtained from foreign sources.

Gross saving by the *corporate sector* as a percentage of gross domestic product weakened from 12½ per cent in the third quarter of 2004 to 11 per cent in the fourth quarter. This can mainly be attributed to higher dividend and tax payments which neutralised the increase in the gross operating surpluses of business enterprises.

The growth in real household disposable income fell short of the growth in real final consumption expenditure by households, thus compressing the household saving ratio. The ratio of *gross household saving* to gross domestic product accordingly declined from 2½ per cent in the third quarter of 2004 to 2 per cent in the fourth quarter.

Gross saving by *general government* as percentage of gross domestic product remained roughly the same from the third to the fourth quarter of 2004. This was mainly due to an increase in revenue collected, which was sufficient to offset the growth in real final consumption expenditure by general government.

Employment

According to the *Survey of Employment and Earnings* (SEE) by Statistics South Africa, enterprise-surveyed employment in the *formal non-agricultural sectors of the economy* increased consistently during the five quarters to September 2004. These increases followed a protracted period of weakness in formal non-agricultural employment. Initially, when employment started to recover from the third quarter of 2003, employment advances occurred at annualised quarter-to-quarter rates of around 2,5 per cent. This rate of increase thereafter accelerated meaningfully to 3,6 per cent in the third quarter of 2004. Employment numbers rose by around 215 000 over this five-quarter period with 58 000 employment opportunities created in the third quarter of 2004 alone, as the pace of expansion in employment gained momentum.

Increases in employment during the third quarter of 2004 occurred in both the private and public sector, but the strongest gains were recorded in the private sector. The level of *private-sector employment* rose at an annualised rate of 3,8 per cent from the second to the third quarter of 2004, with employment gains being most pronounced in the construction sector, the trade, catering and accommodation services sector as well as in the manufacturing sector. By contrast, job opportunities were lost in the sectors for electricity generation and non-gold mining as well as transport, storage and communication, as shown in the accompanying table.

Quarter-to-quarter change in non-agricultural private-sector employment in the third quarter of 2004

Sector	Number	Percentage change (annualised)
Gold mining	1 300	2,9
Non-gold mining	-2 900	-4,2
Manufacturing	14 000	4,5
Electricity supply	-500	-4,7
Construction	11 000	17,8
Trade, catering and accommodation	15 000	4,8
Transport, storage and communication	-700	-1,6
Finance, insurance, real estate and business services	8 000	3,1
Washing and laundry services	400	0,4
Total private sector	46 000	3,8

Source: Statistics South Africa, *Survey of Employment and Earnings*

Employment in the *public sector* rose at an annualised rate of 3,0 per cent in the third quarter of 2004 following an increase of 4,0 per cent in the second quarter. Notwithstanding the fallback in public-sector employment in the opening months of 2004, employment numbers on balance rose by 1,3 per cent in the year to the third quarter of 2004, or by about 21 000 employees. Employment gains in national and provincial government departments exceeded losses in public-sector transport, storage and communication enterprises and in local governments.

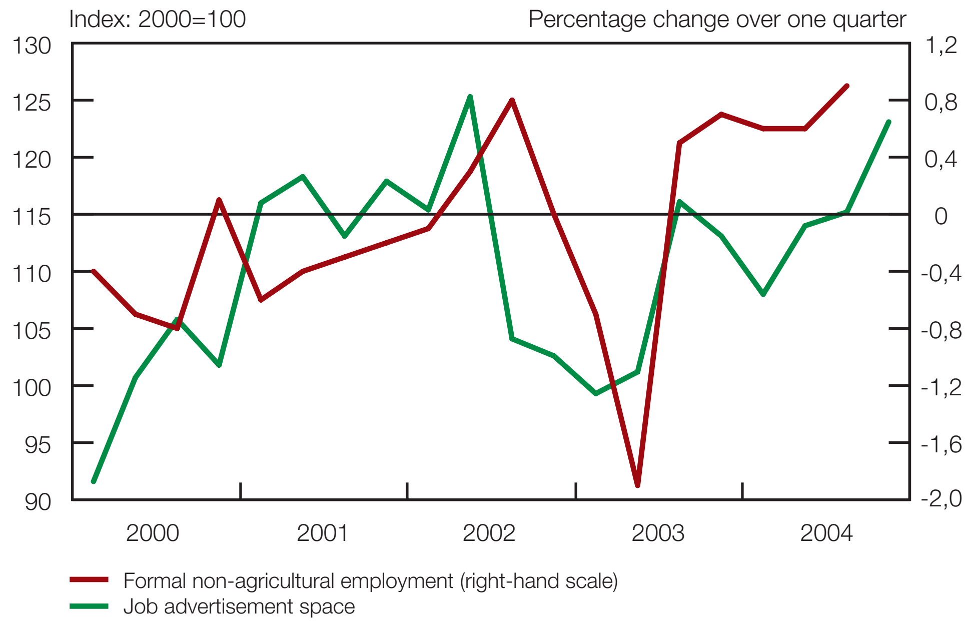
While official employment data for the fourth quarter of 2004 are not available yet, the Investec Purchasing Managers employment sub-index, reflecting purchasing managers' expectations in the manufacturing sector regarding changes in the level of employment, improved somewhat in December 2004 and January and February 2005 after having shown declines in the preceding two months. Notwithstanding the improvement, the indicator remained below the neutral value of fifty and therefore continued to signal expectations of net retrenchments in the sector.

An opinion survey by the Bureau for Economic Research (BER) at the University of Stellenbosch indicates a further meaningful increase in the number of people employed by the *construction sector* in the fourth quarter of 2004. Sales volumes of cement, an indirect indicator of activity in the building industry, rose by as much as 15 per cent in the year to the fourth quarter of 2004 and by 17½ per cent in the year as a whole. In addition, the real value of building plans passed increased by around 28 per cent in the year to December 2004, auguring well for activity levels and employment growth in the construction sector in the months ahead. Opinion survey results by the BER also indicate an expansion in the employee complement in the *wholesale and retail sales sectors* in the closing months of 2004.

Job advertisement space in the print media, which is related closely to changes in formal non-agricultural employment, rose steeply in the fourth quarter of 2004 – the third consecutive quarter of increase. Should these vacancies be filled by suitable candidates in the coming months, employment levels are most likely to increase further.

Within an environment of generally improved employment prospects, Andrew Levy Employment Publications (a private-sector labour consultancy firm) indicates that the number of mandays lost as a result of industrial action rose from 0,7 million in 2003 to 1,1 million in 2004. However, the incidence of industrial action during wage negotiations declined from 8,6 per cent in 2003 to 6,7 per cent in 2004. Consequently, the majority of companies surveyed, i.e. 73 per cent, indicated that wage negotiations had taken place in a positive and constructive bargaining environment.

Formal non-agricultural employment and job advertisement space in the print media



Labour cost and productivity

The increase in *average nominal remuneration per worker* moderated from a year-to-year rate of 9,6 per cent in 2002 to 8,7 per cent in 2003 and to 7,7 per cent in the first three quarters of 2004 when compared with the same period in the preceding year. The rate of increase in nominal remuneration per worker decelerated further to 6,3 per cent in the year to the third quarter of 2004. This slowdown in nominal remuneration growth in the third quarter of 2004 occurred in both the private and public sectors.

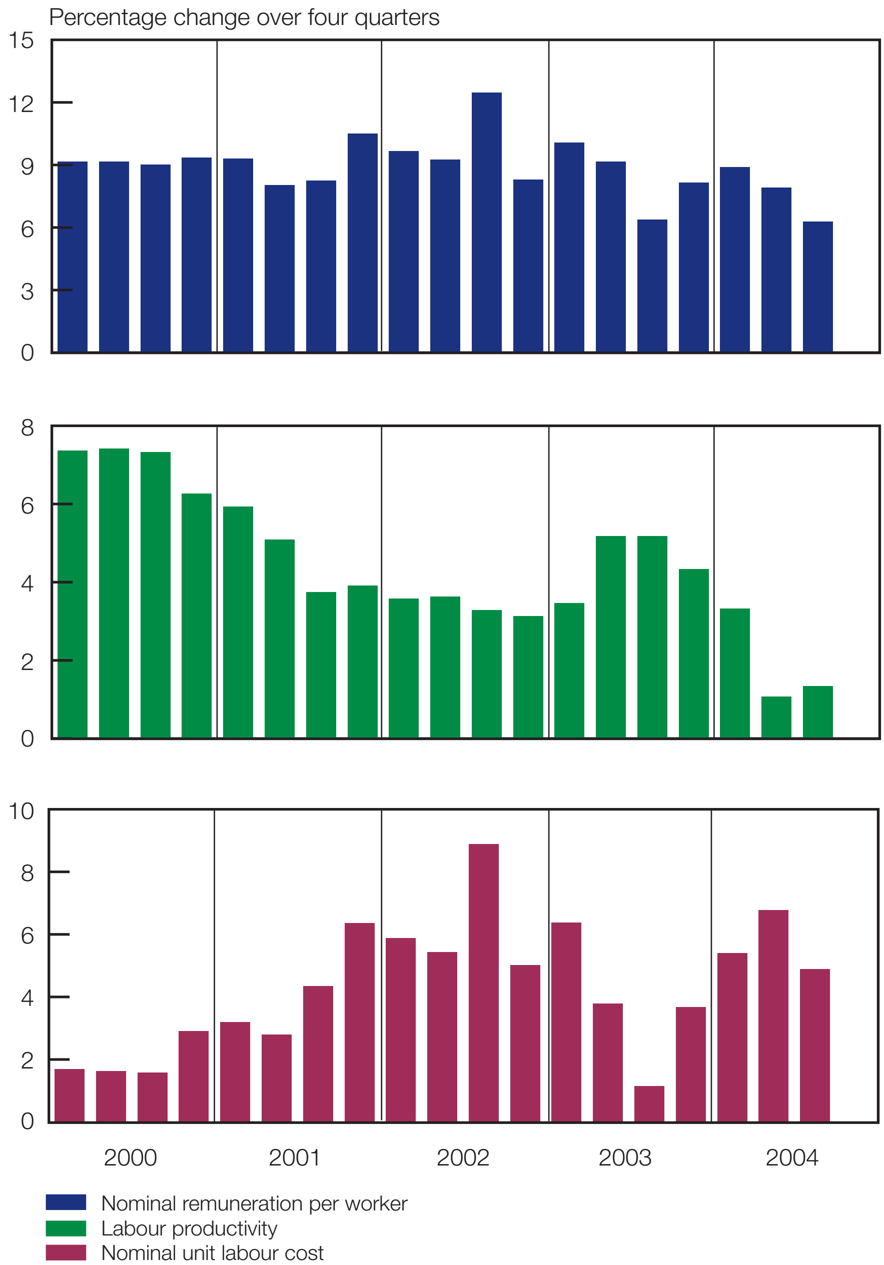
According to Andrew Levy Employment Publications, the average level of *wage settlements* in collective bargaining agreements also declined from 8,9 per cent in 2003 to 6,8 per cent in 2004 as both historical and expected inflation receded. However, the rate of increase in the average *minimum* wage per worker in 2004 at 7,4 per cent was somewhat higher than the average settlement rate.

In some sectors multiyear agreements had been reached in previous years. In the case of the wholesale and retail sector such an agreement resulted in workers in these sectors receiving a minimum wage increase of 8,8 per cent from 1 February 2005, thereby exceeding the general tempo of nominal wage growth per worker in the economy in recent months.

Increases in the average nominal compensation per worker in the *private sector* decelerated from a year-on-year rate of 8,6 per cent in the first quarter of 2004 to 6,4 per cent in the third quarter. This deceleration was fairly pervasive, with the average nominal remuneration per worker only accelerating in the trade, catering and accommodation and non-governmental transport, storage and communication sectors.

The pace of increase in *public-sector* nominal remuneration per worker moderated from a year-on-year rate of 9,6 per cent in the first quarter of 2004 to 6,5 per cent in the third quarter. Nominal wage growth per worker decelerated in all spheres of the public sector except at the local government level, where the rate of increase accelerated to more than 10 per cent in the year to the third quarter of 2004.

Nominal remuneration per worker, labour productivity and unit labour cost in the non-agricultural sectors



Economy-wide labour productivity continued to rise, but its pace of increase in the past two years was more sedate than in preceding years. In fact, the year-on-year rate of increase in *real output per worker in the formal non-agricultural sectors* of the economy, which had slowed down to 3,3 per cent in the first quarter of 2004, moderated even further to 1,1 per cent in the second quarter and 1,3 per cent in the third quarter. Contrary to the deceleration in labour productivity growth in the economy as a whole, production per worker in the *manufacturing sector* increased by 2,9 per cent in the year to the third quarter of 2004.

Labour productivity in formal non-agricultural sectors

Change over four quarters to September 2004

	Per cent
Real output	4,1
Employment	2,8
Production per worker	1,3

The increase in the *cost of labour per unit of production* in the formal non-agricultural sector was contained at a year-to-year rate of 4,0 per cent in 2003, somewhat lower than the 6,0 per cent increase recorded in 2002. Alongside the slowdown in nominal wage growth, the year-on-year rate of increase in nominal unit labour cost decelerated to 4,9 per cent in the third quarter of 2004. Year-on-year increases in nominal unit labour cost in the manufacturing sector also decelerated to 4,9 per cent in the third quarter of 2004 from higher rates in preceding quarters.

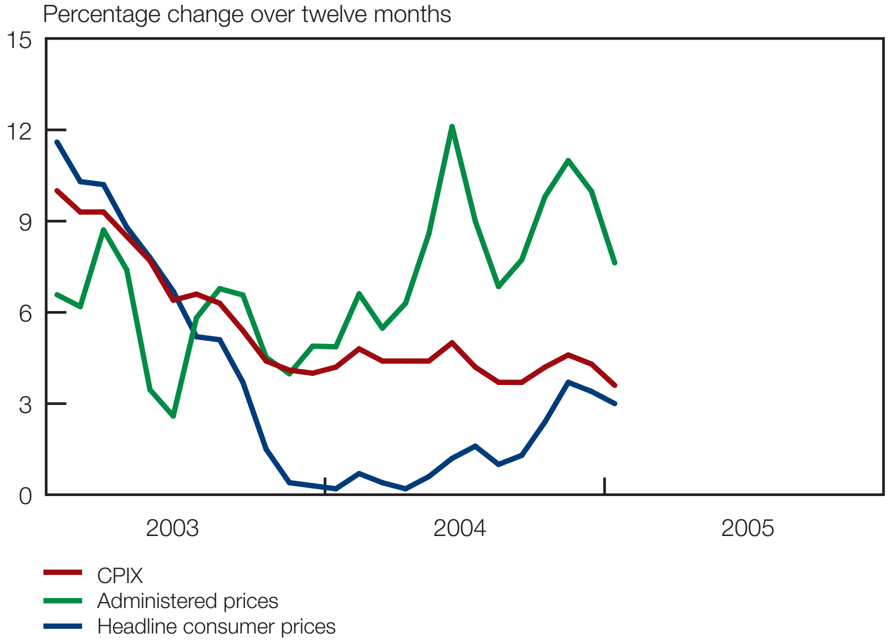
Prices

Mainly on account of the substantial appreciation in the external value of the rand, lower interest rates in the domestic economy and muted increases in food prices, *overall consumer price inflation* decelerated markedly to 1,4 per cent in 2004. This was the lowest annual average rate of inflation in forty years, comparing favourably with rates of 5,8 per cent in 2003 and 9,2 per cent in 2002. Average annual *CPIX inflation*, i.e. overall consumer price inflation excluding home mortgage interest costs, also receded substantially from 6,8 per cent in 2003 to 4,3 per cent in 2004 – its lowest value since the inception of CPIX in 1997. *Year-on-year CPIX inflation* – the inflation-targeting indicator – has remained within the inflation target range of 3 to 6 per cent for seventeen consecutive months and amounted to 3,6 per cent in January 2005. The administered prices component of CPIX, as released by Statistics South Africa in a discussion document, decelerated to a year-on-year rate of increase of 7,6 per cent in January 2005.

The stronger exchange value of the rand continued to exert downward pressure on price growth as is evidenced by developments in the production prices of imported goods. Since April 2003 the production prices of imported goods have decreased continuously for a period of nineteen months. The rate of price *decline* had, however, moderated in the course of 2004 as international crude oil prices rose strongly. Omitting these increases in energy prices from the calculation, the prices of non-oil imported goods fell by 2,1 per cent in the year to January 2005, as opposed to the slight increase of 0,3 per cent in respect of all imported goods. On average, the prices of imported goods declined by 3,9 per cent in 2004, somewhat less than the decline of 4,2 per cent in 2003.

The production prices of almost all categories of imported goods continued to decline in 2004. The only exceptions were the prices of products of petroleum and coal, as well

Headline consumer prices, CPIX and administered prices



as basic metals. The largest decline occurred in the prices of office, accounting and computing machinery at a rate of 16,4 per cent. Price declines of these goods were not only due to the improvement in the exchange rate of the rand, but also due to the price-reducing effects of technological advances in the areas of information technology, computing and communications.

The *decline* in the prices of imported goods was further moderated by a pick-up in production price inflation in South Africa's main trading-partner countries, as these countries also felt the impact of the higher cost of crude oil. Consequently, the year-on-year rate of increase in the composite wholesale price index of South Africa's main trading-partner countries accelerated steeply from 0,9 per cent in March 2004 to 4,2 per cent in December.

Following a five-quarter period of price decline, the prices of imported goods rose from quarter to quarter in each of the final three quarters of 2004, reflecting increases in the prices of basic metals, metal products and imported crude oil. The firm exchange rate

Production prices

Quarter-to-quarter percentage changes at annualised rates

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

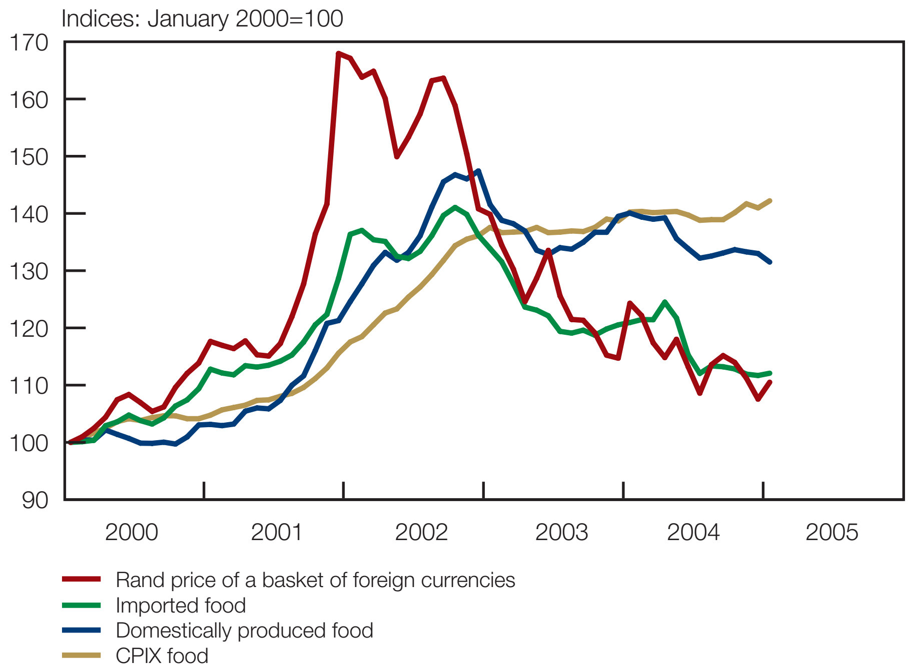
of the rand contributed significantly to muted inflationary pressures, as reflected in low quarter-to-quarter increases in prices in the third and fourth quarters of 2004.

The rise in the production prices of *domestically produced goods* was tempered by the reduction in the intermediate input cost of domestic production, following the rise in the external value of the rand. This led to intensified price competition in general. Accordingly, the year-on-year rate of increase in the prices of domestically produced goods slowed down markedly from 15,3 per cent in August 2002 to 0,2 per cent in November 2003. Subsequently, year-on-year domestically produced goods price inflation drifted higher to around the 3 per cent level, amounting to 3,4 per cent in November 2004. This rate of increase then decelerated to 1,9 per cent in January 2005, especially on account of the decline in petroleum prices. The quarter-to-quarter rate of increase fell to an annualised 0,4 per cent in the fourth quarter of 2004 after it had been as high as 4,8 per cent in the second quarter. On average, the prices of domestically produced goods increased by 2,3 per cent in 2004, which was substantially lower than the 3,9 per cent recorded in 2003.

Notwithstanding the general waning of domestically produced goods price inflation, certain categories of production prices experienced marked increases. Alongside the general rise in international commodity prices, domestic coal prices for instance increased at a year-to-year rate of 24,8 per cent in 2004. Albeit less significant, the prices of other mining products increased by 10,4 per cent, tobacco by 10,1 per cent, and basic ferrous metals by 8,6 per cent. These increases were largely offset by declines in the prices of agricultural products excluding food and manufactured food products. Declines also occurred in the prices of leather and leather products, paper and paper products, wood and wood products as well as textiles, clothing and footwear.

Benign food price inflation at both the agricultural and manufactured level contributed significantly to weaker production price pressures in the past year. In tandem with the decrease in the rand price of a basket of foreign currencies since late 2002, the prices of imported goods have moved to a lower level. Domestically produced food prices also receded, even though they temporarily moved higher in the opening months of 2004

Exchange rate changes and food prices



following domestic drought conditions. Of note is the fact that at the retail level, food prices did not fully respond to the decline in the other measures of food prices, but were "sticky" in the downward direction. This may indicate some remnants of pricing power in the retail sector of the domestic market.

Resulting from the lower rates of *decline* in the prices of imported goods and a slight acceleration in domestically produced goods inflation, *all-goods production price inflation* picked up to a year-on-year rate of 2,5 per cent in November. It decelerated marginally to 1,9 per cent in December 2004 and 1,4 per cent in January 2005. Annual average all-goods production price inflation amounted to only 0,6 per cent in 2004. This compares with rates of increase of 1,7 per cent in 2003 and 14,2 per cent in 2002.

Muted inflationary pressures at the production level in the past two years or so contributed significantly to the waning of *CPIX goods* price inflation. Year-on-year CPIX goods price inflation accordingly declined from a high of 13,4 per cent in October 2002 to a low of 2,0 per cent in December 2003. Subsequently, this rate of increase was pushed higher by increases in the price of petrol, associated with the rise in international crude oil prices. After reaching a recent high of 4,1 per cent in June 2004, year-on-year CPIX goods price inflation receded, on balance, to 2,4 per cent in January 2005. Continued mild year-on-year increases in the prices of food, at around the 2 per cent level during the sixteen months to January 2005, also helped contain the rise in CPIX goods prices. Consequently, the average annual rate of increase in CPIX goods prices decelerated to 2,9 per cent in 2004, as opposed to 6,2 per cent in the preceding year.

As a result of the lower rates of increase in food prices, coupled with declines in the prices of import-price sensitive items such as furniture and equipment, clothing and footwear as well as new and used vehicles, the quarter-to-quarter pace of increase in CPIX goods prices fell from an annualised rate of 4,8 per cent in the first quarter of 2004 to 0,8 per cent in the third quarter. Following the steep increase in petrol prices in October and November 2004, CPIX goods price inflation rose to an annualised rate of 4,4 per cent in the fourth quarter. The quarter-to-quarter rate of increase in CPIX goods prices in the final quarter of 2004 was also pushed higher by increases in the prices of alcoholic drinks and tobacco, clothing and footwear as well as food.

