Quarterly Bulletin

December 2006

South African Reserve Bank

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Introduction

While world economic activity continued to be firm, preliminary statistics indicate somewhat slower global growth in the third quarter of 2006 in comparison with the second quarter. World trade volumes maintained strong growth, while commodity-exporting countries continued to receive favourable prices for their output. At the same time, global inflation remained under control as international oil prices receded from their early August highs while a generally tighter stance of monetary policy also helped to counter inflationary pressures.

In South Africa the rate of growth in real gross domestic product in respect of 2005 was revised marginally upward from just below to just above the 5-per-cent mark. In 2006 the growth estimates in respect of the first half of the year were also revised upward and showed that the real growth rate accelerated from the first to the second quarter, but subsequently lost some of its momentum to register an annualised rate of 4¾ per cent in the third quarter. A number of factors were at work in moderating the rate of economic expansion, including the higher domestic price level, the brisk pace of tax collections, and some constraints limiting growth from the supply side of the economy.

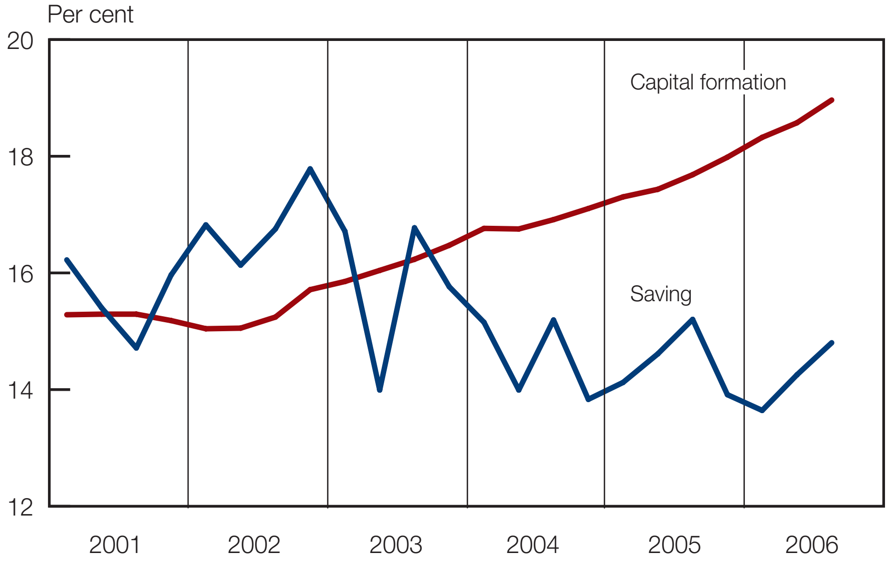
Growth in the third quarter of 2006 decelerated on account of slower growth in both the secondary and tertiary sectors of the economy. In the secondary sector growth slackened in most manufacturing subsectors, including in food manufacturing where reduced intermediate supplies from agriculture inhibited production and higher product prices moderated consumer demand. Real value added by the sector producing electricity was also very subdued during the third quarter. Among the services sectors growth remained generally brisk despite higher levels of domestic prices and interest rates, but the finance subsector experienced a significantly slower pace of expansion during this period on account of a deceleration in the real value added by banks and stockbrokers.

Agricultural production remained under pressure throughout the first three quarters of 2006, partly reflecting the disappointing maize crop harvested during this period. Nevertheless, the pace of contraction in real value added in agriculture moderated considerably during the third quarter. Mining production expanded in both the second and third quarters, although its growth rate edged lower in the third quarter.

Growth in real gross domestic expenditure slowed considerably in the third quarter of 2006. Final consumption expenditure by households continued to rise strongly, but its vigorous momentum has moderated to some extent by the higher prices of goods and services. Household debt as a ratio of annualised disposable income rose to a record level of 73 per cent in the third quarter, while debt service cost also increased significantly. Final consumption expenditure by general government was bolstered in the second quarter by expenditure on military aircraft and then slackened in the third quarter as military purchases receded.

Fixed capital formation, which was already rising at a blistering pace in previous quarters, picked up further growth momentum in the third quarter of 2006. This lifted the ratio of gross domestic fixed capital formation to gross domestic product to almost 19 per cent in the third quarter – the highest it has been since 1990. Rising fixed investment spending was recorded by all the main institutional groupings – general government, public corporations and the private sector – but the strongest growth in the third quarter was registered by the public corporations, especially Transnet. In the private sector the agriculture, manufacturing, construction, commerce and transport subsectors recorded the most vigorous increases in capital expenditure in the third quarter. The high levels of capacity utilisation in most subsectors of the economy prompted strong capital formation, while in agriculture it was spurred by the considerably higher prices of grain and other agricultural products in 2006 to date.

Gross saving and gross capital formation as percentage of gross domestic product



Seasonally adjusted annualised data

Inventories continued to be accumulated in the third quarter of 2006, but at a slower pace than in the first half of the year. Inventories of petroleum products declined, having been built up in the second quarter in anticipation of the routine maintenance of refineries.

The marked deceleration in expenditure growth was reflected in a slower pace of increase in import volumes, as the physical quantity of crude oil imported dropped markedly in the third quarter owing to the maintenance-related scheduled shutdown of some refineries referred to above. At the same time export volumes rose strongly, supported by brisk global demand and the increase in competitiveness of exporters following the depreciation of the rand. This led to a significantly smaller trade deficit in the third quarter. However, this was partly offset by an increase in net services, income and current transfer payments to non-residents, as dividend and interest payments were boosted by solid profits and higher levels of foreign debt and non-resident ownership of South African shares. Nevertheless, the deficit on the current account of the balance of payments narrowed from 5,7 per cent in the second quarter of 2006 to 5,2 per cent in the third quarter. This shortfall was again more than fully financed by financial inflows from abroad, of which inward portfolio investment constituted the most significant element in the third quarter of the year.

The significant depreciation in the exchange value of the rand from May 2006 was reflected in higher prices of imported and import-competing goods and services. Measured from quarter to quarter and annualised, the production prices of imported goods increased at a rate of more than 20 per cent in the third quarter of 2006, whereas in the first quarter of 2006 these prices were still declining. The production prices of domestically produced goods also picked up strongly in the third quarter, with notable contributions from food and products of petroleum and coal.

Consumer price inflation displayed greater inertia than production price inflation. The quarter-to-quarter rate of increase in CPIX nevertheless rose to an annualised rate in excess of 8 per cent in the third quarter. The targeted twelve-month rate of CPIX inflation also accelerated, but stayed below the 6-per-cent upper boundary of the target range. The October 2006 CPIX inflation rate was the 38th successive monthly reading which fell inside the target range, reinforcing expectations that inflation would remain under control. Wage settlements in the first three quarters of 2006, while edging slightly higher, also remained aligned with the inflation target if allowance is made for a moderate increase in labour productivity over time.

While growth in the money supply remained at relatively high levels, it moderated somewhat from mid-2006 as real expenditure and production slowed alongside a mild slackening of turnover in the financial markets and slightly smaller wealth effects as some asset prices lost part of their earlier momentum. Nevertheless, the income velocity of circulation of M3 registered a new record low in the third quarter of 2006. Banks' extension of loans and advances continued to rise vigorously in the third quarter, despite some securitisation transactions which reduced the level of advances on the banks' balance sheet. Mortgage and general advances, in particular, registered strong increases. Traditionally, a tightening of monetary policy takes fairly long to work through to the credit aggregates, which are usually momentum-driven. In this instance the buoyancy of the property market, *inter alia*, supported the continued brisk pace of credit extension, as house prices continued to rise firmly throughout the first ten months of 2006, albeit at a slowing pace. The ongoing need of companies to finance their working capital and fixed investment programmes also fed into the expansion in general advances.

Money-market conditions remained steady as the South African Reserve Bank (the Bank or SARB) raised its repurchase rate by 50 basis points at a time in June, August and October 2006. In raising the repurchase rate the Bank's Monetary Policy Committee, recognising the deterioration in prospects for inflation, acted pre-emptively to moderate the expected acceleration in inflation. Other money-market interest rates moved broadly in step with the repurchase rate.

Bond yields initially rose strongly from May 2006 on account of the interruption in international investors' appetite for emerging-market exposure, the depreciation in the exchange value of the rand and a worsening of inflation expectations. While short-term money-market interest rates rose, largely aligned with increases in the Bank's repurchase rate, longer-term interest rates declined as oil prices started to recede from early August, and as the exchange rate of the rand stabilised and market participants started to view the initial bond yield reaction in May and June as overdone. The announcement in the October 2006 *Medium Term Budget Policy Statement* of further tax revenue overruns reinforced the perceived scarcity of government bond supply in the market, and contributed to a further decline in bond yields. Accordingly, the current shape of the yield curve is slightly downward-sloping.

Tax collections by government in the period April to September 2006 continued to exceed the initial budget projections by a substantial margin. This led to a significant downward adjustment in the expected deficit for 2006/07 announced by the Minister of Finance in October 2006. In the *Medium Term Budget Policy Statement* it was furthermore announced that government expected the brisk revenue collections to continue, and now projected a main budget surplus for 2007/08.

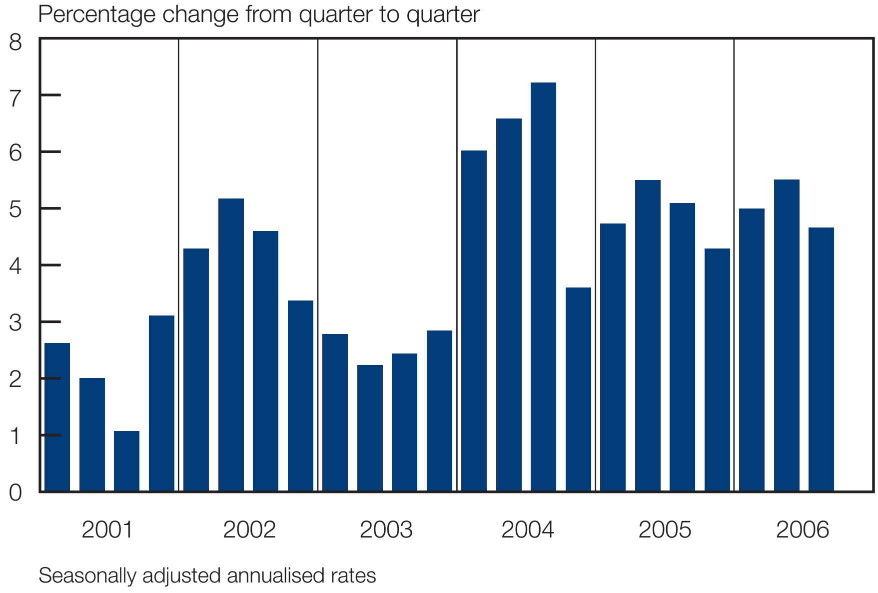
Share prices receded significantly from May 2006. However, within six weeks this downward trend was reversed and share prices started to regain lost ground as commodity prices remained favourable and corporate profits continued to rise. From October 2006 share prices again achieved new record highs, discounting favourable economic prospects as the Accelerated and Shared Growth Initiative for South Africa (Asgisa) gains momentum.

Domestic economic developments

Domestic output

The South African economy expanded further in the third quarter of 2006 but with somewhat less vigour than in the second quarter. Real gross domestic product increased at an annualised rate of 4¾ per cent in the third quarter following strong growth of 5½ per cent posted in the second quarter of 2006. The real gross domestic product in the first three quarters of 2006 was about 4½ per cent higher than in the corresponding period in 2005, falling short of the growth rate of 5 per cent recorded for the calendar year 2005.

Real gross domestic product



The slowdown in real economic growth in the third quarter of 2006 was a reflection of contrasting developments in the main sectors of the economy: Growth in the real value added by the secondary and tertiary sectors moderated, but at the same time real value added by the primary sector declined at a much lower rate than in the second quarter.

The decline in the real value added by the *primary sector* moderated from an annualised rate of 5¼ per cent in the second quarter of 2006 to 1¼ per cent in the third quarter. While the real value added by the mining sector lost some of its upward momentum, the real output of the agricultural sector declined at a considerably slower pace than in the previous quarter.

Agricultural production remained under pressure. This partly reflected the much smaller maize crop harvested in 2006, which limited the contribution of field crop production to real agricultural output. In addition, the real value added by livestock and horticultural production remained rather lacklustre. The real value added by the agricultural sector accordingly contracted by 15 per cent in the first three quarters of 2006 compared with an increase of 4 per cent in 2005 as a whole.

Maize production

	2004/05	2005/06
Area planted (million hectares)	3,2	2,0
Production (million tons)............................	11,7	6,6

Source: Crop Estimates Committee

The real value added by the *mining sector* increased at an annualised rate of 3¼ per cent in the third quarter of 2006, slower than the growth rate of 5 per cent attained in the second quarter. Year on year, real value added by the mining sector in the first three quarters of 2006 contracted by 3½ per cent compared with an increase of 2½ per cent registered for the calendar year 2005 as a whole. Against the backdrop of a relatively high gold price, the gold-mining industry continued to mine ore with a lower gold content. Consequently, the real value added by the gold-mining sector declined further in the third quarter of 2006. The real output of diamond mining also contracted, alongside a weaker global demand for jewellery.

Real gross domestic product
Percentage change at seasonally adjusted annualised rates

	2005					2006		
Sectors	1st qr	2nd qr	3rd qr	4th qr	Year	1st qr	2nd qr	3rd qr
Primary sector	10¼	-½	0	-¼	3	-6¼	-5¼	-1¼
Agriculture.................	-2	-1¼	½	1	4	-16½	-27½	-13
Mining	16	0	-½	-¾	2½	-1½	5	3¼
Secondary sector	2	10¼	6	3	5½	4¾	7¼	5½
Manufacturing	¾	11	6	1½	5	3¼	6¼	4¾
Tertiary sector	5½	4¼	5½	5¾	5¼	7	6	5
Non-agricultural sector ..	*5¼*	*5½*	*5¼*	*4½*	*5¼*	*5¾*	*6¼*	*5*
Total	4¾	5½	5	4¼	5	5	5½	4¾

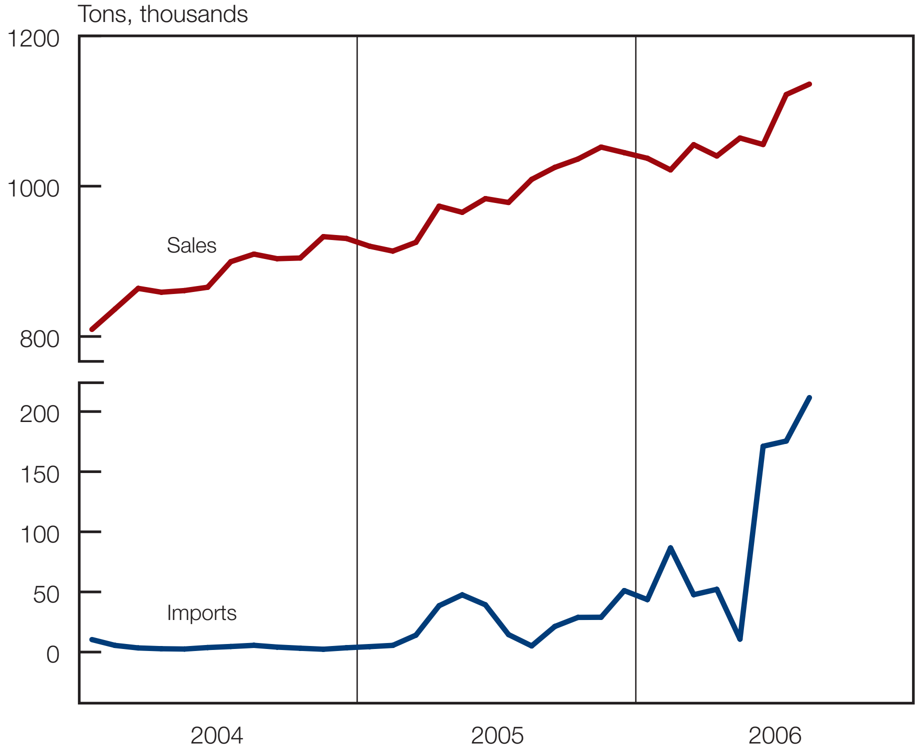
The real value added by platinum mining increased further in the third quarter of 2006 albeit at a slower pace. The output of platinum mines expanded as new production facilities became operational alongside buoyant demand. Global demand for platinum increased unabatedly as the use of catalytic converters rose with the penetration of motor vehicle ownership.

The growth in real value added by the *manufacturing sector* slowed from an annualised rate of 6¼ per cent in the second quarter of 2006 to 4¾ per cent in the third quarter. Quarter-to-quarter growth decelerated in most manufacturing subsectors over the period. The real value added by the subsector manufacturing food and beverages was adversely affected by higher food prices which reduced consumer demand for these products, as well as by subdued agricultural output which limited the intermediate supplies to manufacturing plants. In addition, the real output of petroleum, chemical and rubber products slowed somewhat from the solid growth attained in the second quarter, partly due to scheduled maintenance to domestic petroleum refineries in the third quarter. Production increased further in the subsectors that manufacture basic iron and steel products, motor vehicles and other transport equipment as well as textile, clothing, leather and footwear products.

While the growth in the real value added by the manufacturing sector slowed on a quarter-to-quarter basis in the third quarter of 2006, real manufacturing production in the first three quarters of 2006 still exceeded output by 4¼ per cent in the first three quarters of 2005 – in keeping with the annual growth recorded for the calendar year 2005. The utilisation of production capacity in the third quarter of 2006 remained high at 85,9 per cent, marginally lower than the rate of 86,3 per cent recorded in the second quarter.

The real value added by the *construction sector* remained buoyant, registering double-digit growth for every quarter from 2005 through to 2006. While this mainly reflected the relatively high level of residential construction, the civil construction industry also benefited as the construction and maintenance of new roads were stepped up from the beginning of 2006, while various building projects in the retail sector continued. Consequently, the real value added by the construction sector remained strong although quarter-to-quarter growth decelerated from an annualised rate of 14½ per cent in the second quarter to 14¼ per cent in the third quarter of 2006. Real construction output in the first three quarters of 2006 rose by 13¼ per cent compared with the corresponding period in 2005, thereby exceeding the annual growth for the year 2005 as a whole. As a reflection of the brisk construction activity, cement imports rose significantly from around mid-2006.

Cement sales and imports



Three-month moving averages

Growth in the real value added by the sector that supplies *electricity, gas and water* slowed from an annualised rate of 4¼ per cent in the second quarter of 2006 to ¾ of a per cent in the third quarter. This slowdown could be attributed to an increase in electricity imported, the deceleration in real economic growth and slightly less chilly conditions in the second half of winter.

Alongside the slowdown in overall economic activity, growth in real output of the retail sector also decelerated from its earlier exuberant pace. This resulted from a marginal slowdown in consumption demand in the third quarter, as demand for both durable and non-durable goods slowed amidst higher levels of domestic prices and interest rates. The real value added by the motor trade subsector slowed from the second to the third quarter of 2006 as a result of the scaling back of purchases of new motor vehicles by private consumers. However, conditions in the catering and accommodation subsector improved from the second to the third quarter of 2006, partly boosted by foreign visitors to the country. The combined effect of developments in these subsectors was a slowdown in growth in the real value added by the *trade sector* from an annualised rate of 6½ per cent in the second quarter of 2006 to 6¼ per cent in the third quarter. When comparing the first three quarters of 2006 to the corresponding period in 2005, the level of the real value added by the trade sector was 7 per cent higher, exceeding the growth recorded for 2005 as a whole.

Following an annualised increase of 5¾ per cent recorded in the second quarter of 2006, the growth in real value added by the *transport, storage and communication sector* slowed to 5½ per cent during the third quarter. This was partly due to a marginal weakening of both land transport and communication activity. However, the real value added by the transport, storage and communication sector in the first three quarters of 2006 was 5½ per cent higher than in the first three quarters of 2005, the same rate attained for the calendar year 2005.

The real value added by the *finance, insurance, real-estate and business services sector* increased at an annualised rate of 6 per cent in the third quarter of 2006, compared with a rate of 10 per cent recorded in the second quarter. The slowdown in the growth in real output can mainly be ascribed to a deceleration in the real value added by banks and stockbrokers. The weaker output of securities dealers reflected a somewhat lower volume of shares traded on the JSE Limited. Overall, growth in the real value added in the finance, insurance, real-estate and business services sector came to 8 per cent for the first nine months of 2006 compared with the first nine months of 2005. This growth was considerably higher than the rate of 5½ per cent registered in 2005 as a whole.

Real value added in the government services sector rose steadily in both the second and third quarters of 2006 as the staff complement expanded. The personal services sector also continued to record steady growth in real value added in both quarters.

Domestic expenditure

Growth in *aggregate real gross domestic expenditure* slowed considerably from an annualised growth rate of 7½ per cent in the second quarter of 2006 to 2 per cent in the third quarter. The slower rate of expenditure growth could mainly be attributed to a slowdown in the accumulation of inventories as well as a decline in real final consumption expenditure by general government. Only real gross fixed capital formation picked up momentum in the third quarter of 2006. Nevertheless, growth in real gross domestic expenditure for the first three quarters of 2006 compared with the same period in 2005 came to 7¾ per cent, notably higher than the 6 per cent registered in 2005 as a whole.

Real *final consumption expenditure by households* increased further in the third quarter of 2006, albeit at a slightly slower pace than the growth rates registered in the first and second quarters of the year. After an annualised growth rate of 7¾ per cent was recorded in the second quarter of 2006, real household expenditure continued at a brisk pace registering a growth rate of 7¼ per cent in the third quarter. Markedly lower growth in spending on durable and non-durable goods more than offset the stronger growth in real outlays on semi-durable goods and services. The slowdown in real outlays by households can be attributed to

- a marginal decline in consumer confidence during the third quarter of 2006;
- the onset of a tightening phase in monetary policy with successive increases in interest rates; and
- steady increases in the prices of some products.

Real gross domestic expenditure

Percentage change at seasonally adjusted annualised rates

	2005					2006		
Components	1st qr	2nd qr	3rd qr	4th qr	Year	1st qr	2nd qr	3rd qr
Final consumption expenditure by households	6	5¾	6	6	6½	8¼	7¾	7¼
Final consumption expenditure by general government	¼	5¾	5¾	15	5¼	-3	16	-4
Gross fixed capital formation	9½	8¾	11¼	11½	9½	13¼	11¼	13¾
Change in inventories (R billions)*	12,3	7,4	13,5	2,0	8,8	16,1	16,4	9,2
Gross domestic expenditure	6¾	5½	8	6	6	14½	7½	2

* Constant 2000 prices

Despite the slower growth posted in the third quarter of 2006, the growth in real expenditure by households amounted to 7 per cent in the first nine months of 2006 compared with the corresponding period in 2005, which is substantially higher than the growth rate of 6½ per cent registered for 2005 as a whole.

The buoyant demand for *durable consumer goods* that reached its fastest growth in the fourth quarter of 2005 lost some momentum in the third quarter of 2006, with growth slowing from an annualised rate of 13 per cent in the second quarter of 2006 to 7 per cent in the third quarter. Household expenditure on personal transport equipment – especially on new motor vehicles – fell, but this was partly offset by sustained brisk spending on most other discretionary items. The lower level of spending on personal transport equipment may partly be attributed to higher bank lending rates. However, real outlays on items such as furniture and household appliances continued to increase at substantially higher growth rates in the third quarter, compared to the second quarter of 2006.

Real final consumption expenditure by households

Percentage change at seasonally adjusted annualised rates

	2005					2006		
Components	1st qr	2nd qr	3rd qr	4th qr	Year	1st qr	2nd qr	3rd qr
Durable goods	15½	17¼	10¼	24	18¾	18¾	13	7
Semi-durable goods	19¼	12¾	16	8	16½	23	24¾	25¼
Non-durable goods	3¼	4¼	4¼	4¾	4¾	4¼	6¾	1¾
Services	2½	2¼	3¼	2¼	2½	4¼	1¾	6
Total	6	5¾	6	6	6½	8¼	7¾	7¼

Growth in real final consumption expenditure by households on *semi-durable goods* was sustained at blistering annualised rates of 24¾ and 25¼ per cent in the second and third quarters of 2006, respectively. Buoyant spending on clothing and footwear, and recreational and entertainment goods was partly offset by slower growth in purchases of household textiles, furnishings and glassware as well as motor car tyres, parts and accessories.

