Quarterly Bulletin

June 2006

South African Reserve Bank

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Contents

Quarterly Economic Review

Introduction 1
Domestic economic developments 4
- Domestic output 4
- Domestic expenditure 6
- Factor income 11
- Saving 11
- Employment 11
- Labour cost and productivity 13
- Prices 15

Foreign trade and payments 20
- International economic developments 20
- Current account 21
- Financial account 24
- International reserves and liquidity 26
- Foreign debt 26
- Exchange rates 27

Monetary developments, interest rates and financial markets 30
- Money supply 30
- Credit extension 31
- Interest rates and yields 33
- Money market 38
- Bond market 40
- Share market 42
- Market for derivatives 44
- Real-estate market 44
- Non-bank financial intermediaries 45

Public finance 46
- Non-financial public-sector borrowing requirement 46
- Budget comparable analysis of national government finance 48

Statements issued by Mr T T Mboweni, Governor of the South African Reserve Bank

Statement of the Monetary Policy Committee
13 April 2006 53

Statement of the Monetary Policy Committee
8 June 2006 57

Article

Estimating household-sector wealth in South Africa 61

Statistical tables

Contents .... S – 0
Key information .... S – 148

Quarterly Economic Review

Introduction

Global economic growth remained strong in the first quarter of 2006. Real output growth in the United States exceeded 5 per cent in the first quarter, alongside a continuous expansion in the Japanese economy and signs of a more sustained recovery in the euro area. In the major emerging-market economies growth remained solid. The fortunes of exporters of oil and other commodities continued to be bolstered by buoyant prices fetched by these products in the international markets.

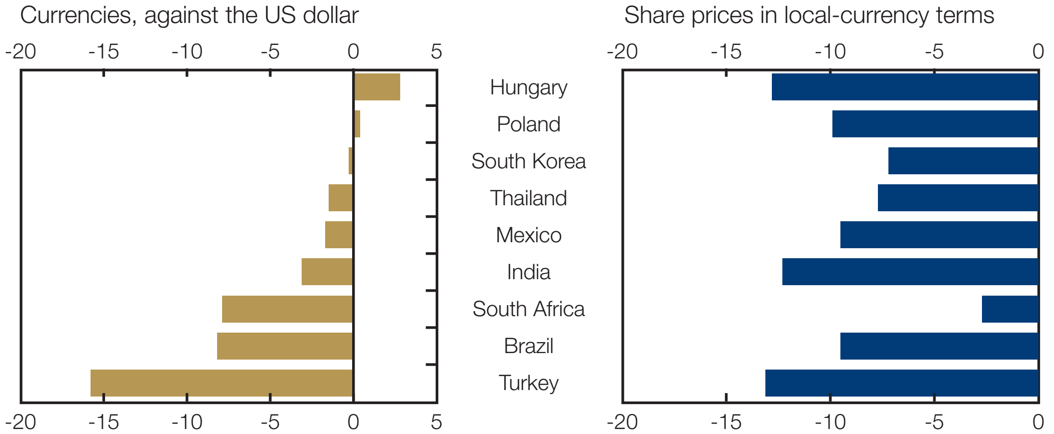
However, in the international financial markets there were signs of a change in sentiment in the second quarter of 2006 as international investors lost some of their appetite for exposure to emerging markets, resulting in the depreciation of a number of emerging-market currencies, lower share prices and a widening of the risk premia on these countries' debt securities. South Africa was one of the countries affected, with the external value of the rand depreciating by approximately 10 per cent in the final three weeks of May and share prices falling significantly at the same time, reinforced by a decline in the prices of gold and platinum from earlier exceptionally high levels.

Real economic growth in South Africa accelerated in the first quarter of 2006 as the real value added by the secondary sector picked up significantly, buoyed by a recovery in manufacturing output, alongside brisk output growth in the tertiary sector. A discordant note originated in the primary sector, where real value added contracted in the first quarter as livestock production weakened and output volumes edged lower in gold mining and a number of other mining subsectors.

Aggregate real gross domestic expenditure recorded very strong growth in the first quarter of 2006. Real household consumption expenditure maintained a brisk pace of increase in the first quarter, while growth in real fixed capital formation gained further momentum. Real inventories rose strongly in the first quarter, restoring *inter alia* buffer stocks as petroleum refineries resumed normal production following the supply disruptions which developed towards the end of 2005. In the absence of further high-

Emerging-market currencies and share prices

Percentage change from 30 April 2006 to 31 May 2006



value military items being acquired by the South African National Defence Force in the first quarter of 2006, real final consumption expenditure by general government contracted somewhat.

The vibrant domestic expenditure was reflected in brisk imports. At the same time the country's export performance deteriorated, resulting in a widening in the deficit on the current account of the balance of payments to 6,4 per cent of gross domestic product in the first quarter of 2006 – the highest deficit ratio in 24 years. This was despite a moderate improvement in South Africa's terms of trade in the first quarter as the prices of certain export commodities recorded robust increases. Inflows through the financial account of the balance of payments remained more than adequate to finance the deficit on the current account, with portfolio inflows the largest contributor to the surplus on the financial account. Significant foreign direct investment and other investment inflows augmented portfolio investment in the first quarter of 2006, resulting in an overall balance-of-payments surplus and improvement in the authorities' net gold and foreign exchange reserves.

Employment in both the private and public sectors of the economy expanded further in the final quarter of 2005, with some indications that this trend continued into the early part of 2006. While wage settlements in the first five months of 2006 remained reconcilable with the inflation target, a significant part of the workforce in the private security industry engaged in a protracted wage-related strike during the second quarter of the year.

Inflation remained well contained, both at the production and consumer price level. By April 2006 twelve-month CPIX inflation had been maintained inside the target range of 3 to 6 per cent for 32 consecutive months. Furthermore, if petrol and food are excluded from the consumer price basket on account of their volatility, the inflation in the remaining items fell marginally below the bottom of the target range in recent months. The results of surveys conducted in the first half of 2006 indicate that inflation expectations were benign, while bond yields sketched a similar picture. Nevertheless, an upward trend in food inflation started to emerge in the data from late 2005, while the depreciation of the exchange value of the rand in May 2006 provided further reason for developments in inflation to be closely monitored.

In early 2006 growth in the broadly defined money supply accelerated to twelve-month rates last observed in 1989, reflecting the vibrant domestic expenditure and income, strong wealth effects resulting from brisk increases in asset prices, and the related vigorous levels of activity in the financial markets. Similarly, the already high rates of increase in banks' loans and advances gained further momentum in the first quarter of 2006. Growth over twelve months in mortgage advances reached 30 per cent as the real-estate market maintained strong momentum, while the other types of credit extension also recorded buoyant increases. Although there was an acceleration in the corporate sector's utilisation of credit, the bulk of the increase in the banks' loans and advances continued to flow to the household sector. The ratio of household debt to disposable income of households accordingly scaled new heights in the first quarter of 2006. With nominal lending rates having remained at relatively low levels over the past year, however, the household sector's debt service burden remained fairly modest.

In the fiscal year 2005/06 the non-financial public sector recorded a cash surplus for the first time in history, amounting to 0,7 per cent of gross domestic product. The turnaround from a borrowing requirement in the previous year to a surplus was mainly due to a considerably smaller national government deficit and a larger surplus in the books of the non-financial public-sector enterprises. In turn, these were respectively related to the strength of the economy and the accompanying brisk increases in tax revenue collected by national government, and to the long gestation period before the fixed investment projects of some non-financial enterprises get underway.