Inflation in CPIX components

Percentage change over same period in previous year

	Weights	2004 (annual average)	2005 Jan
Alcoholic beverages and tobacco	3,1	10,1	10,0
Transport running cost	5,7	10,2	9,0
Total housing services	13,4	8,7	6,4
Services excluding housing and transport	16,5	6,5	*6,0*
Total transport services	3,9	3,5	*3,3*
Total other goods (not included elsewhere)	17,5	3,6	*3,0*
Food	26,9	2,0	1,4
Furniture and equipment	3,2	0,5	-0,1
Vehicles	5,7	-0,8	-1,4
Clothing and footwear	4,1	-3,8	-2,8
Total CPIX	**100,0**	4,3	***3,6***

Italics denote year-on-year increases within the inflation target range of between 3 and 6 per cent for the latest available observation

Unlike goods price inflation, year-on-year *CPIX services price inflation* consistently remained in excess of the 6 per cent upper limit of the inflation target range from the inception of this measure in January 1997 to December 2004. Nonetheless, year-on-year CPIX services price inflation moderated, on balance, from 8,6 per cent in September 2003 to 6,5 per cent in December 2004. Subsequently, year-on-year CPIX services price inflation fell below the upper limit of the inflation target range in January 2005 and amounted to 5,9 per cent. Housing services price inflation fell back from year-on-year rates in excess of 10 per cent in the closing months of 2003 and the first few months of 2004 to 6,4 per cent in January 2005. Notwithstanding rising energy costs, overall CPIX services price inflation benefited from relatively low increases in transport services prices at year-on-year rates of between 2,4 and 3,4 per cent during the eleven months to January 2005.

Based on the results from the most recent *Labour Force Survey*, monthly increases of 0,8 per cent will apply to domestic worker wages in the period from September 2004 to February 2005. When annualised, these increases amount to 10 per cent, well in excess of recent economy-wide nominal wage growth per worker.

The quarter-to-quarter rate of increase in CPIX services prices remained at annualised rates of approximately 6 per cent during the whole of 2004, accelerating somewhat to 6,7 per cent in the fourth quarter. The slowdown in the quarter-to-quarter pace of increase in transport services prices in the final quarter of 2004 partly counteracted the acceleration in the prices of housing services and services not related to housing or transport.

Notwithstanding CPIX inflation remaining within the inflation target range for seventeen consecutive months by January 2005, a renewed surge in international crude oil prices at the start of 2005, fairly sizeable increases in certain administered prices and buoyant domestic demand conditions are likely to put a floor under inflation in the near term. However, the fiscal prudence applied by government, muted increases in consumer food prices and lower wage settlement rates as well as reasonably well-contained price inflation in the rest of the world, are likely to mitigate inflationary pressures in the months ahead.

Foreign trade and payments

International economic developments

Early estimates put real growth in the world economy for 2004 at around 5 per cent – the highest global growth rate in almost three decades. The acceleration in growth was widespread across regions and countries, but was mainly driven by the United States' solid pace of expansion, while China also acted as an increasingly important catalyst of global growth.

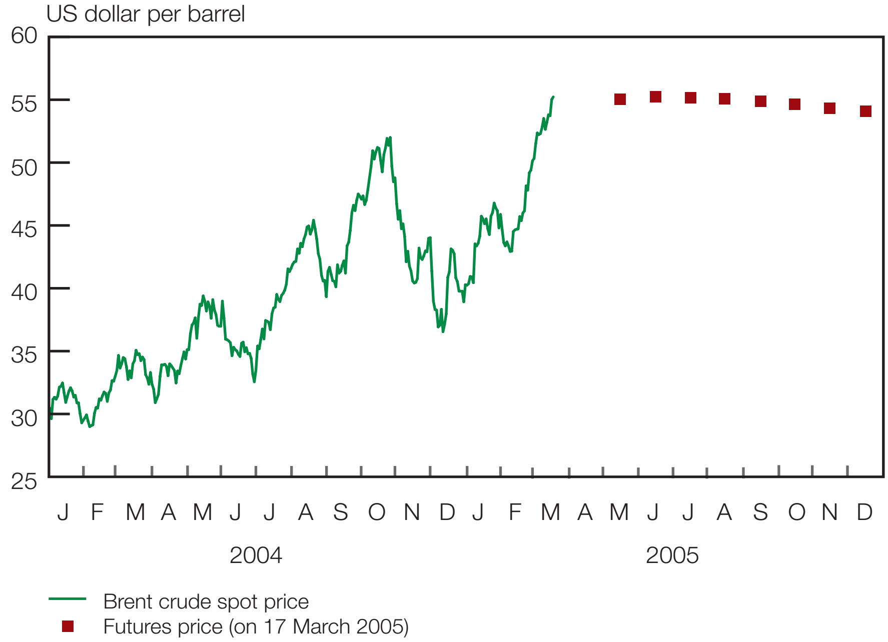
Economic growth in the euro area improved during the first half of 2004 but moderated in the second half, while output growth in the United Kingdom remained generally buoyant during the whole of that year. After contracting in the second and third quarters of 2004, Japan's economy grew moderately in the fourth quarter. The economic growth in the Asian emerging-market economies was generally strong in 2004, not least due to increased exports to China. Economic activity in Africa and Latin America benefited during 2004 from the global economic recovery and strong demand for commodities.

Tsunami disaster

The IMF and the World Bank have recently released a preliminary assessment of the macroeconomic impact of the Tsunami disaster of 26 December 2004. The estimated death toll is almost 300 000 with the highest number of deaths in Indonesia. The damage to housing and infrastructure has been the greatest in Indonesia, the Maldives and Sri Lanka. The impact on economic growth in 2005 is expected to be limited in most countries – varying between zero and one percentage point – with the exception of the Maldives where preliminary estimates show a decline of 5 percentage points.

The strong global economic recovery contributed to upward pressure on commodity prices. The international prices of most metals, minerals and agricultural commodities were generally buoyant during 2004. The price of Brent crude oil also rose strongly from around US$30 per barrel at the beginning of 2004 to US$52 per barrel in October. It subsequently

Price of Brent crude oil



declined to below US$37 per barrel in early December 2004, reflecting the easing of a number of supply concerns and speculative pressures that previously caused oil prices to reach record-high levels. Crude oil prices again started to increase later in December after the OPEC countries decided to reduce actual production by 1 million barrels per day from January 2005. The oil price reached levels around US$47 per barrel before temporarily dropping below US$43 per barrel in early February 2004 after the elections in Iraq passed without disruptions to oil production. In mid-March 2005 crude oil prices exceeded US$53 per barrel after the International Energy Agency increased its estimate for global oil demand for the third consecutive month. Crude oil prices increased further to new record-high levels around US$55 per barrel after OPEC's decision on 16 March 2005 to increase output quotas did not ease concerns that global oil production may fail to keep pace with rising demand. Oil futures contracts suggest a moderate decline in oil prices towards the end of the year.

Many central banks tightened monetary policy during 2004 and early 2005 (see the accompanying table). Since 1 January 2005, monetary policy has been tightened in Australia, Brazil, Chile, Hong Kong, Mexico, New Zealand, Thailand and the United States. The central banks in the Czech Republic, Hungary and Israel, however, have lowered interest rates since the beginning of 2005.

Key central bank interest rates

Per cent

Countries	1 Jan 2004	17 Mar 2005	Net change since 1 Jan 2004 (percentage points)	Latest change (percentage points)	
United States	1,00	2,50	+1,50	2 Feb 2005	(+0,25)
Japan*	0,00	0,00	0,00	19 Mar 2001	(-0,15)
Euro area	2,00	2,00	0,00	6 Jun 2003	(-0,50)
United Kingdom	3,75	4,75	+1,00	5 Aug 2004	(+0,25)
Canada	2,75	2,50	-0,25	19 Oct 2004	(+0,25)
Denmark	2,00	2,00	0,00	6 Jun 2003	(-0,50)
Sweden	2,75	2,00	-0,75	7 Apr 2004	(-0,50)
Switzerland	0 – 0,75	0,25 – 1,25	+0,50	16 Sep 2004	(+0,25)
Australia	5,25	5,50	+0,25	2 Mar 2005	(+0,25)
New Zealand	5,00	6,75	+1,75	10 Mar 2005	(+0,25)
Israel	4,80	3,50	-1,30	1 Feb 2005	(-0,20)
China	5,31	5,58	+0,27	29 Oct 2004	(+0,27)
Hong Kong	2,50	4,00	+1,50	3 Feb 2005	(+0,25)
India	4,50	4,75	+0,25	26 Oct 2004	(+0,25)
Malaysia	**	2,70	0,00	23 April 2004	**
South Korea	3,75	3,25	-0,50	11 Nov 2004	(-0,25)
Taiwan	1,38	1,75	+0,37	31 Dec 2004	(+0,12)
Thailand	1,25	2,25	+1,00	2 Mar 2005	(+0,25)
Brazil	16,50	19,25	+2,75	16 Mar 2005	(+0,50)
Chile	2,25	2,75	+0,50	10 Feb 2005	(+0,25)
Mexico***	6,17	9,59	+3,42	25 Feb 2005	(+2 mil pesos)
Czech Republic	2,00	2,25	+0,25	27 Jan 2005	(-0,25)
Hungary	12,50	8,25	-4,25	21 Feb 2005	(-0,75)
Poland	5,25	6,50	+1,25	25 Aug 2004	(+0,50)
Russia	16,00	13,00	-3,00	15 Jun 2004	(-1,00)
South Africa	8,00	7,50	-0,50	13 Aug 2004	(-0,50)

* Japan eased monetary policy several times during 2003 and again in January 2004 by increasing the target range for the outstanding balance on reserve accounts at the Bank of Japan.

** The central bank of Malaysia introduced a new interest rate framework on 23 April 2004.

*** The Bank of Mexico uses the money-market shortage to influence liquidity conditions, while the interest rate is market determined.

Source: National central banks

Current account

As could be expected against the background of a vigorous upturn in economic activity, South Africa's *trade balance* with the rest of the world deteriorated considerably in 2004. With net service, income and current transfer payments to non-residents largely unchanged, the deficit on the *current account of the balance of payments* accordingly widened considerably: As a ratio of gross domestic product the current-account deficit rose from 1,5 per cent in 2003 to 3,2 per cent in 2004.

The significant widening of the deficit on the current account in 2004 resulted mainly from the sustained high level of real economic activity and concomitant strong increase in merchandise imports. Robust domestic demand and the strengthening of the exchange rate of the rand were reflected in the physical quantity of imported goods, which advanced by no less than 16½ per cent over the period.

Balance of payments on current account

Seasonally adjusted and annualised
R billions

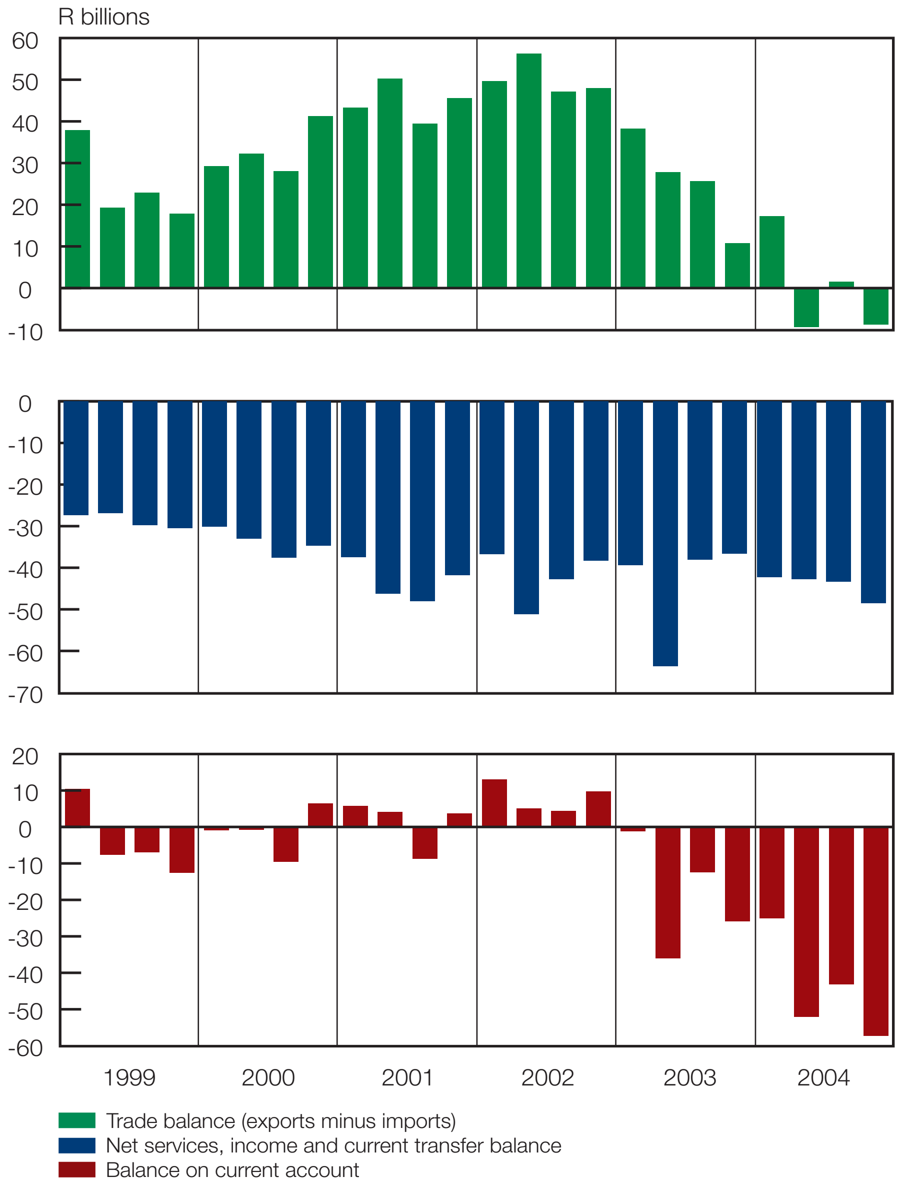
	2003	2004				
	Year	1st qr	2nd qr	3rd qr	4th qr	Year
Merchandise exports	256,3	260,7	278,0	286,3	290,7	278,9
Net gold exports	34,2	33,4	33,3	29,7	35,0	32,8
Merchandise imports	-265,0	-276,9	-320,7	-315,7	-334,4	-311,9
Trade balance	**25,5**	**17,2**	**-9,4**	**0,3**	**-8,7**	**-0,2**
Net service, income and current transfer payments	-44,4	-42,3	-42,7	-43,4	-48,6	-44,2
Balance on current account	**-18,9**	**-25,1**	**-52,1**	**-43,1**	**-57,3**	**-44,4**

After having contracted in the third quarter of 2004, the deficit on the current account widened considerably in the fourth quarter. A renewed sharp increase in the value of imports more than neutralised the increased export values of goods and gold over the period. The positive trade balance in the third quarter of 2004 consequently turned into a substantial deficit in the fourth quarter. A larger shortfall in net service and income payments to non-residents also contributed to the current-account deficit. Relative to gross domestic product, the current-account deficit amounted to 4,0 per cent in the fourth quarter of 2004, compared with 3,1 per cent in the third quarter.

The value of *merchandise exports*, which had risen by 6½ per cent in the second quarter of 2004, increased at a far slower pace in the second half of 2004; in fact the value of exported goods in the fourth quarter of 2004 was only 1½ per cent higher than in the third quarter. The increase in the fourth quarter of 2004 was caused by a rise in the exports of agricultural and mining products, mainly related to relatively high world prices of key commodities exported from South Africa. Export values of manufactured goods declined over the period. For 2004 as a whole, export values were 8½ per cent higher than in 2003.

The physical quantity of exported goods declined in both 2002 and 2003, but rose by almost 5½ per cent in 2004. A stronger world economy and buoyant demand for commodities contributed to higher export volumes, particularly of mining products. In the fourth quarter of 2004 merchandise export volumes rose by 4 per cent compared with the third quarter.

Balance of payments: Current account

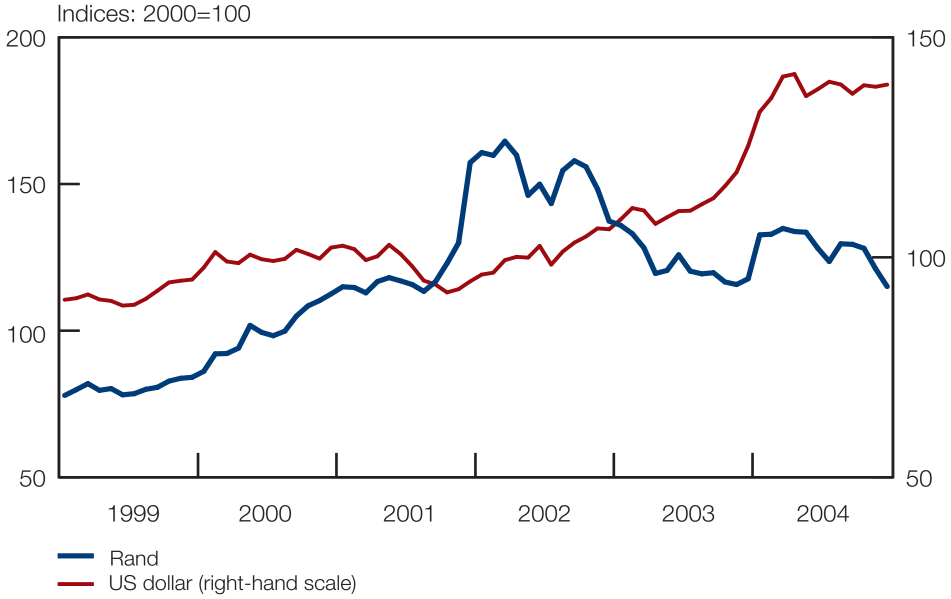


Seasonally adjusted and annualised

The rand prices of goods exported from South Africa, which had shown a steady decline from the second quarter of 2004, decreased by a further 2½ per cent in the fourth quarter. The decline in the fourth quarter reflected a slight increase in the weighted effective exchange rate of the rand. For the year 2004 the rand prices of exported goods increased by about 3 per cent, while the rand prices of commodity exports increased by about 5 per cent.

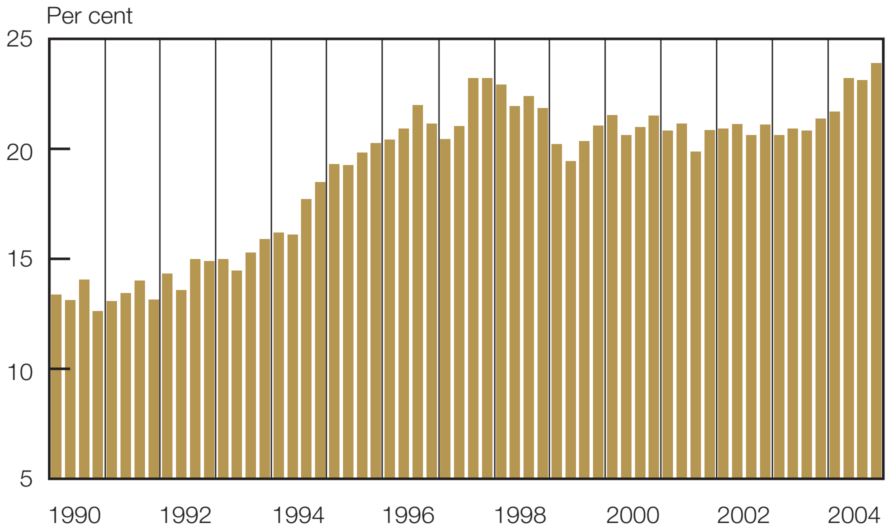
The value of South Africa's annualised net *gold exports*, which had declined sharply to R29,7 billion in the third quarter of 2004, rose by 18 per cent to R35,0 billion in the fourth quarter. The higher value of gold exports resulted from an increase in the physical quantity of gold exports as well as a rise in the realised price of gold exported. The volume of gold exports receded by 7½ per cent in the third quarter of 2004, but rose by 13 per cent in the fourth quarter, indicating that South African mining houses ran down their inventories over the latter period. After having declined in the third quarter of 2004, the realised rand price of gold increased by 4 per cent in the fourth quarter. Mainly due to continued strong consumer demand and a weaker US dollar the average fixing price of gold on the London market rose by 8 per cent to US$434 per fine ounce in the fourth quarter of 2004. The increase in rand terms fell below that, as a result of the continuous strengthening of the exchange rate of the rand against other foreign currencies.

Prices of South African non-gold commodity exports



Having remained fairly flat in the first nine months of 2003, the value of *merchandise imports* rose almost unabatedly for five consecutive quarters up to the end of 2004; the rand value of imported goods in the fourth quarter of 2004 was no less than 24 per cent higher than in the corresponding quarter of 2003. In the fourth quarter of 2004, the value of imported goods rose by 6 per cent, with increases registered in all the main categories of imports. In particular, the value of imported manufactured goods rose by 8 per cent in the fourth quarter as the growth in aggregate gross domestic expenditure led to a greater demand for imported intermediate, capital and consumer goods. A naval vessel counted among the high-value items imported in the fourth quarter.

Import penetration ratio



The physical quantity of merchandise imports, having increased only marginally in the third quarter of 2004, rose by 4½ per cent in the fourth quarter. South Africa's import penetration ratio (i.e. the ratio of real merchandise imports to real gross domestic expenditure) rose from 21,7 per cent in the first quarter of 2004 to 23,9 per cent in the fourth quarter. For 2004 as a whole, the volume of merchandise imports rose by 16½ per cent. The strong rise in the import penetration ratio probably partly reflected the substitution of imported goods for domestically produced goods in response to the decline in the relative prices of imported goods.

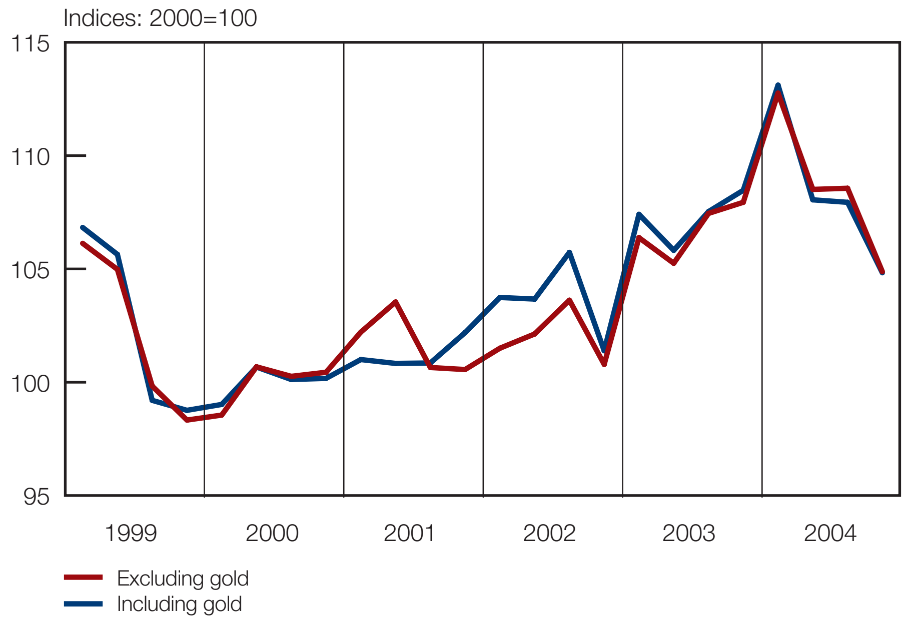
The average price level of imported goods in rand increased by 1½ per cent in the fourth quarter of 2004 and rose by only ½ a per cent in 2004 as a whole. Increases in the international price of crude oil were partly offset by the increase in the weighted effective exchange rate of the rand over the period.

The deficit on the services, income and current transfer account of the balance of payments widened from R43,4 billion in the third quarter of 2004 to R48,6 billion in the fourth quarter. This weakening was mainly due to an increase in net income payments, which rose from R26,2 billion in the third quarter of 2004 to R30,6 billion in the fourth quarter as dividend receipts from non-residents decreased.

Terms of trade

South Africa's terms of trade recorded a recent high in the first quarter of 2004 when prices of commodity exports were exceptionally favourable while the international price of crude oil remained relatively subdued. Gains in the price of crude oil were instrumental in drawing the terms of trade lower in the last three quarters of 2004.

Terms of trade



Financial account

In the final quarter of 2004 the financial account of the balance of payments (including unrecorded transactions) recorded a net inward movement of capital for the seventh consecutive quarter. The inflow of capital amounted to R31,4 billion in the fourth quarter of 2004 compared to a net inflow of R22,6 billion in the third quarter. Both portfolio and other investment capital recorded sharply higher inflows on a net basis, while the direct investment category registered a net outflow of capital in the fourth quarter of 2004. In total the financial account recorded a net inward movement of capital to the value of R96,2 billion in 2004 – considerably higher than the net inflow of capital of R70,5 billion recorded in 2003.