After recording an annualised growth rate of 6¾ per cent in the second quarter of 2006, real household spending on *non-durable goods* slowed to 1¾ per cent in the third quarter. Real outlays on most categories of non-durable goods lost momentum during the third quarter. The lower growth in spending on food, beverages and tobacco, household fuel and power as well as on petroleum products can probably be attributed to rising prices of most of these products during the third quarter.

By contrast, strong growth was recorded in households' consumption of services during the third quarter. Growth in real final consumption expenditure by households on *services* increased at a rate of 6 per cent in the third quarter compared with a rate of 1¾ per cent recorded in the second quarter of 2006, with rental services particularly rising strongly.

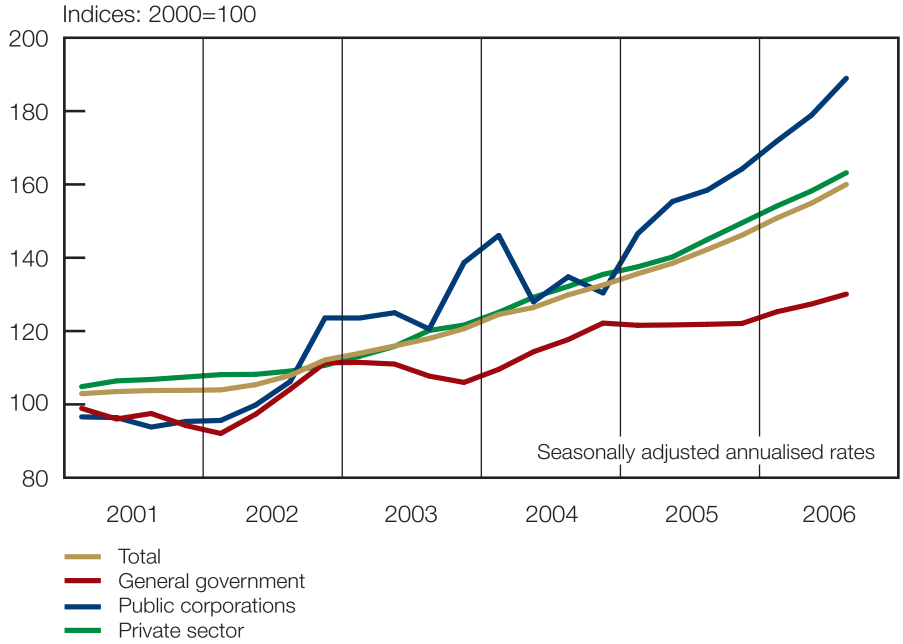
Following an annualised rate of increase of 16 per cent recorded during the second quarter of 2006, *real final consumption expenditure by general government* contracted by 4 per cent in the third quarter. The decline in the third quarter of 2006 was due to statistical base effects – although there were purchases of military equipment in both the second and the third quarters, the value of the outlays in the third quarter was significantly lower. Real expenditure on compensation of employees edged higher in the third quarter of 2006, compared to the second quarter. Real final consumption expenditure by general government increased by 6½ per cent in the first three quarters of 2006, compared with the corresponding period in 2005 – notably higher than the increase of 5¼ per cent recorded in 2005 as a whole.

The growth momentum in *real gross fixed capital formation* accelerated further from an annualised rate of 11¼ per cent in the second quarter of 2006 to 13¾ per cent in the third quarter. Lively capital programmes initiated by private business enterprises, public corporations as well as the general government buoyed growth in capital expenditure, lifting the ratio of gross fixed capital formation to gross domestic product from 18½ per cent in the second quarter of 2006 to 18¾ per cent in the third quarter – the highest ratio having been recorded since 1990. Real gross fixed capital formation gradually gained momentum across a number of sectors in order to expand capacity and improve infrastructure. Growth in the first three quarters of 2006 compared to the same period in 2005 amounted to 11¾ per cent, substantially higher than the rate of 9½ per cent recorded in 2005 as a whole.

Real gross fixed capital formation in the *private sector* continued at a strong pace, growing at annualised rates of 11¼ per cent and 13¼ per cent in the second and third quarters of 2006, respectively. All the major subsectors of the private sector stepped up real gross fixed capital formation, especially the agriculture, manufacturing, construction, commerce and transport subsectors. Real fixed capital outlays by the agricultural sector increased substantially as the sector benefited from a strong recovery in tractor sales to the traditionally maize-growing areas. Farmers' confidence may have been boosted by the considerably higher prices of grain and other agricultural products, which underpinned current and prospective farm income. Tractor prices were also viewed as relatively favourable.

Building activity in the non-residential sector expanded briskly with the construction of new shopping malls and related infrastructure. This was complemented by a strong demand for office and industrial space. Growth in the residential building sector slowed, partially due to rising building costs alongside a deceleration in house price inflation.

Components of real gross fixed capital formation



Real gross fixed capital formation by *public corporations* accelerated further in the third quarter of 2006, led by Transnet. Most public corporations stepped up capital expenditure programmes, with imports of machinery and equipment for the expansion of power and communication networks accelerating in the third quarter of 2006. Growth in real gross fixed capital formation by *general government* also accelerated from the second to the third quarter of 2006. Fixed investment outlays on the provincial and local government level were mainly focused on the construction and improvement of roads, especially in rural areas.

Following accumulation at a brisk annualised rate of R16,4 billion in the second quarter of 2006, *real inventory* investment declined to R9,2 billion in the third quarter. The lower rate of inventory accumulation in the third quarter can be ascribed to a depletion of inventories in the mining sector, especially the gold-mining sector. In addition, inventory investment slowed in the manufacturing sector partly due to sales from inventories and lower imports of crude oil as refineries had to undergo planned maintenance; this was probably also the reason for the build-up of stock in the second quarter. Wholesale, retail and motor trade inventories fell back in the third quarter, probably related to some economising as holding costs rose. As a result of these developments, the ratio of industrial and commercial inventories to non-agricultural gross domestic product amounted to 15 per cent in the third quarter of 2006, marginally lower than the ratio registered in the preceding quarter.

Factor income

The growth in total nominal factor income, measured over one year, accelerated from 10½ per cent in the second quarter of 2006 to 11¾ per cent during the third quarter. Both the nominal compensation of employees and the operating surpluses of business enterprises gained momentum in the third quarter.

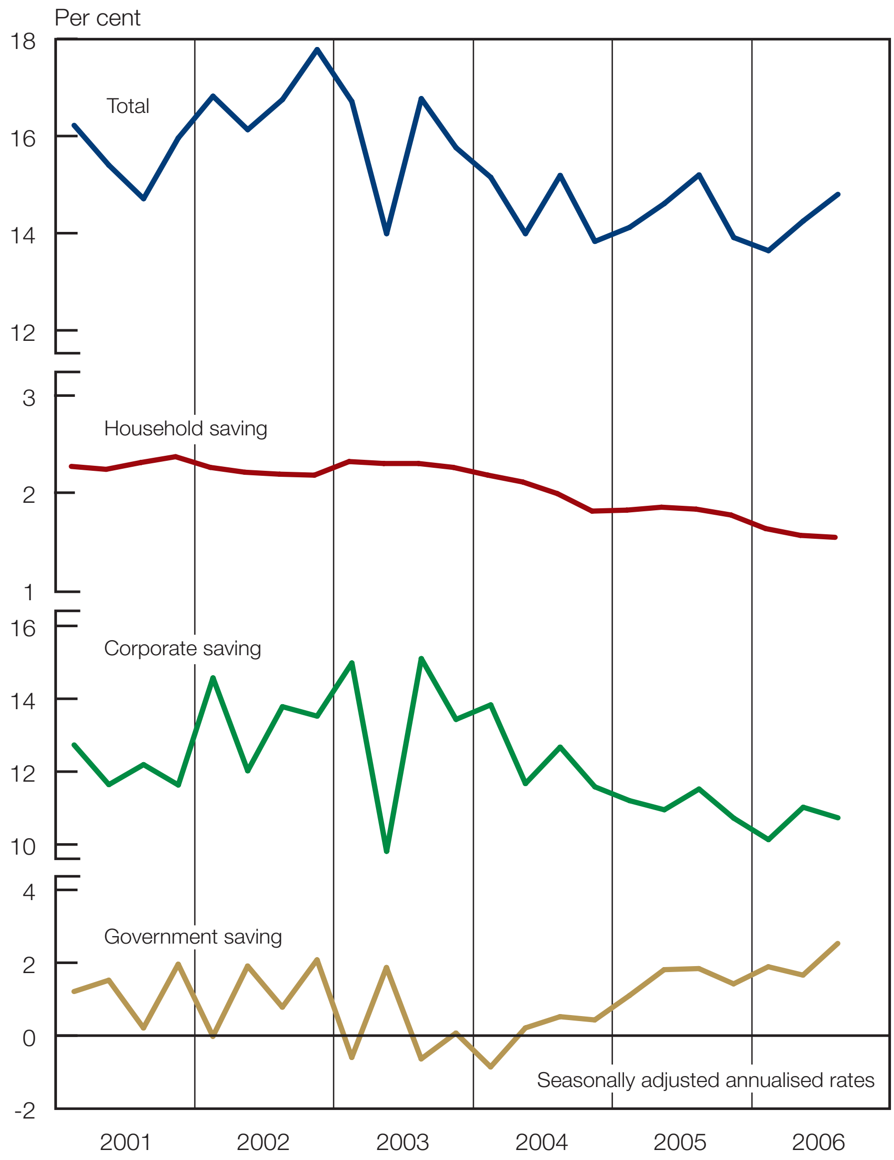
The year-on-year growth in compensation of employees accelerated from 7½ per cent in the second quarter of 2006 to about 8 per cent in the third quarter. This was probably more a result of staff numbers increasing than of a pronounced acceleration in wage settlement rates. The improvement in the compensation of employees was recorded in several sectors including the manufacturing, trade and finance sectors.

Despite the slower growth in real economic activity, growth in the gross operating surplus of business enterprises, measured over four quarters, increased from 13½ per cent in the second quarter of 2006 to 15½ per cent in the third quarter. Several economic sectors contributed to the improvement in aggregate gross operating surplus. Solid growth was recorded in the operating surpluses of goods-producing sectors such as mining and construction, as well as the transport sector. In addition, growth in the operating surpluses of the manufacturing and trade sectors also improved though at a slower pace than in the second quarter. Accordingly, the ratio of gross operating surplus to total factor income edged higher from 49¾ per cent in the second quarter of 2006 to 51 per cent in the third quarter.

Gross saving

The national saving ratio, i.e. the ratio of total gross saving to gross domestic product, increased from 14 ¼ per cent in the second quarter of 2006 to 14 ¾ per cent in the third

Gross saving as percentage of gross domestic product



quarter. This improvement in the saving ratio brought the saving ratio for the first nine months of 2006 to 14 ¼ per cent, marginally lower than the ratio in 2005. However, the dependence on foreign capital to finance gross capital formation eased somewhat from a dependence ratio of 31 per cent in the first quarter of 2006 to 26 per cent in the third quarter.

Gross saving of the corporate sector as a percentage of gross domestic product declined slightly from 11 per cent in the second quarter of 2006 to 10¾ per cent in the third quarter. This can be attributed largely to increased tax and dividend payments. Although the corporate saving ratio inched lower in the third quarter of 2006, the saving ratio for the first nine months of the year came to 10½ per cent, marginally lower than the ratio recorded in 2005.

The gross saving ratio of the household sector declined from an average of 1¾ per cent recorded in 2005 to 1½ per cent in the first three quarters of 2006. This weakening in the gross saving ratio of the household sector was the counterpart to households' strong propensity to consume. At the same time the household debt ratio, i.e. household debt as a proportion of annualised disposable income of households, which breached 70 per cent for the first time in the second quarter when it rose to 70¾ per cent, increased further to 73 per cent in the third quarter of 2006. Debt service cost at the same time increased from 7½ per cent to 8¼ per cent of disposable income as interest rates rose.

Gross saving by general government as a percentage of gross domestic product bounced back quite remarkably from 1¾ per cent in the second quarter of 2006 to 2½ per cent in the third quarter. The strengthening in the saving ratio was the net result of strong increases in current income from taxes, which surpassed the increases in government's recurrent expenditure.

Employment

According to the latest *Labour Force Survey* (LFS) by Statistics South Africa, overall employment in the economy increased by around 1,2 million over the three-year period to March 2006. As many as 544 000 additional jobs were created in the year to March 2006, thereby lowering the official unemployment rate to a six-year low of 25,6 per cent. As could be expected in an environment of improved employment prospects, a meaningful number of previously discouraged job-seekers again started to actively search for job opportunities.

Employment
Millions

	Mar 2002	Mar 2003	Mar 2004	Mar 2005	Mar 2006
Total employment	11,62	11,30	11,39	11,91	12,45
Formal non-agricultural employment	7,10	7,23	7,48	7,75	8,06
Unemployment rate (per cent)	*29,7*	*31,2*	*27,9*	*26,5*	*25,6*

Source: Statistics South Africa, *Labour Force Survey*, March 2006

Consistent with the sustained robust consumer demand, the majority of new jobs created during the year to March 2006 was in the wholesale and retail trade sector. In addition, employment gains were registered in the agricultural and manufacturing sectors of the economy. Employment growth in the construction sector slowed meaningfully from a gain of around 154 000 in the year to March 2005 to 51 000 in the year to March 2006. In the financial intermediation sector employment growth also decelerated, but still contributed about 10 per cent of the total number of new jobs created in the year to March 2006. The level of employment in the sectors for mining and quarrying, utilities, transport and community and personal services declined over the period.

Annual change in employment by industry

	Year to March	
Industry	2005	2006
Wholesale and retail trade	294 000	347 000
Agriculture	-88 000	147 000
Manufacturing	58 000	74 000
Financial intermediation	71 000	53 000
Construction	154 000	51 000
Private households	50 000	11 000
Unspecified/other	2 000	-1 000
Utilities	19 000	-22 000
Mining and quarrying	-132 000	-27 000
Transport	11 000	-38 000
Community and personal services	76 000	-52 000
Total	515 000	544 000

Source: Statistics South Africa, *Labour Force Survey*, March 2006

The enterprise-based *Quarterly Employment Statistics* (QES) survey by Statistics South Africa, a narrower indicator of employment, indicated that 62 000 jobs were created in the formal non-agricultural sector in the second quarter of 2006. This increase raised the number of employees in that sector to 7,24 million, 3,1 per cent more than in the second quarter of 2005. Employment growth was fairly pervasive as employers in both the private and public sector expanded their employee complements in the second quarter of 2006. Growth in private-sector employment nevertheless outpaced employment gains in the public sector by a fair margin.

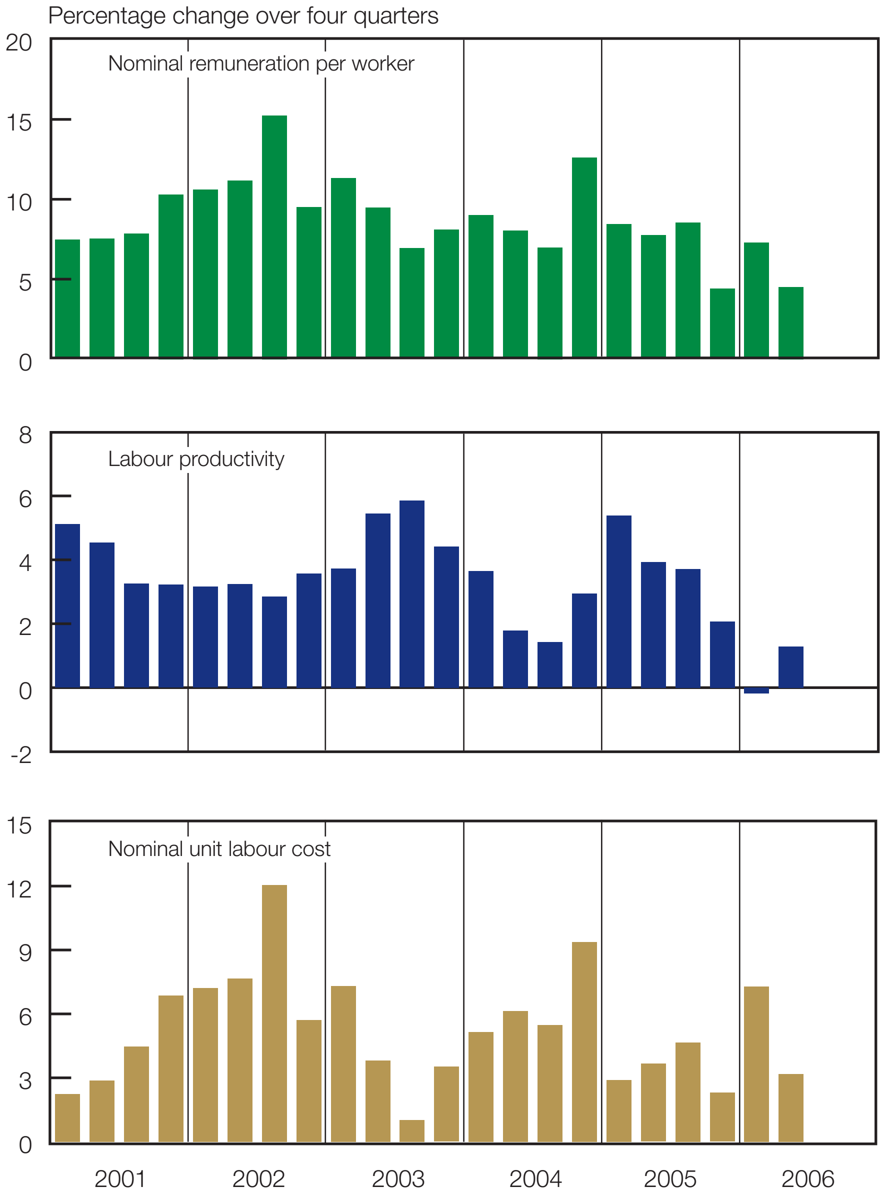
A fairly general contraction in employment numbers in *private-sector enterprises* in the first quarter of 2006 was followed by renewed employment gains in the second quarter. New job gains were especially noted in the gold-mining sector, transport, storage and communication sector as well as in the finance, real-estate and business services sector. Contrary to the acceleration in private-sector employment, employment growth in the *public sector* slowed considerably from the first quarter of 2006 to the second quarter. Employment losses in local governments and national departments in the second quarter of 2006 were, however, countered by employment gains in the rest of the public sector. The overall level of public-sector employment advanced at an annualised rate of 1 per cent in the second quarter of 2006 – the ninth consecutive quarter of increase.

Conditions remained conducive to further job gains in the third quarter of 2006. The most recent business survey conducted in the building and construction sector by the Bureau for Economic Research (BER) confirms that overall building activity maintained its lively pace in the third quarter of 2006, although some moderation in building activity in the residential property market was noted. According to the Rand Merchant Bank/BER Business Confidence Index, business confidence in the third quarter of 2006 rose to a level last seen eighteen years ago. The employment component of the Investec Purchasing Managers Index also suggested gains in employment in the third quarter and in October 2006.

Labour cost and productivity

The rate of increase in *nominal remuneration per worker* decelerated to 7,2 per cent in 2005, meaningfully lower than in preceding years, and remained around this level in the first quarter of 2006. Subsequently, the year-on-year rate of increase in nominal remuneration per worker in the formal non-agricultural sectors of the economy decelerated to 4,5 per cent in the second quarter. Lower increases in remuneration growth were fairly pervasive throughout the private and public sector. Declines in nominal remuneration per worker were registered in the community, social and personal services sector as well as in the electricity generation sector over the period.

Labour cost and productivity in the formal non-agricultural sector



Information obtained from Andrew Levy Employment Publications (a private-sector labour consultancy) indicates that the average level of *wage settlements* in collective bargaining agreements increased marginally from 6,2 per cent in the nine months ending

September 2005 to 6,4 per cent in the first nine months of 2006. Settlements ranged from 4,6 per cent in the retail sector to 8,9 per cent in the mining sector. The majority of settlements, i.e. 87 per cent, applied for a one-year period, while the remainder applied for two to three years.

The pace of increase in nominal remuneration per worker in the *public sector* slowed to 6,8 per cent in 2005 and further to 3,4 per cent in the year to the second quarter of 2006. Consistent with the general slowdown in nominal wage growth per worker in the public sector as a whole, wage growth in national departments receded meaningfully over this period, but still remained substantially in excess of that in other tiers of the public sector.

Similar to the slowdown in nominal wage growth per worker in the public sector, remuneration growth in the *private sector* slowed from an average annual rate of 7,1 per cent in 2005 to 5,0 per cent in the year to the second quarter of 2006. Barring the already mentioned decreases in remuneration per worker in certain sectors, year-on-year nominal wage growth in the second quarter of 2006 varied between 5,4 per cent in the gold-mining sector and 14,2 per cent in the non-gold mining sector.

Consistent with the increases in the overall level of employment, year-on-year *labour productivity growth* in the formal non-agricultural sector slowed considerably in the course of 2005, amounting to 2,1 per cent in the fourth quarter of that year. Notwithstanding this slowdown, average labour productivity growth for 2005 as a whole still outpaced that in the preceding year by a considerable margin. Having remained essentially unchanged in the first quarter of 2006, production per worker increased again somewhat in the year to the second quarter of 2006. Year-on-year labour productivity growth in the *manufacturing sector* accelerated consistently during the six months to June 2006, amounting to 3,3 per cent in the second quarter of 2006. At this rate, labour productivity growth in the manufacturing sector outpaced that for the economy as a whole.

Given the deceleration in the rate of increase in average nominal remuneration per worker, as well as the pick-up in labour productivity growth, the rate of increase in *nominal unit labour cost in the formal non-agricultural sector* slowed markedly from a level well above the inflation target range in the first quarter of 2006 to one which falls comfortably within the target range. The year-on-year increase in nominal unit labour cost of 3,2 per cent in the non-agricultural sector as a whole in the second quarter of 2006 was on a par with that of the manufacturing sector and accordingly consistent with the containment of inflationary pressures in the domestic economy.

Prices

Price inflation in the domestic economy accelerated noticeably as 2006 progressed, primarily due to steep increases in international crude oil prices up to August 2006, rising food price inflation and sustained strong consumer demand. Moreover, the depreciation of the exchange rate of the rand adversely affected the outlook for inflation. Notwithstanding increased price pressures emanating from these sources, year-on-year CPIX inflation has remained soundly within the inflation target range of between 3 and 6 per cent during the past three years.

Mainly driven by the depreciation of the rand since the middle of May 2006, the level of year-on-year *imported goods price inflation* rose from around the 6-per-cent level at the beginning of 2006 to 10,4 per cent in October – the highest rate of increase in almost four years. Higher rates of increase were evident in almost all imported goods price categories, indicating a broadening of price pressures at the production level. More pronounced increases were recorded in October 2006 for agricultural food products, basic metals as well as mining and quarrying products. Measured from quarter to quarter and expressed at an annualised rate, the prices of imported goods increased by 21,2 per cent in the third quarter of 2006, whereas in the first quarter of 2006 these prices were still declining.