Despite this disciplined fiscal setting, several imbalances and pressure points in the economy clearly worsened. In its April 2006 statement the Monetary Policy Committee warned that the risk of an acceleration in inflation has increased, but kept the repurchase rate unchanged. At its June meeting the Committee found that the inflation outlook had deteriorated somewhat as a result of higher international oil prices, the weaker exchange rate and continued high levels of consumer expenditure. Furthermore the Committee was of the view that the risks to the inflation outlook were on the upside. Accordingly, on 8 June 2006 an increase in the repurchase rate from 7,00 per cent to 7,50 per cent per annum was announced. This followed a period of 14 months during which the repurchase rate had been kept unchanged, and has also been the first increase in the benchmark rate since September 2002.

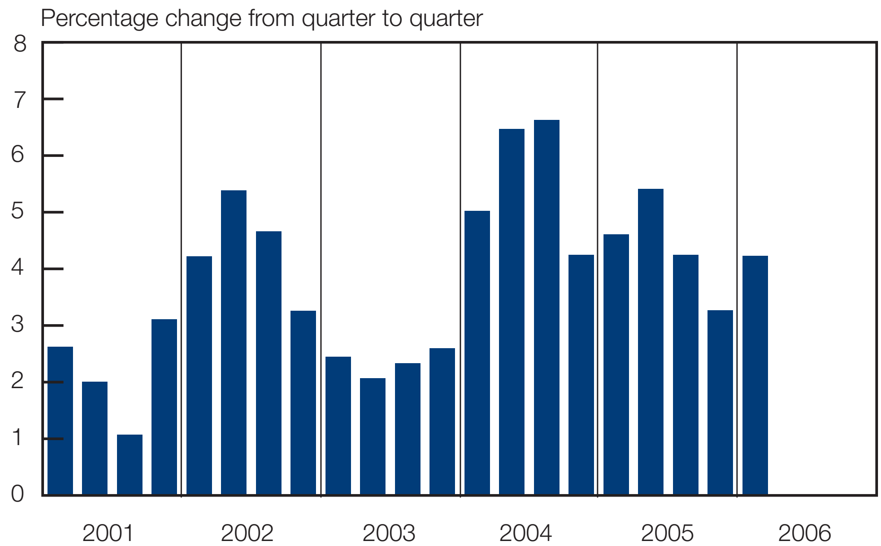
Domestic economic developments

Domestic output[1]

Growth in *real gross domestic product* accelerated to an annualised rate of 4 per cent in the first quarter of 2006, compared with a revised growth rate of 3 per cent recorded during the fourth quarter of 2005. The increase in economic activity in the first quarter of 2006 was largely due to a significant expansion in the real value added by the secondary sector, which was supported by a further increase in the real value added by the tertiary sector. By contrast, the real value added by the primary sector contracted further in the first quarter of 2006. Excluding agriculture, real gross domestic product increased at an annualised rate of about 4½ per cent in the first quarter of 2006.

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

Real gross domestic product



Seasonally adjusted annualised rates

The real value added by the *primary sector* declined at an annualised rate of 2½ per cent in the fourth quarter of 2005. This rate of decline worsened to 4 per cent in the first quarter of 2006, reflecting a contraction in real output of both the agricultural and mining sectors. Following an increase of 4 per cent in the fourth quarter of 2005, the real value added by the *agricultural sector* contracted at an annualised rate of 7 per cent in the first quarter of 2006. This was mainly due to weaker livestock production. Field crop and horticulture production remained steady in the first quarter of 2006.

The real value added by the *mining sector* contracted at annualised rates of 5½ per cent in the fourth quarter of 2005 and 3 per cent in the first quarter of 2006. The latter decline was evident in most subsectors but was softened somewhat by an improvement in the real value added by the platinum mines. Platinum output was lifted in part by the return to full-capacity utilisation of a smelter which had not been operational in the fourth quarter of 2005 – a welcome development given the strong demand for and exceptional price performance of platinum.

The secular decline in gold-mining output paused in the fourth quarter of 2005, but resumed in the first quarter of 2006 as the physical quantity of ore milled contracted alongside a slight decline in the average grade of ore milled. The disappointing reduction in gold production was recorded despite an increase of 7½ per cent in the average rand price of gold. Diamond-mining output declined on account of waning profitable deposits of these precious stones.

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
Primary sector	8½	2½	½	-2½	3	-4
Agriculture	6½	3	10	4	5½	-7
Mining	9½	2	-3½	-5½	2½	-3
Secondary sector	-½	7½	5½	1½	4½	5½
Manufacturing	-2½	8	5½	-½	4	4½
Tertiary sector	6	4½	4½	5	5	5½
Non-agricultural sector	*4½*	*5*	*4*	*3½*	*5*	*4½*
Total	4½	5½	4	3	5	4

Growth in the real value added by the *secondary sector* accelerated from an annualised rate of 1½ per cent in the fourth quarter of 2005 to 5½ per cent in the first quarter of 2006. While a solid recovery in real output of the manufacturing sector was the major contributor to the growth in the real value added by the secondary sector, it was also underpinned by an expansion in the real value added by the sector supplying electricity, gas and water as well as the construction sector.

The real value added by the *manufacturing sector*, which had declined by ½ a per cent in the fourth quarter of 2005, subsequently regained momentum and increased at an annualised rate of 4½ per cent in the first quarter of 2006. Growth in the real value added by the manufacturing sector in the first quarter of 2006 benefited from strong domestic demand and increased production in some subsectors to reduce the backlog of unfilled orders. Nevertheless, a modest decline in the utilisation of production capacity in manufacturing was registered in the first quarter of 2006.

An analysis of the various manufacturing subsectors yields a mixed picture. A marked improvement was recorded in the manufacturing output of the petroleum and chemical subsector where output rebounded, following a decline in the fourth quarter of 2005 when refineries were upgraded to phase out leaded fuel. These refineries have since resumed full production and this boosted the real value added by the petroleum and chemical subsector.

The firm demand for new motor vehicles – both for domestic consumption and for export markets – continued to boost growth in the real manufacturing output of motor vehicles and other transport equipment. However, the manufacturers of basic metals failed to capitalise fully on the commodity price boom, and quarter-to-quarter growth in real output slowed somewhat. Disappointingly, the real value added by the subsector that manufactures food and beverages declined further in the first quarter of 2006, although at a more sedated pace than in the fourth quarter of 2005.

Growth in the real value added by the sector supplying *electricity, gas and water* maintained an annualised rate of 3½ per cent in both the fourth quarter of 2005 and the first quarter of 2006. Despite power disruptions in some areas, growth in aggregate electricity production held up well during this period. The real value added by the water subsector, however, contracted in the first quarter of 2006 as widespread rain obviated consumer demand for purchased water.

Activity in the *construction sector* remained buoyant during the first quarter of 2006. The construction of shopping malls and office complexes in particular maintained its momentum in the first quarter of 2006. While delays on account of rain contributed to a slight cooling off in the residential building sector, activity remained quite high, particularly in the construction of security complexes. Higher capital expenditure on infrastructure in certain provinces and stronger investment in the mining sector buoyed the demand for construction works. As a result of these developments, growth in the real value added by the construction sector accelerated from an annualised rate of 12½ per cent in the fourth quarter of 2005 to 13½ per cent in the first quarter of 2006.

The real value added by the *tertiary sector* increased at an annualised rate of 5 per cent in the fourth quarter of 2005, accelerating to 5½ per cent in the first quarter of 2006. The higher growth could mainly be ascribed to a brisk increase in the real value added by the finance, insurance, real-estate and business services sector which more than fully offset slower growth in the trade and the transport, storage and communication sectors.

Growth in the real value added by the *trade sector* slowed from an annualised rate of 9 per cent in the fourth quarter of 2005 to 5 per cent in the first quarter of 2006. The growth in real value added by the retail subsector tapered off as the fast pace of growth in the demand for consumer goods slackened somewhat. Likewise, growth in real value added by the motor trade subsector slowed in the first quarter as the increase in the demand for motor vehicles by private individuals and businesses tapered off.