Net financial transactions not related to reserves

R billions

	2003	2004				
	Year	1st qr	2nd qr	3rd qr	4th qr	Year
Change in liabilities						
Direct investment	5,4	8,7	-1,6	1,7	-5,0	3,8
Portfolio investment	7,8	5,1	14,1	3,0	22,7	44,8
Other investment	8,9	4,1	4,5	-2,9	7,8	13,5
Change in assets						
Direct investment	-4,4	0,4	-9,4	-0,6	-0,8	-10,4
Portfolio investment	-1,0	0,0	-1,5	-1,3	-3,2	-6,0
Other investment	25,9	-3,0	6,2	4,0	10,9	18,1
Total financial transactions*	**70,5**	**15,1**	**27,1**	**22,6**	**31,4**	**96,2**

* Including unrecorded transactions

Foreign-owned assets in South Africa

Foreign-inward direct investment into South Africa contracted by R5,0 billion in the fourth quarter of 2004 compared to an inflow of R1,7 billion in the third quarter. The outflow during the fourth quarter of 2004 resulted from the sale of a foreign direct investor's remaining share in Telkom to a South African entity. This was partly countered by drawings made on short-term credit facilities by direct investment enterprises in South Africa. Inward direct investment recorded an inflow of R3,8 billion for 2004 as a whole compared to an inflow of R5,4 billion in 2003.

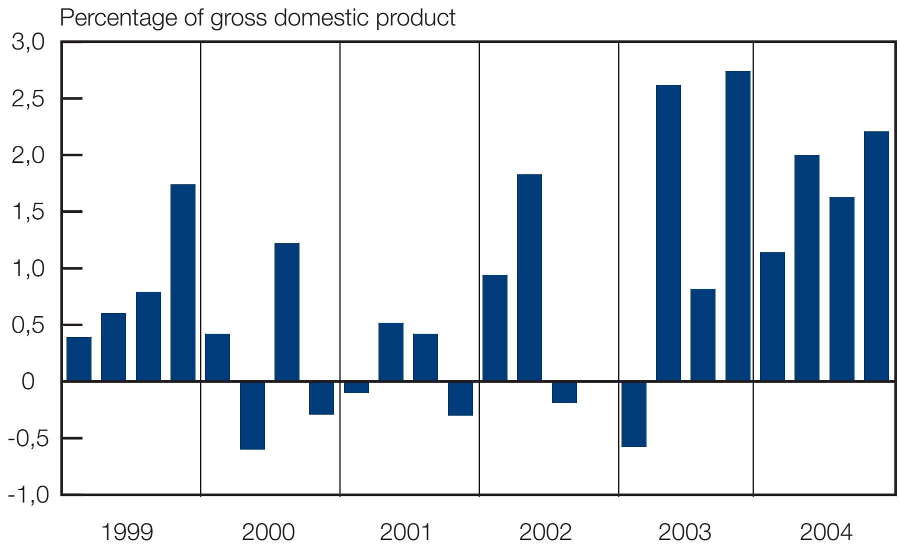
Foreign portfolio investors increased their holdings of South African equity and fixed interest securities in the fourth quarter of 2004; despite the repayment of a 300 million euro international bond by the National Treasury, a net amount of R22,7 billion was invested in the country. The brisk net inward movement of capital in the fourth quarter of 2004 was accompanied by a strong performance of equity and bond prices. This was the fourth consecutive quarter in which portfolio investment recorded an inflow, and also represented the highest quarterly inflow for the year. Inward portfolio investment recorded an inflow of R44,8 billion for 2004 as a whole compared to an inflow of R7,8 billion in 2003.

Other foreign investment into South Africa registered an inflow of R7,8 billion in the fourth quarter of 2004, following an outflow of R2,9 billion in the third quarter. This inflow resulted from an increase in foreign loans extended to South African banks, which was only partly countered by repayments made on long-term loan commitments by the public as well as the private sectors, and a reduction in non-resident deposits with local banks. For 2004 as a whole, inward other investment recorded an inflow of R13,5 billion compared to an inflow of R8,9 billion in 2003.

South African-owned assets abroad

Direct investment abroad by South African entities changed from an outflow of R0,6 billion in the third quarter of 2004 to an inflow of R0,8 billion in the fourth quarter. This inflow resulted from the repatriation of short-term financing from abroad, notwithstanding the continued acquisition of foreign companies by South African companies. However, acquisitions tended to dominate over the longer term: Outward direct investment recorded an outflow of R10,4 billion for 2004 as a whole following an outflow of R4,4 billion in 2003.

Net financial transactions not related to reserves



Portfolio investment abroad (i.e. the acquisition of foreign debt and equity securities) by South African investors – mainly institutional investors – registered an increased outflow of R3,2 billion in the fourth quarter of 2004; foreign portfolio assets to the value of R1,3 billion were acquired in the third quarter of 2004. Outward portfolio investment recorded an outflow of R6,0 billion for 2004 as a whole compared to an outflow of R1,0 billion in 2003.

Other outward investment contracted by R10,9 billion in the fourth quarter of 2004, compared to a decline of R4,0 billion in the third quarter. The inflow of funds in the fourth quarter resulted from a reduction in rand-denominated deposits with foreign banks and a decrease in loans extended by South African banks to foreign banks. Outward other investment recorded an inflow of R18,1 billion for 2004 as a whole compared to an inflow of R25,9 billion in 2003.

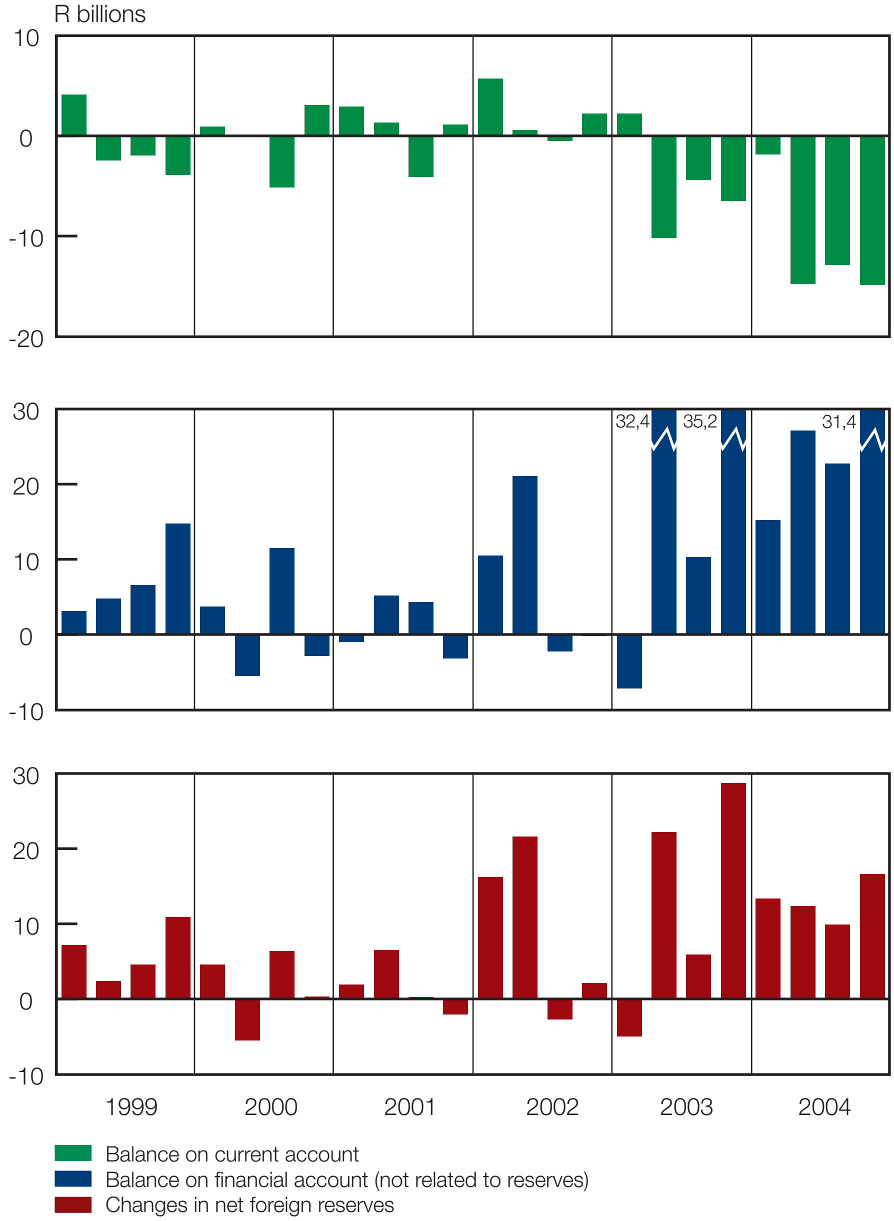
International reserves and liquidity

As a result of continued net inflows of capital on the financial account of the balance of payments, which exceeded the growing deficit on the current account, South Africa's overall balance of payments recorded a surplus of R16,6 billion in the fourth quarter of 2004 compared to a surplus of R9,9 billion in the third quarter. For 2004 as a whole the overall balance of payments recorded a surplus of R52,1 billion, which was marginally higher than the R51,8 billion surplus registered in 2003.

The gross international reserves of the Reserve Bank increased at a measured pace from US$8,0 billion at the end of 2003 to US$12,2 billion at the end of September 2004 and

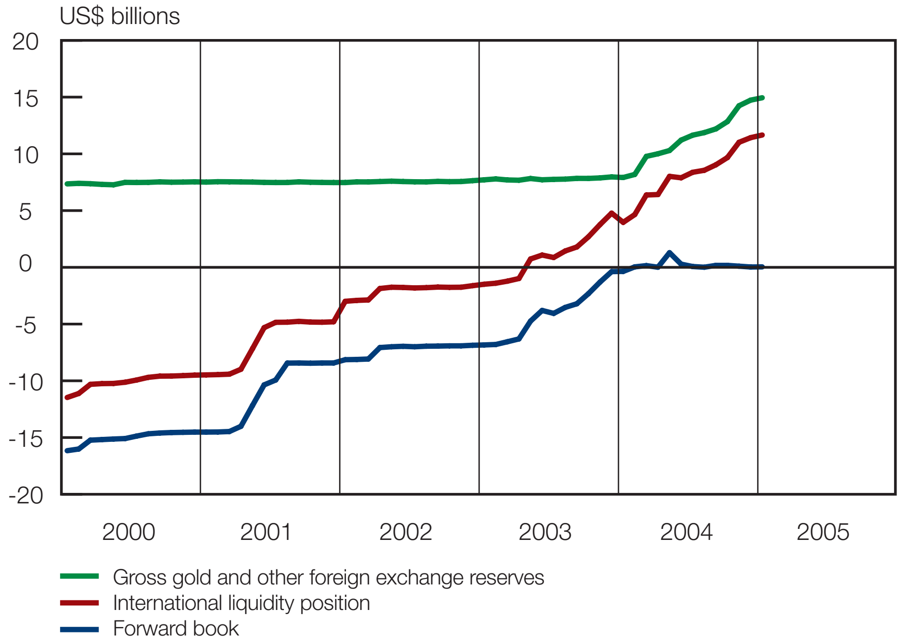
US$14,7 billion at the end of December. It came to US$15,4 billion at the end of February 2005. The Bank's month-end utilisation of foreign short-term credit facilities remained roughly unchanged at around US$3,5 billion from early 2004 to the end of February 2005.

Balance of payments: Overall balance



The international liquidity position of the Reserve Bank increased further by US$2,4 billion during the fourth quarter of 2004 to US$11,4 billion at the end of December. This could be compared with only US$4,8 billion at the end of 2003. During early 2005 the international liquidity position increased further, reaching a level of US$12,2 billion at the end of February.

Gross reserves, international liquidity position and forward book of the South African Reserve Bank



Foreign debt

South Africa's total outstanding foreign debt increased by US$0,7 billion during the third quarter of 2004 to a level of US$39,5 billion at the end of September. This increase could be attributed to rand-denominated debt which rose by US$1,8 billion from the end of June 2004 to the end of September. Outstanding debt denominated in foreign currency declined by US$1,1 billion over the same period.

Foreign debt of South Africa

US$ billions at end of period

Period	2002	2003	2004 1st qr	2004 2nd qr	2004 3rd qr
Foreign-currency denominated debt...	**25,0**	**27,4**	**27,9**	**27,4**	**26,3**
Bearer bonds.......................................	7,8	9,7	9,6	9,5	9,6
Other:					
Public sector..................................	5,0	4,9	4,4	4,6	4,7
Monetary sector.............................	6,2	5,9	7,4	7,0	5,9
Non-monetary private sector...........	6,0	6,9	6,5	6,3	6,1
Rand-denominated debt	**7,7**	**9,8**	**11,3**	**11,4**	**13,2**
Bonds..	4,5	4,2	4,4	3,9	5,1
Other	3,2	5,6	6,9	7,5	8,1
Total foreign debt................................	**32,7**	**37,2**	**39,2**	**38,8**	**39,5**

The increase in rand-denominated debt in the third quarter of 2004 could mainly be attributed to an increase in non-resident investors' holdings of public-sector bonds. Over the same period, non-resident investors also increased their rand-denominated deposits with South African banks.

The decline in foreign-currency denominated debt in the third quarter could primarily be attributed to a reduction in non-resident foreign-currency denominated deposits with and loans extended to South African banks. The South African Reserve Bank also repaid part of its syndicated loan facility to the value of US$230 million.

In rand terms South Africa's total outstanding foreign debt increased by R11 billion from R243 billion at the end of June 2004 to R254 billion at the end of September 2004.

South Africa's foreign debt as a ratio of gross domestic product compares favourably with the ratio for other developing countries. Of the groups listed in the accompanying table, only Central and Eastern Europe and the Western Hemisphere recorded an increase in the ratio of foreign debt to gross domestic product over the period under consideration.

Emerging-market and developing countries: Ratio of foreign debt to gross domestic product

Per cent

End of period	1998	1999	2000	2001	2002	2003
Emerging-market and developing countries	43,2	45,1	40,5	39,5	39,8	38,1
Regional groups						
Africa	66,8	66,1	61,8	59,1	57,5	49,9
Sub-Saharan Africa	68,9	69,1	65,3	63,5	61,2	52,7
Central and Eastern Europe	42,4	46,5	50,2	52,2	54,1	54,7
Commonwealth of Independent States	58,1	75,2	56,0	46,7	42,5	38,4
Developing Asia	37,2	34,3	30,7	29,8	27,4	25,4
Middle East	55,5	52,6	46,6	45,7	46,8	43,8
Western Hemisphere	38,1	44,4	38,9	38,8	43,6	43,9
South Africa	27,9	29,2	27,7	26,0	29,5	22,4

* Source: IMF *World Economic Outlook* – September 2004, and South African Reserve Bank

Exchange rates

The exchange rate of the rand continued to appreciate in 2004, supported by firm commodity prices and investor interest in South Africa. Against individual currencies, however, the exchange value of the rand was heavily influenced by the behaviour of the US dollar on international foreign exchange markets. On a trade-weighted basis the rand on balance increased by 11,7 per cent in 2004, following increases of 24,2 per cent and 16,2 per cent in

Exchange rates of the rand

Percentage change

	31 Mar 2004 to 30 Jun 2004	30 Jun 2004 to 30 Sep 2004	30 Sep 2004 to 31 Dec 2004	31 Dec 2004 to 28 Feb 2005
Weighted average*	2,4	-3,2	6,6	-1,2
Euro	2,0	-4,3	3,3	0,2
US dollar	1,0	-2,6	14,3	-2,6
British pound	2,6	-2,2	6,6	-2,5
Japanese yen	6,1	-0,8	5,7	-1,0

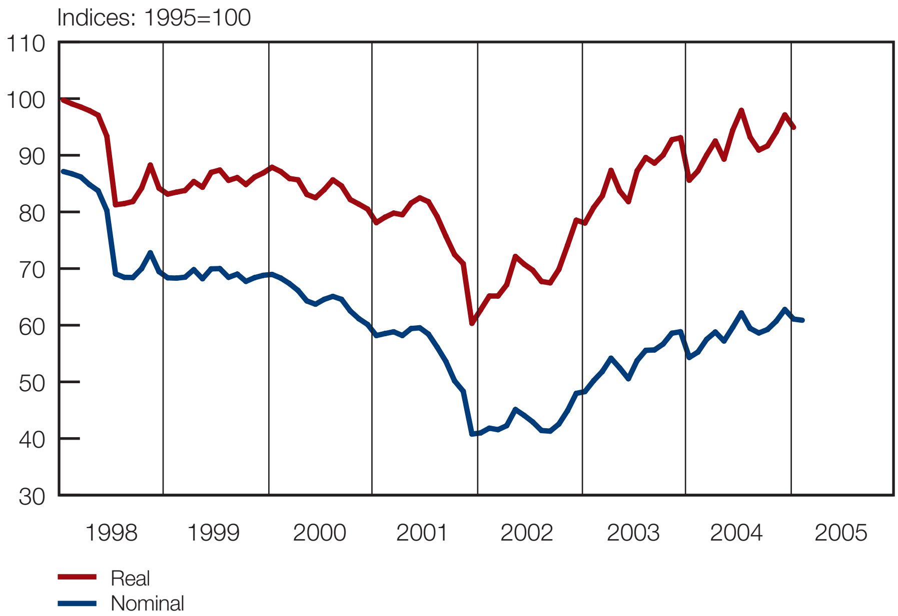
* Against a basket of 13 currencies

2002 and 2003, respectively. In the fourth quarter of 2004 the trade-weighted exchange rate of the rand increased by 6,6 per cent. Against the US dollar, the rand appreciated by no less than 14,3 per cent. However, from the end of December 2004 to 28 February 2005, the weighted average exchange rate of the rand decreased by 1,2 per cent.

The factors which contributed to the strengthening of the rand during the fourth quarter include expectations of significant future foreign direct investment inflows as well as a ratings upgrade by Fitch Ratings from stable to positive in October 2004. In January 2005 Moody's Investor Service upgraded South Africa's local foreign currency debt and bank deposits as well as the country's foreign currency-denominated bonds and notes to a Baa1 rating. South Africa is now rated alongside Bahrain, Chile, Malaysia and Thailand.

The net average daily turnover in the domestic market for foreign exchange, which had decreased to US$10,8 billion in the third quarter of 2003, increased to US$12,4 billion in the fourth quarter of 2004. The value of transactions in which non-residents participated increased from US$7,4 billion per day to US$9,2 billion per day over the same period. Participation by resident parties decreased marginally from the third to the fourth quarter of 2004.

Effective exchange rates of the rand



The real effective exchange rate of the rand appreciated by 4,3 per cent from December 2003 to December 2004. In December 2004 the real effective exchange rate of the rand was more or less at the same level than in the early months of 1998, prior to the South East Asian financial crisis.

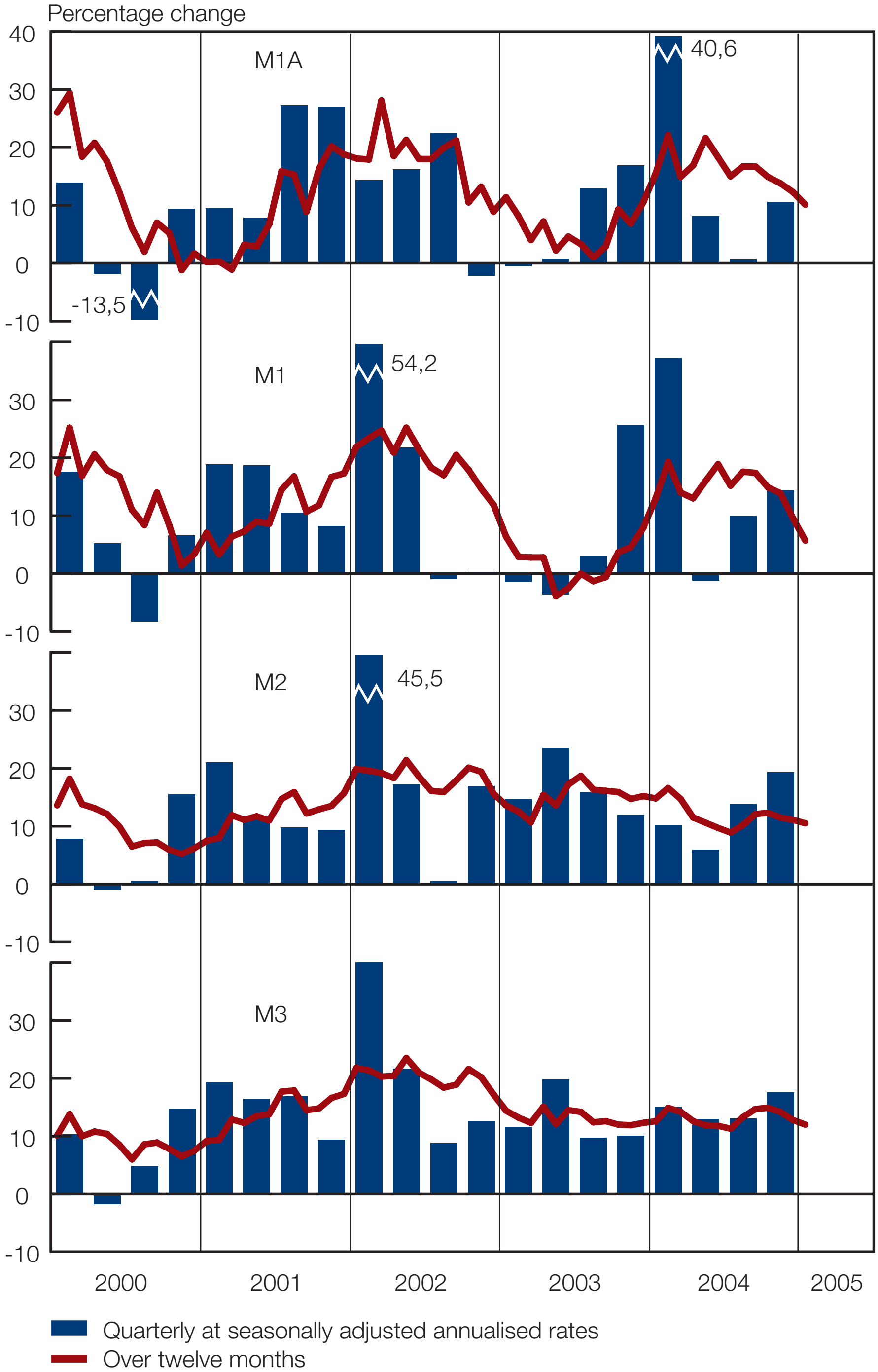
Monetary developments, interest rates and financial markets

Money supply[2]

During 2004 growth in the broadly defined money supply, M3, maintained a robust pace, consistent with firm increases in nominal income, expenditure and wealth. Having remained unchanged at 13,0 per cent in the second and third quarters of 2004, the quarter-to-quarter growth rate in M3 accelerated to 17,6 per cent in the fourth quarter.

2 *The quarter-to-quarter growth rates referred to in this section are seasonally adjusted and annualised.*

Monetary aggregates



Measured over twelve months, growth in M3 exceeded 11 per cent throughout 2004, registering the highest value for the year of 14,9 per cent in October. Twelve-month growth in M3 decelerated to 12,8 per cent in December 2004 and 12,0 per cent in January 2005 as private-sector M3 deposits were drained by tax collections which flowed into government deposits with the banking system; government deposits are not included in M3. This build-up in government deposits was largely intended to fund the coupon interest payments on government bonds and the redemption of the second tranche of the R150 bond at the end of February 2005. The combined amount of interest payments and debt redemptions by government on 28 February came to R39,3 billion.

Twelve-month growth in all the narrower monetary aggregates broadly resembled the growth of M3 and remained at relatively high levels during 2004. Quarter-to-quarter growth in all the aggregates picked up further in the final quarter of the year, with cheque and transmission deposits and other short and medium-term deposits registering the strongest increases.