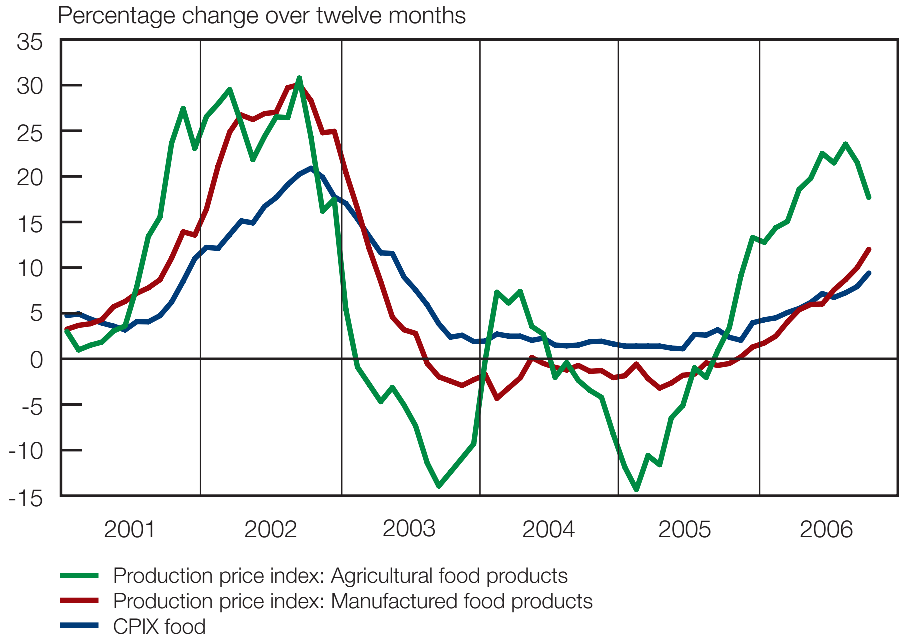
Production prices

Quarter-to-quarter percentage change at annualised rates

Period		Domestically produced goods	Imported goods	Overall production prices
2005:	1st qr	1,5	-2,7	0,6
	2nd qr	5,2	14,1	6,6
	3rd qr	6,6	11,7	8,5
	4th qr	6,2	1,7	2,8
	Year	**2,9**	**3,6**	**3,1**
2006:	1st qr	5,6	-0,1	4,2
	2nd qr	10,6	10,8	10,7
	3rd qr	16,9	21,2	17,8

Significant increases in the prices of food products at both the agricultural and manufactured level, together with a steep increase in the prices of electrical machinery, non-ferrous basic metals as well as mining products pushed *domestically produced goods price inflation* to levels last experienced in late 2002. In the year to October 2006 agricultural food prices rose by 17,7 per cent and manufactured food prices by 12,0 per cent, while the prices of electrical machinery and apparatus surged by as much as 34,3 per cent. Year-on-year inflation in the prices of domestically produced goods accordingly accelerated to 9,9 per cent in October 2006. Measured from quarter to quarter, domestically produced goods price inflation tripled in the third quarter of 2006 compared with the first quarter of the year.

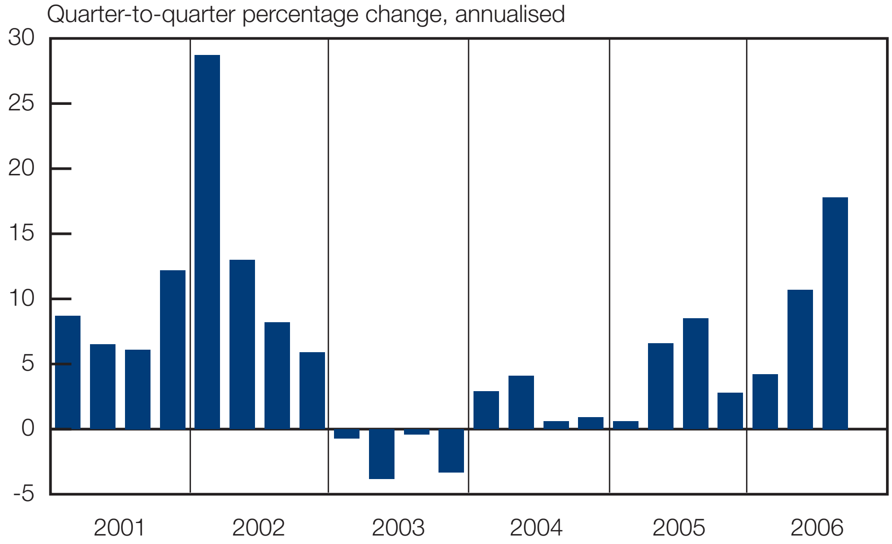
Food prices



Resulting from the acceleration in both imported goods price inflation and domestically produced goods price inflation, *all-goods production price inflation* rose to a year-on-year rate of 9,2 per cent in August 2006 – the highest rate of increase in 44 months. This rate of increase moderated slightly to 9,0 per cent in September 2006 as inflation in the prices of mining and quarrying products, agricultural products as well as products of petroleum and coal moderated somewhat. Subsequently, this rate of increase accelerated to 10,0 per cent in October 2006. When the rapidly rising energy and food prices are excluded from the all-goods production price index, an increase of 8,6 per cent was recorded in the year to October 2006. This lower rate of increase, however, still represented a significant acceleration from the opening months of 2006. Consistent with the acceleration in year-on-year production price inflation, the quarter-to-quarter pace of inflation accelerated markedly in the third quarter of 2006.

All-goods production price index

Quarter-to-quarter percentage change, annualised



Food prices

Percentage change over twelve months

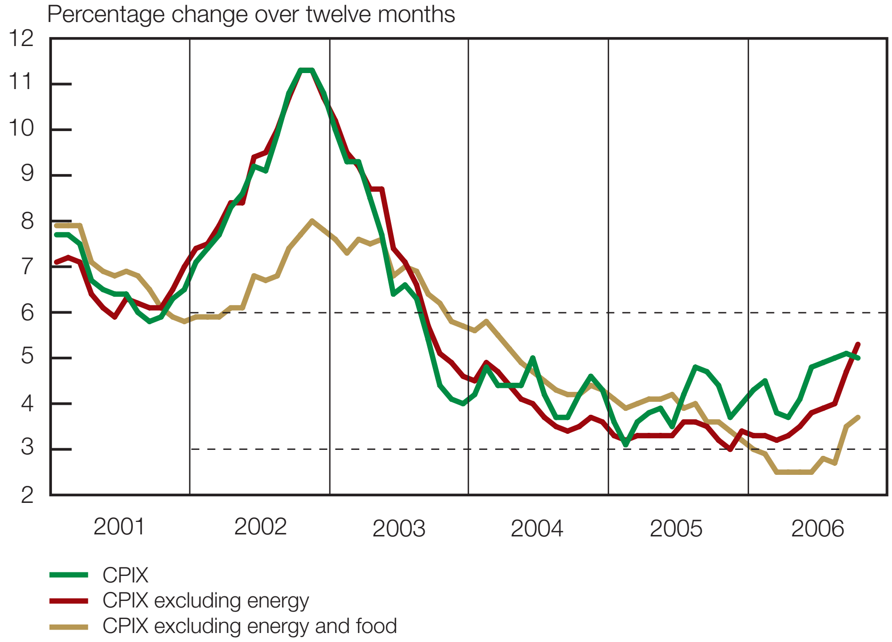
Period		Domestic production prices of food: Agricultural food	Domestic production prices of food: Manufactured food	Domestic production prices of food: Total	CPIX consumer food prices
2005:	Jul	-1,0	-1,7	-1,4	2,7
	Aug	-2,0	-0,4	-1,1	2,6
	Sep	0,9	-0,7	-0,1	3,2
	Oct	3,4	-0,5	1,1	2,4
	Nov	9,1	0,2	3,8	2,0
	Dec	13,3	1,3	6,2	4,0
	Year	**-3,0**	**-1,2**	**-2,0**	**2,1**
2006:	Jan	12,8	1,7	6,2	4,3
	Feb	14,4	2,5	7,2	4,5
	Mar	15,1	4,0	8,5	5,1
	Apr	18,6	5,4	10,6	5,5
	May	19,8	6,0	11,5	6,2
	Jun	22,5	6,0	12,6	7,2
	Jul	21,5	7,5	13,1	6,7
	Aug	23,5	8,7	14,6	7,2
	Sep	21,5	10,0	14,7	7,9
	Oct	17,7	12,0	14,3	9,4

In harmony with the upward trajectory in production price inflation since the beginning of 2006, *CPIX inflation* accelerated to 5,1 per cent in September 2006 and 5,0 per cent in October, from 3,7 per cent six months earlier. Higher consumer food prices accounted for the bulk of the increase in CPIX inflation in the year to October 2006. In fact, when food prices are omitted from the calculation, CPIX inflation generally remained at around the 4-per-cent level during the eleven months to September 2006, falling to 3,4 per cent in October. Compared with the first quarter of 2006, the quarter-to-quarter rate of increase in CPIX almost tripled to an annualised 8,4 per cent in the third quarter.

Following the significant increase in the production prices of food, CPIX consumer food price inflation more than doubled from a year-on-year rate of 4,3 per cent in January 2006 to 9,4 per cent in October. A disaggregation of consumer food price changes shows that increases in the price of meat outpaced those in all other food categories, followed by increases in the price of fish and fish products, while the price of milk, cheese and eggs increased only marginally over the same period. Inflation in the prices of grain products, despite falling below overall food price inflation in the year to October 2006, accelerated briskly in recent months.

The combined effect of rising petrol and food prices, as well as higher prices of alcoholic beverages and tobacco products, pushed year-on-year *CPIX goods price inflation* to 6,0 per cent in August 2006. This increase materialised despite price declines in the categories for furniture and equipment, clothing and footwear as well as new and used vehicles. Following a sizeable decrease in petrol prices in September 2006 and October, CPIX goods price inflation moderated somewhat in those months. Despite this moderation in year-on-year CPIX goods price inflation, the quarter-to-quarter rate of increase accelerated markedly to 10,1 per cent in the third quarter of 2006 – the highest rate of increase in the past three-and-a-half years.

CPIX



Contrary to the acceleration in CPIX goods price inflation, *CPIX services price inflation* moderated considerably from rates around 8 per cent in 2003 to 3,5 per cent in August 2006. This deceleration in CPIX services price inflation resulted mainly from a moderation in the rate of increase in domestic workers' wages and medical services prices, as well as absolute declines in communication costs. Following the incorporation of the most recent results from the *Labour Force Survey* regarding domestic worker wages, year-on-year CPIX services price inflation picked up to 4,4 per cent in September 2006 and 4,6 per cent in October. At an annualised rate, CPIX services price inflation matched the upper limit of the inflation target range in the third quarter of 2006. Being mainly constituted of services prices, the increase in the prices of *administered goods and services* decelerated to 6,7 per cent in the year to September 2006. Following a substantial drop in petrol prices, administered price inflation receded to 3,9 per cent in the year to October 2006.

Inflation in CPIX components

Percentage change over twelve months

	Weights	October 2006
Food and soft drinks	26,9	9,1
Alcoholic beverages and tobacco	3,1	8,4
Services excluding housing and transport	*16,5*	*5,2*
Other goods (not included elsewhere)	*17,5*	*4,7*
Transport services	*3,9*	*3,7*
Transport running cost	5,7	0,8
Vehicles	5,7	-0,8
Furniture and equipment	3,2	-0,8
Clothing and footwear	4,1	-9,5
Total CPIX	**100,0**	**5,0**

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

CPIX inflation expectations, as measured by the *Inflation Expectations Survey* of the BER for the third quarter of 2006, rose in respect of all three expectation periods. According to the survey, participants on average expect that annual average CPIX inflation will rise to 4,9 per cent in 2006, an increase of 0,5 percentage points compared with the outcome of the previous survey which polled expectations in the second quarter of 2006. Surveyed participants on average expect inflation to accelerate to 5,3 per cent in 2007 and to moderate to 5,0 per cent in 2008.

CPIX inflation expectations

Per cent, as surveyed in the third quarter of 2006

Average inflation expected for	Financial analysts	Business representatives	Trade union representatives	All surveyed participants
2006	4,8	5,0	5,0	4,9
2007	5,4	5,4	5,2	5,3
2008	4,7	5,4	4,9	5,0

Foreign trade and payments

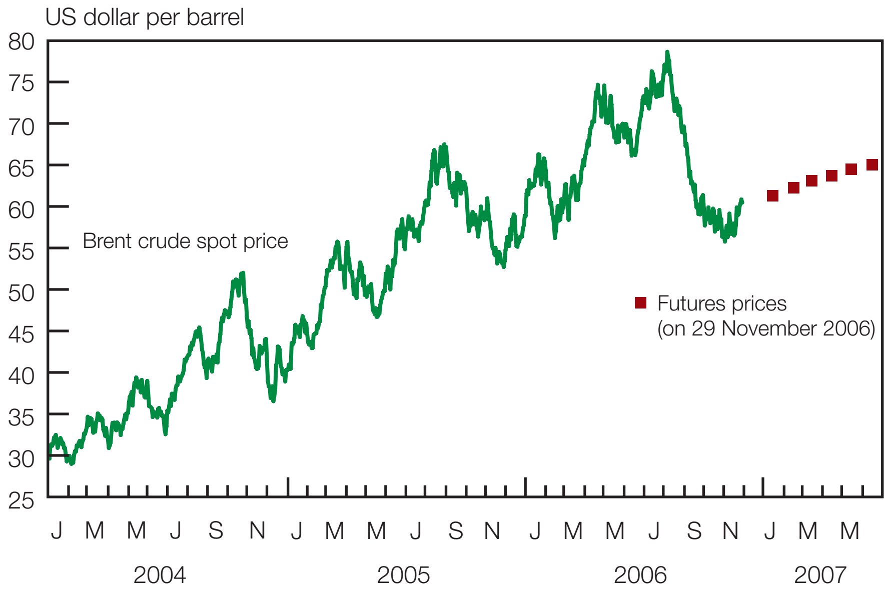
International economic developments

Global economic growth remained robust during the first three quarters of 2006 although economic activity moderated in some countries. According to the latest IMF *World Economic Outlook*, global production is estimated to increase at a rate of 5,1 per cent in 2006, before slowing down marginally in 2007. These projections are corroborated by the composite leading indicator of the Organisation for Economic Co-operation and Development (OECD), which suggests a slowdown in the pace of economic expansion in the advanced economies towards the end of this year.

Economic growth in the United States slowed during the second and third quarters of 2006 mainly reflecting lower activity in the housing market, high energy prices and the tighter monetary policy stance. After decelerating during the first two quarters of 2006, the Japanese economy grew at a stronger-than-expected pace in the third quarter. Growth in the euro area reached its fastest pace in six years in the first half of 2006, boosted mainly by robust domestic demand. Most major emerging-market economies in Asia, Europe and Latin America continued to record robust economic growth in the second quarter of 2006, underpinned by steady growth in domestic demand and the strong performance of the external sector. Available indicators suggest a continuation of the growth momentum in the next quarter. In China, however, economic activity moderated somewhat in the third quarter in response to the monetary tightening and government measures to slow the pace of economic activity. Real output growth in sub-Saharan Africa also remained strong, aided by favourable commodity prices, brisk global demand and initiatives to reduce the debt burden of the heavily indebted poor countries.

After reaching record-high levels of close to US$80 per barrel in early August 2006, Brent crude oil prices receded to levels below US$56 per barrel in early November. The decline in crude oil prices was mainly driven by factors such as the end of the summer driving season in the United States, the easing of geopolitical tensions in the Middle East

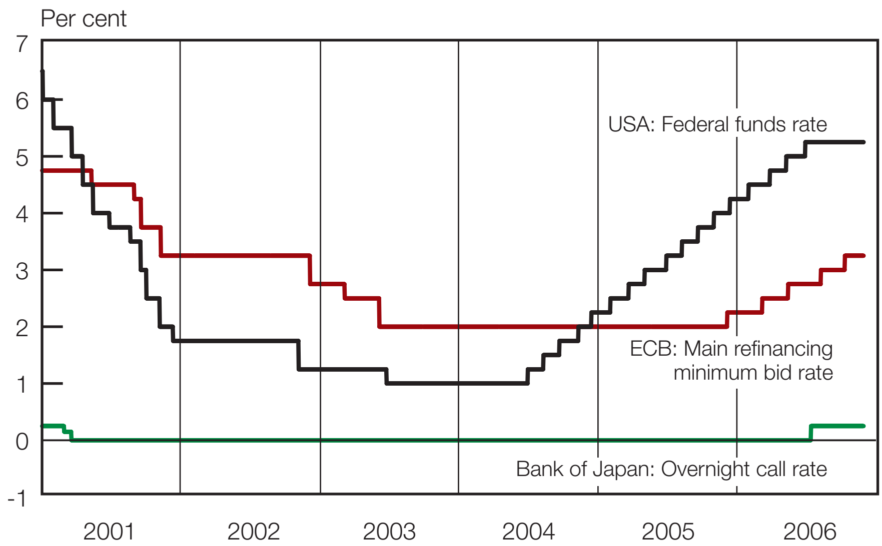
Brent crude oil prices



and fading supply concerns. In addition, the absence of significant weather-induced supply disruptions in the Gulf of Mexico, the swift restoration of production at an oil field in Alaska and the comfortable levels of US oil inventories served to arrest fears of increasing prices ahead of the northern hemisphere winter. In mid-October OPEC agreed to reduce production by 1,2 million barrels per day from the beginning of November in an effort to stem sliding prices. Crude oil prices rebounded towards the end of November to levels above US$60 per barrel following warnings of future cutbacks by Saudi Arabia, forecasts of cooler weather in the United States and renewed attacks on oil facilities in Iraq. Futures prices in the last week of November suggest Brent crude oil prices of around US$62 per barrel for delivery in the first quarter of 2007.

In recent months several central banks across the world have steadily increased official interest rates in response to rising inflationary pressures. The acceleration of core consumer prices in the United States has been a major concern to the *US Federal Open Market Committee;* as a result, the target for the federal funds rate has been raised at 17 consecutive meetings, but has been left unchanged since June 2006. The *Bank of Japan* has ended its quantitative easing monetary policy and increased the uncollateralised overnight call rate by 25 basis points in July. The *European Central Bank* raised its key interest rate in early October to 3,25 per cent, the fifth increase in ten months due to the risks to price stability over the medium term.

Central bank policy rates



Monetary policy was also tightened in recent months by central banks in other countries, including Australia, the Czech Republic, Denmark, Hungary, Sweden, Switzerland, Taiwan and the United Kingdom. However, central banks in countries such as Brazil, Indonesia, Israel and Russia, recently reduced policy rates.

Current account[1]

1 Unless stated to the contrary, the current-account flows referred to in this section are seasonally adjusted and annualised.

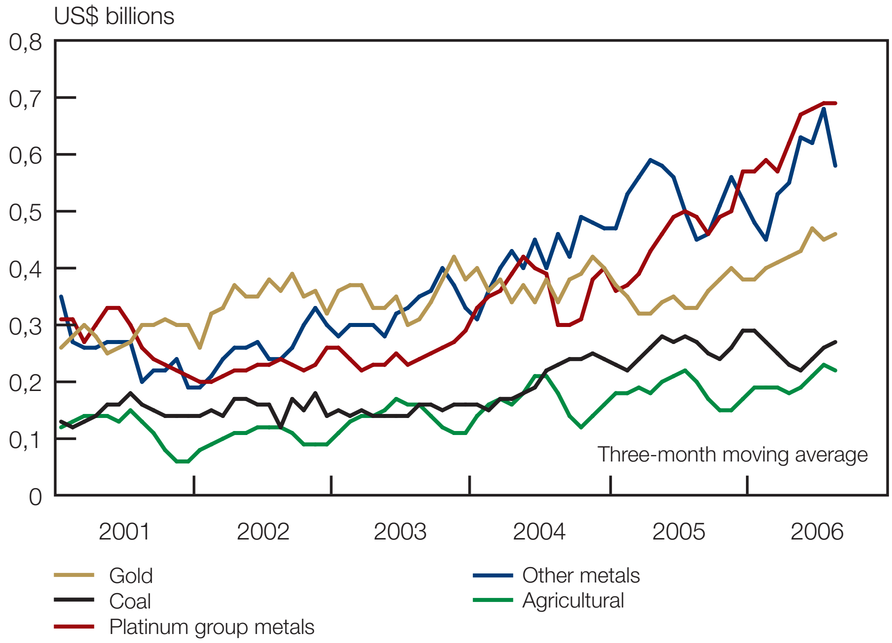
The relatively favourable global economic environment together with the lower external value of the rand boosted the value of South Africa's merchandise exports in the third quarter of 2006. At the same time, the value of merchandise imports increased at a somewhat slower pace than in the preceding quarter. As a result, the deficit on the trade account of the balance of payments narrowed from R35,6 billion in the second quarter of 2006 to R24,9 billion in the third quarter. The improvement in the trade balance was, however, partly offset by larger net payments for services and income to non-residents. The balance on the current account accordingly shrank to a deficit of R90,4 billion or 5,2 per cent of gross domestic product in the third quarter of 2006.

Balance of payments on current account
R billions

	2005				2006		
	2nd qr	3rd qr	4th qr	Year	1st qr	2nd qr	3rd qr
Merchandise exports	331,2	344,1	340,7	325,1	326,0	368,3	427,6
Net gold exports	25,9	26,0	31,3	27,0	29,3	33,7	39,4
Merchandise imports	-356,4	-384,4	-378,7	-359,8	-388,2	-437,6	-491,9
Trade balance	0,7	-14,3	-6,7	-7,7	-32,9	-35,6	-24,9
Net service, income and current transfer payments	-50,6	-44,7	-59,8	-50,7	-67,2	-59,7	-65,5
Balance on current account	-49,9	-59,0	-66,5	-58,4	-100,1	-95,3	-90,4
As percentage of gross domestic product	*-3,3*	*-3,8*	*-4,1*	*-3,8*	*-6,1*	*-5,7*	*-5,2*

The value of *merchandise exports* advanced strongly in both the second and third quarters of 2006. Increases in both the price and volume of goods exported lifted export earnings by about 16 per cent in the quarter ended September 2006. Although international commodity prices expressed in US dollar terms drifted marginally lower in the third quarter of 2006, the depreciation in the exchange value of the rand nevertheless raised the unit price of exported goods by about 9 per cent. This followed an increase of 6 per cent in the second quarter of 2006.

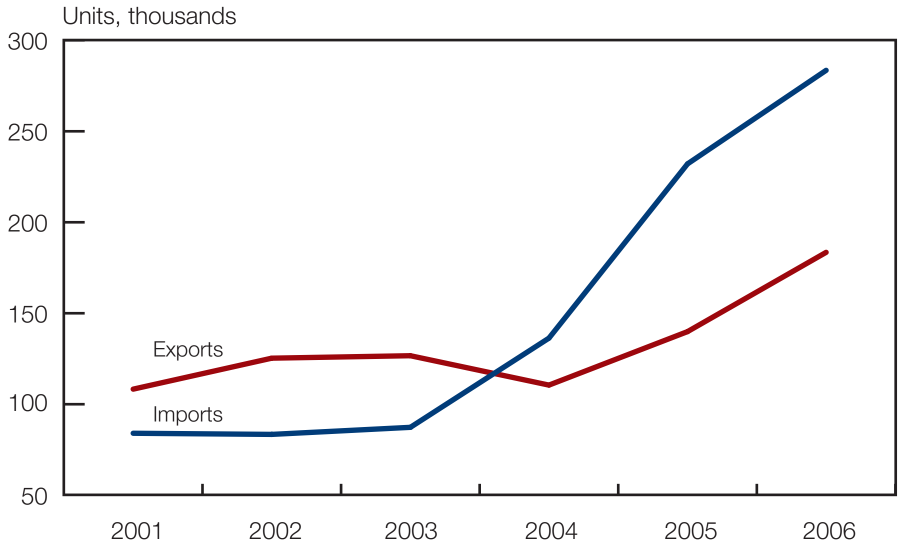
Export revenue from selected South African commodities



Source: SARB, SARS

The sustained favourable global economic conditions in South Africa's main trading-partner countries contributed to a further increase in merchandise export volumes. Having increased by almost 7 per cent in the second quarter of 2006, the volume of merchandise exports rose by about 6½ per cent in the third quarter. The increase in the competitiveness of exporters following the depreciation of the rand, together with relatively firm commodity prices, probably encouraged producers in both the manufacturing and mining sector to expand their exports. In particular, increases were noted in the subcategories for machinery and electrical equipment, vehicles and transport equipment, base metals and articles of base metals, and the platinum group metals. The number of vehicles exported in the first nine months of 2006 exceeded the level in the corresponding period of 2005 by no less than 40 per cent.