Growth in the real value added by the *transport, storage and communication sector* slowed from an annualised rate of 6½ per cent in the fourth quarter of 2005 to 5 per cent in the first quarter of 2006. This was mainly due to slower growth in real value added by cellphone communication and land transport. After many years of exceptional growth, it appears as though the growth in the cellphone industry may have stabilised, resulting in more modest quarterly growth rates in the communication subsector. The real value added by the provision of goods and passenger transport services actually declined due to industrial action in the railway sector during the first quarter of 2006. Activity at South African harbours also declined slightly in the first quarter of 2006, partly on account of lower export volumes.

The real output of banks rose exceptionally strongly in the first quarter of 2006 alongside brisk demand for credit by the household and business sectors. The real value added by security dealers also increased strongly in the first quarter of 2006, reflecting the buoyant conditions on the JSE Limited. As a result of all these developments, growth in the real value added by the *finance, insurance, real-estate and business services sector* accelerated from an annualised rate of 3½ per cent in the fourth quarter of 2005 to 9 per cent in the first quarter of 2006.

Domestic expenditure

Growth in *real gross domestic expenditure* continued to outpace that of real gross domestic production by a substantial margin in the first quarter of 2006 – growth in aggregate expenditure accelerated to an annualised rate of no less than 14½ per cent in the first quarter of 2006, compared to a growth rate of 4 per cent in real gross domestic production. The strong expenditure growth could mainly be attributed to faster growth in real gross capital formation, i.e real gross fixed capital formation and inventory investment. This took place against a backdrop of firm growth in imports. Growth in real final consumption expenditure by households was sustained at a similar rate to that of the fourth quarter, while real final consumption expenditure by general government declined in the first quarter of 2006.

Real gross domestic expenditure

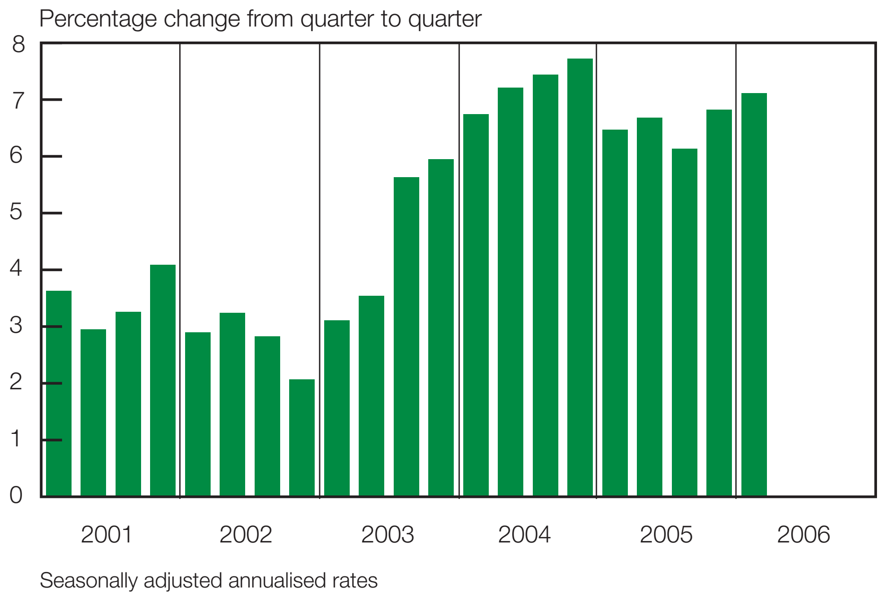
Percentage change at seasonally adjusted annualised rates

	2005					2006
Components	1st qr	2nd qr	3rd qr	4th qr	Year	1st qr
Final consumption expenditure by households	6½	6½	6	7	7	7
Final consumption expenditure by general government	1	6	5½	14½	5½	-2½
Gross fixed capital formation..........	11	5½	8½	8½	9	10½
Change in inventories (R billions)*...	12,3	6,1	13,3	2,3	8,5	12,9
Gross domestic expenditure	7	6	7½	4	6	14½

* At constant 2000 prices

Real final consumption expenditure by households remained quite strong in the first quarter of 2006 with growth proceeding at an annualised rate of 7 per cent, the rate also attained during the fourth quarter of 2005. This was a result of a strong increase in real outlays on semi-durable goods and services. However, the growth rate of real household outlays on durable and non-durable goods lost some momentum over the period.

Real final consumption expenditure by households



Growth in real final consumption expenditure by households on *durable goods* slowed from an annualised rate of 24½ per cent in the fourth quarter of 2005 to a still high 13 per cent in the first quarter of 2006. This could mainly be attributed to less vigorous increases in household expenditure on furniture and household appliances, personal transport equipment as well as recreational and entertainment goods. The demand for transport equipment – notably new cars – increased further, albeit at a slower pace, as households continued to take advantage of stable car prices and a favourable interest rate environment.

The lower prices of clothes boosted real household outlays on clothing and footwear, lifting quarter-to-quarter growth from an annualised rate of 6½ per cent in the fourth quarter of 2005 to 22½ per cent in the first quarter of 2006. Real household outlays on household textiles and furnishings also performed well in the first quarter of 2006. Although spending on motor vehicle parts and accessories slowed, this was more than offset by brisk spending in the other categories. Consequently, growth in real household spending on *semi-durable goods* accelerated from an annualised rate of 8½ per cent in the fourth quarter of 2005 to 18 per cent in the first 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
Durable goods	12	20½	8	24½	18	13
Semi-durable goods	17½	13½	19½	8½	17	18
Non-durable goods	5½	4½	4½	6	5	3½
Services	3	3½	3	3	3	5½
Total	**6½**	**6½**	**6**	**7**	**7**	**7**

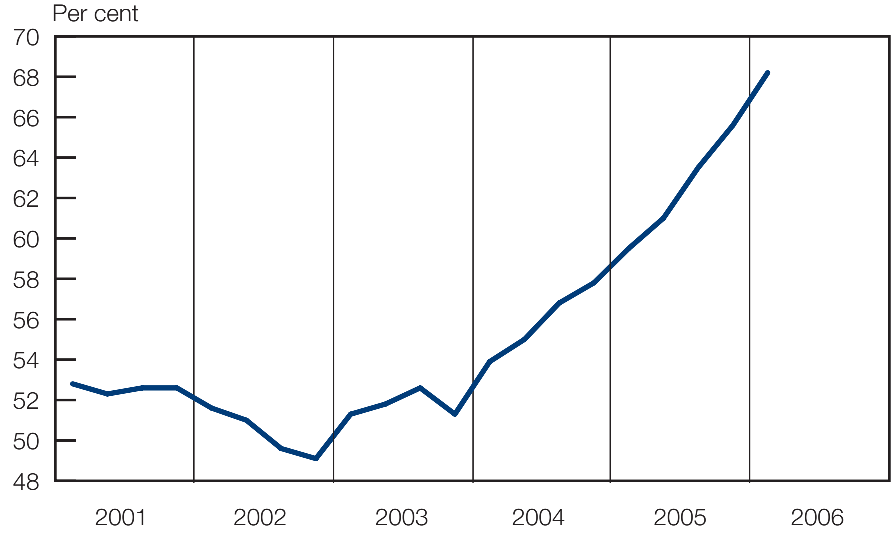
Real final consumption expenditure by households on *non-durable goods* lost some momentum, slowing from an annualised growth rate of 6 per cent in the fourth quarter of 2005 to 3½ per cent in the first quarter of 2006. Households scaled down expenditure on food and beverages, household fuel and power, medical and pharmaceutical products as well as on entertainment goods as the prices of these items edged higher. However, real expenditure on petroleum products expanded in the first quarter of 2006 following a contraction in the second half of 2005.

Following an increase at an annualised rate of 3 per cent in the fourth quarter of 2005, growth in real final consumption expenditure by households on *services* picked up to 5½ per cent in the first quarter of 2006. Higher spending was mainly focused on rent, medical services and recreational and entertainment services.