During the fourth quarter of 2004, the increase in M3 deposit holdings was almost equally divided between the household and corporate sectors. The household sector's deposits increased by R10,3 billion in the fourth quarter of 2004, while the corporate sector's deposit holdings rose by R10,7 billion. The increases were mainly concentrated in short and medium-term deposits, partly due to the reallocation of funds away from deposits with maturities beyond six months, given the prevailing low interest rate environment. Over the twelve months to December 2004 household deposits rose by 10,1 per cent and corporate deposits by 14,3 per cent.

Growth in monetary aggregates

Per cent at seasonally adjusted annualised rates

	2004		
	2nd qr	3rd qr	4th qr
Notes and coin in circulation	5,9	18,2	18,7
Cheque and transmission deposits	8,5	-2,4	9,0
M1A	**8,1**	**0,7**	**10,6**
Non-cheque demand deposits	-11,7	22,6	18,3
M1	**-1,2**	**10,0**	**14,0**
Other short and medium-term deposits	14,9	18,4	24,9
M2	**5,9**	**13,8**	**19,1**
Long-term deposits	90,2	7,2	6,9
M3	**13,0**	**13,0**	**17,6**

Annualised growth in M3 exceeded the growth in nominal gross domestic product by 9,6 percentage points in the fourth quarter of 2004. As a result, the income velocity of circulation of M3 declined further from 1,65 in the third quarter of 2004 to 1,61 in the fourth quarter – the lowest level on record since 1965. Several forces were at work to raise the level of money supply on a structural basis, such as:

- improved access to the banking system for the previously unbanked;
- low inflation and positive real interest rates on deposits, raising the attractiveness of bank deposits as an asset class; and
- strong and protracted real upward revaluation of real-estate and other asset values, raising the overall value of asset portfolios – a portion of which tends to be held in bank deposit form.

M3 increased by R21,0 billion from the end of the third quarter of 2004 to the end of the fourth quarter. The statistical counterparts to these increases are tabled below.

Counterparts of change in M3

R billions

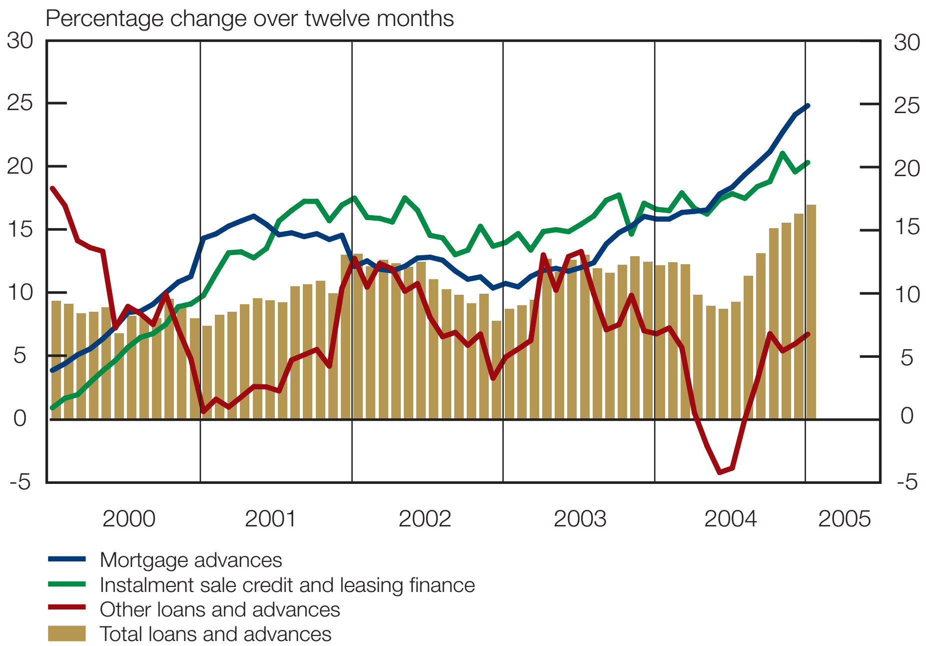
Counterparts	2004			
	3rd qr		4th qr	
Net foreign assets		16,1		3,2
Net claims on the government sector		-26,2		3,9
Gross claims	-7,0		18,6	
Government deposits (decrease +; increase -)	-19,2		-14,7	
Claims on the private sector		45,7		68,6
Investments and bills discounted	2,1		22,7	
Total loans and advances	43,6		45,9	
Net other assets		-6,4		-54,7
Total change in M3		**29,2**		**21,0**

As shown in the table, rising claims of the banks on the domestic private sector continued to be the most significant counterpart to the increase in M3 in the fourth quarter of 2004. The rise in these claims was in turn mainly driven by the strong growth in total loans and advances. This increase was to some extent neutralised by a sharp decline in *net other assets*, which continued to be affected by the marking to market of positions in derivative instruments.

Credit extension

The low level of interest rates, strong growth in domestic expenditure, the rebound in the corporate sector's demand for bank-intermediated funding and the wealth effects associated with buoyant conditions in the real-estate and financial markets continued to

Loans and advances to the private sector



3 *Total loans and advances to the domestic private sector consist of instalment sale credit, leasing finance, mortgage advances, overdrafts, credit card advances 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.*

support solid growth in total loans and advances[3] extended to the private sector during the fourth quarter of 2004. Twelve-month growth in loans and advances accelerated further from 13,2 per cent in September 2004 to 16,3 per cent in December and 17,0 per cent in January 2005.

The quarterly growth in banks' loans and advances to the domestic private sector accelerated further from 12,5 per cent in the third quarter of 2004 to 27,0 per cent in the fourth quarter.

Growth in credit aggregates

Per cent at seasonally adjusted annualised rates

Component	2004			
	1st qr	2nd qr	3rd qr	4th qr
Claims on the domestic private sector*	-1,3	4,5	13,3	31,4
Total loans and advances	12,5	10,1	12,5	27,0
Asset-backed credit	15,3	18,8	22,9	28,8
Instalment sale credit and leasing finance	17,1	17,2	20,8	23,5
Mortgage advances	15,2	19,1	24,3	30,0
Other loans and advances	4,6	-9,3	-3,1	34,5

* Claims on the domestic private sector comprise total loans and advances to the private sector, investments and bills discounted.

Throughout 2004, the growth in total loans and advances was mainly driven by brisk demand for asset-backed credit, although in the four months to December 2004 there was a considerable increase in *other loans and advances*.

In the fourth quarter of 2004 total loans and advances increased by R45,9 billion, with asset-backed credit contributing R35,1 billion to this total. Quarterly growth in asset-backed credit was brisk throughout 2004 and accelerated from 22,9 per cent in the third quarter of 2004 to 28,8 per cent in the fourth quarter.

Mortgage advances increased by R28,7 billion in the fourth quarter of 2004 as banks experienced strong demand for such finance while the Land Bank also raised its extension of such advances to co-operatives. The household sector accounted for 75 per cent of the overall increase in mortgage advances during the quarter while companies accounted for the remaining 25 per cent. Growth over twelve months in such advances accelerated from 20,2 per cent in September 2004 to 24,8 per cent in January 2005, again providing testimony to the buoyant trading conditions in the real-estate market.

Instalment sale and leasing finance which is directed at financing expenditure on vehicles and other durable goods remained buoyant, consistent with the strong growth in the relevant components of domestic expenditure. Twelve-month growth in this credit category exceeded 16 per cent throughout 2004 and accelerated to around 20 per cent by the year-end. With very little change in the prices of durable goods, these increases in credit extended were a reflection of rapidly rising volumes of goods being financed. Financing of new and used motor vehicles contributed 23,4 per cent and 30,6 per cent, respectively, to the increase in instalment sale and leasing finance in the fourth quarter of 2004.

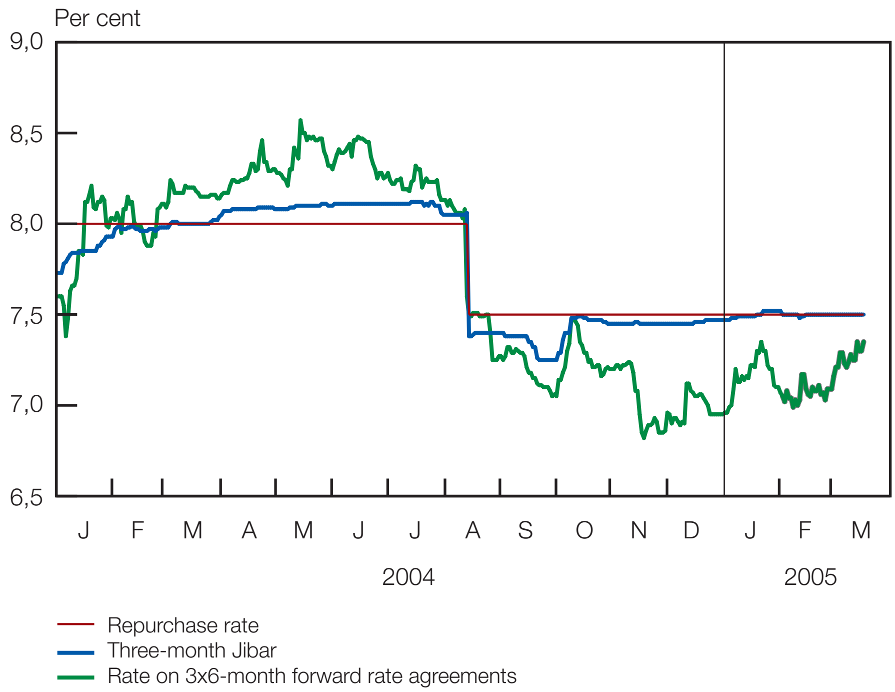
Twelve-month growth in *other loans and advances* accelerated from 3,1 per cent in September 2004 to 5,4 per cent in December as there was an increase in the corporate sector's demand for bank-intermediated funding in the fourth quarter of 2004.

The household sector's use of loans and advances increased by R29,8 billion in the fourth quarter of 2004 whereas that of the corporate sector rose by R16,1 billion, extending the pattern already observed in the earlier part of the year. Over the twelve months to December 2004 banks' loans and advances to households rose by 23,2 per cent, while that to companies expanded by only 10,6 per cent. Conversely, corporate *deposits* with banks rose more rapidly than that of households over the year to December 2004, suggesting that most companies enjoyed strongly positive cashflows over this period.

Interest rates and yields

On 12 August 2004, the Reserve Bank's Monetary Policy Committee (MPC) announced a reduction in the repurchase rate by 50 basis points to 7,50 per cent. However, based on a more neutral assessment of inflationary pressures and risks the MPC left the repurchase rate unchanged at 7,50 per cent at the October and December 2004 and February 2005 meetings. (The December 2004 and February 2005 MPC statements discussing the developments underlying these decisions are reproduced in full elsewhere in this *Bulletin*).

Money-market interest rates



After the August 2004 decision of the MPC was announced, the private-sector banks lowered their prime overdraft rate and predominant rate on mortgage loans by half a percentage point to 11 per cent, and have subsequently maintained their benchmark lending rates at that level.

The South African Overnight Interbank Average (SAONIA) rate broadly followed movements in the repurchase rate but was also influenced by conditions in the interbank market. The SAONIA rate varied around an average level of 6,80 per cent in the seven months to mid-March 2005 and amounted to 6,71 per cent on 17 March 2005.

Other money-market interest rates also moved lower following the reduction in the repurchase rate in August 2004, remaining relatively stable during the remainder of 2004 and the early months of 2005 – largely due to the unchanged monetary policy stance during this period.

Having declined by 81 basis points from 8,06 per cent on 12 August to 7,25 per cent on 30 September 2004, the three-month Johannesburg Interbank Agreed Rate (Jibar) increased somewhat and amounted to 7,45 per cent at the end of October 2004. Subsequent fluctuations in this rate were quite modest, and it stood at 7,53 per cent on 17 March 2005.

Similarly, the tender rate on 91-day Treasury bills declined during August and September 2004, but subsequently rose from 7,20 per cent in the last week of September to 7,28 per cent at the end of October. The amount of 91-day Treasury bills on offer at the weekly tender was increased by R0,15 billion to R2,25 billion on 22 October 2004 – partly to raise government funding ahead of the large coupon interest payments and redemption on the second leg of the R150 government bond at the end of February 2005. The rate amounted to 7,20 per cent on 18 March 2005.

Following the Reserve Bank's decision at the December 2004 MPC meeting to maintain an unchanged monetary policy stance, rates on forward rate agreements (FRAs) – which had reflected an "average" expectation in the market that there would be a modest reduction in the repurchase rate in December 2004 – rose somewhat. Subsequent expectations of changes in the monetary policy stance were largely shaped by movements in the exchange rate of the rand and were reflected in forward interest rates.

Subsequent to the announcement of an unchanged monetary policy stance on 10 February 2005, rates on FRAs again rose somewhat. However, they remained below the corresponding Johannesburg Interbank Agreed Rates, and consequently still indicated expectations of future easing of short-term interest rates among participants in that market.

The increase in the *predominant rate on twelve-month fixed deposits* from 6,1 per cent in December 2003 to 7,8 per cent in June 2004 was reversed when the private banks generally lowered these deposit rates to 6,4 per cent in December 2004. These rates remained unchanged until February 2005. In *real terms*, using historical year-on-year increases in CPIX, the twelve-month fixed deposit rate rendered investors a before tax real return of 2,7 per cent in January 2005, somewhat higher than the average before tax real return of 2,6 per cent recorded during 2004.

The rates of interest on RSA Government Retail Bonds, launched by the National Treasury in May 2004 to promote a savings culture among citizens, were lowered by 75 basis points, effective from 1 January 2005. This followed a previous reduction of 100 basis points in September 2004. Since inception the rates on these bonds have changed as shown in the accompanying table.

Interest rates on RSA Retail Bonds

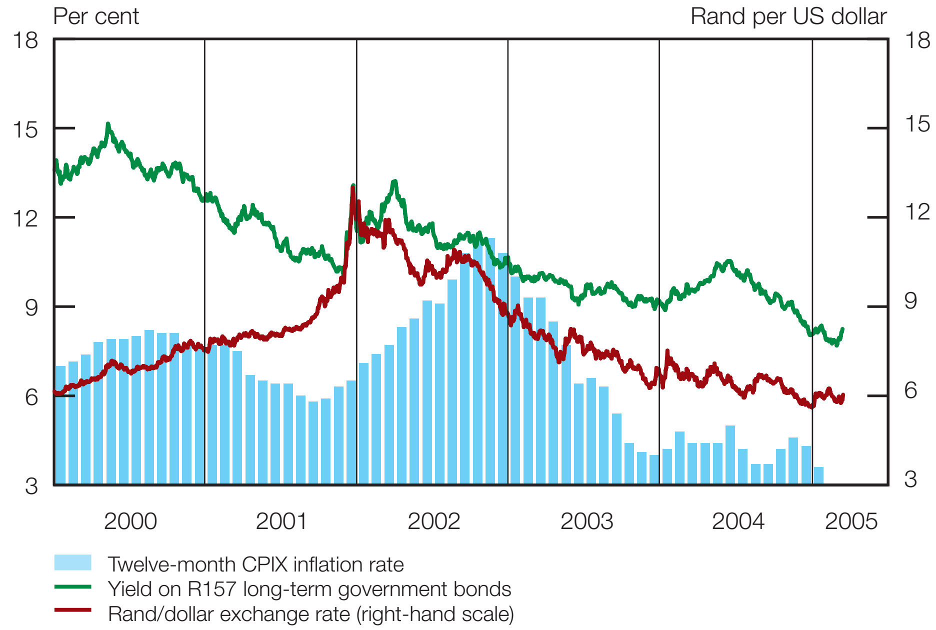
Per cent

Effective from	2-year bond	3-year bond	5-year bond
24 May 2004	9,25	9,50	10,00
1 Sep 2004	8,25	8,50	9,00
1 Jan 2005	7,50	7,75	8,25

Key administered interest rates have generally remained unchanged since September 2004. The *official rate of interest* applicable to fringe benefit taxation, as defined by the Income Tax Act, remained at 8,5 per cent to February 2005 following the 50-basis-point reductions in both March 2004 and September. The *maximum annual finance charges rates* on money loans and credit and leasing transactions, as laid down by the Usury Act, similarly remained unchanged at 20 per cent per annum for amounts of R10 000 or less and 17 per cent per annum for amounts above R10 000, but not exceeding R500 000, since 17 September 2004. In total, the two reductions in 2004 lowered the rates on each category by 200 basis points.

The *daily average yield* on the long-term R157 government bond (maturing in 2015) fluctuated around a declining trend from a recent high of 10,53 per cent on 15 June 2004 as the exchange value of the rand appreciated and the inflation outlook improved. The yield on this bond reached a low of 8,04 per cent on 24 December 2004 and subsequently increased moderately to 8,36 per cent on 21 January 2005. Responding to the release of better-than-expected inflation data for December 2004 and marginally lower-than-expected growth in gross domestic product in the fourth quarter of 2004, yields again declined to a record low of 7,69 per cent on 28 February 2005. Yields this low were previously recorded more than thirty years ago.

Bond yield, CPIX inflation and exchange rate



The downward momentum in the long-term bond yield slowed after the repurchase rate was kept unchanged at the February meeting of the Monetary Policy Committee. It subsequently fluctuated within a narrow range and amounted to 8,24 per cent on 17 March. The bull run in the bond market during the second half of 2004 and the first months of 2005 was occasioned by, among other things:

- the appreciation and sustained resilience of the exchange value of the rand;
- subdued domestic inflation;
- low bond yields in international bond markets generally;
- the upgrade of South Africa's sovereign rating during October from a stable to a positive outlook by Fitch Ratings, and an upgrade of South Africa's foreign currency debt by Moody's Investors Service in early January 2005;

- expectations in some quarters of monetary policy easing; and
- the rebalancing of portfolios by investors tracking the All Bond Index (ALBI) of the Bond Exchange of South Africa when the weighting structure of this index was revised.

The ALBI is widely used as a measure for assessing bond portfolio performance. During February 2005 its duration was adjusted due to term-to-maturity considerations. This included the removal of the short-term R152 government bond from the index and the inclusion of the longer-term R204 bond. Demand for bonds across the maturity spectrum was affected as investors adjusted portfolios accordingly, with increased appetite for the longer-term bond.

On 28 February 2005 South Africa's financial markets received a large inflow of funds when the R151 government bond, the second of the three tranches of the R150 government bond, was repaid. The capital redemption value amounted to R26 billion. At the same time coupon payments on these and other outstanding government bonds added a further R13 billion of cash flows to the market. The remaining daughter tranche of the R150 government bond, namely the R152, matures on 28 February 2006.

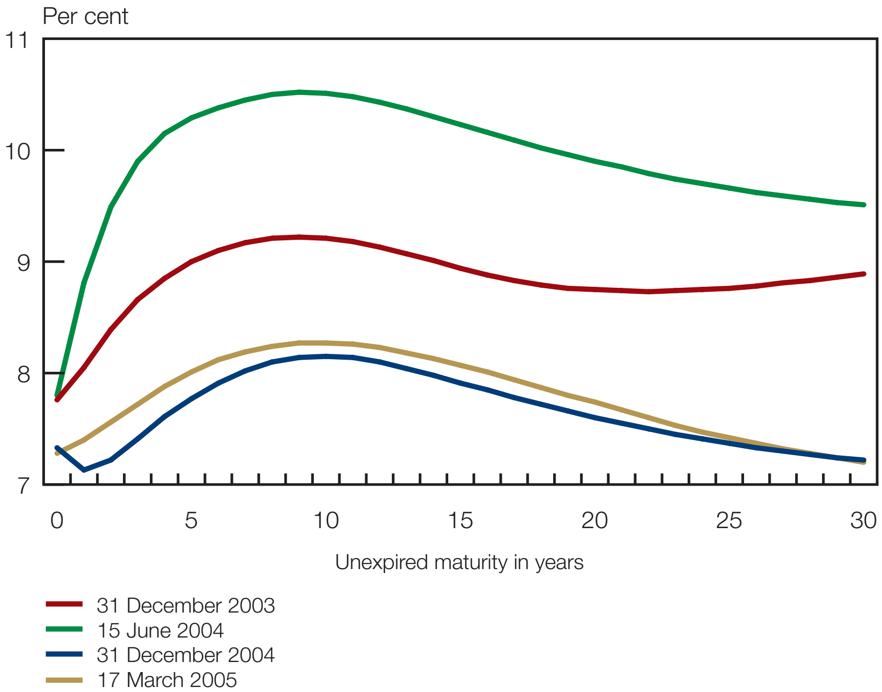
The *real* or *inflation-adjusted yield on long-term government bonds* (using historical year-on-year increases in CPIX as an indicator of expected price changes) increased from 4,4 per cent in February 2004 to 5,8 per cent in August, the highest real yield recorded since June 2000 as inflation remained relatively subdued. Subsequently, the real yield declined to 4,4 per cent in January 2005 as nominal bond yields receded.

The *yield curve* initially flattened from July 2004 as the inflation outlook became more benign before declining in August – most visibly at the short end – as bond yields responded to the lowering of the repurchase rate. The downward movement continued to late December 2004 as inflation slowed and the exchange value of the rand remained relatively strong. After a slight upward movement in January 2005, due to a moderately weaker rand exchange value, the level of the yield curve again declined to new lows in the first days of February following increased expectations of further monetary policy easing over the short term. The extreme short end of the curve increased somewhat following the February 2005 MPC decision to keep the repurchase rate unchanged. Subsequently, the yield curve reverted back to December 2004 levels, with yields on bonds with a maturity exceeding 12 years retaining a downward-sloping bias towards mid-March. The movements displayed by bond yields towards the middle and long end of the curve were supported by, among other things, the change in the duration of the ALBI in February and the cautious approach of the MPC at recent meetings, reinforcing favourable long-term inflation expectations.

Due to the change in the slope of the yield curve, the *yield gap*, i.e. the difference between bond yields at the extreme long and short ends of the yield curve, became negative from 3 December 2004. The inverse yield gap widened to 82 basis points on 28 February 2005 as the slope of the yield curve became more inverted at the longer end, before narrowing to 8 basis points on 17 March.

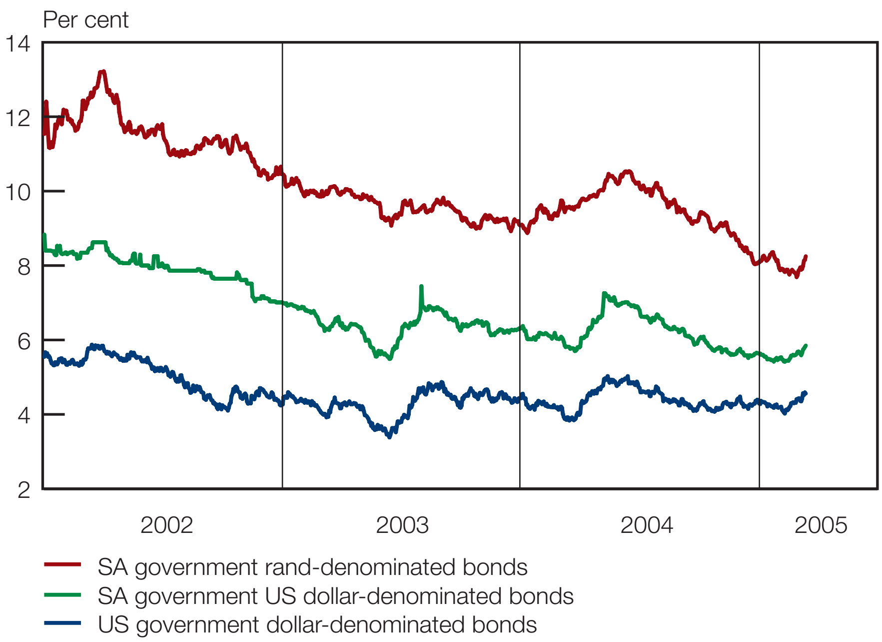
The favourable inflation outlook was also apparent from the movements in the *break-even inflation rate*. This approximation of expected long-term inflation is calculated as the difference between the nominal yield on conventional bonds and the real yield on inflation-linked bonds within the five-to-eight-year maturity range. Expected long-term inflation derived in this way decreased sharply from above the 6-per-cent level early in May 2004 to a historical low of 3,66 per cent on 28 February 2005, and came to 4,22 per cent on 17 March 2005.