Total exports and imports of motor vehicles



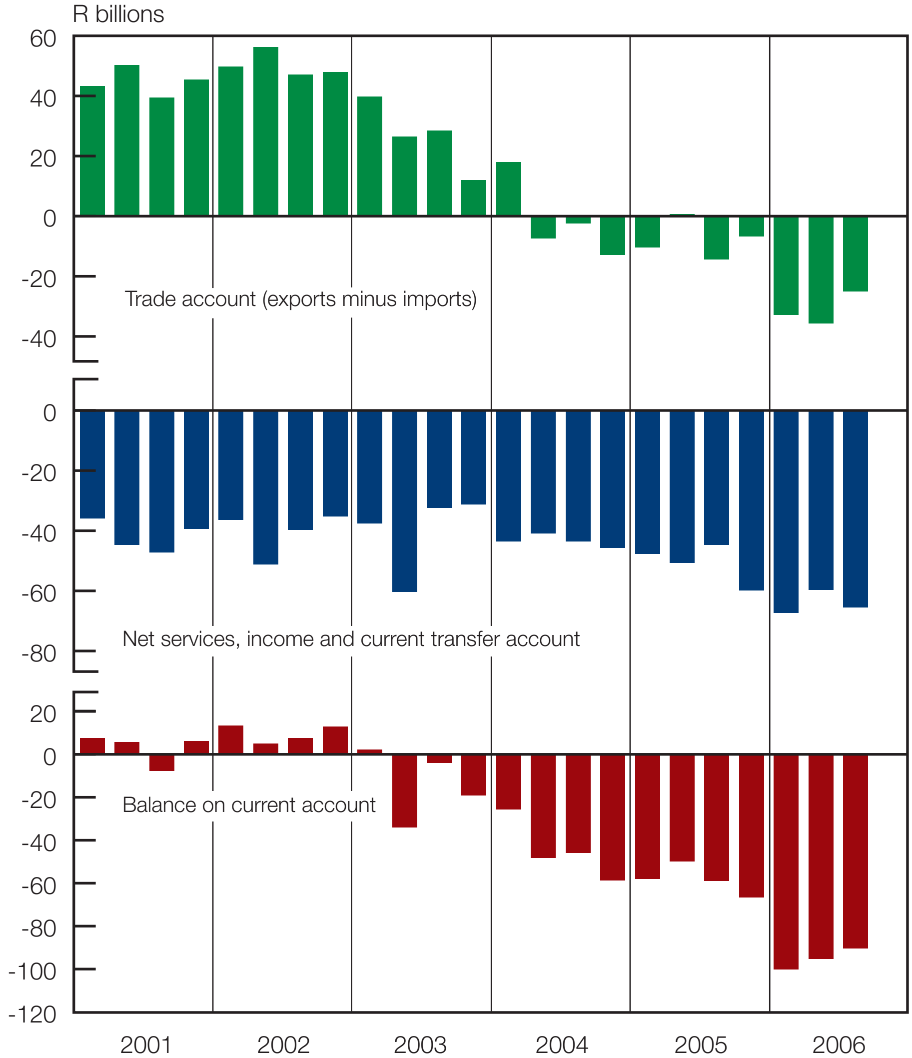
Source: Naamsa. 2006 figures estimated based on first nine months

While the dollar price of gold on the London market dropped by about 1 per cent from the second to the third quarter of 2006, the average realised rand price advanced by 9½ per cent over the same period. The physical quantity of gold exports advanced by 6½ per cent in the third quarter of 2006 following a decline in the second quarter. South African gold producers stepped up production and even sold part of their stockpile in response to the more favourable rand price of gold.

Despite the slower growth in gross domestic expenditure, a further strong increase in the volume of non-oil imports was recorded in the third quarter of 2006. The volume of non-oil imported goods rose by 8½ per cent in the quarter ended September 2006 compared with an increase of 7 per cent in the preceding quarter. However, owing in part to the scheduled shutdown of a number of domestic oil refineries to allow for maintenance work, the physical quantity of imported crude oil dropped markedly in the third quarter. As a result, the total volume of *merchandise imports* advanced by only 3 per cent in the third quarter of 2006, following a robust increase of 8½ per cent in the second quarter. The average price level of imported goods surged by 9 per cent in the third quarter of 2006 compared with an increase of 4 per cent in the preceding quarter.

The combination of higher import prices and an increase in import volumes resulted in a relatively sharp increase in the value of merchandise imports, which rose by 12½ per cent from the second quarter of 2006 to the third quarter. Reflecting the underlying momentum in gross fixed capital formation and consumption expenditure, pronounced increases were registered mainly in the category for manufactured goods. Increases were registered in the subcategories for machinery and electrical equipment, textiles and textile articles, vehicles and transport equipment and chemical products, in particular.

Balance of payments: Current account



In the third quarter of 2006, the deficit on the net services, income and current transfer account with the rest of the world widened to R65,5 billion or to about 3,7 per cent of gross domestic product. Dividend and interest payments to non-residents remained strong, buoyed by positive profit announcements as well as the higher level of outstanding foreign debt and non-resident ownership of South African shares. The net payment for other services such as architectural, engineering and other technical services also accelerated meaningfully over the period.

South Africa's international terms of trade, which had improved in the second quarter of 2006, weakened somewhat in the third quarter.

Financial account

After abating somewhat in the second quarter of 2006, capital inflows into the country gained renewed momentum in the third quarter when a surplus of R35,4 billion was recorded. The strong inward movement of capital was preceded by months of risk aversion towards emerging-market countries. During the third quarter of 2006 net capital inflows were recorded in the categories for portfolio and other investment; direct investment recorded a net outflow of capital over the same period. As a result, the net cumulative inflow of capital during the first three quarters of 2006 amounted to R96,2 billion compared with an inflow of R71,2 billion recorded during the same period of 2005.

Net financial transactions not related to reserves

R billions

	2005			2006		
	3rd qr	4th qr	Year	1st qr	2nd qr	3rd qr
Change in liabilities						
Direct investment	29,9	6,1	39,9	8,4	3,8	-0,3
Portfolio investment	8,4	-4,1	36,1	52,9	36,0	23,9
Other investment	3,7	-1,1	26,9	15,2	27,5	17,4
Change in assets						
Direct investment	-3,4	-4,8	-6,0	-2,2	-9,1	-35,0
Portfolio investment	-3,2	-3,6	-6,0	-3,4	-3,3	-2,5
Other investment	-28,6	9,6	-22,3	-44,0	-16,9	14,9
Total financial transactions*	**22,1**	**21,4**	**92,6**	**32,3**	**28,5**	**35,4**

* Including unrecorded transactions

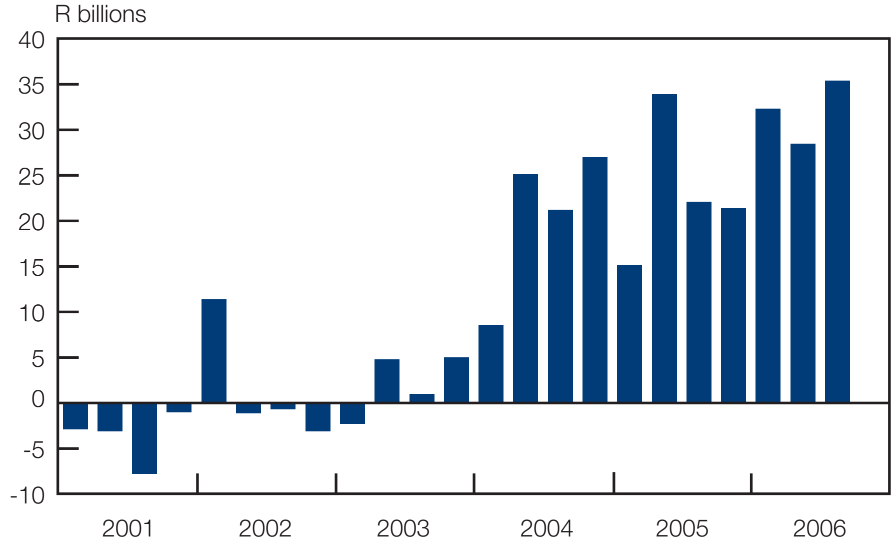
Foreign-owned assets in South Africa

Foreign direct investment into South Africa switched from an inflow of R3,8 billion in the second quarter of 2006 to an outflow of R0,3 billion in the third quarter. The acquisition of a significant additional interest in a domestic resource and a sugar producing company by foreign direct investors was more than neutralised by the repayment of a foreign loan by a foreign direct investment enterprise in South Africa.

Foreign portfolio investors continued to increase their holdings of South African equity and fixed interest securities in the third quarter of 2006. The inflow in the third quarter of 2006 amounted to R23,9 billion compared with an inflow of R36,0 billion registered in the preceding quarter. Although non-resident purchases of South African equity securities through the JSE Limited slowed in the third quarter of 2006, these net inflows were supplemented by a domestic telecommunications company's issuance of additional shares to non-resident investors as part of the funding of the acquisition of foreign direct investment assets. In addition, the higher level of domestic interest rates also sparked renewed foreign interest in the domestic bond market. Cumulatively, the inflow of portfolio capital amounted to R112,8 billion in the first nine months of 2006 – significantly more than similar inflows recorded in any previous calendar year.

Other investment flows into South Africa amounted to R27,5 billion in the second quarter of 2006, receding to R17,4 billion in the third quarter. This inflow of capital mainly comprised long-term foreign loans obtained by the private sector and short-term foreign borrowings by the domestic banking sector. Contrary to the increase in non-resident investors' foreign-currency and rand-denominated deposits with South African banks in the first half of 2006, these investors withdrew deposits to the value of R11,2 billion in the third quarter of 2006.

Balance on financial account



Including unrecorded transactions

South African-owned assets abroad

Outward direct investment which recorded an outflow of R9,1 billion in the second quarter of 2006 registered an outflow of R35,0 billion in the third quarter when a South African telecommunication company acquired a controlling interest in an offshore company. This outflow of capital was the largest ever to be recorded in a single quarter.

Portfolio investment by South African entities abroad declined to R2,5 billion in the third quarter of 2006 from an outflow of R3,3 billion in the second quarter. South African institutional and individual investors continued to diversify their investment abroad in terms of existing Exchange Control Regulations.

Other outward investment from South Africa changed to an inflow of R14,9 billion in the third quarter of 2006 from an outflow of R16,9 billion in the second quarter. The extension of trade finance by South African business enterprises to non-residents was more than countered by the repatriation of South African banks' foreign-currency deposits previously held with foreign banks.

Foreign debt

South Africa's total outstanding foreign debt increased from US$53,0 billion at the end of March 2006 to US$55,1 billion at the end of June. This increase in the country's foreign debt liabilities could be attributed to an increase in foreign-currency denominated debt; rand-denominated debt decreased over the period.

The increase in foreign-currency denominated debt could mainly be ascribed to the issuance of an international bond of €750 million by the national government, which was partly offset by the government's redemption of a €500 million international bond. In addition, private business enterprises raised their long and short-term foreign borrowing substantially while non-resident investors increased their deposits with South African banks in the second quarter of 2006.

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

	2005			2006	
	2nd qr	3rd qr	4th qr	1st qr	2rd qr
Foreign-currency denominated debt...	**28,0**	**27,9**	**28,1**	**29,7**	**33,1**
Bearer bonds	8,8	9,4	9,1	10,0	10,7
Public sector	4,5	4,6	4,6	4,6	4,6
Monetary sector	8,1	7,5	7,9	8,6	10,1
Non-monetary private sector	6,6	6,4	6,5	6,5	7,7
Rand-denominated debt	**17,0**	**18,0**	**18,1**	**23,3**	**22,0**
Bonds	6,5	6,0	6,3	6,5	6,0
Other	10,5	12,0	11,8	16,8	16,0
Total foreign debt................................	**45,0**	**45,9**	**46,2**	**53,0**	**55,1**

Measured in rand, South Africa's outstanding foreign debt rose from R328 billion at the end of March 2006 to R393 billion at the end of June, mainly due to the depreciation of the exchange value of the rand.

The ratio of total external debt to gross domestic product increased from 19,1 per cent at the end of 2005 to 21,8 per cent at the end of June 2006. Relative to total export earnings, total foreign debt rose from 64,9 per cent to 72,7 per cent over the same period.

International reserves and liquidity

The large deficit on the current account of the balance of payments in the third quarter of 2006 was more than adequately financed by net financial inflows from abroad. South Africa's net international reserves accordingly increased by R7,1 billion in the third quarter of 2006. Cumulatively, the country's net international reserves rose by R22,1 billion in the first nine months of 2006 compared with an increase of R27,7 billion in the first three quarters of 2005.

The value of the gross gold and other foreign reserves of the Bank (i.e. the international reserves before accounting for reserve-related loans) increased from US$24,0 billion at the end of June 2006 to US$24,7 billion at the end of September before declining marginally to US$24,6 billion at the end of October as government repaid some of its foreign-exchange commitments. At the same time, the Bank's short-term credit facilities utilised declined from US$3,5 billion at the end of June 2006 to US$3,2 billion at the end of September and remained unchanged at the latter level up to the end of October.

The international liquidity position of the Bank improved from US$20,2 billion at the end of June 2006 to US$21,2 billion at the end of September, edging higher to US$21,4 billion at the end of October.

Exchange rates

The exchange rate of the rand came under pressure in May 2006 due to heightened global risk aversion towards emerging-market countries and a reduction in some export commodity prices. It weakened further during the third quarter of 2006 as uncertainty among non-resident investors about the deficit on the current account of the balance of payments prevailed. The weighted exchange rate of the rand, which had decreased by 16,2 per cent from the end of March 2006 to the end of June, on balance, declined by a further 7,2 per cent from the end of June 2006 to the end of September. During October it strengthened somewhat as the market digested news of high-profile inflows of funds into South Africa.

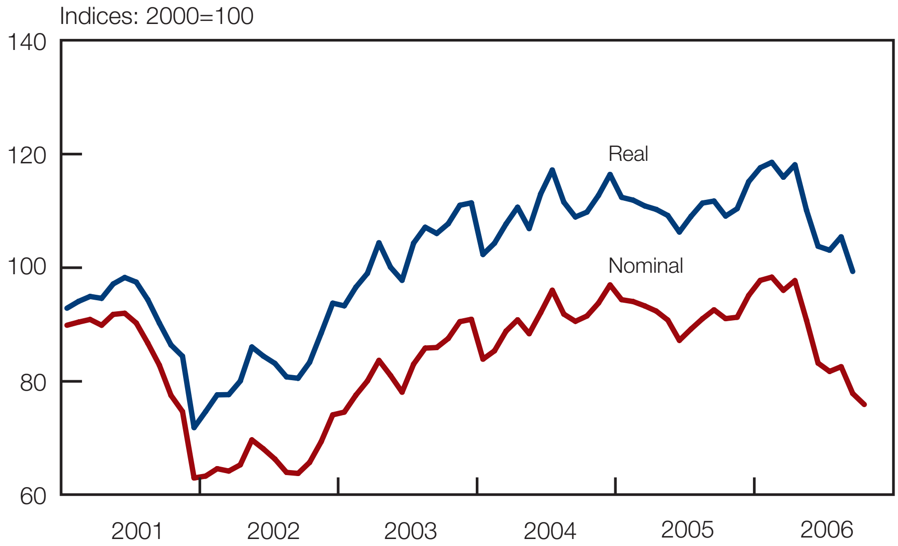
Exchange rates of the rand
Percentage change

	30 Dec 2005 to 31 Mar 2006	31 Mar 2006 to 30 Jun 2006	30 Jun 2006 to 29 Sep 2006	29 Sep 2006 to 31 Oct 2006
Weighted average*	1,0	-16,2	-7,2	1,1
Euro	-0,2	-17,2	-7,0	1,4
US dollar	2,0	-13,2	-7,3	1,6
British pound	1,3	-17,6	-9,2	-0,1
Japanese yen	2,2	-15,2	-4,6	1,2

* Against a basket of 13 currencies

The real effective exchange rate of the rand declined by 14 per cent from December 2005 to September 2006 and by 11 per cent over the twelve months to September 2006, indicating enhanced international competitiveness of South African producers.

Effective exchange rates of the rand



The net average daily turnover in the domestic market for foreign exchange which increased to US$14,8 billion in the second quarter of 2006, remained broadly unchanged in the third quarter. The high level of activity in the domestic market for foreign exchange during the second and third quarters of 2006 reflected in part the volatility in the exchange value of the rand and the continued attractiveness of the South African market for fixed-interest securities, both on an outright and repurchase-transaction basis.

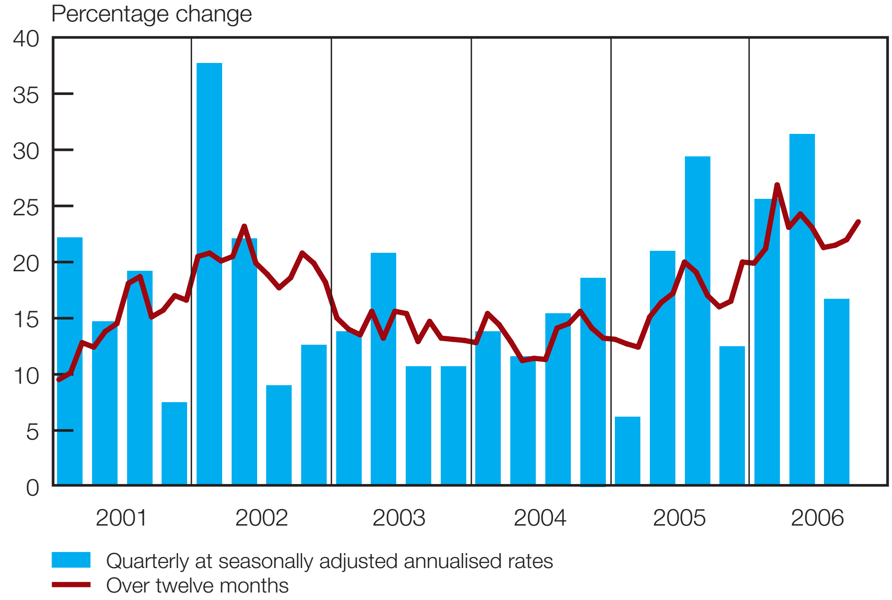
Monetary developments, interest rates and financial markets

Money supply[2]

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

While growth in the broadly defined money supply (M3) remained at relatively high levels, it moderated somewhat from mid-2006, consistent with rather less buoyant conditions in the real economy, less forceful wealth effects as some asset prices hesitated, as well as a mild slowdown in financial market turnover. The yield-seeking motive for holding interest-bearing monetary assets was nevertheless reinforced by the upward trend in the domestic interest rate cycle and the speculative and precautionary motive by the volatility in the financial markets.

Growth in M3



The quarter-to-quarter seasonally adjusted and annualised growth in M3 decelerated from 31,4 per cent in the second quarter of 2006 to 16,7 per cent in the third quarter. A similar trend was observed in growth over twelve months, as it also decelerated from 23,0 per cent in June 2006 to 21,9 per cent in September but re-accelerated to 23,5 per cent in October.

The annualised quarter-to-quarter growth in the narrower monetary aggregates broadly resembled that in M3 as shown in the accompanying table.

Monetary aggregates
Per cent at seasonally adjusted annualised rates

	Quarter-to-quarter growth	
	2nd qr 2006	3rd qr 2006
M1A	19,3	11,2
M1	31,6	27,9
M2	25,8	19,9
M3	31,4	16,7

Growth in M3 during the third quarter of 2006 was concentrated in the bank deposit holdings of the private corporate sector. The household sector contributed R14,0 billion to the increase in M3 during the third quarter, in comparison to the corporate sector's R32,8 billion.

The quarter-to-quarter seasonally adjusted and annualised growth in nominal gross domestic product exceeded growth in M3 by 3,2 percentage points in the third quarter of 2006. Consequently, the income velocity of circulation of M3 increased to 1,39 in the third quarter of 2006 from a record low in the second quarter.

Money supply (M3) increased by R46,8 billion from the end of the second quarter of 2006 to the end of the third quarter. The statistical counterparts of the change in M3 are reflected in the accompanying table.

Counterparts of change in M3

R billions

	2nd qr 2006	3rd qr 2006
Net foreign assets	29,0	-10,0
Net claims on the government sector	-13,7	-7,5
Claims on the private sector	49,3	96,0
Net other assets and liabilities	-35,2	-31,7
Total change in M3	29,4	46,8

Statistically, the increase in M3 during the third quarter of 2006 was more than fully explained by yet another consecutive record increase in the banks' claims on the private sector, mainly reflecting strong growth in loans and advances. Net claims on the government sector declined as government deposits rose following the strong tax receipts, especially during the month of September 2006.

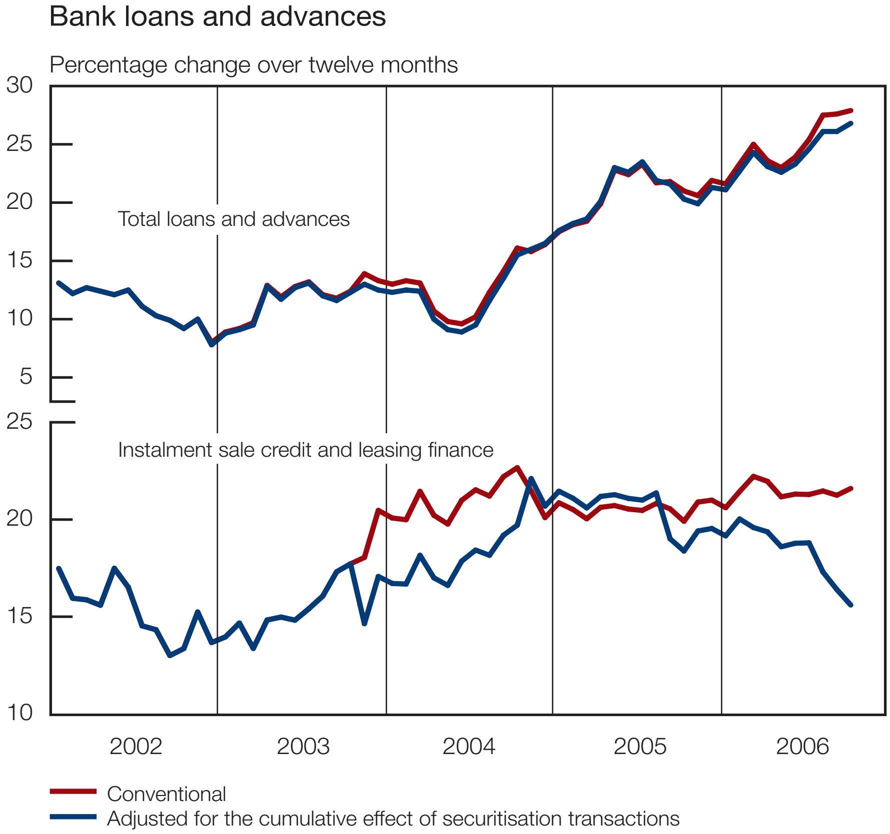
The decline in other assets and liabilities continued to be affected by the requirement that banks mark their positions in derivative instruments to market.

Credit extension

Growth in total loans and advances[3] extended to the private sector remained strong despite the higher lending rates following the increase in the repurchase rate by a cumulative 150 basis points in June, August and October 2006. This initial insensitivity of credit demand to the onset of a tightening cycle in interest rates is not unusual. Firm domestic expenditure and disposable income, the relatively low level of debt servicing costs and wealth effects emanating from the financial and real-estate markets continued to support growth in total loans and advances. Over this period, non-performing loans remained low, rendering support to banks' willingness to extend credit.