The ability of households to maintain relatively high levels of spending was supported by a further robust increase in real disposable income of households in the first quarter of 2006. In addition, households made use of credit facilities mainly to finance the acquisition of fixed property and durable goods. This contributed to overall household debt as percentage of annualised disposable income increasing from 65½ per cent in the fourth quarter of 2005 to a new record high of 68 per cent in the first quarter of 2006. For the time being, the cost of servicing the debt remained fairly low, inching higher to 7¼ per cent of household disposable income in the first quarter of 2006.

Real final consumption expenditure by general government reversed from an increase at an annualised rate of 14½ per cent in the fourth quarter of 2005 to a decline of 2½ per cent in the first quarter of 2006. The extraordinary growth in the fourth quarter was

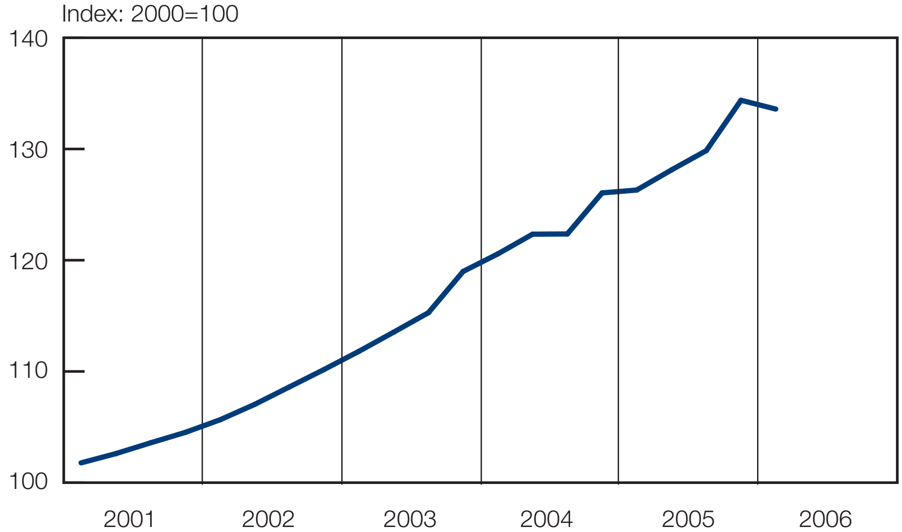
Household debt as percentage of disposable income



Seasonally adjusted

achieved on account of the purchase of a submarine, whereas no such extraordinary purchases took place in the first quarter of 2006. Growth in real expenditure on compensation of employees continued in the first quarter of 2006 at the same measured pace as in the preceding quarter.

Real final consumption expenditure by general government

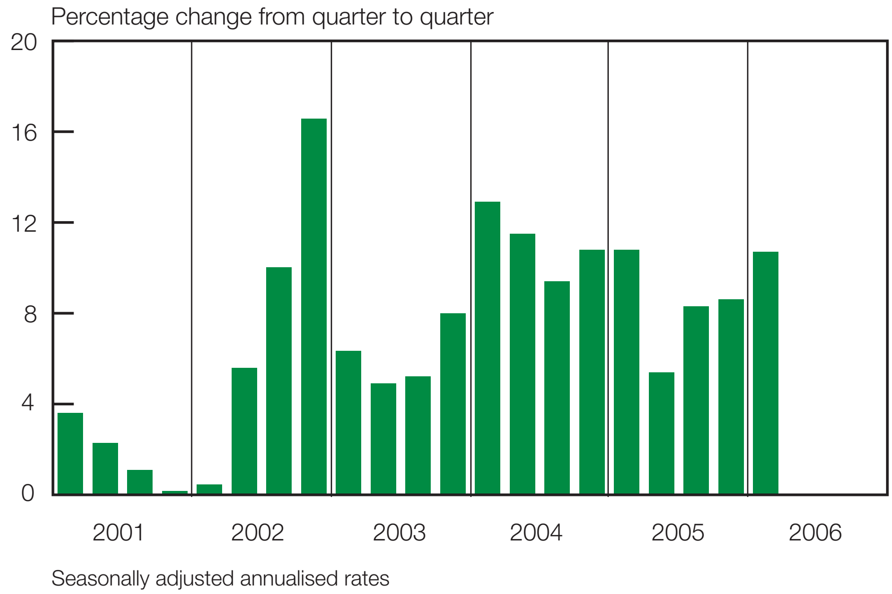


Seasonally adjusted

Real gross fixed capital formation increased at an annualised rate of 8½ per cent in the fourth quarter of 2005, gaining momentum as it reached 10½ per cent in the first quarter of 2006. This acceleration resulted from substantially higher growth in real capital outlays by private business enterprises and public corporations, while real gross fixed capital formation by general government rose only marginally from the fourth quarter of 2005 to the first quarter of 2006. The robust increase in overall fixed capital expenditure lifted the ratio of gross fixed capital formation to gross domestic product from 17,3 per cent in the fourth quarter of 2005 to 17,8 per cent in the first quarter of 2006.

Growth in real gross fixed capital formation by private businesses accelerated from an annualised rate of 9½ per cent in the fourth quarter of 2005 to 11½ per cent in the first quarter of 2006. The agricultural sector contributed to the stronger investment expenditure in the first quarter as it stepped up its real outlays on machinery and equipment. In addition, the decline in real capital outlays by the mining sector throughout all four quarters of 2005 was halted by an increase at an annualised rate of 6 per cent being recorded in the first quarter of 2006. Some projects which had been suspended when mining profits came under pressure as a consequence of high input cost and a stronger exchange rate, were resumed as the prevailing boom in commodity prices contributed to an improvement in the balance sheet of mining companies and boosted projected returns. New projects commenced in both the gold and platinum-mining sectors. Real gross fixed capital formation also rose further in several other sectors of the economy, though at a slower pace than in the fourth quarter of 2005. These included the transport and communication sector as well as the finance sector.

Real gross fixed capital formation



Public corporations contributed significantly to overall real gross fixed capital formation in the first quarter of 2006. In particular, Transnet increased investment in rolling stock as part of its drive to alleviate transport bottlenecks and improve the service delivery of the railway network for both commuters and business enterprises. The other public corporations also increased their real capital outlays, although not at the same robust pace as in the fourth quarter of 2005.

Real gross fixed capital formation by general government moved essentially sideways in the fourth quarter of 2005 but rose by ½ a per cent in the first quarter of 2006. While real capital expenditure on all three levels of government remained rather low, brisk increases have been incorporated in the budget for 2006/07.

Real inventory investment[2] increased from a subdued annualised rate of R2,3 billion in the fourth quarter of 2005 to R12,9 billion in the first quarter of 2006. Most of the inventory accumulation occurred in the manufacturing sector, which coincided with an increase in imports and the resumption of normal production by petroleum refineries. The build-up was

2 *At constant 2000 prices.*

largely confined to oil inventories, as other manufacturing subsectors increased inventory holdings more sparingly. A modest accumulation of inventories was recorded in the trade sector as demand for consumer goods continued to increase in the first quarter of 2006. The strong accumulation of inventories in the first quarter contributed approximately 3½ percentage points to growth in real gross domestic expenditure.

Factor income

The year-on-year growth in total nominal *factor income* accelerated from 10½ per cent during the fourth quarter of 2005 to 11½ per cent in the first quarter of 2006. This can mainly be attributed to higher growth in gross operating surpluses of business enterprises.

Growth in *compensation of employees*, measured over four quarters, was sustained at a growth rate of 9 per cent in both the fourth quarter of 2005 and the first quarter of 2006. During the first quarter of 2006 most sectors of the economy recorded growth over one year in compensation of employees similar to that in the previous quarter, except in the mining, trade, and transport, storage and communication sectors, where growth slowed down.