Yield curves



The *sovereign risk premium* on South Africa's foreign-currency denominated bonds trading in international markets shrank considerably from May 2004 to February 2005. The spread on the ten-year US dollar-denominated bond, issued at 195 basis points above US Treasury notes of similar maturity at the end of May 2004, more than halved as it declined by 101 basis points to February 2005. This followed the upgrade of South Africa's sovereign rating by international credit ratings agencies during October 2004 and January 2005. The decline coincided with a decline to record low levels of the yield spreads of emerging markets' sovereign debt over benchmark United States Treasury Bonds

Yields on long-term government bonds



(measured by the JP Morgan Emerging Markets Bond Index or EMBI+). South Africa carries a weight of 1,99 per cent in the EMBI+ index, which tracks total returns on external-currency denominated debt instruments of the emerging markets and currently covers 111 instruments across 18 countries.

The *currency risk premium* on South African government bonds (measured as the differential between South African government bond yields on rand-denominated debt in the ten-to-twelve year maturity range issued in the domestic market and dollar-denominated debt issued in the United States market) also declined sharply from 381 basis points in March 2004 to 205 basis points in February 2005, reaching its lowest level since November 2001.

Credit ratings and interest rates on sovereign bonds

Credit ratings by international ratings agencies help investors to fathom the credit risk associated with fixed-income securities. The ratings agencies give an independent opinion of the risk that a country would default on its foreign-currency debt.

The higher rating of South Africa's foreign-currency debt, bank deposits and foreign currency-denominated bonds from Baa2 to Baa1 by Moody's Investors Service in January 2005 recognised the country's prudent macroeconomic policies, improving economic growth prospects and substantially stronger foreign reserves position.

On the ratings scale used by Moody's Investors Service the highest rating is Aaa for bonds judged to be of the best quality. C denotes the lowest rated class of bonds, with poor prospects of ever attaining any real investment standing. The numerical modifiers indicate the higher end or lower end of the rating category. Ratings of Baa3 and higher are investment grade, while those below Baa3 are non-investment grade. Apart from credit ratings, other factors such as liquidity and term to maturity influence market yields on bonds.

A selection of sovereign bond yields on 28 February 2005

Per cent*	Maturity (years)	Moody's rating	Country
4,38	10	Aaa	United States
4,57	8	Aaa	Sweden
4,40	5	Aa1	Belgium
4,61	10	Aa2	Italy
4,76	8	A2	China
4,99	9	A3	Korea
5,21	**9**	**Baa1**	**South Africa**
5,65	10	Baa1	Mexico
4,60	5	Baa2	Barbados
6,11	13	Baa3	Russia
6,82	10	Ba1	Panama
7,81	9	Ba2	Colombia
6,83	10	Ba3	Peru
6,61	10	B1	Turkey
7,84	9	B1	Brazil
8,08	9	B2	Venezuela
41,28	10	Caa1	Argentina

* Rates on US dollar-denominated bonds in the 5 years and longer maturity range. Source: Bloomberg

by H E Coetzer

Money market

Overall money-market conditions remained stable during the fourth quarter of 2004 and the first two months of 2005. During this period, the Reserve Bank maintained the amount of liquidity provided at the weekly main refinancing auction at levels around R13 billion; this was also the approximate level of the average daily liquidity requirement of the private-sector banks.

The statistical counterparts of the money-market liquidity flows from October 2004 to February 2005 are shown in the accompanying table.

Money-market liquidity flows

R billions (easing +, tightening –)

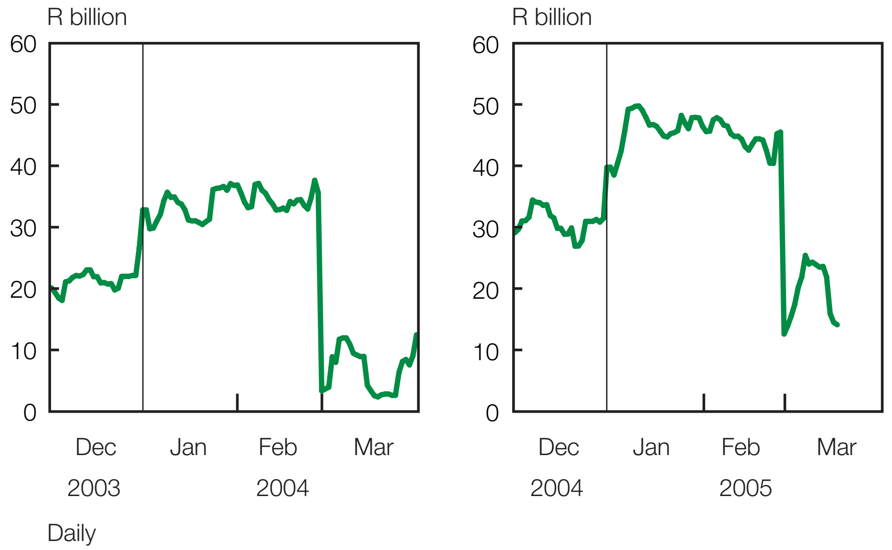
	Oct – Dec 2004	Jan – Feb 2005
Notes and coin in circulation	-3,8	2,1
Required cash reserve deposits	-1,9	0,6
Redemption of foreign loans by National Treasury	-2,6	0,0
Money-market effect of Reserve Bank's foreign exchange transactions	16,1	4,3
Government deposits	-6,4	6,4
Use of liquidity management instruments*	-2,2	0,0
Outright sales of government bonds	-0,6	0,0
Government redemption and interest payments to Bank	0,0	-10,0
Other items net	1,4	-3,4
Banks' liquidity requirement	**0,0**	**0,0**

* Reserve Bank debentures and reverse repurchase transactions

The Bank gradually increased its foreign exchange reserves by buying foreign currency in the market, thereby expanding money-market liquidity by R20,4 billion in the five months to February 2005.

At the end of February 2005 government paid an aggregate amount of R39,3 billion in coupon interest and capital redemption of the second tranche of the R150 government bond. In preparation for this event the government accumulated exceptionally large

Government deposits in the Tax and Loan Accounts



balances on its Tax and Loan Accounts with the private-sector banks, and then ran down these deposits in order to meet the obligations as they fell due. With funds flowing from government accounts with the private-sector banks to private-sector investors' accounts with the same banks, the banks' aggregate liquidity requirement would have remained unchanged, apart from R10 billion that was due to the Reserve Bank – the Bank held a significant amount of maturing bonds and also earned interest on these.

On balance, notes and coin in circulation outside the Reserve Bank rose by R3,8 billion during the fourth quarter of 2004, tightening liquidity in the money market. As shown in the accompanying table, the increase in notes and coin was somewhat less buoyant during December 2004 and the amount in circulation also peaked earlier than in the previous year. This was despite strong final consumption expenditure in December 2004, and may partly be related to the environment of low inflation. In addition, a lower measured level of notes circulating outside the Reserve Bank was recorded on account of somewhat higher limits set for its notes-held-to-order arrangement with the banks. A higher amount of notes was then deposited with the Reserve Bank in dedicated vaults off the premises of the Bank but at the instruction of the Bank. The seasonal upward trend was reversed as notes and coin in circulation declined by R1,1 billion in January and by a further R0,9 billion in February 2005, thereby easing liquidity conditions.

Notes and coin in circulation outside the Reserve Bank
R million

Year	Peak date	Peak level	Year-end level	Change, end Nov to end Dec
2000	27 December	34 728	33 619	3 181
2001	27 December	37 995	36 138	2 764
2002	24 December	42 058	39 488	2 150
2003	24 December	47 766	44 671	2 087
2004	17 December	52 387	48 831	305

The Reserve Bank continued to employ various liquidity-draining open-market operations, mainly aimed at offsetting other factors impacting on money-market liquidity. The outstanding amount of interest-bearing liquidity-draining instruments increased from R18,7 billion at the end of October to R21,2 billion at the end of November 2004 – mainly to counter the liquidity injected by the Bank's transactions in the foreign exchange market. The Bank issued R1,9 billion and R1,2 billion worth of 56-day debentures on 1 and 8 December 2004, respectively. This was designed to drain excess liquidity over the festive season.

Outstanding balances of selected money-market intervention instruments
R billions

End of		Reserve Bank debentures	Reverse repurchase agreements	Total instruments outstanding
2004:	Jul	9,1	12,0	21,1
	Aug	9,0	11,0	20,0
	Sep	7,8	9,5	17,3
	Oct	8,2	10,5	18,7
	Nov	9,9	11,3	21,2
	Dec	11,9	7,6	19,5
2005:	Jan	13,2	11,2	24,4
	Feb	12,5	7,0	19,5

The contraction in liquidity, largely on account of the transfer from the Tax and Loan Accounts to the Reserve Bank, enabled the Bank to reduce the amount of outstanding interest-bearing liquidity-absorbing instruments from R24,4 billion at the end of January 2005 to R19,5 billion at the end of February. The composition by type of money-market intervention instrument is provided in the table on the previous page.

Proposed changes to money-market operations

On 10 December 2004, the Financial Markets Department of the South African Reserve Bank issued a consultative paper titled "Modifications to the Money Market Operations of the South African Reserve Bank". This box summarises the main proposals contained in the paper.

The recovery of the exchange rate of the rand over the past three years allowed the Bank to eliminate foreign-currency swaps with counter deposits, generate profits on maturing forward contracts, square off the Bank's oversold foreign exchange forward book and accumulate foreign currency reserves. The partial settlement of the Gold and Foreign Exchange Contingency Reserve Account by the National Treasury, arrangements enhancing the opportunities for the Bank to diversify the instruments in its portfolio, and the complete phasing out of the vault cash deduction when calculating the minimum reserve requirements of banks also helped to provide the Bank with more flexibility in dealing with money-market developments. Under the circumstances the Bank decided to re-evaluate the existing accommodation procedures. Its main objective is to streamline the refinancing operations so as to make them simpler and more transparent, efficient, safe and flexible. The highlights of the proposed modifications to the money-market operations are outlined below.

Changes proposed in December 2004

Repurchase auction changes

- Resume the announcement of the Bank's estimate of the market's liquidity requirement prior to the weekly main repurchase auction.
- Currently, in instances where the Bank has unintentionally over or under-estimated the market's liquidity requirement, supplementary square-off tenders are conducted at the level of the fixed repurchase rate. The abolition of the use of the supplementary square-off facility as a regular feature is proposed. It would instead be reserved for unexpected developments.
- Final clearing or reverse repurchase auctions to accommodate banks with short or long liquidity positions would be conducted at a spread of 50 basis points above or below the prevailing repurchase rate. (Currently the spread is 150 basis points.) The spread would also act as a corridor within which the interbank overnight rate varies.
- The abolition of the marginal lending facility because it is seldom used and when it is used, it is mostly on account of administrative errors associated with the settlement of transactions at the end of the reserve maintenance period.

Eligible instruments for repurchase agreement auctions

- Currently all short-term instruments that qualify for liquid asset requirements are eligible at the repurchase window. It is proposed that instruments issued by public non-financial institutions and guaranteed by government should also be allowed.

The central feature of the Reserve Bank's operations – the conduct of repurchase auctions on Wednesdays with a one-week maturity at a repurchase rate fixed at the level announced by the Monetary Policy Committee – would remain unchanged. Access to cash reserves, through the averaging of reserves actually held against requirements, would also remain unchanged.

by N Gumata and N Nhlapo

In order to improve the composition of the Reserve Bank's Monetary Policy portfolio of government bonds, the Bank continued to restructure its holdings of interest-bearing government bonds by conducting cash-neutral switch auctions and outright sales of such bonds. The total value of government bonds switched between 1 October 2004 and 28 February 2005 amounted to R9,9 billion, whereas outright sales of bonds amounted to R0,6 billion.

Bank's outright sales and switch auctions of government bonds

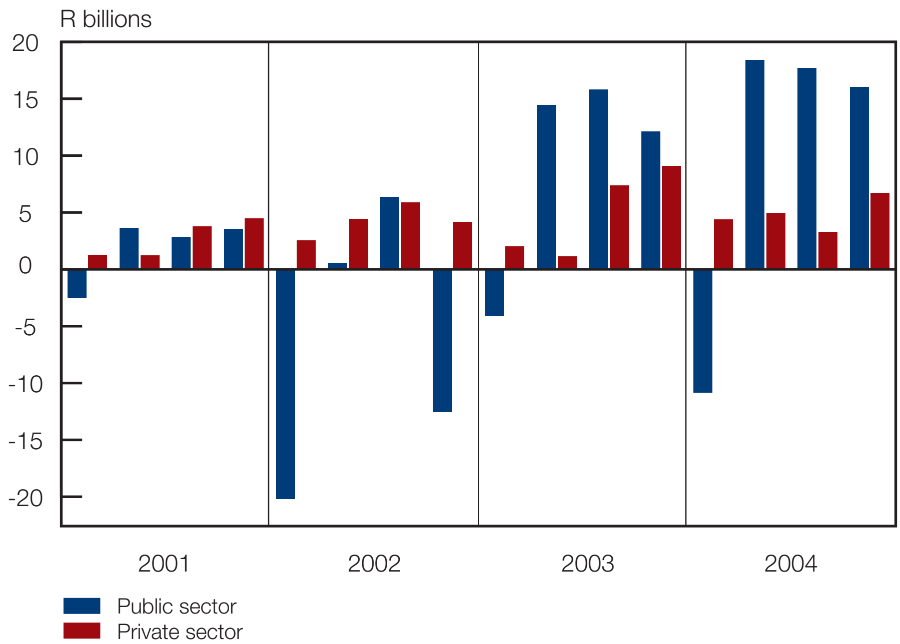
	Outright sales		Switch auctions						
	R152s	Total	R151s into R152s	R151s into R194s	R201s into R152s	R152s into R201s	R194s into R151s	R201s into R151s	Total
2004: Oct to Dec	0,60	0,60	0,34	1,30	1,43	1,5	1,36		5,93
2005: Jan to Feb......					0,14			3,83	3,97

Bond market

Total net issues of fixed-interest securities by *public-sector borrowers* in the domestic primary bond market amounted to R55,5 billion from April to January 2005 (the first ten months of fiscal 2004/05) compared to net issues of R45,9 billion over the same period of fiscal 2003/04. The National Treasury also raised R1,3 billion through the RSA Government Retail Bonds up to the end of February 2005. In the Budget of the national government, presented in February 2005, an amount of R25,8 billion was projected to be raised through net domestic bond issuance in fiscal 2005/06.

National government raised R6,4 billion through the issuance of a US$1 billion ten-year global bond in the *international bond markets* in June 2004, the only such issue in fiscal 2004/05. Foreign debt was, however, reduced by R2,4 billion in October 2004 when a

Net issues in the domestic primary bond market



Euro bond, issued in 1999, reached maturity. An amount of R12,0 billion was projected to be raised through foreign loans in the 2005/06 Budget.

The *outstanding nominal value of private-sector loan stock* listed on the Bond Exchange of South Africa increased by R19,3 billion from R58,4 billion in December 2003 to R77,7 billion in December 2004. Such listings increased by R6,7 billion in the fourth quarter of 2004 and by a further R3,5 billion in January and February 2005.

The value of *commercial paper* listed on the Bond Exchange increased by R5,8 billion in 2004, reaching a level of R15,6 billion in December. The amount in issue increased by R0,3 billion in the first two months of 2005.

In the *international bond markets* non-resident issuer interest in rand-denominated bonds rebounded during 2004. New issues by non-residents of rand-denominated bonds exceeded scheduled redemptions by R3,1 billion during 2004 compared to net redemptions of R2,5 billion in 2003. The European Investment Bank (EIB) was responsible for more than half of the 35 issues that took place during 2004 – in 2003 only 12 such issues were made. In the first two months of 2005 net redemptions by non-residents of rand-denominated bonds amounted to R25 million.

The value of turnover on the Bond Exchange of South Africa of R9,5 trillion in 2004 was 21 per cent less than in 2003. Trading activity in the *domestic secondary bond market* improved somewhat in the second half of 2004, benefiting from the downward movement in bond yields from mid-June and the lowering of the repurchase rate by the Monetary Policy Committee on 13 August. Thus far in 2005 a fair amount of deals were recorded as bond yields continued to decline to record lows and turnover amounted to R1,6 trillion for the two months to February.

The benchmark R153 bond (maturing in 2009/10/11) was the most liquid government bond traded in 2004 with a turnover ratio of 28,4 – measured as the year's nominal value of trade in these bonds relative to their nominal value listed. The second most liquid bond was the R194 (maturing in 2007/8/9) with a turnover ratio of 26,9. By contrast, the liquidity ratio of the four inflation-linked bonds in issue averaged 1,2 in 2004, much lower than that on conventional bonds as the institutional buyers of these bonds tended to buy to hold until maturity. In 2004 the trade in inflation-linked bonds, compared to the trade in all government bonds, comprised only 0,6 per cent of the value of all trades.

Non-residents' net purchases of South African debt securities through the Bond Exchange of South Africa amounted to R0,4 billion in 2004, compared with net sales of R8,1 billion in 2003. Net sales of R4,6 billion in the first half of 2004 were followed by net purchases of R5,0 billion in the second half of the year. In the first two months of 2005 non-residents' bond market transactions vacillated between net sales in January and net purchases in February, which resulted in cumulative net sales to the value of R4,0 billion.

Share market

The total value of equity capital raised in the domestic and international *primary share markets* by companies listed on the JSE amounted to R42,1 billion in 2004, nearly double the R22,7 billion raised in 2003. The quarterly value of capital raised, however, declined sharply from R28,7 billion in the second quarter of 2004 to R4,7 billion in the fourth quarter. Dual-listed companies contributed to the heightened capital-raising activity in 2004. Equity financing amounted to R5,8 billion in the first two months of 2005. In December 2004 Aquarius Platinum became the first foreign company to list on the JSE under the new dispensation for inward-bound dual listings of foreign companies.

Turnover in the *secondary share market* remained buoyant in 2004 and the R1,0 trillion traded on the JSE in that year exceeded turnover in 2003 by 37 per cent. During 2004 turnover at first slowed down from a then record high of R254 billion in the first quarter to R239 billion in the third quarter before increasing to a new record high of R298 billion in the fourth quarter. Trade continued at a brisk pace in the first two months of 2005 and turnover amounted to a cumulative R173 billion during this period as share prices continued along an upward trajectory.

After a slow start when it opened in October 2003, *Alt^{x}*, the alternative exchange of the JSE for small to medium-sized companies, gained momentum during 2004 with ten new listings on the exchange. The combined market capitalisation of the companies listed on Alt^{x} amounted to R0,9 billion at the end of February 2005. This was, however, still only a fraction of the R2,7 trillion market capitalisation of companies listed on the main bourse.

NewGold bullion debentures, which allow exposure to the rand gold price of one hundredth of a fine troy ounce of gold metal, made its debut on 2 November 2004 on the Exchange Traded Funds sector of the JSE. The gold debenture was brought to South Africa by Gold Bullion Securities of London, as part of an initiative by the World Gold Council to boost demand for gold. These debentures allow both institutional and retail investors exposure to gold bullion as an investment vehicle. This makes South Africa the third country after Australia and the United States to offer such an investment opportunity in gold bullion through these gold debentures. Previously, South Africans primarily invested in gold through Krugerrands, jewellery and gold-mining shares.

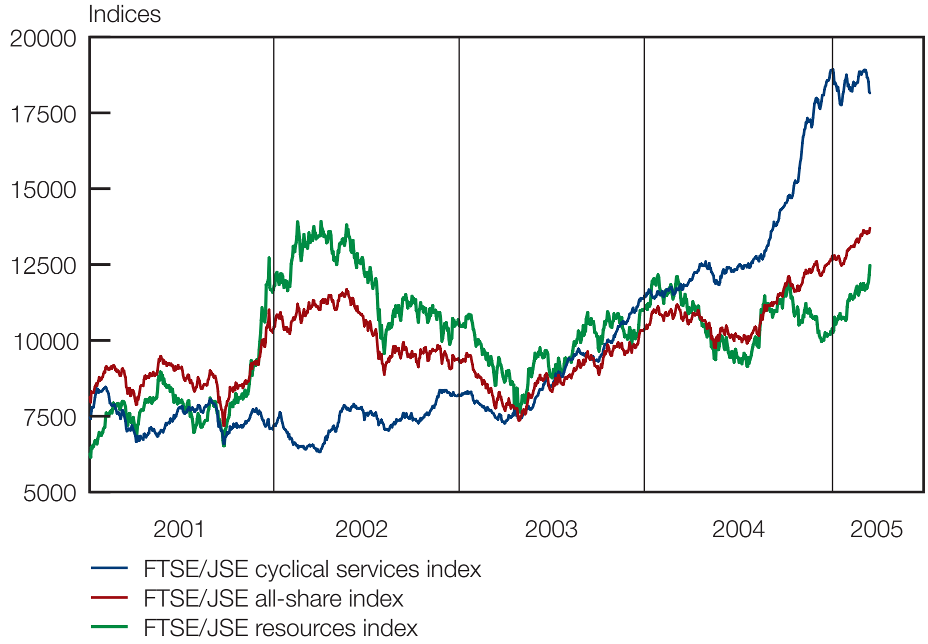
Yield-X, the new interest rate platform announced by the JSE in October 2004, commenced trading on 28 February 2005. The interest rate exchange will focus on interest rate derivatives and is the JSE's fourth electronic clearing and settlement platform, alongside equities, financial futures and agricultural products. The aim of Yield-X is to expand the range of products in the interest rate market and it is expected to attract both institutional and retail investors, thereby encouraging liquidity and market efficiency. Yield-X will operate in a regulated environment overseen by both the JSE and the Financial Services Board.

Non-residents' holdings of shares increased by R32,9 billion in 2004 compared with net sales of R0,4 billion in 2003. This was mostly the result of healthy net purchases of shares from October 2004, which resulted in record-high net purchases of R21,0 billion in the fourth quarter of 2004. Net purchases of this magnitude were previously recorded in the third quarter of 1999 when net purchases of shares amounted to R18,2 billion. Subsequently, non-resident interest waned but remained positive as reflected by cumulative net purchases of shares of R6,7 billion in the first two months of 2005.

The *daily closing level of the all-share price index* reached consecutive record highs from December 2004. Its all-time high on 17 March 2005 represented an increase of 41 per cent from a recent low on 18 May 2004 and was led by strong price increases of 49 per cent in financial shares and 43 per cent in industrial shares, while resources shares improved by 33 per cent over the same period. Firm domestic growth, subdued inflation, the supportive monetary policy environment and favourable world markets and commodity prices contributed to the bull run in the share market from the second half of 2004.

The prices of *resources shares* waxed and waned during the course of 2004 as they remained sensitive to changes in commodity prices and the exchange value of the rand. The resources index at the end of 2004 was 7 per cent lower than 2003, but on balance subsequently gained 22 per cent to 17 March. By contrast, the *cyclical services share* *price index*, a subcategory of the industrial index which includes among others the general retailers, media and entertainment and transport sectors, increased sharply during the course of 2004 as it reflected accelerating growth in economic activity and sustained increases in consumer demand. The cyclical services index improved by 65 per cent from the end of 2003 to the end of 2004 but lost some momentum during the early part of 2005 and fell back by 4 per cent during the 2½ months to 17 March 2005.