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

The securitisation of instalment sale advances to a total value of R7,9 billion during August and September 2006 by some of the banks influenced the level of the standard measure of banks' total loans and advances. A marked divergence developed between the twelve-month growth rates of the standard measure and the measure adjusted for the cumulative effect of securitisation transactions. The gap widened significantly from less than half a percentage point in September 2005 to 1,2 percentage points in October 2006, as shown in the accompanying graph. Nevertheless, as at the end of October 2006 only 2 per cent of banks' total loans and advances were securitised.



The quarter-to-quarter annualised growth in total loans and advances extended to the private sector accelerated from 25,5 per cent in the second quarter of 2006 to 28,6 per cent in the third quarter. Mortgage and general advances recorded significant increases during the third quarter of 2006, as reflected in the accompanying table.

Quarterly changes in credit aggregates
R billions

	2nd qr 2006	3rd qr 2006
Mortgage advances	36,7	44,2
Instalment sale credit and leasing finance	8,1	3,3
Other loans and advances	-2,5	42,6
Overdrafts	4,4	1,8
Credit card advances	2,7	3,3
General advances	-9,6	37,5
Total loans and advances	42,2	90,1

The growth in asset-backed credit remained brisk. Mortgage advances continued to surge, with a record monthly increase of R15,9 billion in July. Growth over twelve months in *mortgage advances* has remained around 30 per cent since March 2006, continuing to benefit from prolonged buoyant conditions in the property market.

Growth over twelve months in *instalment sale credit and leasing finance*, which is directed at financing expenditure on motor vehicles and other durable goods, decelerated from 18,8 per cent in June 2006 to 15,6 per cent in October, partly on account of the securitisation transactions mentioned earlier. Nevertheless, growth in this credit category remained strong, consistent with robust domestic expenditure. The analysis of this credit category by asset type shows that the contribution of new passenger vehicle sales to total instalment sale credit and leasing finance has grown from 23 per cent in the first quarter of 2003 to 32 per cent in the third quarter of 2006, consistent with brisk new passenger vehicle sales released by the National Association of Automobile Manufacturers of South Africa.

The divergence between the conventional measure and the measure adjusted for the cumulative effect of securitisation has increased from 1,5 percentage points in October 2005 to 6,9 percentage points in October 2006, as illustrated in the graph on the opposite page. Of note is that the growth trend displayed by the securitisation-adjusted measure has been range-bound between 20 and 22 per cent since December 2003.

The fact that vehicle prices have been relatively stable mainly due to increased competition and the strengthening of the exchange value of the rand supported this trend.

Led by general advances and credit card advances, twelve-month growth in *other loans and advances* accelerated from 15,0 per cent in June 2006 to 26,3 per cent in October, as the corporate sector increased its use of bank-intermediated funding partly on account of the immediate need to finance working capital as well as fixed investment projects.

The household sector's overall use of bank loans and advances rose by R40,6 billion in the third quarter of 2006 while that of the corporate sector increased by R49,5 billion.

Interest rates and yields

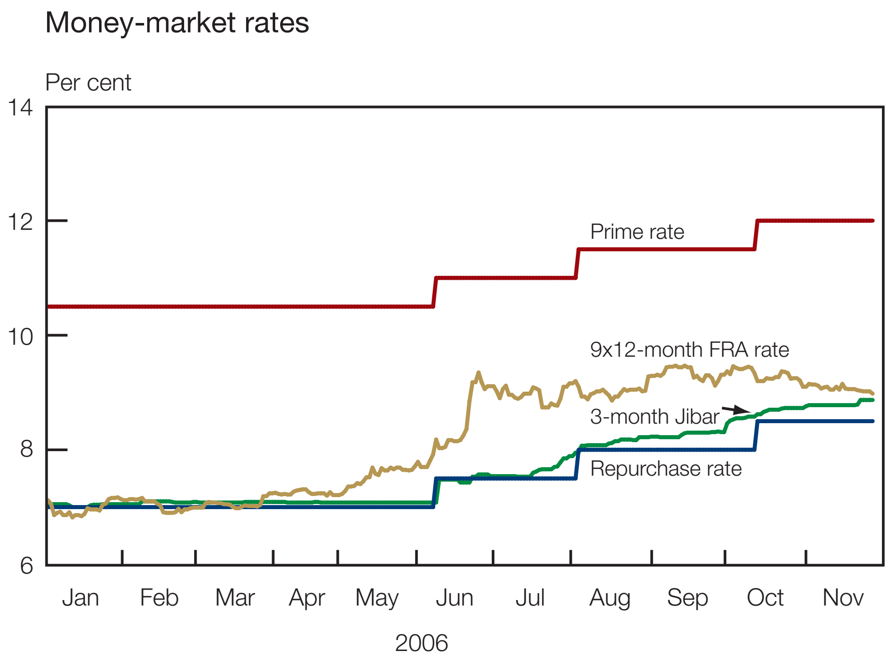
In the current policy-tightening cycle the Monetary Policy Committee (MPC) raised the repurchase rate in June, August and October 2006 by 50 basis points at a time. The rate came to 8,50 per cent after the October 2006 increase, which was in response to the deterioration in the risks to the inflation outlook brought about by the weaker exchange rate of the rand, sustained vibrancy in growth in domestic demand and oil price developments. The October 2006 MPC statement discussing the developments underlying the decision at that time is reproduced in full elsewhere in this *Bulletin*.

The *prime overdraft rate* and *predominant rate on mortgage loans* of the private banks increased from 10½ per cent in May 2006 to 12 per cent from mid-October, coinciding with the tightening in the monetary policy stance.

The *predominant rate on twelve-month fixed deposits* of the private-sector banks similarly increased from 6,2 per cent in April 2006 to 8,1 per cent in October. The increase of 190 basis points exceeded the increase of 150 basis points in the repurchase rate over the same period.

Other money-market interest rates also trended higher during the period under review, partly in anticipation of and partly in response to increases in the repurchase rate.

Following the decrease in international oil prices and the appreciation in the exchange value of the rand, rates on forward rate agreements (FRAs) decreased somewhat during



September 2006. For instance, the 9x12-month FRA rate declined from 9,47 per cent on 14 September 2006 to 9,12 per cent on 27 September. However, the forward rate agreements market still reflected strong expectations of monetary policy tightening going forward. By late November 2006, the market was discounting further increases in the repurchase rate totalling between 50 and 100 basis points over the following nine months.

Certain key administered interest rates were adjusted following the increase in the repurchase rate from June 2006. This included the official rate of interest applicable to fringe benefit taxation, as defined by the Income Tax Act, which was increased from 8,0 per cent to 9,0 per cent, effective from 1 September 2006. The standard interest rate applicable to loans granted by the State Revenue Fund, as defined by the Public Finance Management Act, increased from 10½ per cent to 11 per cent on 1 September 2006.

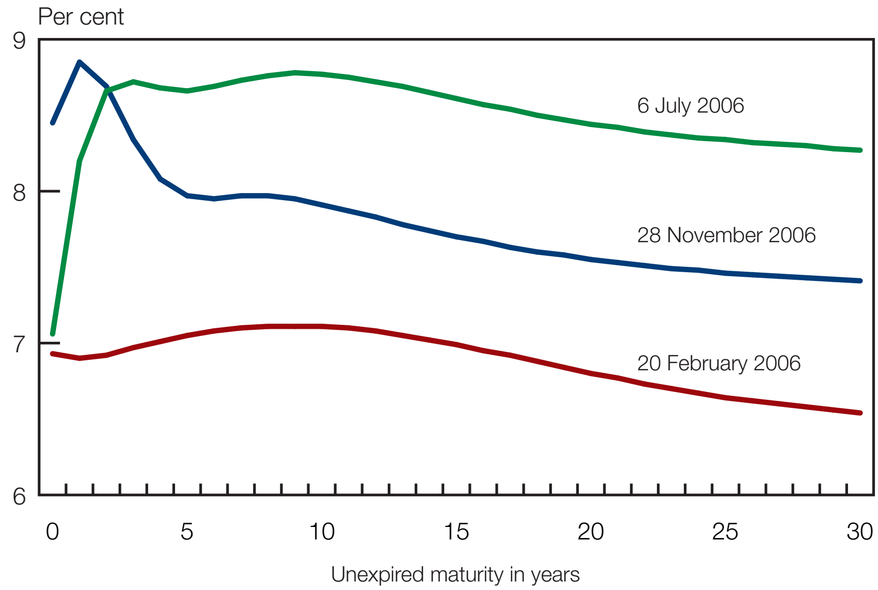
Although the National Credit Act, No 34 of 2005, was passed into law in March 2006, the maximum annual finance charge rates, as laid down by the Usury Act, will continue to apply until 31 May 2007. The Usury Act interest rate limits on money loans and credit and leasing transactions were last changed in September 2004 when it was set at 20 per cent for amounts of R10 000 or less and 17 per cent for amounts above R10 000, but not exceeding R500 000.

The *interest rates on government retail bonds* were increased by a cumulative 125 basis points from June 2006 to August due to the upward trajectory of yields on conventional bonds since February 2006. Subsequently, the rates remained unchanged to the end of November and amounted to 9,0 per cent on the 5-year bond, 8,75 per cent on the 3-year bond and 8,5 per cent on the 2-year bond.

From mid-May 2006 the rise in bond yields gathered momentum with the *daily average yield* on the long-term R157 government bond (maturing in 2015) rising to 8,79 per cent on 26 June, along with the depreciation of the exchange value of the rand and increased global risk aversion towards emerging markets. The upward momentum in domestic long-term bond yields started to peter out from the end of June and yields fluctuated in a narrow range during July and August alongside improvements in the exchange value of the rand, the tighter monetary policy stance and renewed investor interest in emerging markets. However, domestic bond yields again increased to a recent high of 8,89 per cent on 11 September before declining towards the end of October following projections of lower-than-previously-anticipated government bond supply, announced in the *Medium Term Budget Policy Statement* (MTBPS). Thereafter, the yield on the R157 bond continued along its declining path and reached 7,93 per cent on 10 November, helped along by the stronger exchange value of the rand and declining bond yields in major financial centres as growth concerns in these markets re-emerged. The yield on the R157 government bond then fluctuated in a narrow range and came to 7,94 per cent on 28 November.

From a recent low on 20 February 2006, movements in the level and slope of the *yield curve* started to reflect the concerns of market players regarding an increase in inflation. The level of the yield curve moved higher and steepened at the short end as bond yields with longer outstanding maturities rose in response to volatility in global oil prices and a weaker exchange value of the rand. The yield curve flattened at the short end following the tightening of the monetary policy stance in June, August and October, although it continued to reflect expectations of further policy tightening over the short term. At the same time the longer end of the curve moved lower and the entire curve became inverted, suggesting that market players expect inflation risk to remain contained over the longer term and also took note of the October MTBPS projections of lower future bond supply.

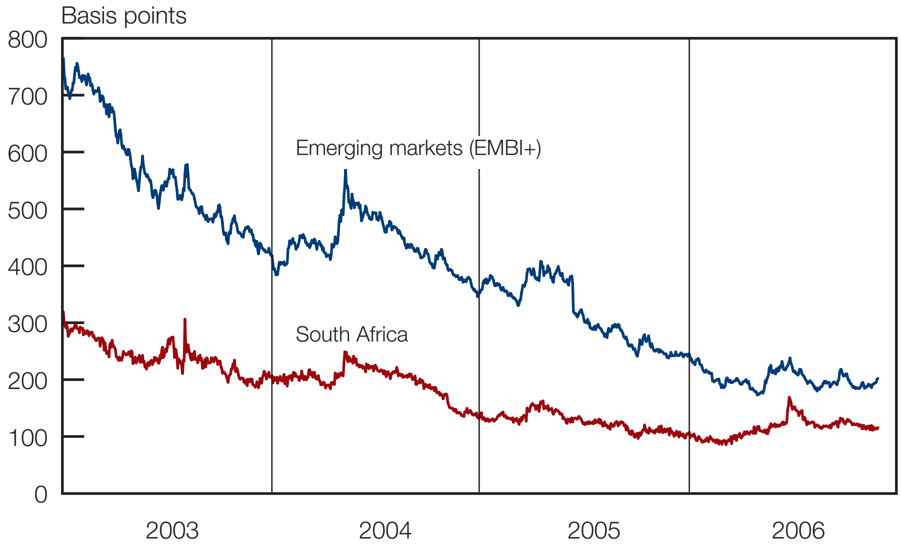
Yield curves



An upward trend in the yields on conventional bonds and declining real yields on inflation-linked government bonds resulted in an upward trajectory in *break-even inflation rates* during 2006. An approximation of expected inflation, the break-even inflation rates over different maturities fluctuated higher from their lows in February 2006 to recent highs in early October. Break-even inflation rates at the shorter end of the maturity range displayed fairly pronounced increases, with rates for the 2008 and 2013 maturities exceeding 6 per cent from around late August 2006. Inflation concerns arising from high oil prices, movements in the exchange value of the rand and risk aversion towards emerging markets were among the factors that contributed to the upward movement in break-even inflation. After reaching a peak of 6,7 per cent on 11 October, break-even inflation in the two-year maturity range reverted to a downward trend and reached 5,8 per cent on 28 November, following the increase in the repurchase rate in October, lower oil prices and some improvement in the exchange value of the rand.

Rising inflation, together with the depreciation of the exchange value of the rand and risk aversion towards emerging markets, contributed to a widening of 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 nine-to-ten year maturity range issued in the domestic market and dollar-denominated debt issued in the United States market) from a low of 116 basis points in April 2006 to 274 basis points in August. This differential again narrowed to 225 basis points in October when the decline in bond yields in the domestic market exceeded the decline in yields on foreign-issued South African bonds.

Yield spreads

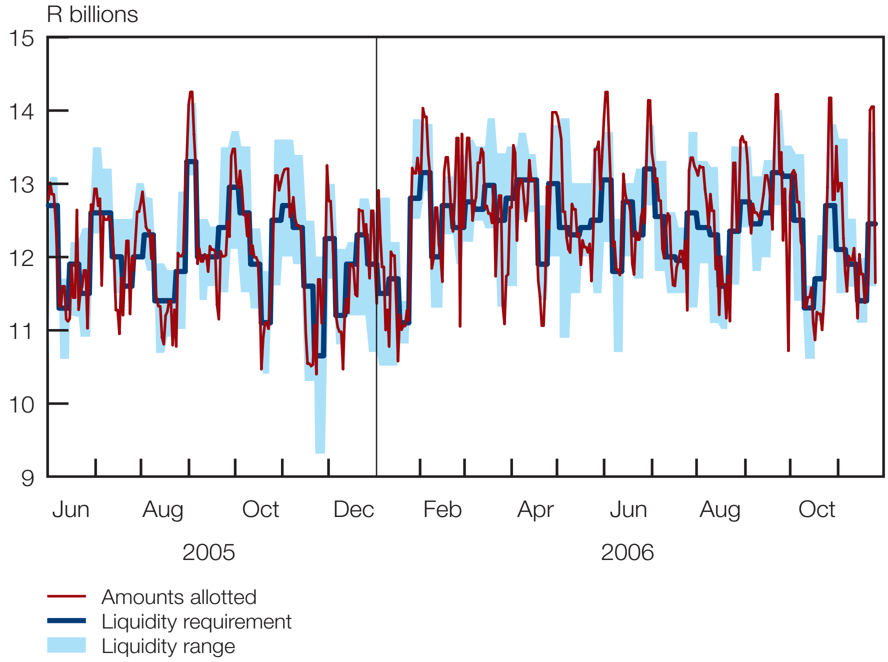


Similarly, the *sovereign risk premium* on South Africa's foreign-currency denominated bonds trading in international markets increased from an all-time low monthly average of 68 basis points in February 2006 to 115 basis points in July. The differential between yields on South African government US-dollar denominated bonds maturing in 2014 and yields on United States Federal Government securities of similar maturity again narrowed to 98 basis points in October, alongside a general reduction of emerging-market external debt spreads as investors' confidence in emerging markets returned.

Money market

The amount of liquidity provided at the weekly main refinancing auction varied between R11,3 billion and R13,2 billion from July to November 2006. The estimated liquidity ranges varied between R10,6 billion and R14,0 billion and the actual daily liquidity requirement of the private-sector banks between R10,7 billion and R14,2 billion over the period under review, occasionally breaching the liquidity range. Banks frequently utilised their cash reserve accounts with the Bank and irregularly accessed the standing facilities and supplementary auctions to square off their positions.

Liquidity requirement, ranges and amounts allotted



The main factors impacting on money-market liquidity flows from July to November 2006 are summarised in the accompanying table.

Money-market liquidity flows

R billions (easing +, tightening -)

	Jul – Sep 2006	Oct – Nov 2006
Notes and coin in circulation	-2,7	-3,0
Required cash reserve deposits	-1,7	-2,7
Money-market effect of SARB foreign exchange transactions	6,0	5,6
Government deposits with SARB	0,1	-0,1
Use of liquidity management instruments*	0,1	1,6
Government redemption and interest payments to Bank	-0,3	0,0
Other items net	-1,4	-0,7
Banks' liquidity requirement (decrease +, increase -)	**0,1**	**0,7**

* SARB debentures and reverse repurchase transactions

The Bank's purchases of foreign exchange added some R5,6 billion to money-market liquidity during the two months to November 2006, compared with R6,0 billion in the third quarter. Over both these periods, the expansionary effect of these purchases was partly neutralised by an increase in both notes and coin in circulation outside the Bank and banks' cash reserve holdings. The improvement in net foreign-exchange reserves was mainly due to the Bank's *creaming off* operations through measured buying of foreign exchange from the market. The restructuring of foreign loan facilities, which included the prepayment of US$300 million on a 3-year US$1 billion syndicated term loan entered into in 2004, also affected the Bank's foreign-exchange transactions.

The total amount of liquidity absorbed from the money market through the use of other interest-bearing instruments, such as long-term reverse repurchase agreements and SARB debentures, was curtailed. It declined from R10,1 billion at the end of May 2006 to R7,3 billion at the end of the third quarter. The outstanding amounts of these instruments amounted to R5,8 billion at the end of November 2006. The decrease partly reflected a sizeable reduction in SARB debentures made available to the market, with issues of two-month debentures in particular being curtailed as market participants' expectations of interest rate increases reduced their appetite for instruments with maturities longer than one month. The table below illustrates the developments in money-market intervention instruments utilised.

Outstanding balances of selected money-market sterilisation instruments

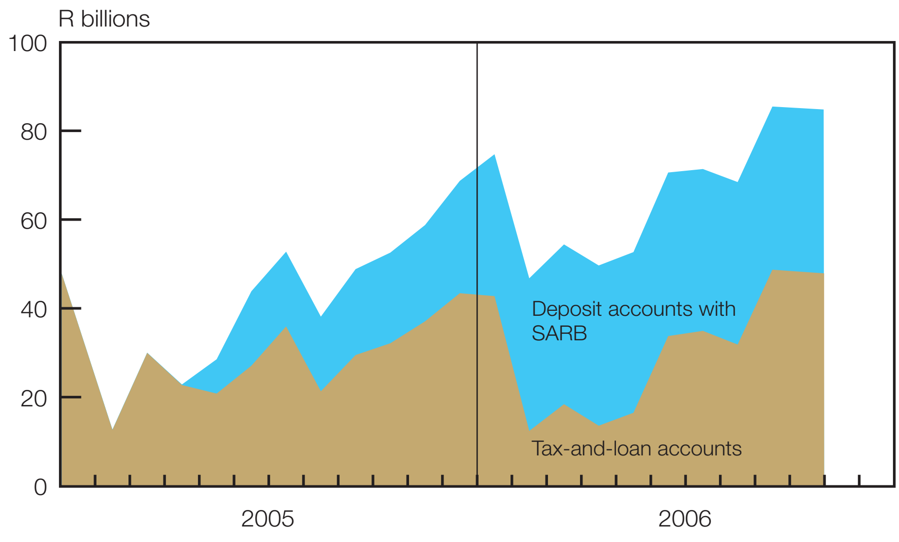
R billions

End of		SARB debentures	Reverse repurchase agreements	Government deposits with the Bank*
2006:	Jan	6,2	2,0	32,0
	Feb	6,2	2,0	34,4
	Mar	6,4	1,5	36,0
	Apr	6,1	3,3	36,1
	May	6,3	3,8	36,2
	Jun	5,4	2,0	36,8
	Jul	5,7	2,3	36,5
	Aug	5,0	2,0	36,6
	Sep	4,3	3,0	36,8
	Oct	2,8	2,8	36,9
	Nov	3,5	2,3	36,9

* Mainly comprising the Paymaster General and the National Treasury special deposit account with the Bank

The Bank's holdings of government bonds in its Monetary Policy Portfolio remained unchanged at R7,7 billion from the end of August 2006 to November. At the end of August 2006, a total of R10,1 billion in coupon interest payments on government bonds was made to non-bank private-sector parties. During September a further payment of R6,0 billion in interest on such bonds was made. This was effectively financed from government deposits in the tax-and-loan accounts with the private-sector banks. However, balances on these deposit accounts remained at relatively high levels of R48,7 billion at the end of September 2006 owing to healthy tax receipts. At that time, a further R36,8 billion was held on deposit with the Bank as shown in the accompanying graph.

Central government deposits



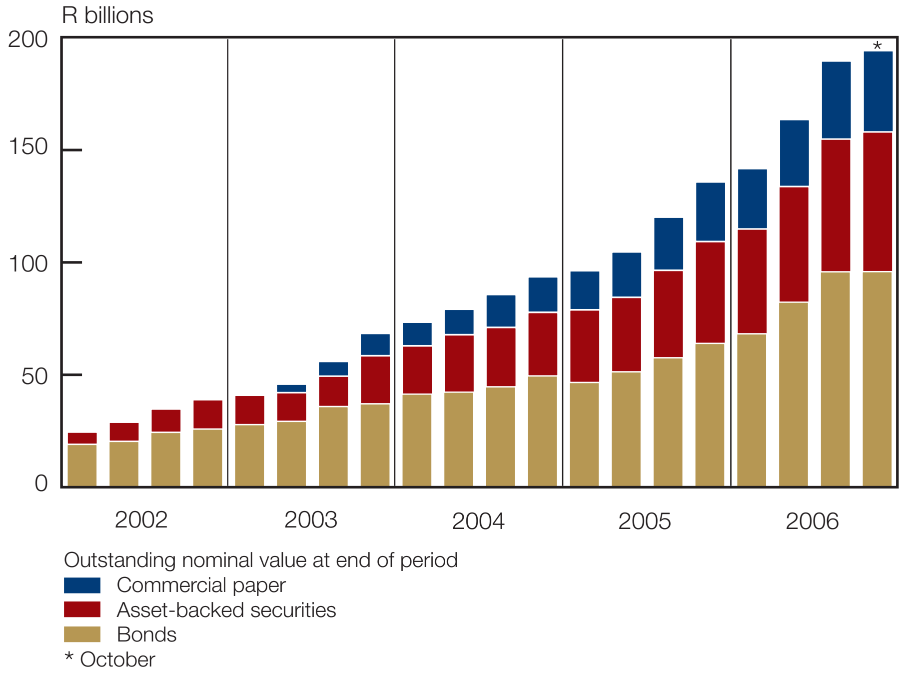
Bond market

The decreased funding requirement of the government due to improved tax collections continued to limit the supply of public-sector debt instruments during 2006. In the first ten months of 2006, net issues of government bonds amounted to R10,4 billion. At the same time net issues of fixed-interest securities by public corporations amounted to R5,0 billion and the City of Johannesburg raised R1,2 billion in June 2006 to fund its capital investment initiatives. In total, the net issues of fixed-interest securities by the *public sector* of R16,7 billion in the first ten months of 2006 fell substantially below the R22,8 billion raised in the corresponding period in 2005.