The solid performance of commodity prices boosted the profitability of the mining sector in the first quarter of 2006. The gross operating surplus of the finance sector also rose strongly, reflecting its brisk performance in the first quarter of 2006, as did the surpluses of the manufacturing and construction sectors. The lively activity in these sectors more than neutralised the slower growth in the gross operating surpluses of the other sectors of the economy. Consequently, growth in the economy's *total gross operating surplus*, measured over a period of one year, accelerated from 12½ per cent in the fourth quarter of 2005 to 14 per cent in the first quarter of 2006.

Saving

Gross saving as percentage of gross domestic product declined from 13½ per cent in the fourth quarter of 2005 to 13 per cent in the first quarter of 2006. The weaker saving was evident in both the corporate and the household sector. Gross saving by general government improved in the first quarter of 2006.

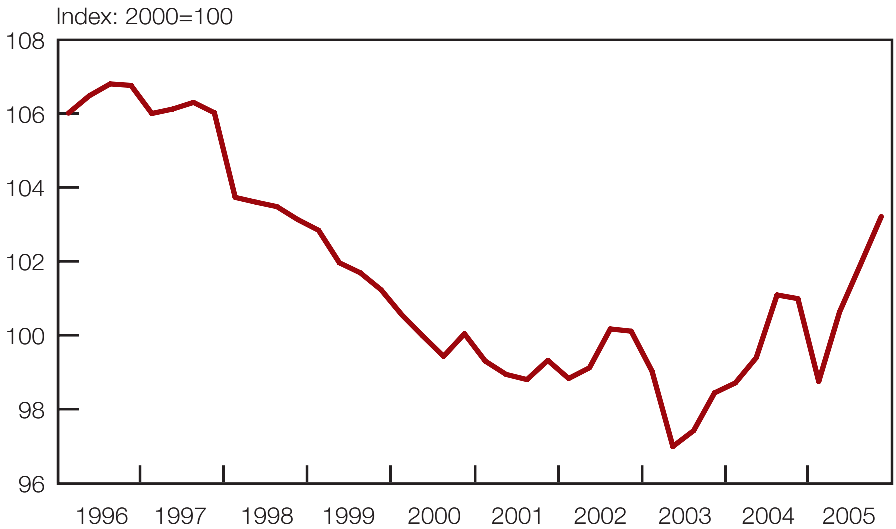
Part of the increase in gross operating surpluses referred to earlier found its way into higher dividend payments. In addition, tax payments by the corporate sector accelerated in the first quarter of 2006. As a result, gross saving by the *corporate sector* as percentage of gross domestic product declined from 11½ per cent in the fourth quarter of 2005 to 10 per cent during the first quarter of 2006.

Gross saving by *general government* as percentage of gross domestic product improved from less than ½ a per cent in the fourth quarter of 2005 to 1½ per cent in the first quarter of 2006. General government saving benefited from strong revenue collections in the first quarter of 2006, while consumption expenditure receded since no large-value military items were acquired. The saving performance of the household sector remained roughly on a par in both the fourth quarter of 2005 and the first quarter of 2006, with a ratio of gross household saving to gross domestic product fractionally above 1½ per cent.

Employment

Consistent with the continued healthy performance of the domestic economy, *enterprise-surveyed formal non-agricultural employment* increased meaningfully during the course of 2005. The number of employed persons in the formal non-agricultural sector increased by 156 000, or by 2,2 per cent, over the year to around 7,2 million in December 2005. Employment gains were fairly widespread throughout the economy and both the private and public sector expanded their employee complements during the period. Employment gains in the twelve months to December 2005 occurred at the same rate in both the private and public sector, raising the level of private-sector employment to 5,64 million and that of the public sector to 1,62 million.

Enterprise-surveyed formal non-agricultural employment



Employment growth in the *private sector* accelerated from a year-on-year rate of 0,1 per cent in the third quarter of 2005 to 2,2 per cent in the fourth quarter. The combined loss of job opportunities in the gold-mining sector and in the finance, insurance, real-estate and business services sector was more than offset by strong increases in employment numbers in especially the construction sector. Employment growth was also assisted by an increase in employment numbers in the trade, catering and accommodation services sector as well as in the transport, storage and communication sector. Encouragingly, employment in the manufacturing sector, which had declined steeply during the six-month period to March 2005, increased at a rate of 1,8 per cent in the year to December 2005.

While building contractors' confidence levels recorded record highs and with employment levels continually rising, the main concern in the building industry was related to the lack of skilled labour to fully meet demand. According to the latest quarterly building and construction sector survey conducted by the Bureau for Economic Research (BER), the shortage of skilled labour has been indicated as a key concern in the construction sector by 98 per cent of respondents.

Alongside the continued increases in non-agricultural private-sector employment, *public-sector* employment totals also expanded. When measured from quarter to quarter and expressed at an annualised rate, public-sector employment increased by 3,6 per cent in the third quarter of 2005 and 2,7 per cent in the fourth quarter. Notwithstanding only a slight increase in public-sector employment in the opening months of 2005, staff numbers in the public sector expanded notably by 3,1 per cent in the year as a whole. Employment gains in national and provincial government departments as well as at local government level exceeded losses in public-sector transport, storage and communication enterprises in 2005.

Change in enterprise-surveyed formal non-agricultural employment over four quarters to December 2005

	Number	Percentage change
Gold mining	-24 000	-13,6
Non-gold mining	1 800	0,6
Manufacturing	20 680	1,8
Electricity supply	3 350	7,9
Construction	76 800	20,5
Trade, catering and accommodation	41 970	3,0
Transport, storage and communication	9 500	4,5
Finance, insurance, real-estate and business services	-11 300	-0,7
Community, social and personal services	4 570	1,5
Total private sector	**123 370**	**2,2**
National, provincial and local government	32 600	2,2
Public-sector enterprises	220	0,1
Total public sector	**32 820**	**2,2**
Grand total	**156 190**	**2,2**

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

Indications are that labour market conditions remained conducive to further employment gains in the opening months of 2006. The volume of job advertisements in the print media, which has historically been fairly well correlated with formal non-agricultural employment, rose by as much as 38 per cent in the year to the first quarter of 2006 – the highest rate of increase in the past decade. At the same time, business confidence according to the Rand Merchant Bank/Bureau for Economic Research Business Confidence Index rose further in the first quarter of 2006 to reach its highest level since 1980. According to the Investec Purchasing Managers sub-index for employment in the manufacturing sector, the level of employment in the sector is, however, expected to contract somewhat in the first quarter of 2006.

The expected further improvement in employment prospects in the opening months of 2006 is corroborated by information from the Unemployment Insurance Fund (UIF). According to the registration figures at the UIF, 500 000 more workers were registered with the Fund in January 2006 compared with the same period in the preceding year. The majority of these were new entrants to the labour market, while the remainder mainly resulted from more employers starting to comply with legislation. More than 7,1 million workers were registered with the Fund at the end of January 2006, compared with just under 6,6 million at the same time in the previous year.

Labour cost and productivity

The year-to-year rate of increase in *average nominal remuneration per worker* amounted to 7,2 per cent in 2005. This rate of increase was significantly lower than in the preceding year when nominal wages per worker increased by as much as 9,1 per cent. Measured over periods of four quarters, the rate of increase in nominal remuneration per worker decelerated from 8,4 per cent in the first quarter of 2005 to 4,6 per cent in the fourth quarter. Lower rates of increase in average nominal remuneration per worker were fairly pervasive, since nominal wage growth slowed down in both the private and public sector in the fourth quarter of 2005.

According to Andrew Levy Employment Publications (a private-sector labour consultancy), the average level of *wage settlements* in collective bargaining agreements declined from 6,8 per cent in 2004 to 6,3 per cent in 2005, remaining at this rate in the first quarter of 2006. Settlements in the first quarter ranged from 5 per cent to 7,5 per cent. Furthermore, the year-on-year rate of increase in average salaries, wages and pensions deposited into the bank accounts of almost 5 million salaried and retired workers, as indicated by the Automated Clearing Bureau, slowed down from 7,6 per cent in the fourth quarter of 2005 to 5,7 per cent in the first quarter of 2006.