Share prices



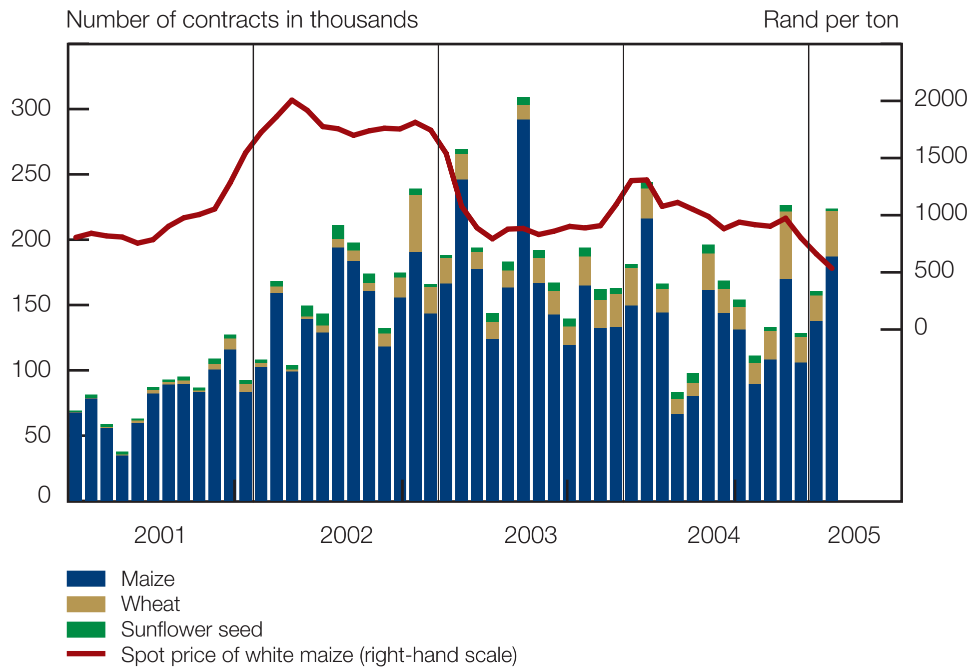
The *dividend yield* on all classes of shares receded from 3,2 per cent in July 2004 to 2,7 per cent in February 2005 as share prices generally increased. The *earnings yield* on all classes of shares decreased from 7,6 per cent in July 2004 to 6,9 per cent in February 2005. Conversely, the *price-earnings ratio* of all classes of shares increased from 13,2 in July 2004 to 14,5 in February 2005.

Market for derivatives

The total number of *futures and options on futures contracts* traded on the Financial Derivatives Division of the JSE Securities Exchange SA increased by 19 per cent from 30,7 million contracts in 2003 to a record high of 36,6 million contracts in 2004. Trade in both the first and final quarters of 2004 exceeded 10 million contracts, with somewhat less activity in the second and third quarters. Trading volumes followed the recovery in the underlying share market, increasing significantly in the second half of 2004. In the first two months of 2005 trade at a quarterly rate came to 7,5 million contracts.

The significant decline in most grain prices, and in particular that of maize, since February 2004 ultimately influenced trade in commodity derivative instruments during 2004 and the first months of 2005. The spot price of white maize as quoted by the JSE Agricultural Products Division declined sharply from R1 463 per ton on 5 February 2004 to R795 per ton on 20 July before increasing to R1 025 on 1 November based on concerns that the low rainfall may hamper planting. Maize prices again fell back to as low as R471 per ton on 25 February 2005 due to better-than-expected rainfall, a generous surplus from the previous season, crop estimates that indicate an increase in the hectares planted and the continued strength of the exchange value of the rand. Prices this low were previously experienced in mid-2000. The number of *commodity futures contracts and options* on such contracts traded on the Agricultural Products Division of the JSE increased from 379 000 contracts in the second quarter of 2004 to 488 000 contracts in the fourth quarter. The 1,9 million contracts traded in 2004 were 18 per cent lower than the 2,3 million contracts traded in 2003. Trade improved to a quarterly rate of 577 000 contracts in the first two months of 2005.

JSE Agricultural Products Division: Commodities traded



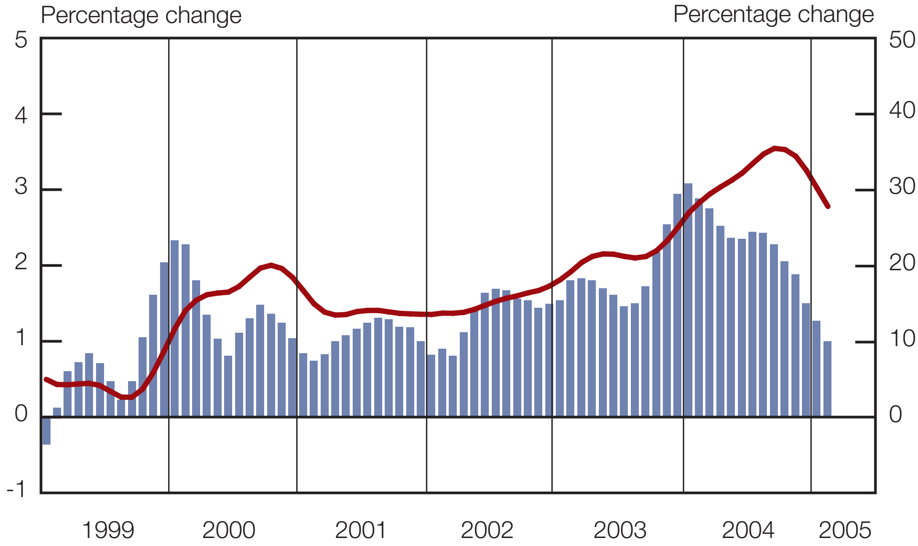
Subsequent to a decline of 70 per cent in 2003 in the number of *warrants* traded on the JSE, trade volumes were maintained at 5,8 billion contracts in 2004. Trading activity was slower in the second half of 2004 and amounted to 1,4 billion contracts in the fourth quarter. Trade increased to a quarterly rate of 1,6 billion contracts in the first two months of 2005. Steadily rising share prices and turnover probably contributed to the increase in the number of warrants listed on the JSE, from 297 in January 2004 to 329 in February 2005.

Real-estate market

The *real-estate market* remained buoyant during 2004, supported by lower interest rates. The value of turnover in the real-estate market, measured by *transfer duty paid*, increased by 54 per cent in 2004 compared with an increase of 29 per cent in 2003. In January 2005 the average level of transfer duty paid increased by 43 per cent compared to January 2004. In the 2005/06 Budget of the national government the transfer duty exemption threshold was raised from R150 000 to R190 000 and the transfer duty brackets were also adjusted.

Year-on-year increases in house prices, as measured by Absa, accelerated almost uninterruptedly from January 2002 and exceeded 35 per cent in September 2004, before slowing somewhat to 28 per cent in February 2005. Indications of a deceleration in the momentum of property price increases is also evident from the decline in the month-on-month rate of increase in house prices from a most recent high of 3,0 per cent in January 2004 to 1,0 per cent in February 2005.

House prices



Percentage change in nominal house prices*
Month on month
Over twelve months (right-hand scale)

* Source: Absa

Public finance

Non-financial public-sector borrowing requirement

The *non-financial public sector* (i.e. the consolidated central, provincial and local governments and non-financial public-sector business enterprises) recorded a cash *surplus* of R7,7 billion in the October-December quarter of 2004 – R0,8 billion less than the cash surplus recorded in the corresponding quarter of 2003. For the first nine months of fiscal 2004/05, a cash *deficit* amounting to R14,8 billion was nevertheless registered – R1,7 billion more than the cash deficit recorded in the first nine months of fiscal 2003/04. As a ratio of gross domestic product, the borrowing requirement for the first nine months of the current fiscal year remained unchanged at 1,4 per cent from the same period of the previous fiscal year.

The cash surplus of the *non-financial public enterprises* decreased from R12,0 billion in the first nine months of fiscal 2003/04 to R9,1 billion in the same period of the current fiscal year.

The financial activities of the *national government* resulted in a cash deficit of R24,1 billion for the first nine months of fiscal 2004/05, moderately higher than the cash deficit of R22,1 billion in the same period of the previous fiscal year.

The *provincial government* deficit of R2,2 billion recorded in the October-December quarter of 2004, lowered their cash *surplus* for the first nine months of fiscal 2004/05 to R6,6 billion. This was still more than twice the size of the cash surplus of R3,1 billion which was recorded in the same period of the previous fiscal year. Provinces' acquisition of non-financial assets for the first nine months of fiscal 2004/05 amounted to R5,6 billion, which represented a decrease of 3,5 per cent compared with the same period of the previous fiscal year.

Local governments' borrowing requirement amounted to R10,5 billion in the first nine months of fiscal 2004/05 compared with a borrowing requirement of R9,8 billion recorded in the same period of the previous fiscal year.

Budget-comparable analysis of national government finance

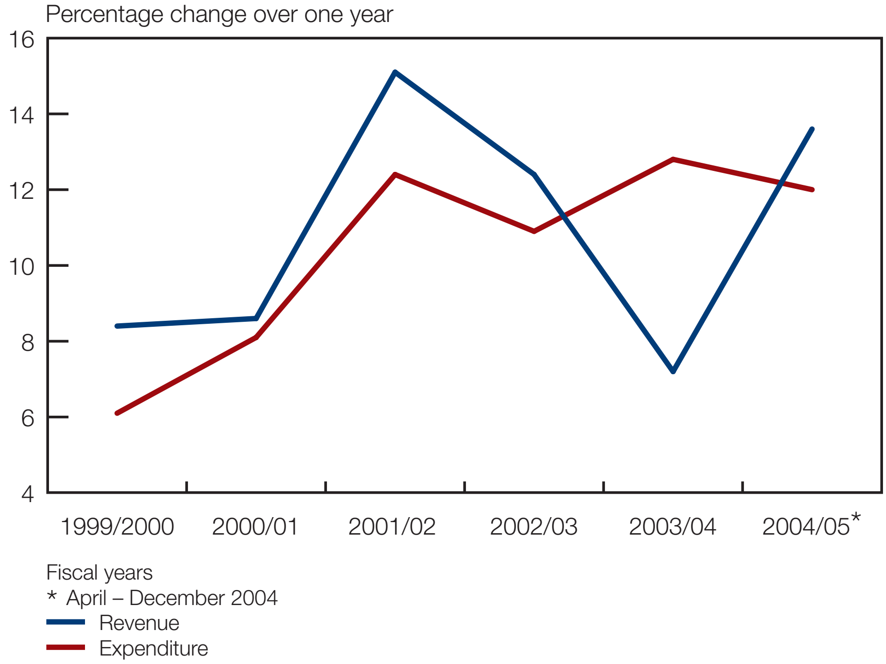
National government expenditure in the first nine months of fiscal 2004/05 amounted to R264 billion – 71,6 per cent of the original budget – or 12,0 per cent more than in the corresponding period of the previous fiscal year. This increase was slightly lower than the originally budgeted increase of 12,2 per cent envisaged in the *Budget Review 2004* for the fiscal year as a whole. This growth rate is also lower than the revised estimate of 13,1 per cent presented in the *Medium Term Budget Policy Statement 2004.*

During the first nine months of fiscal 2004/05 interest paid on national government debt rose at a year-on-year rate of only 6,4 per cent compared with the corresponding period of the previous fiscal year as nominal rates on domestic bonds declined further. The *Budget Review 2004* projected that interest payments would increase at a year-on-year rate of 8,9 per cent.

After allowing for cash-flow adjustments (i.e. transactions recorded in the government accounting system but not yet cleared in the banking system, and late departmental requests) cash expenditure amounted to R262 billion, representing an increase of 11,9 per cent in the first nine months of fiscal 2004/05 when compared with the corresponding period of the previous fiscal year.

National government revenue in the first nine months of fiscal 2004/05 amounted to R249 billion, representing an above-budgeted year-on-year rate of increase of 13,6 per cent. The *Budget Review 2004* estimated that national government revenue would grow at a rate of 9,4 per cent for fiscal 2004/05 as a whole.

National government finances



As shown in the accompanying table, taxes on income, profits and capital gains, the main contributor to total revenue, recorded an increase of 10,3 per cent in the first nine months of fiscal 2004/05 compared with the same period a year earlier. This increase was mainly the result of an increase in personal income tax receipts, which increased by twice as much as corporate income tax collections.

National government revenue in fiscal 2004/05

Revenue source	R billions: Originally budgeted	R billions: Actual Apr – Dec 2004	Percentage change*
Taxes on income, profits and capital gains	189,2	140,9	10,3
Payroll taxes	4,3	3,2	11,3
Taxes on property	6,9	6,6	36,8
Domestic taxes on goods and services	121,5	93,7	19,8
Taxes on international trade and transactions	10,5	9,6	49,2
Other revenue	7,9	4,7	-22,8
Less: SACU** payments	13,3	10,0	37,1
Total revenue	327,0	248,7	13,6

* April – December 2003 to April – December 2004
** Southern African Customs Union

The higher-than-budgeted increase in revenue collections was mainly driven by taxes on property, domestic taxes on goods and services, as well as taxes on international trade and transactions. Taxes on property reflect the robust growth in the real-estate market.

Brisk collections of domestic taxes on goods and services reflect the strong domestic demand for final goods and services. The high collections of taxes on international trade and transactions reflect the rising import volumes related to buoyant domestic expenditure and the relative strength of the exchange value of the rand.

After taking into account cash-flow adjustments due to timing differences between the recording of transactions and bank clearances, national government's cash revenue amounted to R248 billion in the first nine months of fiscal 2004/05, representing an increase of 13,3 per cent compared with the same period of the previous fiscal year.

The net result of revenue and expenditure according to the *Statement of national government revenue, expenditure and borrowing* was a cash book *deficit* of R15,4 billion in the first nine months of fiscal 2004/05 compared with a deficit of R16,9 billion in the same period a year earlier. The *Budget Review 2004* projected a national government deficit of R41,9 billion in fiscal 2004/05, but this estimate was increased to R43,5 billion in the *Adjusted Estimates*.

The *cash-flow deficit* before borrowing and debt repayment amounted to R14,0 billion in the first nine months of fiscal 2004/05, compared with a cash-flow deficit of R15,1 billion recorded in the corresponding period of the previous fiscal year. National government's net borrowing requirement in the first nine months of fiscal 2004/05 was affected by extraordinary payments and receipts. In addition to the cash-flow deficit, an extraordinary payment was recorded in respect of the issue of zero-coupon bonds with a face value of R7,0 billion to the South African Reserve Bank. This issue, which was provided for in the original Budget for fiscal 2004/05, was made in April 2004 to defray part of the realised losses on the Gold and Foreign Exchange Contingency Reserve Account (GFECRA). The net borrowing requirement in the first nine months of fiscal 2004/05 was also increased by costs related to the revaluation of maturing foreign loans at redemption amounting to R1,3 billion.

Although an amount of R2,7 billion was originally projected to be received as extraordinary receipts in fiscal 2004/05 – mainly funds obtained from the restructuring of state-owned enterprises – virtually no funds have been received from this source in the first nine months of the current fiscal year. These extraordinary transactions increased the net borrowing requirement of national government to R22,5 billion in the first nine months of fiscal 2004/05 compared with a net borrowing requirement of R19,9 billion recorded a year earlier.

As indicated in the table on the following page, the greater part of the net borrowing requirement of national government in the first nine months of fiscal 2004/05 was financed through the issuance of bonds in the domestic capital market. Domestic short-term instruments were sold at an average rate of 7,5 per cent per annum, whereas domestic long-term funding was obtained at an average rate of 9,5 per cent per annum in the first nine months of fiscal 2004/05.

In May 2004, the National Treasury launched the RSA Government Retail Bond; these bonds yielded a net amount of R1,1 billion from May to December 2004. In addition, the National Treasury launched the new R203 and R204 fixed-income bonds in May and August 2004, respectively. From April to December 2004 these bonds yielded R12,9 billion to the National Revenue Fund.

National government financing in fiscal 2004/05

R billions

Item or instrument	Originally budgeted	Actual Apr – Dec 2004
Deficit	**41,9**	**14,0***
Plus: Extraordinary payments	7,0	7,2
Cost/profit on revaluation of foreign loans at redemption**	2,2	1,3
Less: Extraordinary receipts	2,7	0,0
Net borrowing requirement	**48,4**	**22,5**
Treasury bills	6,0	5,5
Domestic government bonds	34,3	45,6
Foreign bonds and loans	8,1	5,6
Change in available cash balances ***	0,0	-34,2
Total net financing	**48,4**	**22,5**

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

The issues and redemptions of domestic marketable bonds led to the average outstanding maturity on these bonds decreasing from 98 months at the end of March 2004 to 94 months at the end of December 2004.

Foreign bonds and loans in the first nine months of fiscal 2004/05 include a 10-year global bond issued by National Treasury in June 2004, which yielded R6,4 billion to the National Revenue Fund. Also included in foreign loans is an amount of R3,2 billion drawn on the foreign export credit facilities for the financing of the Strategic Defence Procurement Programme. During the period April to December 2004 foreign bonds and loans to the amount of R4,0 billion were redeemed. The issues and redemptions of foreign marketable bonds led to the average outstanding maturity on these bonds increasing from 79 months at the end of March 2004 to 81 months at the end of December 2004.

Government's cash balances increased by R34,2 billion in the first nine months of fiscal 2004/05, largely in preparation for the redemption of the second leg of the R150 bond as well as interest payments due in February 2005.

Total loan debt of national government increased from R455 billion at the end of March 2004 to R508 billion at the end of December 2004. As a ratio of gross domestic product government debt increased from 35,6 per cent at the end of March 2004 to 37,0 per cent at the end of December. Domestic government debt as a proportion of total government loan debt increased from 85,8 per cent at the end of March 2004 to 87,4 per cent at the end of December, thereby contributing to the increase in total loan debt. Included in this amount are inflation-linked bonds which continued to grow in importance since their introduction in March 2000. These bonds increased from 7,7 per cent of total loan debt at the end of March 2004 to 8,3 per cent at the end of December 2004.

The contribution of foreign loans to the total loan debt of national government amounted to 12,6 per cent at the end of December 2004, compared with 14,2 per cent recorded at the end of March 2004. Since the 2003/04 fiscal year, foreign debt revalued at prevailing exchange rates has been lower than foreign debt valued at the time of issue. This is in contrast to the four fiscal years prior to the 2003/04 fiscal year. This reflects the effect of the recovery in the exchange value of the rand on the outstanding value of foreign loans in rand terms.

The outstanding balance on the GFECRA at the end of March 2004 amounted to R18 billion, but decreased to R12 billion at the end of December 2004 mainly due to the R7 billion payment received from the National Treasury to defray the losses on this account in April 2004. Including this balance, the total national government debt increased from R473 billion at the end of March 2004 to R520 billion at the end of December 2004. As a ratio of gross domestic product, total national government debt increased from 37,0 per cent at the end of March 2004 to 37,9 per cent at the end of December 2004.

The Budget for the fiscal years 2005/06 to 2007/08

The Minister of Finance presented the Budget to Parliament on 23 February 2005 against the background of a solid macroeconomic performance and a supportive international environment. He reiterated that fiscal policy would continue to be supportive of economic growth, development and equity. A sound fiscal stance and prudent debt management over several years had contributed to lower debt service costs and provided a platform for a more accommodative fiscal stance. Accordingly, resources would be moved towards areas of priority, making the Budget more supportive of the poor and more oriented towards building both human and physical capital – essential ingredients for long-term growth and sustainable development.

Government remained committed to maintaining a balance between spending on income support and social development, thereby adhering to its overall social and economic priorities. With a larger proportion of spending on social services going to the poorest 40 per cent of households, the gap between rich and poor would be narrowed. At the same time the Budget would continue to support economic growth through moderate tax relief to both companies and individuals, keeping the overall tax burden around 25 per cent of projected gross domestic product.

The Budget focus in the past five years gradually shifted from an emphasis on lowering the deficit to a fiscal policy that supported economic growth through a more expansionary stance, but strictly within limits of sustainability. A larger deficit was projected in 2005/06, to be followed by slightly higher deficits in the subsequent two years.

Fiscal projections: National government

	2004/05		2005/06		2006/07		2007/08	
	Revised estimate		Medium-term estimates					
	R bn	Annual change Per cent	R bn	Annual change Per cent	R bn	Annual change Per cent	Rbn	Annual change Per cent
Expenditure	**370,1**	**12,6**	**417,8**	**12,9**	**456,4**	**9,2**	**494,9**	**8,4**
Interest	48,7	5,6	53,0	8,9	56,5	6,6	59,3	4,9
Current payments	64,5	13,4	72,3	12,1	78,7	8,8	85,0	8,0
Transfers and subsidies	251,5	13,9	283,8	12,8	308,9	8,8	332,5	7,6
Payments for capital assets	5,4	11,2	6,2	14,1	6,3	2,4	6,7	5,6
Contingency reserve and unallocated funds	-		2,5		6,0		11,5	
Revenue	**338,0**	**12,9**	**369,9**	**9,4**	**405,4**	**9,6**	**444,6**	**9,7**
Deficit before borrowing and debt repayment	**32,2**		**47,9**		**51,0**		**50,3**	
Deficit as ratio of GDP	*2,3%*		*3,1%*		*3,0%*		*2,7%*	
Deficit as ratio of GDP: October 2004 MTBPS	*3,2%*		*3,5%*		*3,2%*		*2,7%*	

National government expenditure was budgeted to increase by 12,9 per cent in fiscal 2005/06 to a level equivalent to 27,3 per cent of the estimated gross domestic product, compared with a revised estimate of 26,4 per cent of the estimated gross domestic product in fiscal 2004/05. It was estimated that national government expenditure would increase at rates below 10 per cent in the subsequent two fiscal years and would be kept at about 27 per cent of the estimated gross domestic product.

Revised estimates of interest payments for fiscal 2004/05 were lower than the originally budgeted amount. It was projected that interest payments on government debt would increase at an average rate of around 8 per cent per annum over the first two years of the medium-term budget cycle, decreasing to 4,9 per cent in 2007/08. A relatively favourable interest rate environment and a well-contained level of debt were foreseen.

Government consumption expenditure was budgeted to continue rising steadily alongside increased investment spending. Real non-interest expenditure was expected to increase by 9,2 per cent in fiscal 2004/05 and at an average annual rate of 5,5 per cent over the three-year budget period. Non-interest spending plans allow for expanded access to social services, improving the livelihood of the poor and the efficiency of public-service delivery. The 2005 Budget provided for increased allocations to improve the conditions of employment, enhance pay progression, and provide for career pathing and performance-related remuneration of public servants. This was especially geared towards police, teachers and social workers; for instance, police numbers would be increased and scarce skills retained.

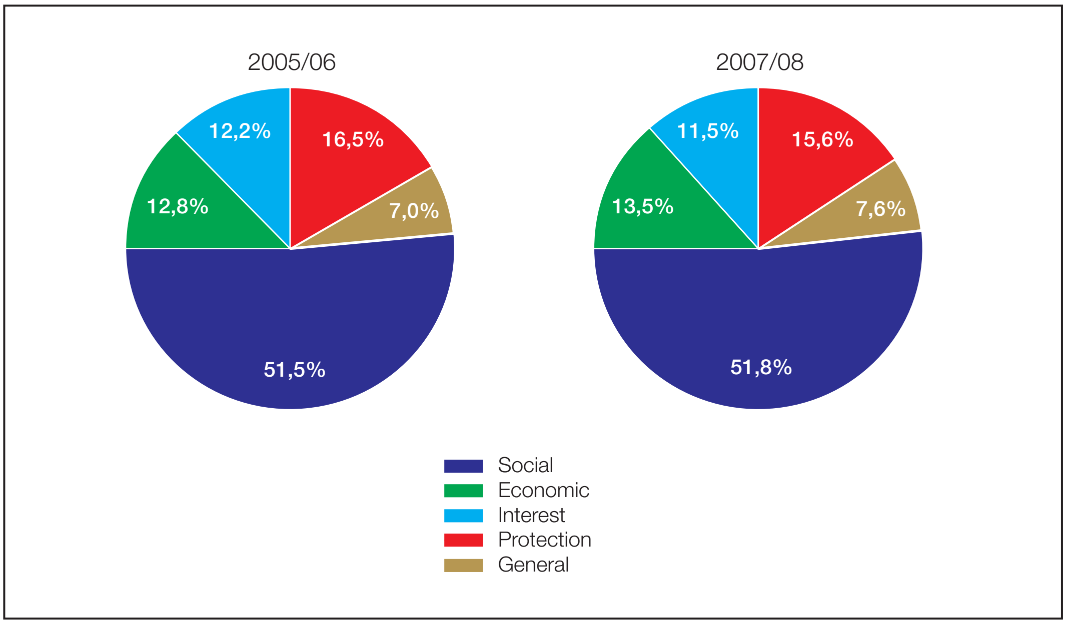
Substantial increases were announced in allocations for capital expenditure in support of economic infrastructure – including transport and logistics infrastructure, electricity generation, and appropriate telecommunications linkages. Investment by both the public and private sectors would form the backbone of economic expansion.