Notwithstanding the low borrowing requirement, the government maintained its presence in the *international bond markets* with the issuance in April 2006 of a €750 million ten-year bond, which mobilised funds to the amount of R5,5 billion. Prior to the issuance by the government, two private-sector companies entered the international markets in January and February 2006 and Eskom issued a €500 million seven-year bond in March. Although no further issuance occurred from May to October, the R12,1 billion raised by public and private-sector borrowers in the first ten months of 2006 exceeded the R8,9 billion raised in the international bond markets in the whole of 2005.

The private sector increasingly sourced funding through the domestic bond market in 2006. After increasing by R19,3 billion in 2004 and R31,5 billion in 2005, the *outstanding nominal value of private-sector loan stock* listed on the Bond Exchange of South Africa (BESA) increased by a further R48,8 billion in the first ten months of 2006.

Private-sector funding in the interest-bearing securities markets



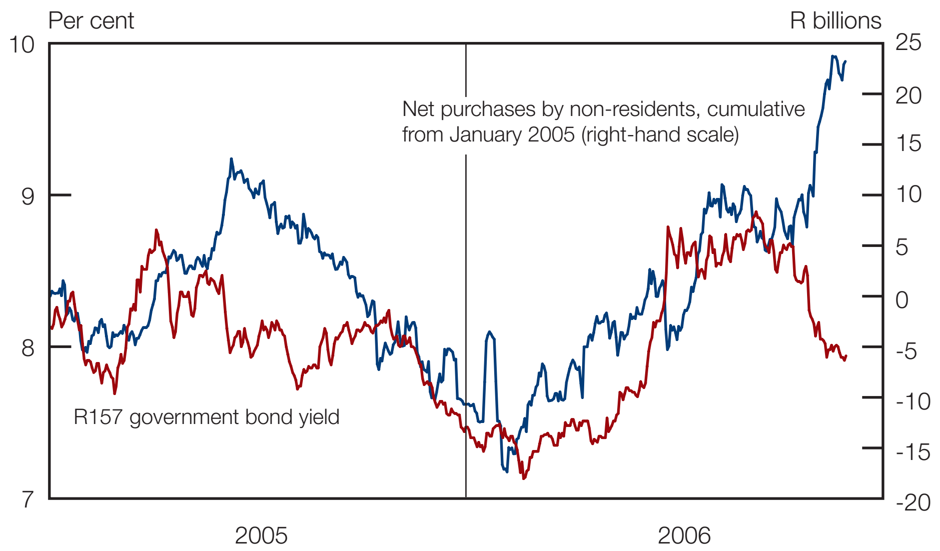
The private sector also attained additional funding through the issuance of short-term *commercial paper*. The value of commercial paper listed on BESA increased by R9,7 billion in the first ten months of 2006, bringing the outstanding nominal value to R36,1 billion in October.

Exchange Control Rulings were amended in October 2006 to provide for *inward listings by foreign issuers* on BESA. This allows foreign entities to raise capital in South Africa with the condition that only non-derivative debt instruments, denominated in rand, may be listed. South African institutional investors may invest in these instruments within their permissible foreign portfolio investment allowances, while an additional five per cent of their total retail assets may be used for investment in African inward listed instruments. Individuals are allowed to invest without restriction. On 30 October a Mauritian bank became the first African entity outside the Common Monetary Area to issue rand-denominated debt on BESA.

Turnover on BESA picked up in the course of 2006 as investors adjusted their bond portfolios in response to rising bond yields and a tightening in monetary policy. During the first half of 2006 the value of turnover improved steadily to set a new record average daily turnover of R67 billion in June. The average daily turnover fell sharply to R56 billion in July, before increasing to R66 billion in value traded per day in October. In the first ten months of 2006, the value of turnover of R11,5 trillion in the domestic secondary bond market was 38 per cent more than in the corresponding period in 2005.

Non-residents' interest in South African debt securities improved markedly shortly after yields on domestic bonds started to increase from their record lows in mid-February 2006. Net sales of bonds of R10,7 billion in 2005 were followed by net purchases of R20,6 billion in the first ten months of 2006 and included record-high net purchases of R11,8 billion in the month of July. Non-residents' daily net purchases of bonds, calculated on a cumulative basis from January 2005, started to fall during the second half of 2005. This accumulated amount was reduced to less than zero in October 2005 and continued on a downward path, before picking up from the end of February 2006. Subsequently, holdings of bonds accumulated rapidly and again turned positive from July 2006, although sporadic episodes of net sales occurred from August as investors worldwide reassessed their investment portfolios. Non-residents' net purchases of bonds turned strongly positive from the end of October, despite improving international share markets and deviated somewhat from the previous trend where non-residents' net accumulation of bonds followed the general direction of bond yields.

Bond yields and net purchases of bonds by non-residents



Non-resident interest in issuing rand-denominated bonds in the international bond markets improved markedly from August 2006. New issues of rand-denominated bonds issued by non-residents in the *European bond markets* exceeded scheduled redemptions by R6,3 billion during the first ten months of 2006. In 2005 net issuance amounted to R6,5 billion. The issuance of rand-denominated bonds in the international bond markets may ultimately be influenced by the amended Exchange Control Ruling, mentioned above, whereby foreign entities are allowed to raise capital in the South African debt market.

After increasing markedly in 2005, the issuance of rand-denominated bonds by foreign borrowers in the *Japanese Uridashi market* remained somewhat subdued during 2006. In the first ten months of 2006, the total nominal value of issues amounted to R3,8 billion, less than half the value raised during the corresponding period in 2005.

Share market

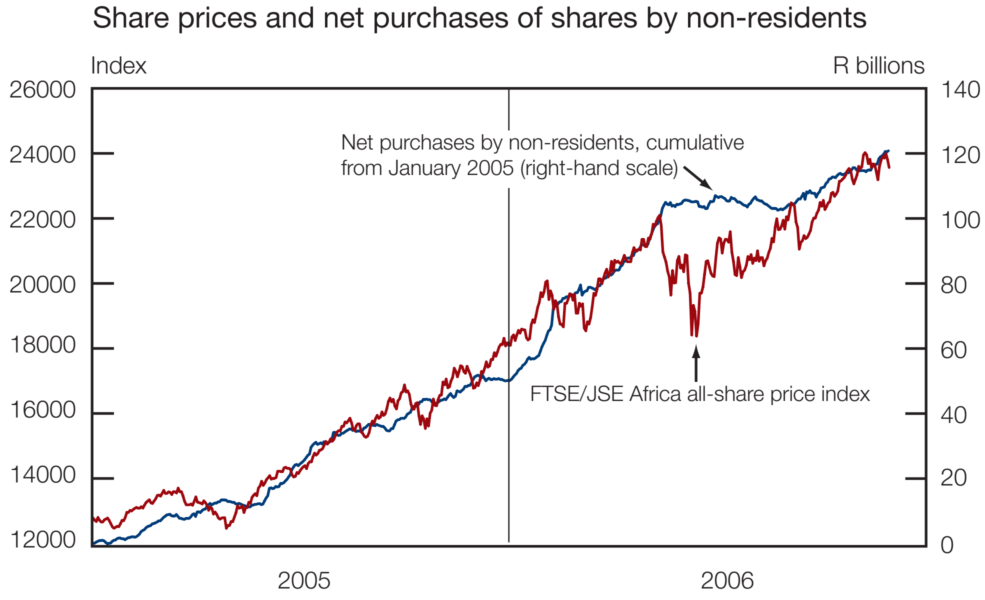
Equity financing gathered further momentum during 2006, as the outlook for the global economy remained positive and share prices continued along their upward trend. The total value of equity capital raised in the *primary share market* by companies listed on the JSE Limited (JSE) amounted to R73 billion for the ten months to October 2006, representing a year-on-year rate of increase of 6 per cent. Of this amount, R38 billion was raised by companies with primary listings on the JSE, while companies with primary listings on foreign bourses and secondary listings on the JSE raised R36 billion. Companies in the financial sector accounted for close to half of the funding activity thus far in 2006.

In October 2006, *Alt^{x}* recorded its first secondary listing when a company with a primary listing on the London Stock Exchange's Alternative Investment Market made its debut on the JSE bourse for small to medium-sized companies. In total, the alternative exchange attracted thirteen new listings in 2006 to push the aggregate number listed to 27 at the end of October. Trading activity on Alt^{x} remained high during 2006 with turnover amounting to R0,8 billion in the first ten months of 2006, compared to R0,2 billion in the corresponding period of 2005. The combined market capitalisation of all companies listed on Alt^{x} increased from R1,9 billion in December 2005 to a new record high of R5,7 billion in October 2006.

In February 2006, a major private bank enhanced the investment product range of the JSE by listing three-year retail deposit notes. Upon a very positive reception this was followed by five-year retail deposit notes, issued in September. Interest on the retail notes are payable on a quarterly basis, linked to the three-month Jibar, and the notes are listed on both the JSE and BESA although trade may only take place on the JSE.

The value of turnover on the JSE in the first ten months of 2006 amounted to R1,8 trillion, or 73 per cent higher than in the corresponding period of 2005. From a record high daily average turnover of R10,7 billion in June 2006, turnover receded to R6,6 billion per day in July before improving to R8,8 billion in September. Even though share prices attained new record highs in October, the average daily turnover fell back to R7,8 billion in October and R8,0 billion in the first weeks of November.

Non-residents' net purchases of shares listed on the JSE amounted to R56,5 billion in the first half of 2006. However, buying interest waned in the third quarter of 2006 and net purchases amounted to only R2,6 billion, recovering to R5,7 billion in October alone. From the beginning of 2006 to the end of October, non-residents' cumulative net purchases of shares amounted to R64,8 billion.



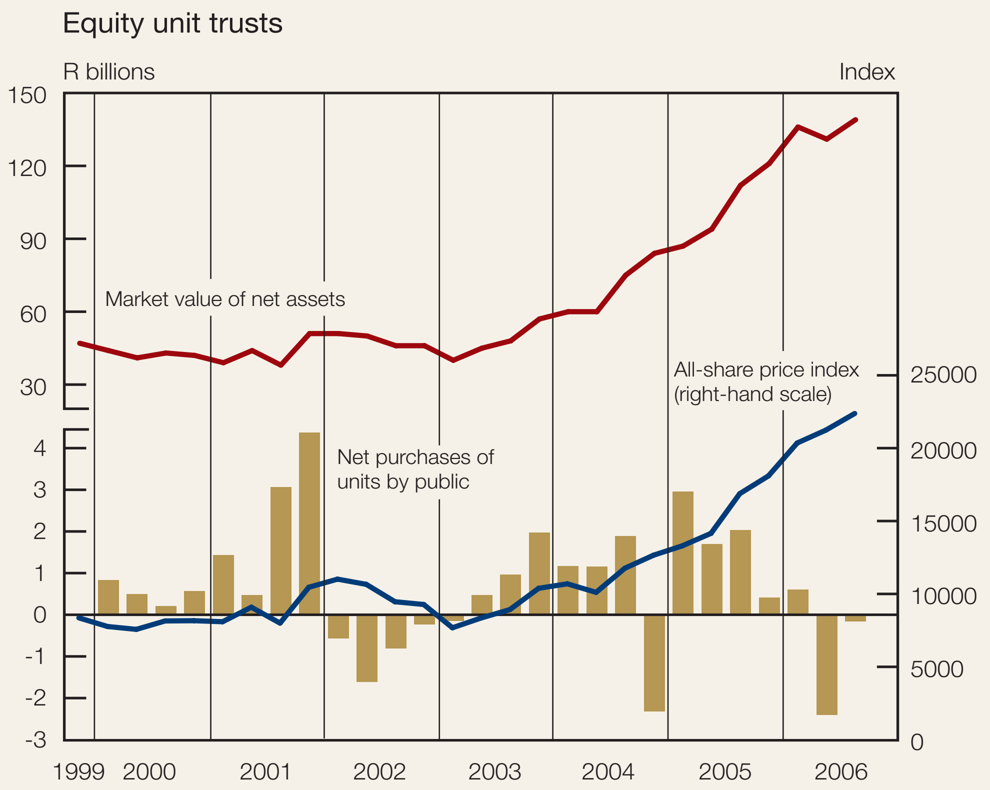
Calculated on a cumulative basis from January 2005, non-residents' net purchases of shares served to support the South African share market during 2005 and 2006, although net purchases slowed significantly from mid-May 2006 as investors paused to assess investment in emerging markets. Net purchases of shares again picked up towards the end of August and increased during September and October, remaining mostly positive to late November alongside rising share prices.

South African share prices fell victim to the nervousness in global markets which weakened sentiment towards emerging markets in May 2006, but this was short-lived. Supported by expectations of continued firm domestic growth, steady commodity prices and general optimism in the global equity markets, the daily closing level of the all-share price index increased by 31 per cent from a recent low on 13 June 2006 to a new record high on 7 November. The buoyant share market conditions in the first eleven months of 2006 were fairly widespread across the various sectors. The daily average price level of shares listed in the resources sector increased by 39 per cent from 13 June 2006 to 7 November, benefiting from improvements in commodity prices and the depreciation of the exchange value of the rand in the second half of 2006. Over the same period the industrial index recorded a gain of 28 per cent, buoyed by persistent consumer demand and expectations of sustained growth in economic activity. The financial index recorded a less pronounced increase of 21 per cent as market players assessed the impact of monetary policy tightening on the profitability of companies in this sector. From the high on 7 November the all-share index declined by 2 per cent to 28 November. This followed from the recent appreciation in the exchange value of the rand, which dampened demand for resources shares, while demand for financial shares remained sensitive to expectations of further increases in the repurchase rate.

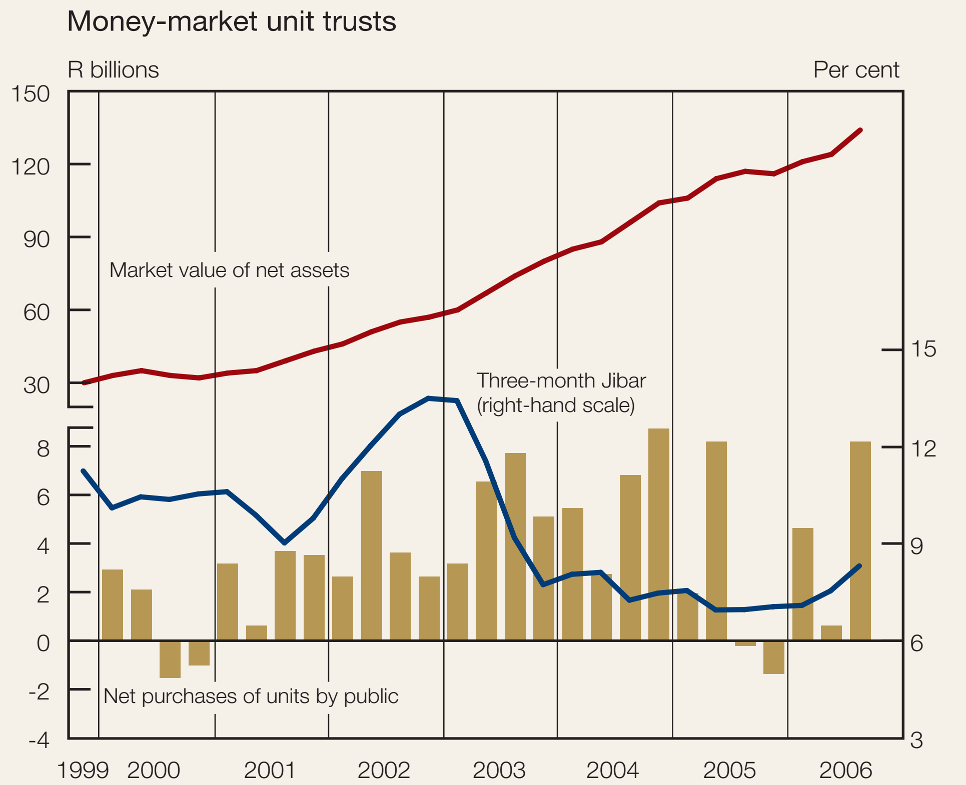
Box: Growth in the unit trust industry

This box contrasts the growth over the past seven years of the three main types of unit trusts – equity, fixed-interest and money-market funds.

Equity unit trusts have traditionally been the cornerstone of the unit trust industry. As may be expected, the market value of these trusts' assets largely reflects the performance of share prices on the JSE Limited, as illustrated in the accompanying graph on the facing page.



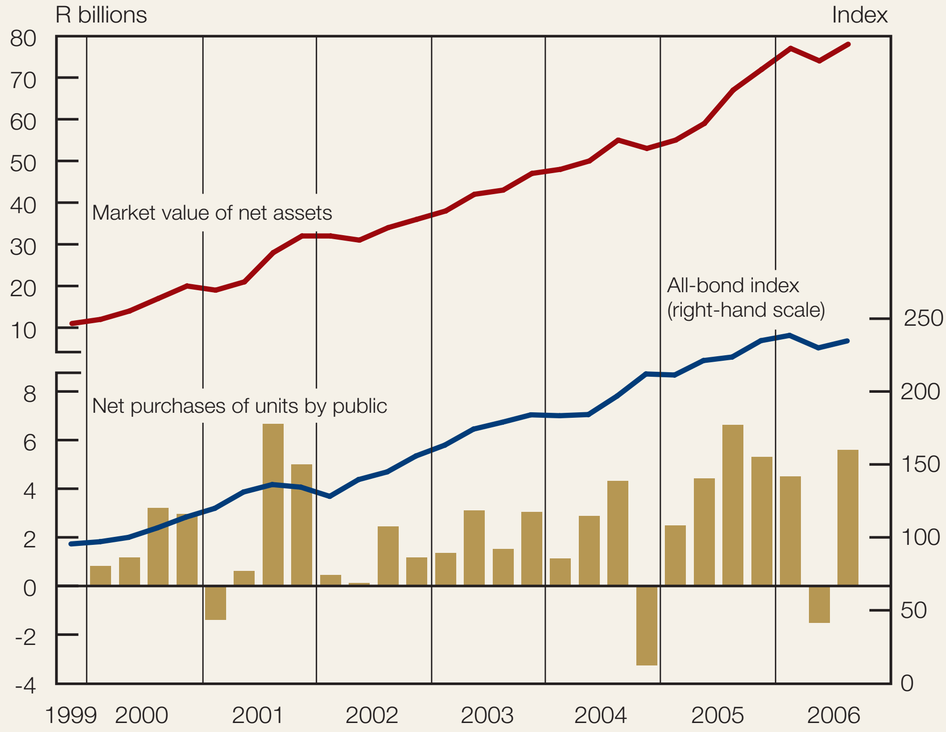
For instance, during the period from the second quarter of 2004 to the first quarter of 2006, the all-share price index increased by 101 per cent. The 129-per-cent increase in the market value of the net assets of equity funds over the same period could predominantly be ascribed to the simultaneous significant increase in share prices. The difference is largely accounted for by the continued inflow of investment through net purchases of units in equity funds by the public. As may be expected, a weak price performance of equities usually discourages the public from investing in equity unit trusts, as happened in 2002 and early 2003. Conversely, rising share prices tend to attract more investment into equity unit trusts, as happened from around mid-2003. However,



profit-taking when share prices seem to be on the high side can lead to disinvestment from these trusts despite an upward trend in equity prices, as in late 2004 and the second quarter of 2006.

As far as money-market unit trusts are concerned, net purchases of units by the public were brisk from 2001 to mid-2005. The lion's share of the increase in the market value of these funds' assets over that period came from such net purchases. These net purchases hesitated in some of the recent quarters, possibly partly as a reflection of the lower level of interest rates.

Fixed-interest unit trusts



Investment in fixed-interest unit trusts came off a low base in 1999, but inflows have generally been brisk in subsequent years. An upward trend in bond prices has bolstered the market value of these funds' assets.

Unit trusts: Market value and related flows
R billions

	Market value of net assets, end Dec 1999	Net purchases of units by public 1 Jan 2000 – 30 Sep 2006	Accruals and revaluations 1 Jan 2000 – 30 Sep 2006	Market value of net assets end Sep 2006
Equity funds...............................	47	19	73	139
Money-market funds..................	30	98	5	133
Fixed-interest funds	10	65	3	78

Throughout the period covered by the analysis, the increase in the market value of the net assets of money-market and fixed-interest funds, notwithstanding substantial changes in interest rates and bond yields, was closely linked to sustained cumulative net sales of units. However, in the case of equity funds, a similar outcome was only evident until the second quarter of 2004, whereafter the significant increase in share prices boosted the market value of the net assets of these funds, explaining the marked gap that developed between the change in market value of net assets and cumulative net sales of units.

M Tlali

Many international equity markets picked up from June 2006 to record either new or multi-year highs in October and early November. The Standard & Poor's (S&P) 500 composite index of the United States stock market increased by 15 per cent from 13 June to record its highest level since 2000 on 22 November. Although South African share prices grew at a much stronger pace in rand terms, the dollar value of the all-share price index recorded an increase of 24 per cent during this period due to the depreciation in the exchange value of the rand. The prices in dollar of South African shares also lagged behind the increase of 29 per cent recorded by the Morgan Stanley Capital International (MSCI) Emerging Markets Index, which measures the overall equity market performance in all emerging markets. From 22 to 28 November the South African all-share dollar index, the S&P 500 index and the MSCI index decreased by 1 per cent.

The *dividend yield* on all classes of shares was maintained at a level of around 2,4 per cent during the first ten months of 2006, somewhat lower than the average of 2,7 per cent recorded in 2005. The *earnings yield* on all classes of shares increased from 6,1 per cent in April 2006 to 6,4 per cent in August, before declining moderately to 6,2 per cent in October. Consequently, the *price-earnings ratio* for all classes of shares came to 16,2 in October 2006, slightly below its recent high of 16,5 in April 2006. The current level of the price-earnings ratio significantly exceeds the average of 14,4 recorded in 2005 as well as its long-term average of 13,7, calculated from 1990 to date, possibly reflecting investors' positive expectations about the future earnings growth of companies.

Market for exchange-traded derivatives

In the first ten months of 2006 turnover values in the financial and interest rate derivative markets on the JSE continued to exceed trade in the same period in 2005 by a substantial margin. Nervousness in financial markets initially led to a general decline in activity from June to August, although trading activity again improved from September. Turnover in the market for exchange-traded derivatives is indicated in the accompanying table.

Derivatives turnover on the JSE, January to October 2006

	Turnover	Change over one year
	R billions	Per cent
Financial futures and options on futures	2 430	103
Warrants	6	112
Agricultural commodity futures and options	127	74
Interest rate derivatives	27	160*

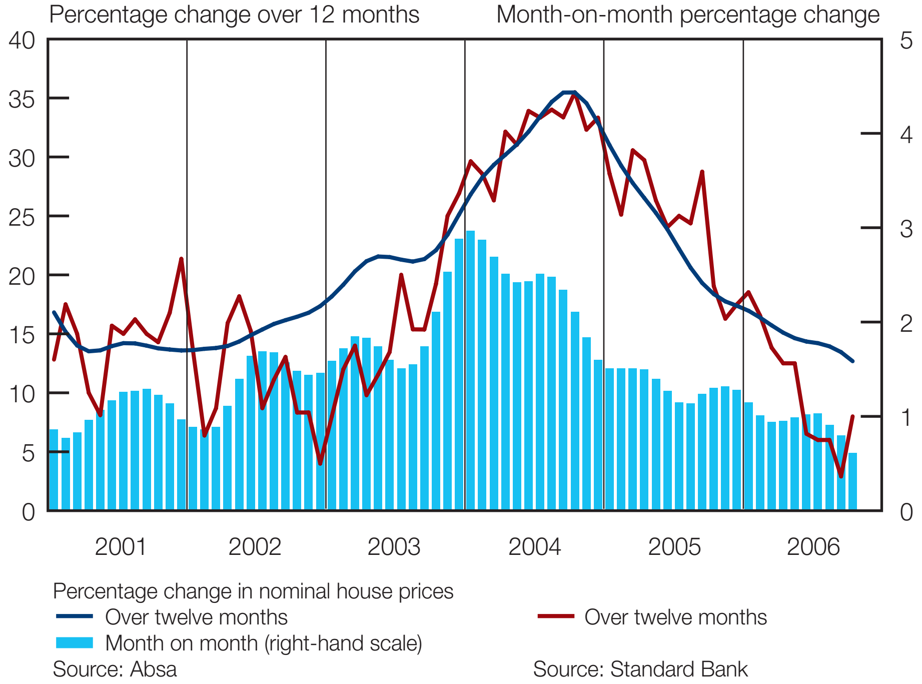
* February to October 2006 compared with February to October 2005

In addition to contracts on index-linked instruments, traded since June 2003, BESA formally started to list derivatives on forward-rate agreements, swaps and options from May 2006. Daily turnover of listed derivatives on BESA amounted to R4,7 billion in the ten months to October and included options on bonds, as well as swaps, where the future cash flows of fixed-interest debt are exchanged for the cash flows of floating-rate debt instruments.