With effect from April 2006 the minimum monthly wage for farm workers around the urban areas increased to R994 and for those in the rural areas to R885, both effectively rising by 12,6 per cent. These wage levels will be raised to R1 041 and R989 respectively in 2007, an increase of 4,7 per cent for farm workers around the urban areas and an increase of 11,8 per cent for farm workers in the rural areas. In 2008, a minimum wage of R1 090 per month will be required across the board in the agricultural sector.

The pace of increase in nominal remuneration per worker in the *public sector* amounted to 6,8 per cent in 2005, considerably slower than in the preceding year. In 2005, lower rates of increase in nominal remuneration per worker were evident throughout the public sector. Notwithstanding the moderation in remuneration growth per worker in the public sector as a whole during 2005, average nominal wage growth per worker at local government level at a rate of 14,0 per cent far exceeded that elsewhere in the public sector. In fact, nominal remuneration per worker in the public sector excluding local governments increased at around 6 per cent on average in 2005. When measured over periods of four quarters, the pace of increase in nominal remuneration per worker at local government level, however, decelerated from rates in excess of 15 per cent in the first half of 2005 to 8,9 per cent in the fourth quarter.

Similar to the slowdown in nominal wage growth in the public sector, increases in remuneration per worker in *private-sector* enterprises rose by only 7,1 per cent in 2005, from 9,3 per cent in the preceding year. In 2005, the most generous increases in nominal remuneration per worker in the private sector occurred in the finance, insurance, real-estate and business services sector as well as in the electricity generation sector. The rates of increase in nominal remuneration per worker in the trade, catering and accommodation services sector as well as in the transport, storage and communication sector were, however, meaningfully lower. An absolute decrease in nominal remuneration per worker in the construction sector in 2005 probably relates to the employment of additional workers on mainly the lower remuneration scales.

Following increases in the overall level of employment, *economy-wide labour productivity growth* slowed down considerably in the course of 2005, i.e. from a year-on-year rate of 5,5 per cent in the first quarter to 2,0 per cent in the fourth quarter. Notwithstanding the moderation in labour productivity growth in the formal non-agricultural sector of the economy in the course of 2005, average labour productivity growth for the year as a whole still outpaced productivity growth in the preceding year by a fair margin. In fact, the year-to-year rate of increase in real output per worker in the formal non-agricultural sector of the economy accelerated from 2,5 per cent in 2004 to 3,7 per cent in 2005. Production per worker in the *manufacturing sector* increased by 4,9 per cent in 2005, meaningfully higher than for the economy as a whole.

Consistent with higher annual average labour productivity growth and the relatively slower pace of increase in nominal remuneration per worker in 2005, the rate of increase in the *cost of labour per unit of production* in the formal non-agricultural sector decelerated markedly from 6,5 per cent in 2004 to 3,4 per cent in 2005. The quarter-to-quarter pace of increase in nominal unit labour cost in the formal non-agricultural sector nonetheless accelerated consistently during the first three quarters of 2005 and amounted to 4,6 per cent in the third quarter. A slowdown in nominal wage growth in the fourth quarter of 2005, however, brought the year-on-year increase in nominal unit labour cost down to 2,6 per cent in that quarter, contributing to the containment of inflationary pressures in the economy.

Prices

Consumer price inflation has receded meaningfully since the first half of 2003 against the backdrop of sound monetary and fiscal policies, the disinflationary benefits of the appreciation of the rand, and steadily declining consumer services price inflation. Accordingly, year-on-year CPIX inflation first fell below the 6-per-cent mark in September 2003 and has subsequently remained within the inflation target range of between 3 to 6 per cent. The marked increase in the international price of crude oil and other commodity prices, accelerating food price inflation and strong consumer demand in general, however, prevented price inflation from declining further. Year-on-year CPIX inflation fluctuated considerably during the course of 2005 and the opening months of 2006 due to monthly changes in the price of petrol. On balance, it rose from a low point of 3,1 per cent in February 2005 to 3,7 per cent in April 2006.

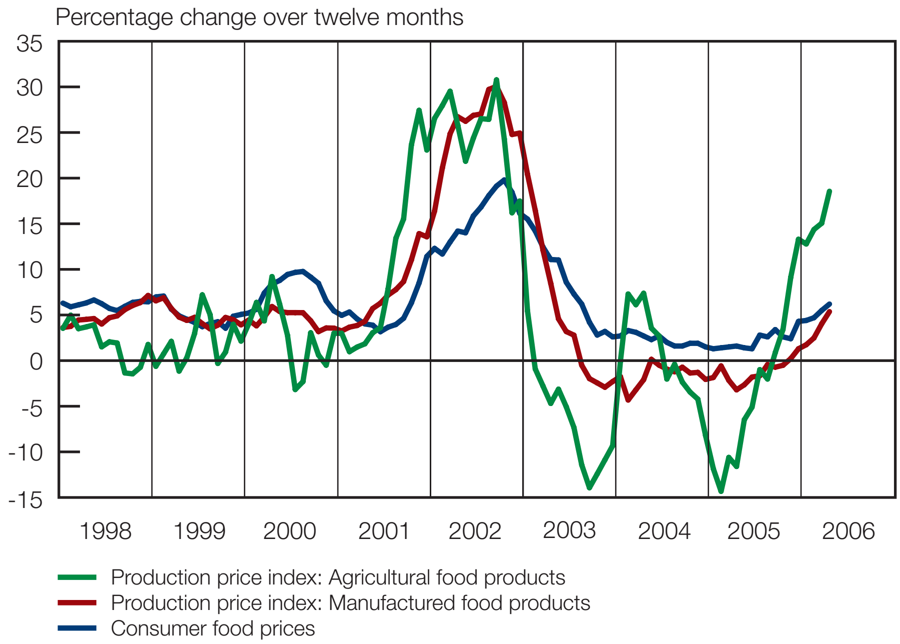
At the level of production prices*, imported goods price changes*, typically being more variable than changes in the prices of domestically produced goods, reverted to increases in March 2005 after a two-year period of price decline. Imported goods price inflation subsequently surpassed domestically produced goods price inflation in June 2005, as the rise in international crude oil prices pushed the index higher. Year-on-year imported goods price inflation exceeded year-on-year domestically produced goods price inflation during the six consecutive months to April 2006.

International Brent crude oil prices rose further from an already high US$63 per barrel in January 2006 to around US$73 per barrel in April. As a result, year-on-year inflation in the *production prices of imported goods* accelerated, on balance, from 0,3 per cent in January 2005 to 6,1 per cent in April 2006. Higher inflation in the prices of imported basic metals and agricultural food as well as paper and paper products also contributed to the acceleration in imported goods price inflation in recent months. When measured from quarter to quarter and expressed at an annualised rate, inflation in the prices of imported goods nonetheless decelerated meaningfully from 13,9 per cent in the third quarter of 2005 to only 0,8 per cent in the fourth quarter. Thereafter, prices actually declined by 0,9 per cent in the first quarter of 2006. This could largely be attributed to the appreciation in the exchange value of the rand in the first three months of 2006, suppressing the prices of imported goods over a wide front.

The prices of imported goods in the mining and quarrying category (inclusive of crude oil) rose by no less than 40,2 per cent in the year to April 2006. Contrary to this marked increase, various other categories with a combined weight of almost 75 per cent in the overall index were still experiencing price increases of less than 2 per cent or even decreases over this period. The most prominent among those categories experiencing price *declines* were radio, television and communication equipment as well as office, accounting and computing machinery. International production price pressures increased somewhat in recent months as energy prices rose. Consequently, the year-on-year rate of increase in the composite wholesale price index of South Africa's main trading-partner countries accelerated from around 2,5 per cent in the middle of 2005 to 4,3 per cent in January 2006, receding slightly to 3,8 per cent in March.