The division of revenue among the three spheres of government (national departments, provincial governments and local governments) once again reflected a shift in favour of provincial and local governments, which are at the centre of social service delivery. However, the financing of social grants would be centralised at the national level and the budget of the Department of Social Development would change significantly with the shift of social security grants to the national sphere. Prior to the National Social Security Grants Agency becoming fully functional, these funds would be allocated to provincial social development departments as conditional grants.

As indicated in the graph on the following page, spending on *social services* would remain the largest functional category of government spending, estimated to amount to 51,5 per cent of the consolidated national and provincial government and social security funds' expenditure in fiscal 2005/06. Spending on these services was expected to increase at an average annual rate of 9,7 per cent over the three-year budget period. In the area of *protection services*, provision was made for an average growth rate of 10,7 per cent per year for police services. Although the provision for general government services seems to be increasing, it was essentially due to the inclusion of a contingency reserve to the amount of R2,0 billion in fiscal 2005/06, R4,0 billion in fiscal 2006/07 and R8,0 billion in fiscal 2007/08. The contingency reserve provides for future unforeseen and unavoidable spending.

The total revised *revenue of national government* was estimated to increase by 9,4 per cent from 2004/05 to 2005/06, and by approximately 9,6 per cent in each of the subsequent two years. National government revenue as a ratio of estimated gross

Functional classification of budgeted government expenditure



Consolidated national and provincial government and social security funds

domestic product was projected to amount to 24,1 per cent in fiscal 2004/05 and to be maintained at approximately that level in the ensuing years.

Specific tax adjustments were announced in the Budget. The tax relief was primarily associated with adjustments to personal income tax rates, corporate income tax rates and direct income tax relief for small business corporations, rendering overall relief to the amount of R10,9 billion in fiscal 2005/06. Some of the major tax proposals are outlined:

- Adjustment of the income tax brackets for individuals, with the maximum marginal rate of 40 per cent reached at a taxable income of R300 001 (previously R270 001) a year.

- The primary rebate was increased from R5 800 to R6 300, increasing the tax threshold by R2 778 to R35 000 per year, or by 8,6 per cent.

- The secondary rebate for individuals 65 years and older was increased to R4 500 raising the tax threshold to R60 000 a year, or by 20 per cent.

- The interest and dividend exemption was increased from the current R11 000 to R15 000 per year for taxpayers under the age of 65 and from R16 000 to R22 000 for senior citizens.

- Taxes on motor car benefits would be raised.

- The standard corporate tax rate would be reduced from 30 to 29 per cent of profits.

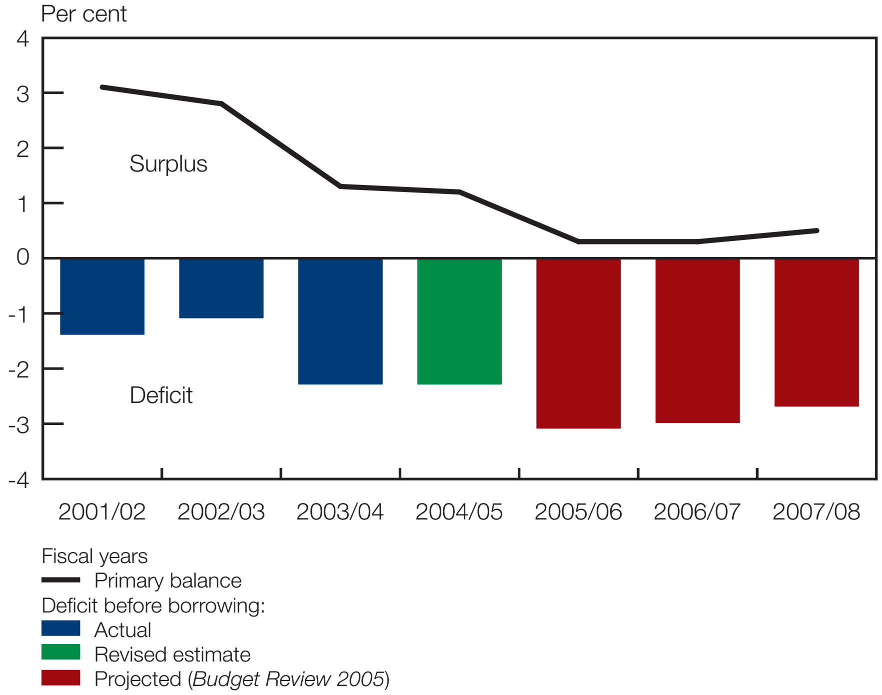
- The transfer duty exempt level of property transactions was increased from R150 000 to R190 000 and the second threshold from R320 000 to R330 000 in order to ease the cost of investment in home ownership.

- The stamp duty on all debit entries on the accounts of bank clients would be eliminated from 1 March 2005.

- Alcohol and tobacco taxes were raised.

Arising from the budgeted estimates of the revenue and expenditure of national government, the estimated deficit before borrowing and debt repayment for the fiscal year 2005/06 came to R47,9 billion, or 3,1 per cent of the projected gross domestic product. It was envisaged that this ratio would recede to 3,0 per cent in fiscal 2006/07 and to 2,7 per cent in fiscal 2007/08. While the primary balance (i.e. the deficit before borrowing excluding interest payments) for 2004/05 would be in a surplus, amounting to 1,2 per cent of estimated gross domestic product, a surplus of approximately 0,3 per cent was envisaged for fiscal 2005/06 and beyond.

National government balances as ratio of gross domestic product



As indicated in the table on the following page, the borrowing requirement of national government was determined after providing for certain extraordinary receipts and payments. In fiscal 2005/06, R1,0 billion will be transferred from the Agricultural Debt Account at the Corporation for Public Deposits to the National Revenue Fund. Together with premiums on bond issues and switch transactions, total extraordinary receipts were expected to amount to R1,5 billion in fiscal 2005/06. Included in extraordinary payments, provision was made for the payment in fiscal 2005/06 of a further R7,0 billion in partial settlement of the outstanding balance on the Gold and Foreign Exchange Contingency Reserve Account.

Sound debt management was set to continue, managing the costs of servicing debt within an acceptable risk management framework. It was envisaged that financing through the issuance of fixed-income bonds would remain the principal means of financing for national government over the medium term. Government also intends developing a fuller Treasury bill yield curve by extending the current range of three and six-month Treasury bills to include initial maturities of one and nine months. Government also made provision for the issuance of two new fixed-income bonds. Foreign bond issues were set to contribute significantly towards financing government. Funding plans for fiscal 2005/06 indicated an envisaged foreign bond issue to the value of US$1,5 billion. A further disbursement of US$0,75 billion was scheduled to be drawn on the arms procurement credit facilities.

It was estimated that national government gross loan debt would increase from R501 billion at the end of fiscal 2004/05 to R551 billion at the end of March 2006 and to R676 billion at the end of March 2008. As a ratio of estimated gross domestic product, national government gross loan debt was expected to increase from 35,7 per cent at the end of fiscal 2004/05 to 36,0 per cent at the end of fiscal 2005/06 and eventually to 36,6 per cent at the end of fiscal 2007/08.

Financing of national government deficit

R billions

Item or instrument	Revised estimate 2004/05	Medium-term estimates 2005/06	2006/07	2007/08
Deficit	**32,2**	**47,9**	**51,0**	**50,3**
Plus: Extraordinary payments[1]	7,1	7,0	-	4,3
Cost/profit on repayment of maturing foreign loans[2]	1,3	0,7	2,4	1,1
Less: Extraordinary receipts[3]	1,7	1,5	0,5	0,7
Net borrowing requirement	**38,9**	**54,1**	**52,9**	**55,0**
Treasury bills	6,0	5,0	6,0	6,0
Domestic government bonds issued	31,1	25,7	40,4	42,3
Foreign bonds and loans[4]	6,1	12,8	5,0	5,2
Changes in available cash balances[5]	-4,3	10,6	1,5	1,5
Total net financing	**38,9**	**54,1**	**52,9**	**55,0**

1 Including payments on the Gold and Foreign Exchange Contingency Reserve Account and premiums paid on debt portfolio restructuring previously included in state debt cost expenditure
2 Revaluation gains or losses. Cost(+)/profit(-)
3 Including proceeds from the restructuring of state assets and strategic stocks. Also included are premiums and book profits resulting from debt restructuring previously included in revenue
4 Excluding revaluation of maturing foreign loans
5 Increase-, decrease+

The public-sector borrowing requirement as a ratio of estimated gross domestic product was projected to increase from 2,8 per cent in fiscal 2004/05 to 3,9 per cent in fiscal 2005/06. A marginal decrease to 3,8 per cent was envisaged in the subsequent two years. The increase in the borrowing requirement could mainly be attributed to an increase in the borrowing requirement of national government and non-financial public enterprises, as capital formation, especially by the latter institutional grouping, was projected to rise significantly.

Public-sector borrowing requirement

R billions

	Revised estimate 2004/05	Medium-term estimates 2005/06	2006/07	2007/08
National government	37,6	53,4	50,4	53,9
Reconstruction and development fund (RDP)	-0,2	-0,2	-0,2	-0,2
Extra-budgetary institutions	-1,6	-1,6	-1,4	-1,1
Social security funds	-4,1	-4,4	-4,4	-4,7
Provincial governments	2,4	-1,6	-1,1	-0,3
Local authorities and local government enterprises	7,8	8,4	9,0	9,5
General government	**41,9**	**54,0**	**52,3**	**57,1**
Non-financial public enterprises	-3,0	5,9	11,5	12,5
Public-sector borrowing requirement	**38,9**	**59,9**	**63,8**	**69,6**
Per cent of GDP	*2,8*	*3,9*	*3,8*	*3,8*

Statement of the Monetary Policy Committee

9 December 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

Revised national accounts statistics released by Statistics South Africa show that growth in real gross domestic product continued to gather momentum during the course of 2004 and reached a seasonally adjusted and annualised rate of 5½ per cent in the third quarter of the year. This good performance of domestic production was supported by relatively buoyant global economic conditions, an improvement in South Africa's terms of trade, rising export volumes and strong domestic demand. Even more significant is that the acceleration in economic growth was accompanied by an increase of roughly 196 000 jobs in the formal non-agricultural sectors in the twelve months up to June 2004 without any meaningful pressure on domestic prices. In fact, CPIX inflation has remained within the inflation target range of between 3 and 6 per cent for the past 14 months.

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) moved into the target range in September 2003. This was accomplished largely owing to persistent monetary and fiscal discipline applied by the authorities, the benefits that are accruing as a result of microeconomic reforms, the appreciation in the external value of the rand, and moderate increases in food prices. CPIX inflation receded further from 5,4 per cent in September to 4,0 per cent in December 2003. Mainly as a consequence of a rise in petrol and diesel prices, twelve-month CPIX inflation increased to 5,0 per cent in June 2004, before declining to 3,7 per cent in September. Increases in transport running costs were responsible for a somewhat higher CPIX inflation figure of 4,2 per cent in October 2004. If petrol and diesel prices are excluded from the CPIX index, the rate of increase over twelve months in the prices of other consumer goods and services declined from 5,7 per cent in September 2003 to 3,5 per cent in October 2004.

As could be expected with the appreciation in the external value of the rand, disinflation in the prices of consumer goods made the largest contribution to the improved inflation outcome in South Africa. Despite the effect of changes in international oil prices, the twelve-month rate of increase in the prices of consumer goods was below the lower limit of 3 per cent of the inflation target in 8 of the 14 months up to October 2004. Increases in petrol and diesel prices mainly brought about higher increases in the other months. The prices of certain consumer goods such as those of furniture and equipment, clothing and footwear, and vehicles actually declined over the twelve months up to October 2004. However, the prices of alcoholic beverages, tobacco and transport running costs continued to rise at rates considerably above the upper limit of the inflation target of 6 per cent.

The twelve-month rate of increase in the prices of consumer services consistently remained above the upper limit of the inflation target. These prices are not directly affected by changes in the external value of the rand and normally take longer to adjust to changed circumstances. The rate of increase in these prices nevertheless also slowed down significantly in 2004. Measured over a period of twelve months, the rate of increase in the prices of consumer services included in the CPIX declined from a peak of 8,6 per cent in September 2003 to 6,3 per cent in October 2004.

The effect of the stronger rand on the prices of goods is clearly illustrated by developments in the prices of imported goods included in producer prices. The prices of these goods measured over a period of one year started to decrease from April 2003 and continued declining up to October 2004. These cheaper imports enabled domestic producers to moderate price increases. As a result, the rate of increase in the prices of domestically produced goods amounted to only 2,7 per cent for the year ended October 2004.

The inflation outlook

The inflation outlook generally remains positive, but there are certain developments that will have to be monitored closely by the Monetary Policy Committee to ensure that inflation remains within the target range. Of particular significance for the continuance of inflation within the target range are the lower inflation expectations. Inflation expectations are very prominent in the inflation process. The recent lower inflation expectations recorded by the Bureau for Economic Research of the University of Stellenbosch, which fell within the inflation target range for the second consecutive quarter, clearly illustrate the improved credibility of monetary policy. These levels of expectations are also an important signal that inflation could remain at low levels.

As already noted, the strength of the rand has been an important factor contributing to bringing inflation down in South Africa and countering the effects of the increase in international oil prices on domestic costs. Although the deficit on the current account of the balance of payments has increased considerably during the course of 2004, this shortfall has been comfortably financed by an inflow of funds from the rest of the world. This clearly reflects the confidence of non-residents in the performance of our economy. At the same time domestic expenditure on goods and services has continued to rise rapidly. All the main expenditure aggregates contributed to this growth, but the rates of increase in expenditure on durable consumer goods and fixed capital formation were high. Both these expenditure components have a high import content.

The growth in the world economy has contributed to the increase in the volume of South African exports as well as the improvement in the terms of trade, which have to some extent offset the rise in imports. The International Monetary Fund expects global economic growth to be around 5 per cent in 2004, followed by a slower but still relatively high rate of 4 per cent in 2005. This should support the growth in South African exports and alleviate pressures on the balance of payments that could arise from the additional imports which may be engendered by further increases in domestic demand.

According to projections by the International Monetary Fund, global inflation could decline marginally from 3,8 per cent in 2004 to 3,6 per cent in 2005. Countries where inflation has started to rise during 2004, such as the United States of America and the newly industrialised countries in Asia, have already taken corrective steps to prevent any further acceleration. Moreover, the recent substantial increase in international oil prices seems to have levelled off in November. The price of Brent crude oil that averaged US$49 per barrel in October 2004 and at one stage during the month reached US$52 per barrel, declined to an average of US$43,45 per barrel in November. However, the oil market is still very nervous, as clearly illustrated by daily fluctuations in prices. The low rates of increase in other international prices should nevertheless contribute to the containment of domestic inflation.

After recovering in 2002 and 2003, the rand has performed more steadily for much of 2004, with reduced volatility helped by the progress which the Bank has made in strengthening the official foreign exchange reserves. Towards the end of this year, the rand has strengthened further. These latest developments reflect a generalised weakening in the US dollar; hence other currencies, including those of some of South Africa's main trading partners, have experienced similar movements.

The weakening in the dollar appears to be part of a process of adjustment in international imbalances. How far this adjustment will run in the months ahead is unclear. The monetary policy stance in South Africa will continue to focus on maintaining inflation within the target range and, to that end, will need to weigh, among other things, the sustainability of recent movements in the rand, the impact such movements may have on the medium-term outlook for inflation, and the desirability of a competitive and stable exchange rate for the rand.

Other factors that could assist the monetary authority in maintaining inflation within the inflation target range include the commitment by the public authorities to low administered price increases and a generally favourable outlook for food prices despite the drought in certain parts of the country. In addition, the *Medium Term Budget Policy Statement* shows a continued determination by the government to maintain fiscal prudence.

The economy will nonetheless have to be managed carefully to maintain price stability. It is in particular very important that capacity constraints be prevented as far as possible. The recent narrowing and perhaps even future disappearance of the gap between potential and actual output could lead to inflationary pressures. The economy is still operating below full capacity, but there are some signs that capacity constraints are starting to appear. Shortages in the domestic production of cement, other building materials and human resources required by the construction sector are examples in this regard. The utilisation of manufacturing production capacity has also increased. Fortunately, domestic fixed capital formation is rising rapidly and decisions have been made by the relevant authorities to upscale the skills development endeavour in the country.

Other developments indicating that it may become more difficult to maintain low inflation include the following:

- The decline in the growth of labour productivity from a year-on-year rate of 3,3 per cent in the first quarter of 2004 to 0,5 per cent in the second quarter. This decrease was due to an increase in formal non-agricultural employment without a concomitant rise in production, as well as a rise in the number of workdays lost as a result of strikes and other forms of industrial action. With the nominal remuneration per worker rising at 7,6 per cent in the year to the second quarter of 2004, it is important that labour productivity rises. These developments caused the year-on-year rate of increase in nominal unit labour cost to rise further from 5,4 per cent in the first quarter of 2004 to 7,1 per cent in the second quarter.

- The recent strong growth in the broadly defined money supply (M3) from a year-on-year rate of 11,8 per cent in June 2004 to 14,9 per cent in October. The increase in M3 deposits over these four months was concentrated in the short and medium-term deposits of the corporate sector and largely reflected the reduced opportunity cost of holding such deposits and the robust growth in domestic expenditure and production. As a result, the rate of increase in the narrower monetary aggregates exceeded the increase in M3. Such growth in monetary aggregates, if maintained, is usually a signal that the rate of inflation could increase over time.

- The acceleration in the twelve-month growth rate in total loans and advances of banks to the private sector from 8,9 per cent in June 2004 to 15,1 per cent in October. Asset-backed credit was mainly responsible for this increase, but in September and October overdrafts, credit cards and general advances started to rise significantly. The increase in the total loans and advances of banks was more or less evenly distributed between the household and corporate sectors over the past four months. Although the outstanding debt of households and the corporate sector is still low, the pace of acceleration in bank credit extension needs to be carefully monitored.

Notwithstanding these signals that inflation could perhaps build up over time, our projections show that with an unchanged monetary policy stance, CPIX inflation will probably not breach the upper 6 per cent of the inflation target during the forecast period up to the end of 2006. The further strengthening of the rand over the past two months and the decline in international oil prices in November resulted in a somewhat lower projected inflation path than that published in the *Monetary Policy Review* in November 2004. Inflation should rise somewhat during the course of 2005, but the upper turning point in the third quarter of that year is now expected to be somewhat lower than that forecast previously. In 2006, CPIX inflation is expected to be comfortably within the target range.

Monetary policy stance

Taking the above developments into consideration, the Monetary Policy Committee has decided to maintain the current monetary policy stance and to keep the repo rate unchanged at 7,50 per cent per annum. As always, the committee will remain vigilant and will stand ready to adjust the repo rate if the inflation outlook changes.

Statement of the Monetary Policy Committee

10 February 2005

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 world economic outlook remains positive. Preliminary estimates made by the International Monetary Fund indicate that world economic growth reached nearly 5 per cent in 2004 – the highest figure in almost three decades. Moreover, this growth was widespread, with particularly high increases in China and other non-Japan Asian countries, the United States of America and a number of emerging-market economies. Economic growth in the Euro area was more moderate at about 2 per cent, but was nevertheless considerably higher than the 0,5 per cent recorded in 2003. Although the IMF forecast indicates some moderation in global economic growth during 2005, it is generally projected to amount to the still high figure of 4 per cent for the year as a whole.

These buoyant world economic conditions together with strong domestic demand led to an acceleration in the rate of increase in the real gross domestic product of South Africa from a seasonally adjusted and annualised rate of 3 per cent in the fourth quarter of 2003 to 5,6 per cent in the third quarter of 2004. National accounts statistics are not yet available for the fourth quarter of 2004, but production statistics for some sectors seem to indicate that growth was firm. However, there are indications of a slowdown in manufacturing sector output growth. Employment in the formal non-agricultural sectors of the economy increased in 2004 after a prolonged period of decline, while domestic inflation remained within the inflation target of 3 to 6 per cent.

The inflation outcome

Since the previous meeting of the Monetary Policy Committee the consumer price index for metropolitan and other urban areas excluding the interest cost of mortgage bonds (the CPIX) has fluctuated around the mid-point of the target range. Owing largely to increases in petrol and diesel prices, the twelve-month growth rate of CPIX at first rose from 4,2 per cent in October 2004 to 4,6 per cent in November. The subsequent decline in the running costs of motor vehicles and lower food prices brought the increase in CPIX down to 4,3 per cent in December. The twelve-month rate of increase in the CPIX excluding petrol, diesel and food prices rose slightly from 4,1 per cent in October 2004 to 4,3 per cent in December.

Measured from quarter to quarter at seasonally adjusted and annualised rates, CPIX inflation accelerated from 2,7 per cent in the third quarter of 2004 to 5,0 per cent in the fourth quarter. This acceleration in the pace of inflation was mainly due to more rapid increases in the prices of goods and occurred in most of the main goods categories with the exception of new and used vehicles.

For the year 2004 as a whole CPIX inflation averaged 4,3 per cent, compared with 6,8 per cent in 2003. The lower inflation was, to a large extent, brought about by continued monetary and fiscal discipline applied by the authorities, an appreciation in the external value of the rand and moderate increases in food prices. These factors had a major impact on the prices of goods, with the result that the rate of increase in the prices of goods averaged only 2,9 per cent in 2004. In contrast, the inflation in service prices included in the CPIX remained stubbornly high at an average of 7,0 per cent. In particular, medical costs and education fees increased at rates well above the upper limit of the inflation target.

For the second year in a row production price inflation in South Africa remained low. The average rate of increase in the all-goods domestic price index amounted to 1,7 per cent in 2003 and 0,6 per cent in 2004. This was largely due to the continued strength of the rand in the foreign exchange markets. The effect of the appreciation in the exchange rate of the rand is clearly illustrated by the further decline of 3,9 per cent in the prices of imported goods in 2004. This decline in the cost of imported goods enabled domestic producers to contain price increases. Consequently, the average rate of increase in the prices of domestically produced goods slowed down from 3,9 per cent in 2003 to 2,3 per cent in 2004.

The rate of decline in the prices of imported goods moderated markedly in the fourth quarter of 2004, but the rate of increase in the prices of domestically produced goods slowed down. Consequently, the rate of increase in the all-goods production price index declined from a seasonally adjusted and annualised level of 2,3 per cent in the third quarter of 2004 to 0,7 per cent in the fourth quarter.

The inflation outlook

In the last quarter of 2004 the rand appreciated further as the United States dollar weakened against the euro and other currencies. During 2005 to date the nominal effective exchange rate of the rand has eased back slightly as the dollar has steadied but nevertheless remains still stronger than the average for 2004 as a whole. The recent easing in the trade-weighted average value of the rand was accompanied by an increase in the Brent price of oil from about US$40 to US$45 over the same period. However, the short-term outlook for inflation improved because the petrol price per litre was lowered further by 44 cents in January and 2 cents in February.

Over the longer term there are a number of developments which could also lead to a favourable inflation outcome. As indicated in the last MPC statement, the recent improvement in inflationary expectations is of particular significance in this regard owing to the prominent role that these expectations play in the monetary policy transmission mechanism. Inflation expectations which fall within the inflation target signal that CPIX inflation could be maintained within the target range of 3 to 6 per cent in the forecast period.

Another important recent development which bodes well for inflation is the marked moderation in salary and wage increases. The rate of increase in nominal remuneration per worker in the formal non-agricultural sectors of the economy moderated from 9,6 per cent in 2002 to 8,7 per cent in 2003 and 6,3 per cent in the year to the third quarter of 2004. Unfortunately, labour productivity growth which averaged 4,5 per cent in 2003, came down to year-on-year figures of 1,1 per cent in the second quarter of 2004 and 1,3 per cent in the third quarter. As a result, the rate of increase in nominal unit labour cost rose from 4,0 per cent in 2003 to 4,9 per cent over the year up to the third quarter of 2004.

Other factors that could contribute to the maintenance of low inflation in the next two years include the commitment by the government to fiscal prudence and of the public authorities to low administered price increases, moderation in the increases in food prices and continued low inflation internationally. The International Monetary Fund expects global inflation to remain at about 3,5 per cent in 2005.