Real-estate market

Growth in residential real-estate prices remained positive but continued to slow in the course of 2006. Increases in the average price of residential property in the middle segment of the market, as measured by Absa, decelerated uninterruptedly from 35,5 per cent in September 2004 to 12,7 per cent in October 2006 – the slowest rate of growth since January 2000. Standard Bank reported an even sharper decline in the year-on-year rate of growth in the median price of all property which it financed, from 35,5 per cent in October 2004 to 8,0 per cent in October 2006. Progressively higher monthly repayments on new mortgage bonds, due to rising house prices and an increase in mortgage rates from June 2006, may partly explain the slowdown in growth in property prices. Upward pressure on house prices is also expected to moderate as higher interest rates contribute to a decline in investor appetite for buy-to-let properties.

House prices

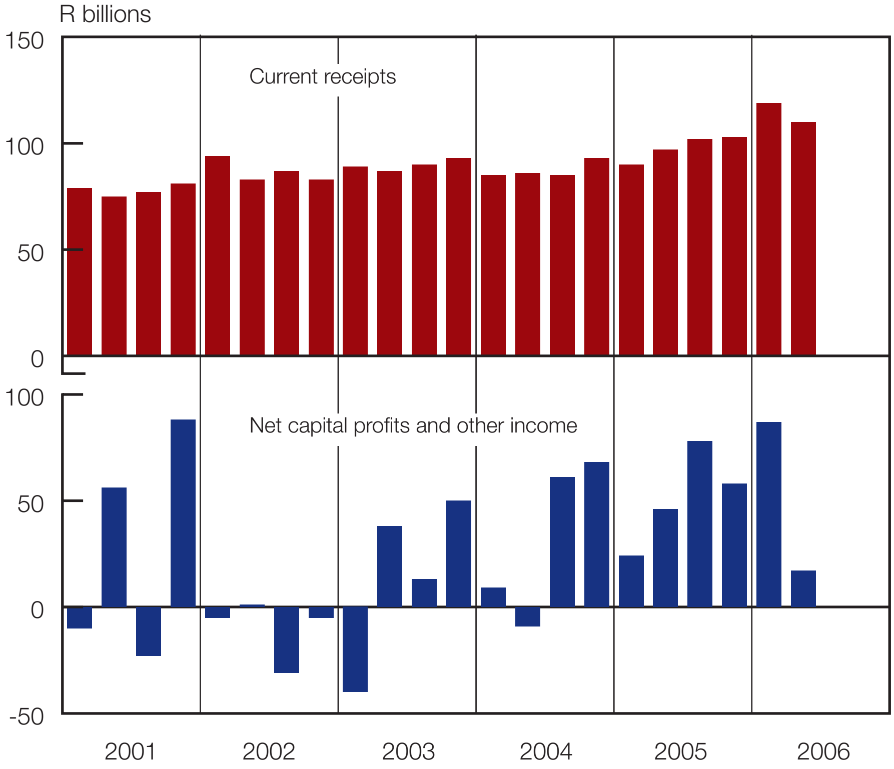


Non-bank financial intermediaries

The generation of membership contributions and premiums by insurance companies and pension funds remains an important driving force behind the growth of these institutions. These inflows are augmented by investment income earned on these funds' assets. Outflows consist mainly of claims and annuities paid out by the insurers and pension funds, as well as administration expenses.

Apart from these flows that are relatively stable, the market value of insurance and retirement funds is strongly influenced by capital profits or losses, as the funds' assets are marked to market with changes in the prices of the shares, bonds and other assets in the funds' portfolios. The accompanying graph shows the development of current receipts (contributions and premiums received and investment income) and net capital profits over the past six years.

Insurers and retirement funds



Public finance

Non-financial public-sector borrowing requirement[4]

4 Calculated as the cash deficit of the consolidated central government, provincial governments, local governments and non-financial public enterprises and corporations.

The *non-financial public sector* recorded a cash deficit of R1,0 billion in the July-September 2006 quarter, lowering the surplus for the first six months of fiscal 2006/07 to R9,0 billion or 1,0 per cent of gross domestic product. This can be compared to a surplus of R8,7 billion or 1,1 per cent of gross domestic product recorded in the corresponding period of the previous fiscal year.

The non-financial public sector's net investment in non-financial assets amounted to R35,2 billion in the first six months of fiscal 2006/07, which was significantly higher than in the corresponding period of the previous fiscal year when it amounted to R28,9 billion. Spending on infrastructure programmes by the public sector at large is set to accelerate further: In October 2006 it was officially estimated to increase to R410 billion in total over the next three years – R38 billion more than originally estimated in the February 2006 *Budget Review.*

Non-financial public-sector borrowing requirement
R billions

	Apr – Sep 2005*	Apr – Sep 2006*
Consolidated general government	2,0	-2,8
Non-financial public enterprises and corporations	-10,7	-6,2
Total	-8,7	-9,0

* Surplus -, deficit +
Components may not add up to totals due to rounding

Non-financial public enterprises and corporations recorded a *cash surplus* of R6,2 billion in the first six months of fiscal 2006/07, significantly lower than the surplus of R10,7 billion recorded in the same period of the previous fiscal year. Net investment in non-financial assets by the major non-financial public enterprises and corporations rose by 22,6 per cent on a year-on-year basis, amounting to R15,5 billion from April to September 2006.

The fiscal performance of *national government* was characterised by strong growth in tax revenue, resulting in cash receipts from operating activities increasing by 17,2 per cent in the first six months of the current fiscal year when compared with the same period of the previous fiscal year. During the period under review, cash payments for operating activities increased by 12,7 per cent. National government's net cash flow from operating activities, together with the net investment in non-financial assets, resulted in a cash deficit of only R7,6 billion in the first six months of fiscal 2006/07 compared to a cash deficit of R15,2 billion in the same period of the previous fiscal year.

The cash surplus of *extra-budgetary institutions* in the July-September quarter of 2006 was estimated to amount to R0,9 billion, accumulating to a surplus of R3,1 billion for the first six months of fiscal 2006/07. This was almost equivalent to the surplus recorded in the same period of the previous fiscal year.

Social security funds recorded a cash surplus of R2,6 billion in the first six months of fiscal 2006/07, which was higher than the surplus of R2,1 billion recorded during the corresponding period of fiscal 2005/06.

Provincial governments recorded a cash deficit of R0,6 billion in the July-September quarter of 2006, bringing the provincial cash surplus for the first six months of fiscal 2006/07 to R10,0 billion – R1,9 billion less than the surplus of R11,9 billion recorded in the same period of the previous fiscal year. The *Provincial Budgets and Expenditure Review 2002/03 – 2008/09* published on 17 October 2006 estimated a small surplus of R0,2 billion for fiscal 2006/07 as a whole. The main source of provincial governments' cash receipts remained grants received from national government.

The cash surplus of the provincial governments was reflected in a slight increase in their bank deposits from R8,4 billion at the end of March 2006 to R8,8 billion at the end of September 2006. At the same time their overall indebtedness to banks also decreased to a negligible amount between the same dates. Their deposits with the Corporation for Public Deposits (CPD) increased from R2,2 billion at the end of March 2006 to R11,6 billion at the end of September 2006.

The cash deficit of *local governments* from April to September 2006 was estimated at R5,2 billion. This was higher than the R3,8 billion deficit in the same period of the previous fiscal year. The higher deficit was partly the result of higher capital spending. The *Local Government Budgets and Expenditure Review 2002/03 – 2008/09* published on 17 October 2006 estimated a deficit of R23,1 billion for fiscal 2006/07 as a whole, allowing for an estimated amount of R24,6 billion in capital expenditure.

Budget comparable analysis of national government finance

Expenditure by national government in the first six months of fiscal 2006/07 was well aligned with budgetary expectations and amounted to R228 billion, representing a year-on-year rate of increase of 11,8 per cent. The *Budget Review 2006* projected that national government expenditure would increase by 13,4 per cent to amount to R473 billion for the full fiscal year.

National government expenditure as a ratio of gross domestic product amounted to 26,5 per cent in the first six months of fiscal 2006/07, almost equivalent to the ratio recorded in the corresponding period of the previous fiscal year.

During the period under review, interest paid on national government debt amounted to R25,7 billion, representing an increase of only 1,2 per cent compared with the corresponding period of the previous fiscal year. Payments for capital assets amounted to R1,4 billion during the first six months of fiscal 2006/07 or 22,1 per cent less than in the same period of the previous fiscal year. The original Budget projected that payments for capital assets would amount to R6,0 billion in fiscal 2006/07 as a whole.

After taking into account cash-flow adjustments (i.e. adjustments resulting from timing differences between the recording of transactions and bank clearances, and late departmental requests for funds), national government's cash-flow expenditure amounted to R225 billion in the first half of fiscal 2006/07, representing an increase of 10,2 per cent compared with the same period of the previous fiscal year.

National government revenue collections continued at a brisk pace, consistent with economic buoyancy in the first six months of fiscal 2006/07. Revenue amounted to R224 billion, representing a year-on-year rate of increase of no less than 17,6 per cent. The *Budget Review 2006* estimated that national government revenue would grow by 8,6 per cent to amount to R446 billion for the fiscal year as a whole.

National government revenue in fiscal 2006/07

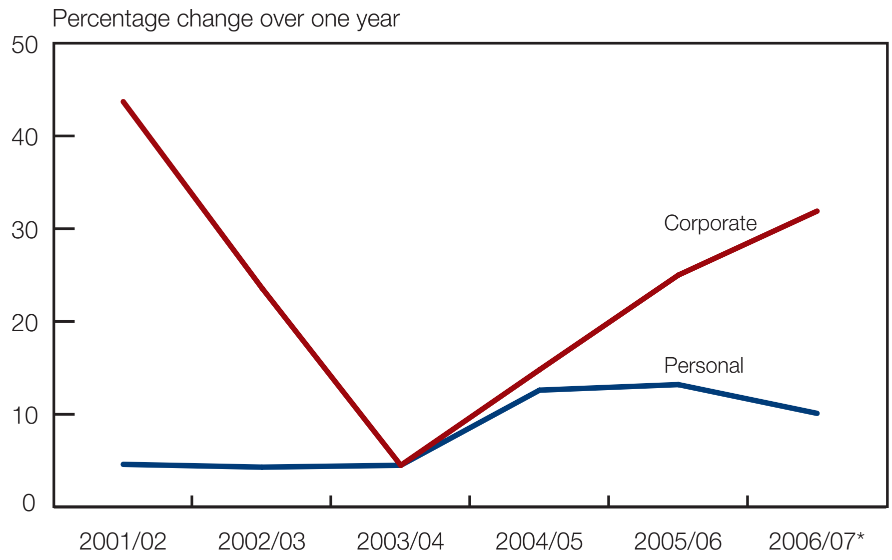
Revenue source	Originally budgeted R billions	Originally budgeted Percentage change Full year	Actual Apr – Sep 2006 R billions	Actual Apr – Sep 2006 Percentage change*
Taxes on income, profits and capital gains	245,8	6,5	128,8	19,7
Payroll taxes	5,6	14,9	2,7	11,7
Taxes on property	8,9	-19,9	5,1	-3,8
Domestic taxes on goods and services	171,7	14,0	80,4	18,1
Taxes on international trade and transactions	23,6	29,7	11,3	35,9
Other revenue	10,5	8,7	5,3	0,5
Less: SACU** payments	19,7	39,6	9,9	46,5
Total revenue	446,4	8,6	223,7	17,6

* April – September 2005 to April – September 2006
** Southern African Customs Union

National government revenue as a ratio of gross domestic product amounted to 26,0 per cent in the first six months of fiscal 2006/07, higher than the ratio of 24,7 per cent in the corresponding period of the previous fiscal year.

The strong revenue performance was broad-based, as shown in the table above. Taxes on income, profits and capital gains increased substantially in the first six months of fiscal 2006/07 compared with the same period a year earlier. This increase

Corporate and personal income tax collections



* April – September 2006

was mainly the result of strong growth in corporate income tax collections, signalling the increased profitability of companies and the continued improvement in tax collection efficiency. Taxes on property continued to show the effect of the reduction in transfer duties announced in the 2006 Budget as well as the slowdown in activity in the real-estate market.

The major components of domestic taxes on goods and services recorded strong growth rates. The strong increase in value-added tax collections was consistent with strong domestic demand. Taxes on international trade and transactions grew strongly in the first half of fiscal 2006/07 as customs duties collected soared, consistent with the strong increase in import volumes and the depreciation of the exchange value of the rand.

The net result of the recorded revenue and expenditure of national government in the first six months of fiscal 2006/07 was a *cash book* deficit before borrowing and debt repayment of R3,9 billion, compared with a R13,4 billion deficit recorded in the corresponding period a year earlier. A deficit of R26,4 billion was originally budgeted for fiscal 2006/07 as a whole. As a ratio of gross domestic product, the national government deficit amounted to 0,5 per cent, significantly lower than the ratio of 1,7 per cent recorded in the corresponding period a year earlier.

The *cash-flow* deficit before borrowing and debt repayment amounted to R1,8 billion in the first half of fiscal 2006/07, far below the R15,2 billion recorded in the first half of fiscal 2005/06. Extraordinary payments included a partial payment for the Saambou Bank liability to the amount of R3,8 billion carried forward from fiscal 2005/06. Extraordinary receipts in the first half of the current fiscal year included special dividends paid by Telkom to the amount of R0,8 billion as well as Limpopo Minerals Trust proceeds amounting to R0,5 billion.

As indicated in the accompanying table, the main funding instrument issued by government during the first six months of fiscal 2005/06 was domestic bonds. During this period, short-term instruments were issued at an average interest rate of 7,3 per cent and long-term fixed-interest bonds at an average yield of 8,0 per cent per annum.

Financing of national government deficit

R billions

Item or instrument	Originally budgeted Fiscal 2006/07	Actual Apr – Sep 2006	Actual Apr – Sep 2005
Deficit	**26,4**	**1,8***	**15,2***
Plus: Extraordinary payments	0,0	3,8	4,5
Cost on revaluation of maturing foreign debt	1,4	0,4	0,0
Less: Extraordinary receipts	0,2	1,3	2,8
Net borrowing requirement	**27,6**	**4,7**	**16,9**
Treasury bills	5,8	7,4	3,9
Domestic government bonds	10,2	22,4	29,5
Foreign bonds and loans	3,8	3,9	1,4
Changes in available cash balances**	7,8	-29,0	-17,9
Total net financing	**27,6**	**4,7**	**16,9**

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

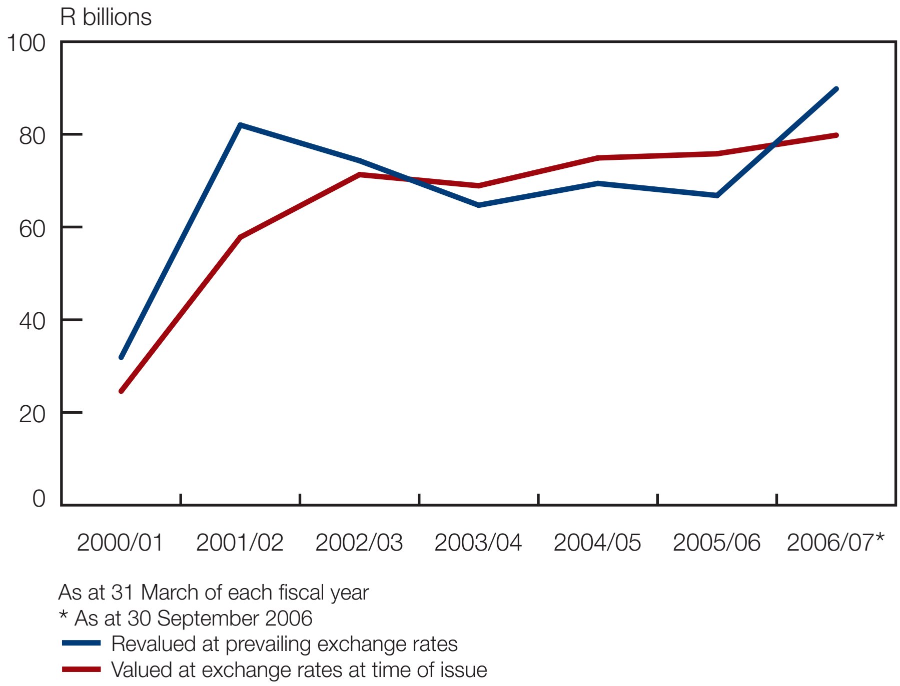
The National Treasury introduced two new fixed-income bonds during the period under review, i.e. the R208 and the R209 bond with various maturities, yielding R2,5 billion to the National Revenue Fund. The average maturity of national government's domestic marketable bonds decreased slightly from 98 months at the end of March 2006 to 97 months at the end of September.

Net issues of foreign bonds and the use of foreign loans amounted to R3,9 billion during the first six months of fiscal 2006/07. A new foreign bond which matures in 2016 was issued in April 2006 and yielded R5,5 billion to the National Revenue Fund. This was, however, partly offset by the redemption of a foreign bond to the amount of R3,3 billion in May 2006. The average outstanding maturity of government's foreign bonds increased from 68 months to 72 months over the same period.

The funding activities of national government resulted in an increase of R29,0 billion in government's bank balances during the first six months of fiscal 2006/07, bringing the level of these balances to R87,2 billion at the end of September 2006. The build-up of cash balances was partly in preparation for interest payments as well as transfers to universities, universities of technology and one technikon at the beginning of 2007.

Total loan debt of national government increased from R528 billion at the end of March 2006 to R583 billion at the end of September 2006. Foreign debt as a proportion of total loan debt amounted to 15,4 per cent at the end of September 2006 compared with 12,6 per cent at the end of March 2006. This partly reflected the effect of the weakening exchange value of the rand on the outstanding value of the foreign bonds and loans in rand terms. Foreign debt revalued at prevailing exchange rates most recently exceeded the rand value of foreign debt at the time of issue. This is in contrast to the period 2003/04 to 2005/06 when it was lower than the rand value of foreign debt at the time of issue. As a ratio of gross domestic product, national government total loan debt increased from 33,4 per cent at the end of March 2006 to 34,9 per cent at the end of September 2006.

Total foreign debt of national government



As at 31 March of each fiscal year
* As at 30 September 2006

Adjusted estimates of national government finance

The Minister of Finance tabled the *Adjusted Estimates of National Expenditure 2006* in the National Assembly on 25 October 2006, seeking approval and adoption by Parliament for the revised spending plans in the 2006/07 fiscal year. In addition to the appropriations in the 2006 Budget, provision was made for a contingency reserve of R2,5 billion and other unallocated funds to the amount of R0,6 billion. Therefore, part of the additional expenditure would be defrayed from these amounts already provided for in the main estimates presented to Parliament in February 2006. The *Adjusted Estimates* provided for an increase of R0,5 billion in projected state debt cost, together with anticipated savings and underspending of R4,2 billion in the current fiscal year. This is expected to bring the net increase in spending in the current fiscal year to R1,5 billion, resulting in a revised estimate of national government expenditure of R474 billion in fiscal 2006/07.

Based on revised macroeconomic projections and the revenue trends for the first six months of the current fiscal year, national government revenue in fiscal 2006/07 is expected to exceed the original budget estimates by R20 billion. This is a result of higher levels of profitability in the corporate sector, increased employment and remuneration levels and robust domestic demand. The robust revenue collections also reflect further improvements by the South African Revenue Service in its systems and processes.

Transfers to the Southern African Customs Union member countries – Botswana, Lesotho, Namibia and Swaziland – are expected to increase by R9,5 billion to amount to R29,2 billion, largely resulting from a significant increase in customs duties. On balance, total adjusted revenue for the full fiscal year was projected to amount to R466 billion or 26,7 per cent of the estimated gross domestic product.

Revised budget estimates for fiscal 2006/07

	R billions
Originally budgeted expenditure	472,7
Plus: Additional expenditure	5,7
Less: Savings and underspending	-4,2
Total adjusted expenditure	**474,2**
Originally budgeted revenue	446,4
Plus: Increase in taxes on income and profits	27,0
Increase in taxes on property	1,4
Increase in domestic taxes on goods and services	1,6
Less: Decrease in other taxes	-0,4
Decrease in other revenue	-0,1
Increase in SACU payments	-9,5
Total adjusted revenue	**466,4**
Originally budgeted deficit	**26,4**
Adjusted deficit	**7,8**

Source: *Medium Term Budget Policy Statement*, October 2006

The revised projections imply a substantial decrease in the budgeted deficit before borrowing and debt repayment. The estimated deficit of R7,8 billion – originally budgeted at R26,4 billion – is expected to equal 0,4 per cent of the estimated gross domestic product for the full fiscal year compared with 1,5 per cent indicated in the original Budget.

The deficit would be financed mainly through the issuance of long-term bonds in the domestic bond market as well as by utilising government's available cash balances.

The *Medium Term Budget Policy Statement 2006*

The Minister of Finance presented the *Medium Term Budget Policy Statement 2006* (MTBPS) to Parliament on 25 October 2006. The 2006 MTBPS reinforces government's development agenda by providing for strong real growth in spending on public services. Over the Medium Term Expenditure Framework (MTEF) period, expenditure growth is now expected to average 7 per cent a year in real terms, with additional resources being earmarked for public infrastructure and service delivery, including the 2010 FIFA World Cup, improvements to the criminal justice system, continued investment in the built environment and other transport and energy needs.

The MTBPS identified the economic challenges facing the country as sustaining growth, broadening economic participation and extending opportunities, strengthening industrial development and trade performance, as well as accelerating the pace of job creation. These challenges will partly be met through a sound tax policy and continued expansion in public spending within a sustainable fiscal framework.

With economic growth expected to strengthen over the medium term, as large-scale public and private infrastructure and investment spending intensifies and structural transformation accelerates, the fiscal stance will result in broadly balanced growth in revenue and expenditure. Spending plans will continue to prioritise infrastructure and social services. Improved government savings and enhanced industrial capacity will moderate external risks and strengthen growth.