Year-on-year inflation in the production prices of *domestically produced goods* more than doubled from around the 2-per-cent level during the first half of 2005 to 5,5 per cent in April 2006. This acceleration in domestically produced goods price inflation not only resulted from the steep increases in the prices of petroleum and coal products but also from the higher prices of goods in other categories: Striking increases of 17,6 per cent in the prices of non-ferrous basic metals, 20,0 per cent in the prices of processed fresh meat, 16,5 per cent in the prices of electrical machinery, and 18,6 per cent in the prices of agricultural food products were recorded during the twelve-month period to April 2006.

Food prices



The quarter-to-quarter and annualised rate of increase in the prices of domestically produced goods picked up from 4,6 per cent in the fourth quarter of 2005 to 6,1 per cent in the first quarter of 2006. This acceleration was mainly evident in the prices of manufactured food products, alcoholic drinks and tobacco as well as basic metals and metal products. Decreases in the prices of textiles, clothing and footwear as well as electricity, gas, water and mining products, however, restrained the pace of price increases in the first quarter of 2006.

With both domestically produced goods and imported goods price inflation accelerating, the year-on-year rate of increase in the *all-goods production price index* more than doubled from 2,3 per cent in June 2005 to 5,5 per cent in April 2006. This rate of increase had been as low as 1,2 per cent in February 2005. Should the primary driver of production price inflation, i.e. energy prices, be excluded from the calculation, all-goods production price inflation would have amounted to an appreciably lower rate of 4,2 per cent in the year to April 2006. Notwithstanding this lower rate of increase, year-on-year non-energy production price inflation has also accelerated markedly from as low as 0,2 per cent in January 2005 to current levels.

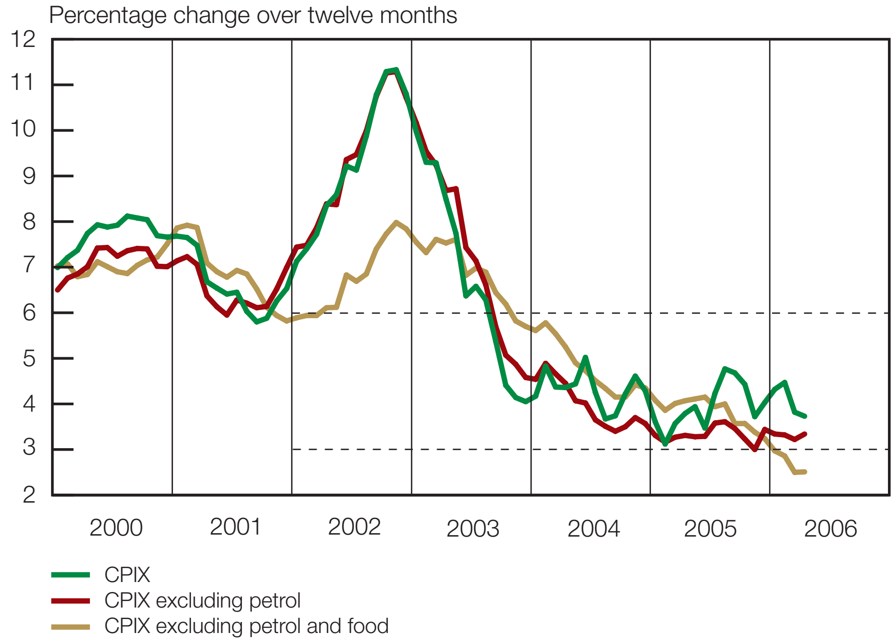
The acceleration in the quarter-to-quarter pace of increase in the all-goods production price index from an annualised rate of 3,5 per cent in the fourth quarter of 2005 to 4,8 per cent in the first quarter of 2006, resulted entirely from higher domestically produced goods price pressures, since imported goods prices actually declined during the period. Lower increases in nominal unit labour cost in the economy in general and in the manufacturing sector in particular, helped contain domestically produced goods price inflation in 2005.

Production prices
Quarter-to-quarter percentage change at annualised rates

Period		Domestically produced goods	Imported goods	Overall production prices
2004:	1st qr......................................	5,7	-3,8	3,7
	2nd qr	3,3	4,8	2,5
	3rd qr	0,5	-1,9	0,6
	4th qr	2,2	0,9	1,7
	Year..	**2,3**	**-3,9**	**0,6**
2005:	1st qr......................................	1,9	-3,2	1,3
	2nd qr	3,9	13,7	5,1
	3rd qr	5,8	13,9	8,6
	4th qr	4,6	0,8	3,5
	Year..	**2,9**	**3,6**	**3,1**
2006	1st qr......................................	6,1	-0,9	4,8

Year-on-year CPIX inflation initially accelerated in the course of 2005 as domestic petrol prices were raised in response to higher international prices of crude oil and petroleum products. The domestic price of petrol rose by as much as 60 per cent in the 21 months to October 2005, but subsequently decreased, on balance, by approximately 7 per cent to April 2006. CPIX inflation accordingly decelerated, on balance, from a most recent high of 4,8 per cent in the year to August 2005 to 3,7 per cent in the year to April 2006. Despite the net reduction in the petrol price since October 2005, the level of the petrol price in April 2006 still exceeded its year-earlier counterpart by a significant margin, adding 0,4 percentage points to the year-on-year measure of CPIX inflation in April 2006. The already mentioned increases in the

CPIX



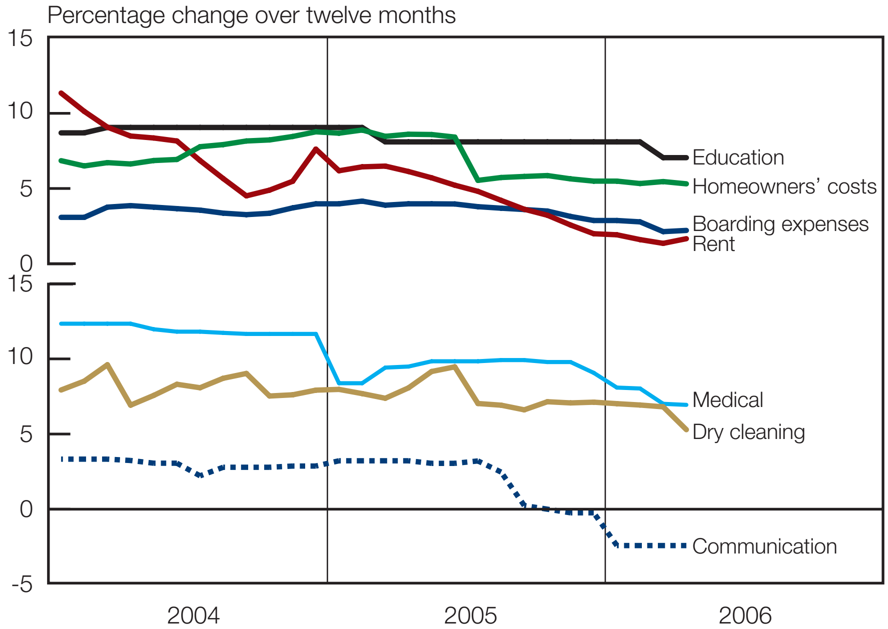
production prices of food partly worked through to consumer food prices, contributing a further 0,8 percentage points to the year-on-year CPIX inflation rate in April 2006. Consequently, if both food and energy prices were to be excluded, CPIX inflation would have amounted to only 2,5 per cent in the year to April 2006.