The major risks to the achievement of the inflation target have not changed to any significant extent since the previous meeting of the Monetary Policy Committee. These include the following:

- The sustained strong growth in domestic demand as a result of lower interest rates, tax deductions, still relatively high personal disposable income growth, positive wealth effects arising from increases in the prices of real estate, shares and bonds, the need for expenditure on infrastructural development and the extension of the production capacity of the economy. The continued strength in demand led to an acceleration in the growth rate of the economy to a seasonally adjusted and annualised rate of 5,6 per cent in the third quarter of 2004. Although some indicators point to a slowdown in the rate of economic growth in the fourth quarter, capacity constraints could eventually put pressure on domestic prices.

- The increase in domestic demand also brought about an increase in the deficit on the current account of the balance of payments due to a sharp rise in the demand for imported goods and services. The rise in imports was partly neutralised by higher exports arising from strong international economic growth and increases in international commodity prices. The deficit on the current account was easily financed by a substantial inflow of portfolio and trade-related capital from the rest of the world, which made it possible to increase the official foreign reserves.

- The continued increases in money supply in 2004. The growth over twelve months in the broadly defined money supply (M3) amounted to 12,8 per cent in December 2004, which was lower than at the end of the preceding quarter but slightly higher than the 12,3 per cent in December 2003. Quarter-to-quarter seasonally adjusted and annualised growth in M3 rose from 13,0 per cent in the third quarter of 2004 to 17,6 per cent in the fourth quarter. During the course of 2004 there was a reallocation of funds from longer term deposits to short-term deposits. Increases in these deposits usually reflect a rise in the transaction demand for money.

- The strong demand for bank credit in 2004. The twelve-month growth rate in the total loans and advances of banks rose from 12,5 per cent in December 2003 to 16,3 per cent in December 2004. The quarterly growth in total loans and advances increased from a seasonally adjusted and annualised rate of 12,5 per cent in the third quarter of 2004 to 27,2 per cent in the fourth quarter. Asset-backed credit was largely responsible for this acceleration. The demand for these kinds of loans measured over a period of twelve months increased from 16,3 per cent in December 2003 to 22,8 per cent in December 2004. In contrast, the twelve-month growth rate of overdrafts, outstanding balances on credit cards and general advances slowed down over the same period, but these loans picked up somewhat in the fourth quarter of 2004.

- The likely impact of external developments, in particular the timing, manner and speed of the processes of adjustment to existing global imbalances. How far these adjustments will run in the months ahead remains unclear. The monetary policy stance in South Africa will continue to focus on maintaining inflation within the inflation target range, and will weigh among others the impact of these adjustments on the rand, the impact of such movements on the medium-term outlook for inflation, and the need for South Africa to have a competitive and stable exchange rate.

The recent favourable developments have improved our inflation forecasts and have led to a downward revision of inflationary pressures over the forecast period up to the end of 2006. According to our central forecast, CPIX inflation could rise moderately during 2005 to a little above the midpoint of the range and then ease somewhat during the rest of the forecast period.

Monetary policy stance

The Monetary Policy Committee deliberated extensively on the appropriate policy stance at this particular point in time. Given the presence of so many uncertainties and given the balance of risks, the MPC decided to maintain the current stance and keep the repo rate unchanged at 7,5 per cent per annum. The MPC will continue to monitor developments in the economy and the factors affecting inflation very closely and will stand ready to adjust the stance in either direction if necessary, depending on the outlook for inflation.

Note on flows of funds in South Africa's national financial accounts for the year 2003

by Z Nhleko and D H Meyer[1]

Introduction

The national financial accounts, also known as the flow-of-funds accounts, provide a framework for summarising financial flow data in a consistent manner and show the fundamental relationships that exist among the monetary and financial statistics, national accounts, balance of payments and government finance. South Africa's national financial accounts for 2003 are presented on pages S-44 to S-53 of this issue of the *Quarterly Bulletin.*

This note focuses on developments in both the real and financial activities of the key groups of economic agents in 2003. Attention is given to the analysis of the financing balances of the various economic sectors, the lending and borrowing needs among sectors and changes in the mix of financial market instruments issued and acquired.

In the compilation of the national financial accounts, institutional sector data are obtained from surveys and other sources of information available to the Research Department of the South African Reserve Bank. Eleven institutional sectors are identified and the final consolidation process entails the balancing of contra entries among the various sectors[2].

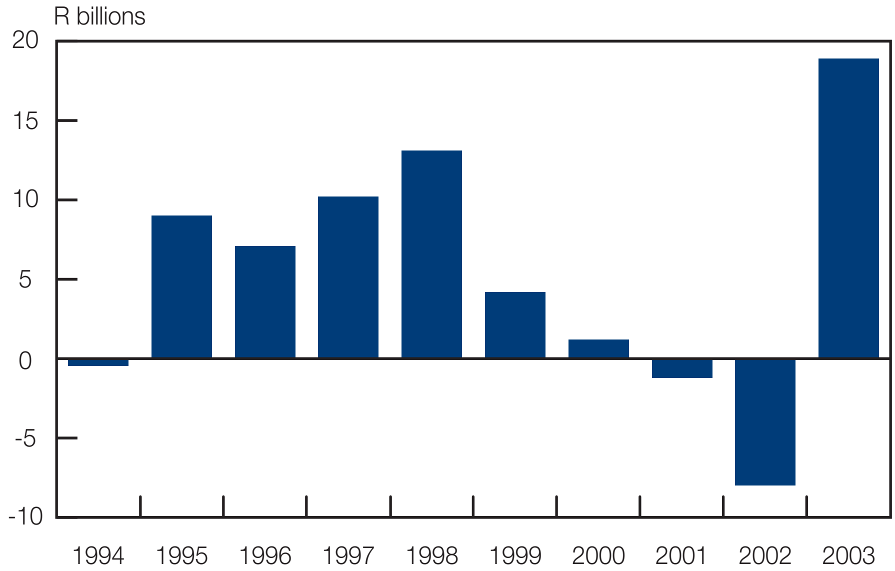
1 The views expressed are those of the authors and do not necessarily reflect the views of the South African Reserve Bank. The Reserve Bank wishes to express its sincere appreciation to all the reporting organisations – government departments, financial market and other public and private-sector institutions – for their co-operation in furnishing the data used for the compilation of South Africa's financial accounts.

2 See also M A Kock and D H Meyer: A note on flows of funds in South Africa's national financial accounts for the year 1999. Quarterly Bulletin, *No 219, March 2001 for a more comprehensive discussion of the compilation of the accounts.*

Financing balances

The flow-of-funds accounts not only show the interrelationships among the various sectors, but also indicate the extent to which domestic economic activities are funded by the rest of the world. Individual sectors may experience either saving deficits or surpluses; but for the economy as a whole, investment cannot exceed saving unless supplemented by transactions with the rest of the world. Since South Africa's reintroduction into the

Augmentation to domestic savings from the rest of the world



global arena, the economy has frequently relied on net lending from the rest of the world. The extent to which domestic saving has been consistently augmented by inflows from the rest of the world over the past ten years is indicated in the graph on the previous page. These flows, by definition, are the mirror image of the balance on the current account of the balance of payments.

Table 1 summarises and compares the saving and investment activity in South Africa for 2002 and 2003 across all sectors. The foreign sector, which had been in a deficit in 2002, reverted to being a net supplier of funds in 2003. The domestic economy was therefore a net borrower of funds from the rest of the world in 2003.

Table 1 Financing balances[1,2] 2002 and 2003
R millions surplus units (+)/deficit units (-)

	2002			2003		
	Gross saving	Gross capital formation	Net lending (+) /net borrowing (-)	Gross saving	Gross capital formation	Net lending (+) /net borrowing (-)
Foreign sector[3]	-8 010	-	-8 010	18 548	-	18 548
Financial intermediaries	24 970	10 384	14 586	30 135	4 232	25 903
General government	3 152	24 346	-21 194	-11 231	38 871	-50 102
Non-financial business enterprises						
Public	32 878	16 519	16 359	31 909	21 965	9 944
Private	95 527	112 538	-16 062	109 033	123 350	-14 317
Households[4]	38 176	23 855	14 321	36 487	26 463	10 024
Total	187 642	187 642	-	214 881	214 881	-

1 Gross saving plus net capital transfers less gross capital formation. Gross capital formation consists of total fixed-capital formation and total changes in inventories, before providing for consumption (depreciation) of fixed capital.
2 A positive amount reflects a net lending position and by implication a net acquisition of financial assets, whereas a negative amount reflects a net borrowing position and by implication a net incurrence of financial liabilities.
3 A positive amount reflects a surplus for the rest of the world and therefore a deficit on South Africa's balance on current account of the balance of payments. A negative amount represents a deficit for the rest of the world and a surplus on South Africa's balance on current account of the balance of payments.
4 Including unincorporated business enterprises and non-profit institutions serving households.

General government stepped up its gross capital formation by a considerable amount and at the same time reduced saving in 2003, leading to a more-than-twofold increase in its net borrowing. *Non-financial public-sector business enterprises* and *households* recorded smaller financing surpluses. Gross saving by *non-financial private business enterprises* was insufficient to finance their own collective gross capital formation, although the shortfall was less than in 2002.

Gross saving by non-financial private business enterprises for the year 2003 amounted to 9 per cent of gross domestic product while non-financial public business enterprises and households each equalled 3 per cent of gross domestic product and financial intermediaries 2 per cent. Non-financial private business enterprises contributed more than 50 per cent of total gross saving in both 2002 and 2003.

Sectoral analysis

The national financial accounts facilitate the analysis of economic sectors from a wide variety of vantage points. The lending and borrowing needs of individual sectors and changes in their preference for financial-market instruments are briefly reviewed in this section.

Foreign sector

The foreign sector includes all non-resident units that enter into transactions with South African residents and, as such, represents the reverse image of South Africa's balance of payments.

As noted in Table 2, the domestic economy's total net acquisition of financial assets in 2003 was achieved by incurring domestic financial liabilities and receiving inflows from the rest of the world. The ultimate result was that South Africa was a net borrower from the rest of the world in order to finance the deficit of R18,6 billion on the current account of the balance of payments. In essence, the foreign sector filled the gap between domestic saving and investment.

Table 2 Flow of funds: Foreign sector and combined domestic sectors, 2003

R millions

	Domestic institutional sectors	Rest of the world	Total
Gross saving	196 333	18 548	214 881
Gross capital formation	214 881	-	214 881
Net lending (+)/net borrowing (-)	**-18 548**	**18 548**	-
Net acquisition of financial assets	471 622	51 576	523 198
Net incurrence of financial liabilities	490 170	33 028	523 198

Non-residents invested in government bonds, shares and other financial assets. They also extended a significant amount of funds to the domestic sectors through trade credit and short-term loans. Domestic sectors recorded increases in their holdings of foreign shares, long-term loans and other financial assets, while a sizeable amount in trade credit and short-term loans was repaid. Gold and foreign exchange held by other monetary institutions increased significantly in 2003.

Financial intermediaries

Financial intermediaries perform an integral financial intermediation function in the economy. These institutions accept surplus funds from ultimate savers, converting them into financial assets suitable for meeting the financing requirements of ultimate borrowers. Financial intermediaries in South Africa consist of both banks and non-bank institutions.

Five subsectors are identified, namely the monetary authority, other monetary institutions, the Public Investment Commissioners, insurers and retirement funds, and other financial institutions. Each of these is discussed below.

Monetary authority

The main functions of the monetary authority, consisting of the South African Reserve Bank and the Corporation for Public Deposits, are the formulation and implementation of monetary policy, the issuance of money, international reserves management, bank supervision and the pursuit of financial stability. This sector interacts mostly with other monetary institutions, the central government and the foreign sector.

The continuation of the restructuring of the cash reserves requirement with regard to the exclusion of vault cash held by banks, led to an increase in the amount of banks' deposits with the South African Reserve Bank. A reduction in other financial assets of the monetary authority occurred when the National Treasury compensated the Bank with R7,0 billion for part of the realised losses previously accumulated on the Gold and Foreign Exchange Contingency Reserve Account. Furthermore, the phasing out of special money-market swaps with counter foreign-currency deposits during 2003, led to a decline in other financial assets. Calculated in rand terms and adjusted for valuation, gold and other foreign exchange reserves held by the monetary authority recorded a decrease in 2003.

Other monetary institutions

The other monetary institutions sector is made up of the consolidated accounts of banks, mutual banks, the Land Bank and the Postbank. This sector is usually a financing-surplus sector or a net lender of funds as indicated in the abbreviated flow of funds presented in Table 3.

Table 3 Flow of funds: Other monetary institutions, 2003

Transaction items	Sources/ liabilities R millions	Uses/ assets R millions
Gross saving	17 099	
Gross capital formation		3 111
Net lending (+)/net borrowing (-)	13 988	
Net financial investment (+/-)		13 988
Net incurrence of financial liabilities	147 632	
Net acquisition of financial assets		161 620
Gold and other liquid foreign assets	-	56 691
Monetary deposits	106 384	2 205
Bank loans and advances	-6 395	33 891
Bills, bonds and loan stock	2 256	14 656
Mortgage loans	-	45 986
Other assets/liabilities	45 387	8 191
Total sources/liabilities and uses/assets	**164 731**	**164 731**
	Per cent	
Percentage of total sources used for gross capital formation	1,9	
Percentage of total sources used to acquire financial assets	98,1	
Percentage of total asset flows	21,6	
Percentage of total financial intermediary asset flows	59,9	
Total assets/liabilities as a percentage of GDP	13,2	

Other monetary institutions recorded gross saving of R17,1 billion and gross capital formation of R3,1 billion in 2003. Monetary deposits amounting to R106,3 billion were received and other liabilities, consisting mostly of derivative instruments, rose by R45,4 billion during the year concerned.

Intermediation of funds towards deficit sectors was effected through bank loans and advances amounting to R33,9 billion, mortgage loans to the value of R46,0 billion and bills, bonds and loan stock amounting to R14,7 billion. The movements in other assets and liabilities of this sector were partly due to the adoption of accounting standard AC133 which, among other things, requires the on-balance sheet recognition of financial asset and liability positions with regard to derivative instruments. Furthermore, other monetary institutions increased their gold and other liquid foreign assets by R56,7 billion as their role in the guardianship of liquid international assets continued to grow. In 2003, other monetary institutions invested 98 per cent of their total resources in financial assets. This sector's asset flows accounted for close to 60 per cent of financial intermediary asset flows and 22 per cent of total asset flows. This sector's total asset and liability flows amounted to 13 per cent of gross domestic product in 2003.

The flow-of-funds accounts reveal an important turning point in the credit extension tide in 2003. In 2002 the bulk of bank loans and advances were taken up by non-financial private corporate business enterprises. In 2003 the situation changed as households increasingly absorbed more bank loans and advances than the private enterprises. This could partly be attributed to favourable structural changes that afforded households greater access to the banking system, reinforced by generally declining interest rates on advances during 2003. Simultaneously, private enterprises exhibited an increased preference for financing sourced in domestic capital markets as well as short-term finance from the rest of the world.

Public Investment Commissioners

The main function of the Public Investment Commissioners (PIC) is to invest funds on behalf of public-sector entities. The bulk of funds received is from government's official pension and provident funds. In 2003 the PIC received inflows of R33,3 billion. The bulk of these funds was invested in government bonds. About 15 per cent of the increment in the PIC's financial assets was invested directly in shares, while cash holdings increased moderately in 2003. The amount allocated to other external fund managers remained virtually unchanged during the period under review. The PIC accounted for 12 per cent of the total financial intermediary asset flows; in 2002 they accounted for 15 per cent of these asset flows.

Insurers and retirement funds

The insurers and retirement funds sector recorded a net financing surplus of R10,5 billion and continued to fulfil an important role in the financial markets by accounting for 22 per cent of financial intermediary asset flows in 2003. This sector's total asset and liability flows amounted to 5 per cent of gross domestic product in 2003. As indicated in Table 4, their total indirect financing of gross capital formation through the acquisition of financial assets amounted to R61,3 billion. They received the bulk of their funds through premium contributions by members which amounted to R63,3 billion.

Healthier domestic economic conditions and a strengthening exchange rate of the rand probably contributed to a reduction in their foreign asset holdings during 2003. On balance, insurers and retirement funds preferred long-term domestic investments such as shares and government bonds during the year 2003, while their holdings of monetary deposits showed no significant change. The official pension and provident funds increased their investment portfolios with the Public Investment Commissioners by R28,3 billion.

Table 4 Flow of funds: Insurers and retirement funds, 2003

	R millions
Financing balance	**10 491**
Net incurrence of financial liabilities	**50 856**
Members' interest in the reserves of retirement and insurance funds	63 281
Other liabilities	-12 425
Net acquisition of financial assets	**61 347**
Monetary deposits	-87
Other deposits	27 079
Public Investment Commissioners	28 313
Foreign deposits	-3 594
Other	2 360
Bills and bonds	-3 588
Short-term government bonds	-11 276
Long-term government bonds	5 967
Other	1 721
Other loan stock and preference shares	508
Domestic	7 220
Foreign	-6 712
Shares	26 128
Domestic	28 869
Foreign	-2 741
Other assets	11 307
	Per cent
Percentage of total asset flows	8,1
Percentage of total financial intermediary asset flows	22,4
Total assets/liabilities as a percentage of GDP	4,9

Other financial institutions

Other financial institutions consisting of, among others, unit trusts, participation bond schemes, finance companies and financial public enterprises, acquire funds and carry out investments through sales of units in unit trusts, lending and similar activities. Within these institutions unit trusts experienced the liveliest financial activity in 2003.

As depicted in Table 5, other financial institutions received funds from both domestic and foreign investors amounting to R39,5 billion. Households remained the dominant investor group, contributing a sizeable amount of deposits to these financial institutions in 2003. A preference for investment in monetary deposits was evident, while investments in shares and other loan stock and preference shares were responsible for 21 per cent of the growth in total assets. As in the case of the insurers and retirement funds, domestic investment was favoured relative to foreign investment. The increase in other assets also included the extension of loans to other entities. This sector accounted for 18 per cent of the total financial intermediary asset flows in 2003 compared with 13 per cent in 2002. The total asset and liability flows of other financial institutions amounted to 4 per cent of gross domestic product in 2003.

Table 5 Flow of funds: Other financial institutions, 2003

	R millions
Financing balance	**721**
Net incurrence of financial liabilities	**47 482**
Deposits received	39 542
Trade credit and short-term loans	1 213
Other loan-stock and preference shares	108
Long-term loans	6 105
Other liabilities	514
Net acquisition of financial assets	**48 203**
Monetary deposits	17 282
Other deposits	2 276
Foreign deposits	2 476
Other	-200
Bills and bonds	-3 667
Short-term government bonds	6 285
Long-term government bonds	-2 130
Other	-7 822
Trade credit and short-term loans	-499
Other loan stock and preference shares	2 375
Domestic	2 947
Foreign	-572
Shares	7 879
Domestic	13 198
Foreign	-5 319
Other assets	22 557
	Per cent
Percentage of total asset flows	6,3
Percentage of total financial intermediary asset flows	17,5
Total assets/liabilities as a percentage of GDP	3,9

Central and provincial governments

Increased gross capital formation and capital transfers to other sectors resulted in an increase in the financing deficit of the central and provincial governments from around R12,4 billion in 2002 to R30,6 billion in 2003. An amount of R62,9 billion was raised in the financial markets through the net incurrence of financial liabilities to finance this deficit.

As depicted in Table 6, the central and provincial governments were able to finance a significant portion of their deficits through the issuance of bonds, mainly in the domestic market. Capital raised in the domestic sectors amounted to R67,1 billion. Marketable government bonds to the value of R46,1 billion were issued in 2003, of which R10,6 billion were foreign issues. In total, the central and provincial governments reduced their reliance on foreign financing by repaying more debt than they issued in these markets.

Table 6 Flow of funds: Central and provincial governments, 2003

	R millions
Financing balance	**-30 623**
Net acquisition of financial assets	32 293
Net incurrence of financial liabilities	62 916
Net incurrence of financial liabilities by financial instrument	**62 916**
Treasury bills	6 500
Short-term government bonds	-3 863
Long-term government bonds	49 944
Non-marketable government bonds	-6 584
Other	16 919
Financing by sector	**62 916**
Foreign sector	-4 213
Public Investment Commissioners	22 024
Insurers and retirement funds	-5 299
Other financial institutions	5 525
Other domestic sectors	44 879

Local governments

Local governments recorded an overall financing deficit of R19,5 billion in 2003. The deficit was financed by borrowing mainly in the domestic markets. Coupled with its borrowing activities to finance the deficit was the reduction of the sector's extension of trade credit and short-term loans as well as other assets.

Non-financial public corporate business enterprises

The non-financial public corporate business enterprises sector recorded a net financing surplus of R9,9 billion in 2003. Not only were these enterprises able to finance their gross capital formation, but they were also able to channel excess funds to deficit sectors. This was done through increasing their holdings of long-term government bonds, increasing trade credit extended to other entities and increasing their monetary deposits. The surplus was therefore not only utilised to reduce this sector's own financial liabilities, but also to finance deficit sectors in 2003.

Non-financial private corporate business enterprises

Table 7 shows that non-financial private corporate business enterprises recorded a financing deficit of R14,3 billion in 2003 – a significant improvement from the R21,0 billion deficit recorded in 2002. The deficit was funded in the financial markets through the issuance of shares, bills, bonds and loan stock as well as mortgage loans, trade credit and short-term loans. Excess funds were deposited with monetary institutions, invested in foreign shares and other financial assets. The gross capital formation of R123,4 billion represented more than half of the total gross domestic capital formation in 2003 and, as such, indicates the important contribution made by this sector towards real economic activity. The total asset and liability flows of non-financial private corporate business enterprises amounted to 16 per cent of gross domestic product in 2003.

Table 7 Flow of funds: Non-financial private corporate business enterprises, 2003

Transaction items	Sources/ liabilities R millions	Uses/ assets R millions
Gross saving	107 766	
Capital transfers	1 267	
Gross capital formation		123 350
Net lending (+)/net borrowing (-)	-14 317	
Net financial investment (+/-)		-14 317
Net incurrence of financial liabilities	93 233	
Net acquisition of financial assets		78 916
Monetary deposits	-	34 866
Other deposits	2 339	228
Bank loans and advances	19 943	-
Trade credit and short-term loans	49 386	-24 972
Bills, bonds and loan stock	9 157	7 069
Shares	30 369	-11 224
Domestic	27 233	-25 255
Foreign	3 136	14 031
Long-term and mortgage loans	13 857	4 867
Other assets/liabilities	-31 818	68 082
Total sources/liabilities and uses/assets	**202 266**	**202 266**
	Per cent	
Percentage of total sources used for gross capital formation	61,0	
Percentage of total sources used to acquire financial assets	39,0	
Percentage of total asset flows	26,6	
Total asset/liabilities as a prcentage of GDP	16,2	

Households

Households recorded a financing surplus and, as such, provided funds to deficit sectors in 2003. Households had access to additional funding through bank loans and other advances, and mortgage loans. In 2003 households increased their interest in retirement and life funds and their deposits with banks and other financial institutions, such as unit trusts.

Summary and conclusion

The acquisition of financial assets and the incurrence of financial liabilities in 2003 by the various economic sectors occurred against the backdrop of declining interest rates and a slower rate of increase in the general price level (inflation). The growing credibility of the inflation-targeting monetary policy framework and a reduction in inflation expectations influenced the financial decision-making processes in the South African economy, some of the consequences being reflected in the flow of funds.

The analysis of South Africa's national financial accounts for the year 2003 reveals that:

- the acquisition of domestic financial assets by foreigners exceeded the acquisition of foreign assets by South Africans, resulting in a net inflow of funds from the rest of the world to South Africa;

- the continued restructuring of the cash reserve requirements by the South African Reserve Bank led to an increase in deposits of the banking sector with the South African Reserve Bank;
- a shifting of credit extended by banks to households away from non-financial private corporations;
- an increased preference by general government for financing the net borrowing requirement in the domestic financial markets;
- the continued and growing importance of the other financial institutions sector in the financial intermediation process;
- the significant contribution made by non-financial private business enterprises towards gross capital formation; and
- the continued importance of households as net providers of funds to deficit sectors.

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