Fiscal projections

	Revised estimates 2006/07	Medium-term estimates 2007/08	2008/09	2009/10
	R billions			
National government				
Revenue	466,4	543,0	586,4	633,5
Expenditure	474,2	533,7	590,2	643,7
Budget balance*	-7,8	9,3	-3,8	-10,2
Consolidated general government borrowing requirement**	13,1	-3,6	9,9	17,1
Public-sector borrowing requirement	21,0	10,2	30,8	40,9
	Ratio of gross domestic product			
	Per cent			
National government				
Revenue	26,7	28,2	27,7	27,2
Expenditure	27,2	27,7	27,8	27,6
Budget balance*	-0,4	0,5	-0,2	-0,4
Consolidated general government borrowing requirement**	0,8	-0,2	0,5	0,7
Public-sector borrowing requirement	1,2	0,5	1,5	1,8

* Surplus +, deficit -
** Surplus -, deficit +

Source: *Medium Term Budget Policy Statement*, October 2006

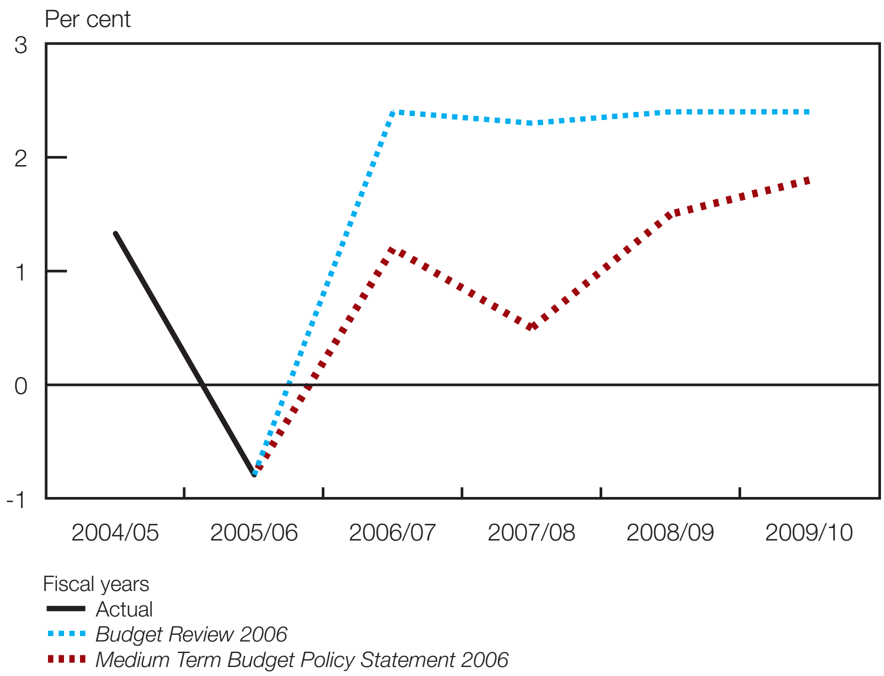
As indicated in the table on the facing page, fiscal prudence evidenced in the previous fiscal years is expected to continue at all levels of government. The national government deficit for the current fiscal year is expected to amount to 0,4 per cent of gross domestic product. In the 2007/08 fiscal year the budget balance is estimated to be a surplus of 0,5 per cent of gross domestic product, against the backdrop of buoyant revenue collections and declining debt service costs. This will revert to a deficit of 0,2 per cent in the following fiscal year, and as the capacity to spend on infrastructure programmes improves, a moderate deficit of 0,4 per cent of gross domestic product is envisaged by the end of the MTEF period.

The improved budget balance is reflective of a prolonged surge in revenue under favourable economic conditions, together with the lagged effects of deficit reduction on debt service costs. Alongside the recent moderate tightening of monetary policy, this will provide a strong platform to increase investment and withstand possible adverse economic conditions.

The public-sector borrowing requirement is set to grow from 0,5 per cent of gross domestic product in fiscal 2007/08 to 1,8 per cent by the 2009/10 fiscal year.

National government's real non-interest expenditure is projected to increase by 7 per cent per annum over the medium term. Debt service costs as a percentage of estimated gross domestic product were expected to decline further to 2,2 per cent in fiscal 2009/10, enabling government to sustain the expansion in expenditure over the medium term.

Non-financial public-sector borrowing requirement as a ratio of gross domestic product



The 2007 MTEF provides for additional spending of R80 billion over the 2006 Budget forward estimates. Of the proposed additional allocations, R32,9 billion is earmarked for national departments, R28,2 billion for provinces and R18,9 billion for local government. Priority needs include improving the quality of health services, education, welfare and social security as well as the criminal justice system. The additional provincial allocations will expand social and economic infrastructure and service delivery. Additional allocations proposed for municipalities will put local government in a better position to improve the quality and availability of basic municipal services and ensure the construction and renovation of stadiums and related infrastructure ahead of the 2010 FIFA World Cup.

In order to ensure an equitable, affordable and sustainable road accident compensation system, the MTBPS announced Cabinet's approval of a strategy to restructure the Road Accident Fund as part of a wider reform of the social security system. The strategy proposes the introduction of a Road Accident Fund benefit scheme as a non-fault system of compensation to ensure the progressive realisation of the right to health care and social security. Although the scheme would be more affordable, it will require significant funding to address outstanding claims liability and support restructuring once new legislation is in place.

Statement of the Monetary Policy Committee

12 October 2006

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

Introduction

Recent domestic economic developments indicate that the risks to the inflation outlook to which the Money Policy Committee (MPC) drew attention in previous statements remain. The domestic economy continues to grow at a brisk pace while domestic demand growth has sustained its vibrancy, buoyed by strong credit extension. The deficit on the current account of the balance of payments continues to be at levels which may strongly influence the exchange rate outlook. The exchange rate has depreciated further since the previous MPC meeting and broad-based pressure from producer prices has become more pronounced.

Internationally, oil prices have moderated somewhat, which has allowed for a reduction in petrol prices in two consecutive months. However, in line with declining oil prices, commodity prices in general have also declined recently. The outlook for the international economy remains positive although there are still uncertainties relating to the growth outlook in the United States of America. The latest *World Economic Outlook* of the International Monetary Fund (IMF) says that global growth is expected to moderate slightly from 5,1 per cent in 2006 to 4,9 per cent in 2007. Against the background of generally tighter monetary policies globally, world inflation is expected to remain under control and average 3,7 per cent next year, slightly higher than the April projection of the IMF.

Recent developments in inflation

Inflation has continued to display an upward trend. Year-on-year inflation as measured by the consumer price index for metropolitan and other urban areas excluding the interest cost on mortgage bonds (CPIX) has increased in each month since April of this year when it measured 3,7 per cent. By August this year, CPIX inflation had increased to 5,0 per cent. Goods prices increased at a year-on-year rate of 6,0 per cent compared to 3,5 per cent for services in August. The main inflation drivers in the goods category were again food and petrol prices. The prices of a number of food products have been increasing at high rates, in particular meat prices which increased at year-on-year rates of 15,2 per cent in August. Meat has a weight of about 7 per cent in the CPIX basket, and in August its contribution to CPIX inflation was similar to that of petrol and diesel. Petrol and diesel prices, which have a weight of 5,04 per cent in the CPIX basket, increased at year-on-year rates of 22,1 per cent. By contrast, clothing, footwear and furniture and equipment prices continued to decline, while administered prices excluding energy increased at a year-on-year rate of 4,2 per cent.

Production price inflation increased markedly and across a broad spectrum of categories. Measured year on year, production price inflation had increased to 9,2 per cent in August 2006. Of particular concern was the 9,6-per-cent increase in domestically produced goods inflation, up from 8,1 per cent the previous month. Imported goods inflation measured 7,8 per cent in August compared with 8,2 per cent in July. The categories displaying the highest month-on-month increases were agricultural products, manufactured food and electricity, gas and water.

The outlook for inflation

In the short term, the increase in CPIX inflation is expected to be moderated somewhat by the reductions in the domestic petrol price, amounting to R0,36 and R0,50, which took effect in September and October, respectively. Pressures emanating from production prices, however, indicate that some countervailing movements can be expected. The outcome of the Bank's forecasting models shows that over the forecast period, inflation is expected to continue its upward trend towards the upper end of the target range and remain at levels of around 6 per cent between the second and fourth quarters of 2007. Thereafter CPIX inflation is expected to decline gradually to reach around 5,4 per cent by the end of the forecast period in the fourth quarter of 2008.

Market expectations of inflation, as indicated by the break-even inflation rates (i.e. the yield differential between inflation-linked bonds and conventional government bonds), also show an upward trend over the shorter maturity range. Inflation expectations as reflected in the survey conducted on behalf of the Bank by the Bureau for Economic Research (BER) have also moved higher. Compared to the previous quarter, inflation expectations during the third quarter of this year increased in respect of every forecast year. Average inflation expectations increased by 0,5 per cent for 2006 to 4,9 per cent, while for 2007 they increased by 0,4 per cent to 5,3 per cent. Inflation is then expected to decline to 5,0 per cent in 2008. Despite this upward movement, expectations are still within the inflation target range during all the forecast years. Given the importance of inflation expectations in the price and wage formation process, it is vital that the MPC remains vigilant to ensure that expectations stay entrenched within the 3-to-6-per-cent range.

A number of factors have contributed to the adverse inflation outcomes and outlook, and continue to pose a risk to future outcomes. Domestic expenditure remained buoyant in the second quarter of this year. Real domestic final demand increased at an annualised rate of 10 per cent in the second quarter, with strong growth in final consumption expenditure by both households and general government, as well as fixed capital formation.

Strong household consumption expenditure remains one of the primary risk factors. In the second quarter of this year, household consumption expenditure increased at an annualised rate of 8 per cent, the highest quarter-on-quarter growth rate since 1995. There are few indications that this trend has been reversed despite the most recent interest rate changes. However, it is recognised that it is possibly too early to assess fully the impact of monetary policy actions. One tentative indication of a possible slowdown in demand growth is seen in motor vehicles sales. In the third quarter of this year, sales of new motor vehicles declined by 0,3 per cent. On a month-on-month basis, sales in September declined by 3,6 per cent.

This strong demand is supported by higher asset prices and increased credit extension to the private sector. Share prices on the JSE Limited reached new record highs recently while house prices have continued to increase, albeit at a slower rate. Growth over twelve months in total loans and advances extended to the private sector grew at a level of 26,1 per cent in August. Mortgage advances continued to be the largest component of credit extension. This component is likely to react to interest rate changes with a lag, given the time taken to finalise property transfers. The higher rates of credit extension have contributed to the further increase in household indebtedness which in the second quarter of this year rose to 70 per cent of household disposable income.

Growth in money supply (M3) remains brisk. Twelve-month growth in money supply decelerated from 23,0 per cent in June to 21,2 per cent in July before accelerating marginally to 21,4 per cent in August. The income velocity of circulation of M3 declined from 1,43 in the first quarter of 2006 to a low of 1,37 in the second quarter. This is yet another indication of ample liquidity in the South African economy.

Recent exchange rate developments might pose a risk to the inflation outlook. Since early May, the rand has depreciated on a trade-weighted basis by almost 22 per cent. At these levels, it is possible that some pass-through to higher prices might occur. The challenge for monetary policy is to ensure that this effect is minimised. Part of the explanation for the recent adjustment in the rand exchange rate lies in the reaction of the market to the current-account deficit which has averaged over 6 per cent of gross domestic product during the first half of this year. Other factors influencing the exchange rate include the lower commodity prices, the repricing of risk in a number of emerging markets and a general tightening of monetary policy globally.

While noting potential risks that may emanate from the relatively high deficit on the current account of the balance of payments, the MPC noted that this deficit continues to be reasonably well financed. The overall balance-of-payments situation is in surplus and has allowed further improvements in the external position of the country, with official reserves continuing to improve. Official gross gold and other foreign exchange reserves stood at US$24,6 billion at the end of September 2006 and net reserves amounted to US$21,2 billion.

Food prices also pose a significant risk to inflation. Food prices in general have increased by 7,2 per cent and agricultural prices at the producer price level have increased at a year-on-year rate of 20,4 per cent. In 2005 food price inflation averaged 2,1 per cent and exerted significant downward pressure on the overall inflation trend. Higher maize prices are also likely to be sensitive to exchange rate developments. Maize product inflation in CPIX is on an upward trend but is still relatively low, having measured 4,7 per cent in August, and further pressure is expected from this source.

There have, however, been some positive developments. In particular, the threat to inflation posed by the international oil prices has subsided to some extent. Having reached levels of almost US$80 per barrel in August of 2006, the price of Brent crude has now fallen to below US$60 per barrel. The timing of this adjustment has happened by chance or luck, as a high and rising oil price coupled with a depreciating rand would have had a marked and rapid impact on inflation. In August and September, the decline in international oil prices more than offset the upward pressure exerted by the exchange rate on petrol prices. Despite this positive development, the MPC considers the risk to inflation from this source still to be on the upside. The tight supply-and-demand conditions in the oil markets coupled with the sensitivity of oil prices to geopolitical tensions mean that oil prices could respond quickly to any new adverse developments. Furthermore, the decision by the Organization of Petroleum Exporting Countries to cut quotas by 1 million barrels per day could slow the decline in oil prices.

Labour market developments do not appear to pose a threat to the inflation outlook at present. Having increased by 7,3 per cent in the first quarter of this year, unit labour costs increased by 3,2 per cent in the second quarter. Trends in inflation expectations will be critical in the months ahead. Should expectations increase significantly above those indicated earlier, this is likely to be reflected in higher wage demands which may impact on the price formation process. Although at this stage wage costs do not pose a threat to inflation, these developments will be closely monitored by the MPC.

The developments outlined above have taken place against the background of a buoyant economy. In the second quarter of this year, the economy grew by 4,9 per cent on an annualised basis, compared to 4 per cent in the previous quarter. Nevertheless economic growth this year is still expected to be lower than the 4,9 per cent average recorded last year. At these levels, growth is still in line with, or slightly above, what our studies indicate to be the potential output of the economy. The Rand Merchant Bank/BER Business Confidence Indicator is still at a high level, while the Investec/BER Purchasing Manager's Index (PMI), although lower in October, still reflects a positive outlook for the manufacturing sector. The recent BER manufacturing survey indicates that although there has been a marginal decline in confidence in the consumer goods sector, the capital and intermediate goods sectors have maintained a positive outlook.

Monetary policy stance

Having considered in detail all the recent economic data and other developments impacting on inflation, the MPC remains concerned about the outlook for inflation and is of the view that the risks to the outlook are still on the upside. Accordingly, the MPC has decided that a further upward adjustment in the repo rate is appropriate at this juncture. The repo rate is therefore increased by 50 basis points to 8,5 per cent per annum with effect from Friday, 13 October 2006. The MPC will continue to monitor all economic, financial and other relevant developments and stands ready to act in order to ensure that the monetary policy stance remains consistent with achieving the inflation target.

Note on the interrelationship between commodity prices, the exchange rate and domestic prices

by M Kock[1]

This note briefly reviews the interrelationships between commodity prices, the exchange rate and domestic inflation. It updates and extends the analysis of the international commodity prices boom and its impact on the South African economy which was presented as a box on "Commodity prices in South Africa" in the November 2004 *Monetary Policy Review*.

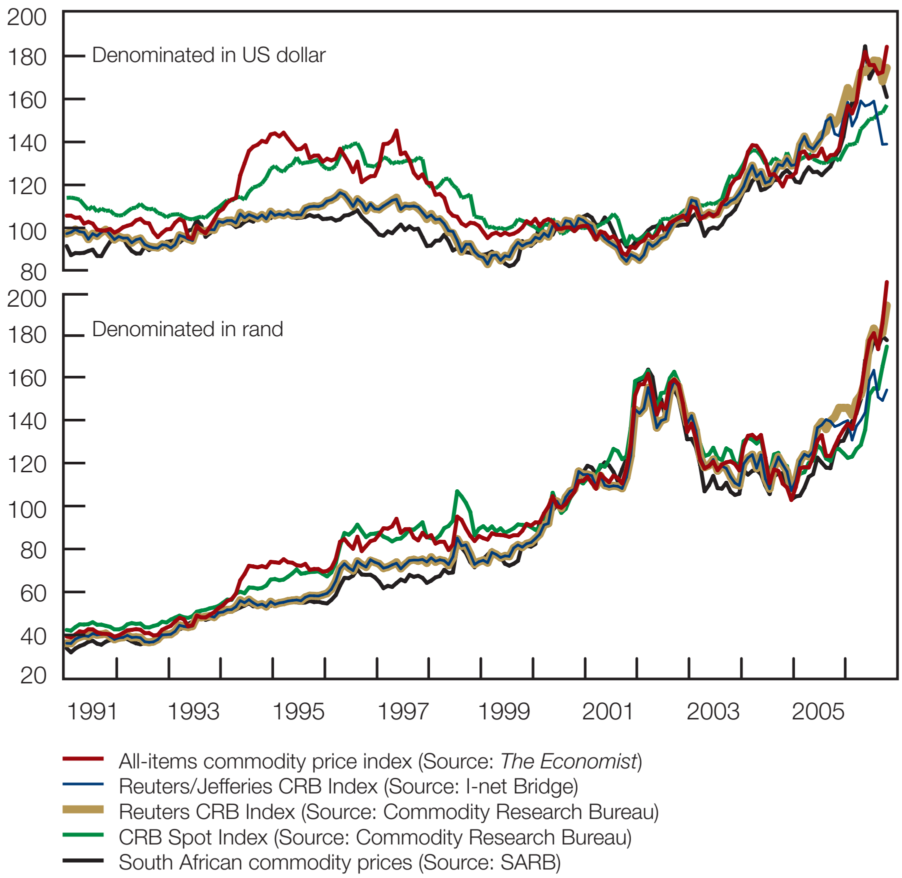
1 The views expressed are those of the author and do not necessarily reflect the views of the South African Reserve Bank.

There are various barometers of commodity prices.[2] However, there tends to be a considerable degree of correlation between these prices, since some of the drivers of international commodity prices, such as the strength of global demand, are felt across all commodities. The most relevant commodity price indicator for South African exports is the price index compiled by the South African Reserve Bank which uses weights based on the importance of the various commodities in the South African "export basket". The fairly strong correlation between this index and other frequently used commodity price indices is illustrated in the accompanying graph. Although it seems that the conclusions of the analysis would broadly hold irrespective of which measure is used, there are some notable divergences which are especially evident during the period 1994 to 1999.

2 The Economist all-items commodity price index includes food and industrial commodities with the latter comprising of non-food agriculturals and metals. The Commodity Research Bureau (CRB) indices are sourced from http://www.crbtrader.com. The Reuters/Jefferies CRB Index is a benchmark for long-only broadly diversified investments in commodities. For more information see Jefferies.com. The CRB Spot Index is a measure of price movements of twenty-two basic commodities assumed to be those that are first to be influenced by changes in economic conditions. The Reuters CRB Index serves as a dynamic representation of overall broad trends in commodity prices.

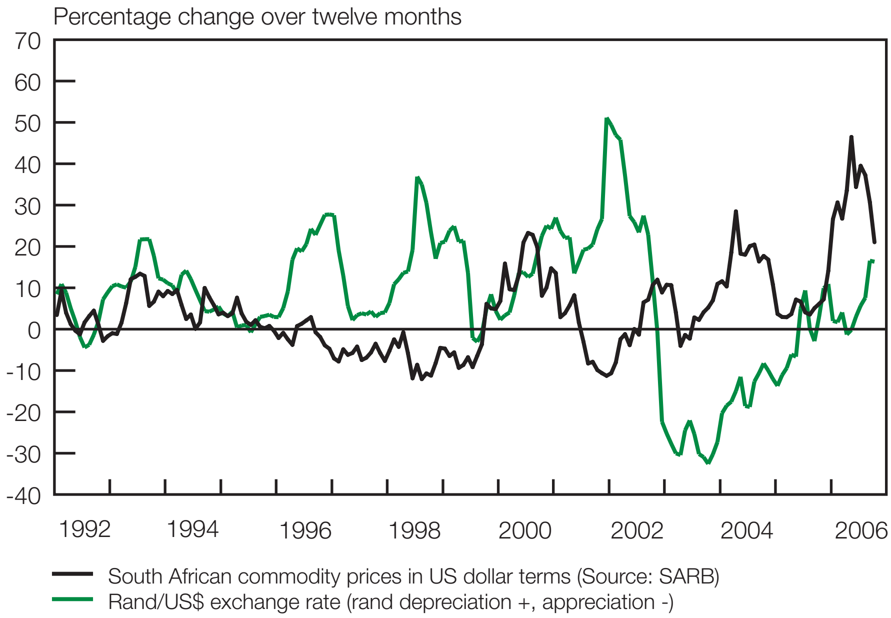
Commodity prices

Indices: 2000=100



While South Africa's exports have become increasingly diversified over time, commodities continue to be a major contributor to export earnings. Changes in commodity prices accordingly have a significant impact on the foreign-exchange value of the rand, not only through the resultant changes in the supply of foreign currency flowing into the market but also more immediately through expectations based on the observed spot prices of commodities. This is illustrated in the accompanying graph, which for instance shows that in 2001 a decline in commodity prices was accompanied by, and probably exacerbated, rand depreciation. However, other forces were at work at the same time. It should be pointed out that the relationship is far from perfect, and that movements in both the US dollar prices of commodities and the exchange value of the rand against the dollar may on occasion simply reflect strength or weakness of the dollar against currencies in general.

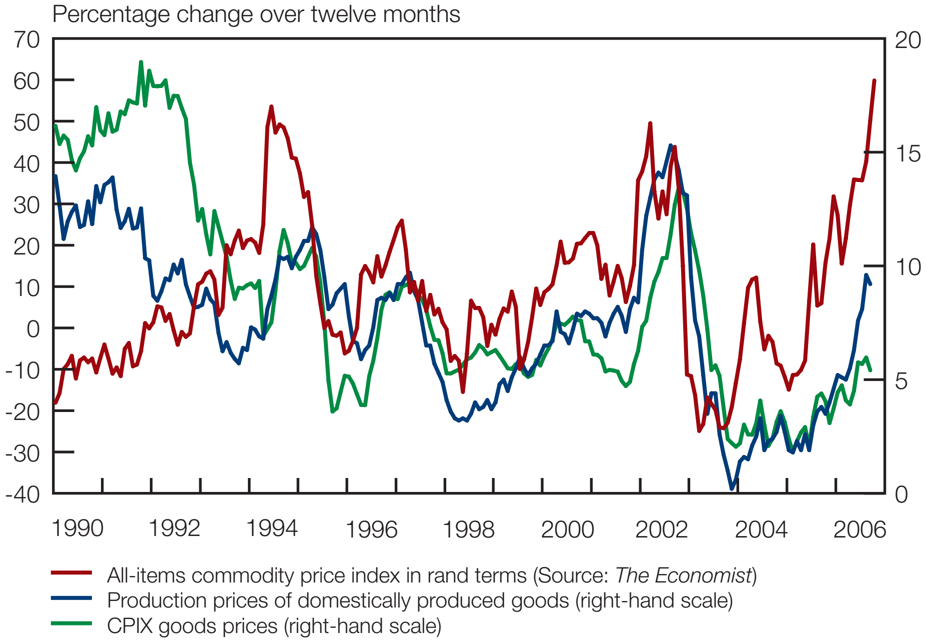
South African export commodity prices and the exchange rate



From May 2006 in particular, the exchange value of the rand depreciated significantly while the commodity prices relevant to South Africa receded somewhat. As of late, the exchange value of the rand recorded year-on-year rates of depreciation of 16,5 per cent in September and 16,3 per cent in October 2006.

South African export commodity prices therefore constitutes one of the determinants of the exchange value of the rand, and in this way feeds into the inflation process. Observing this channel, one would expect higher commodity prices in dollar to be associated with a stronger rand and lower inflation. However, there is also a cost-push channel through which commodity prices affect domestic inflation. In this instance, however, it is not the prices of South African export commodities that are relevant, but rather a broader measure of international price pressures. Furthermore, the analysis should be based on commodity prices denominated in rand terms as the relevant currency for valuing input cost in the South African industry that will be reflected in domestic producer price inflation and CPIX goods inflation. In this connection *The Economist* all-items commodity dollar index converted from US dollar to rand at the average US$/rand exchange rate was used.

Commodity prices and domestic inflation



The graph above indicates that *The Economist* commodity price index in rand terms tends to be a leading indicator of domestic production price inflation which, in turn, spills over into CPIX[3] goods price inflation.

Since May 2006 the weakening of the exchange value of the rand has pushed commodity prices in rand terms higher. As in 2001 and 2002, domestic production and CPIX goods price inflation have responded by accelerating significantly.

Inflation is a complex process involving the interaction between numerous variables. Any analysis which narrows it to only two or three variables is clearly oversimplified, but at the same time it can be extremely helpful by capturing and illustrating at least some of the key drivers of price pressures. In this spirit, the analysis in this note indicates that commodity prices in rand terms are a leading indicator of domestic production price inflation and CPIX goods price inflation.

3 CPIX is the overall consumer price index, excluding interest rates on mortgage bonds, for metropolitan and other urban areas. CPIX only became available from 1998. Before that, the CPI goods price index was used.