Mainly driven by higher rates of increase in the prices of food and alcoholic drinks and tobacco, the quarter-to-quarter pace of increase in CPIX accelerated from 2,9 per cent in the fourth quarter of 2005 to 3,1 per cent in the first quarter of 2006. Apart from the higher price increases in these two categories, the prices of goods generally declined in the first quarter of 2006 while CPIX services price inflation moderated meaningfully.

CPIX goods price inflation not only fluctuated considerably during the past two years due to the monthly changes in petrol prices, but moved to a higher level from around the middle of 2005. In fact, when measured over periods of twelve months, CPIX goods price inflation more than doubled from 2,0 per cent in June 2005 to 4,8 per cent in February 2006. This rate of increase decelerated somewhat to 3,9 per cent in April 2006 as year-on-year petrol price inflation decelerated in that month. Subdued year-on-year increases in the category for *other goods*, constituting around 27 per cent of the CPIX goods basket, as well as decreases in the prices of new and used vehicles, clothing and footwear as well as furniture and equipment suppressed the inflationary effects of higher food and alcoholic drinks and tobacco prices in recent months. Price increases in these latter two CPIX goods categories lifted the quarter-to-quarter rate of increase in CPIX goods prices from an annualised rate of 3,0 per cent in the fourth quarter of 2005 to 3,8 per cent in the first quarter of 2006.

Unlike the variability in CPIX goods price inflation, as already mentioned, *CPIX services price inflation* has decelerated consistently since the closing months of 2003. After subsiding below the 6-per-cent upper limit of the inflation target range in July 2005, year-on-year CPIX services price inflation receded to 3,5 per cent in April 2006. Since January 2006, year-on-year CPIX services price inflation has actually receded to below

Prices of selected services in the CPIX basket



CPIX goods price inflation for the first time since early 2003. The deceleration in CPIX services price inflation during recent months resulted mainly from lower rates of increase in the prices of housing services. At a year-on-year rate of 3,6 per cent in April 2006, housing services price inflation stood at roughly half its rate of 7,0 per cent recorded eight months earlier. Year-on-year inflation in transport services prices was also comfortably contained below the two-per-cent level during the ten months to March 2006, despite the higher fuel costs faced by transport services providers. This rate of increase subsequently rose slightly to 2,1 per cent in April 2006. The quarter-to-quarter pace of increase in CPIX services prices decelerated markedly from 3,4 per cent in the fourth quarter of 2005 to as low as 1,0 per cent in the first quarter of 2006.

As indicated in the accompanying table, only two of the ten main components, constituting 8,8 per cent of the overall CPIX basket, increased at year-on-year rates in excess of six per cent in April 2006. On the contrary, year-on-year inflation in the prices of five components, with a combined weight of around 34 per cent, fell below the lower boundary of the inflation target range. Three components, accounting for more than half of the weight of the CPIX basket, fell within the range. Year-on-year inflation in transport running cost, being directly related to petrol prices, exceeded price increases in all other categories of goods and services by a fair margin in April 2006.

Inflation in CPIX components

Percentage change over twelve months

	Weights	April 2006
Transport running cost	5,7	9,5
Alcoholic beverages and tobacco	3,1	7,9
Food	26,9	*5,5*
Services excluding housing and transport	16,5	*3,7*
Housing service	13,4	*3,6*
Other goods (not included elsewhere)	17,5	2,5
Transport services	3,9	2,1
Vehicles	5,7	-0,3
Furniture and equipment	3,2	-2,1
Clothing and footwear	4,1	-6,2
Total CPIX	100,0	3,7

Italics denote values inside the inflation target range of between 3 and 6 per cent for the latest available observation

In April 2006, year-on-year inflation in the prices of administered goods and services amounted to 5,2 per cent, substantially lower than the rate of 11,2 per cent seven months earlier. However, if petrol prices were excluded, administered prices would have increased at a year-on-year rate of 3,3 per cent in April 2006, slightly exceeding the lower limit of the inflation target range. This reduction in administered price inflation resulted mainly from decreases in communication costs and public hospital fees in recent months; these have a combined weight of around 16 per cent in the index.

In recent months a number of factors have contributed to the containment of inflation, such as moderate wage settlements and increases in nominal unit labour cost, declining services price inflation in general and moderate inflation expectations. However, developments around the exchange value of the rand, widening current-account deficit, volatile and rising international crude oil prices, rising food prices and the sustained buoyancy in consumer demand need to be closely monitored on account of the risks which they may pose to the inflation outlook.

Foreign trade and payments

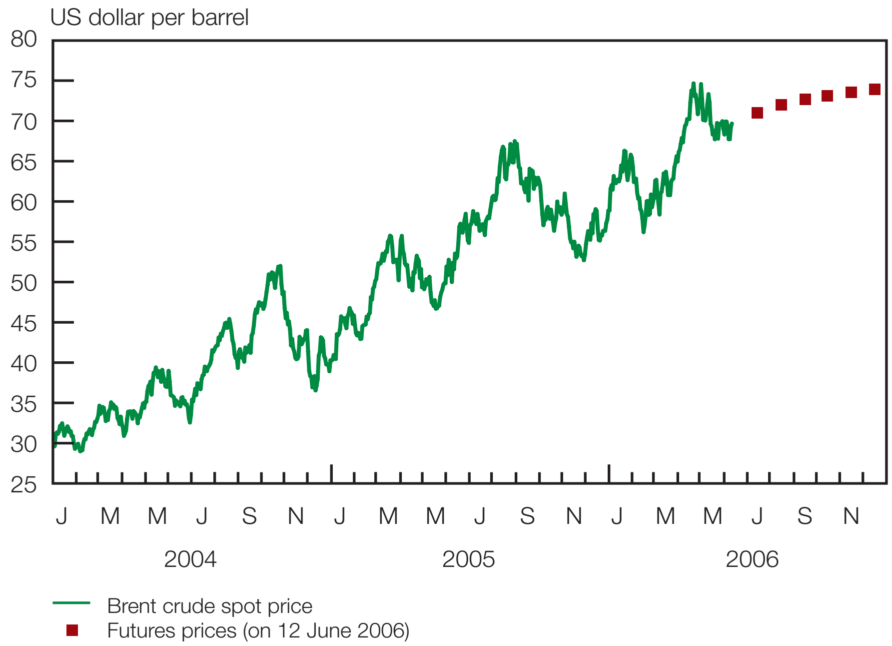
International economic developments

Global economic growth remained strong in the first quarter of 2006, having moderated slightly from almost 5½ per cent in 2004 – the highest level in three decades – to just below 5 per cent in 2005. The United States remained an important catalyst of global growth, while Japan's economy continued to expand alongside signs of a more sustained recovery in the euro area. In the major emerging-market countries growth remained solid, notably in China, India and Russia.

Real output growth in the United States rebounded strongly in the first quarter of 2006 after slowing in the final quarter of 2005 due in part to the temporary adverse impact of various hurricanes. The euro area also recorded a slowdown in economic growth in the fourth quarter of 2005, but economic activity bounced back in the first quarter of 2006. In Japan, economic growth decelerated in the first quarter of 2006, but the economy is expected to continue to recover. Real economic growth remained vigorous in most major emerging-market countries in Latin America and Asia during the first quarter of 2006. The current global economic outlook remains positive despite sustained high and volatile oil prices and substantial global current-account imbalances. This prognosis also extends to Africa, where growth appears to be more robust and sustainable than before.

The spot price of Brent crude oil increased from approximately US$56 per barrel in mid-February 2006 to new record-high levels of around US$75 per barrel towards the end of April 2006. Rising crude oil prices have been fuelled by supply constraints in Nigeria, concerns over Iran's nuclear programme and declining inventory levels in the United States. Brent crude oil prices fell in May 2006 to below US$70 per barrel on account of lower International Energy Agency estimates of global oil demand growth for 2006 and mild temperatures in the first quarter. There was further downward pressure on crude oil prices in early June following the death of a prominent al-Qaeda leader in Iraq. Crude oil prices have, however, increased to levels of around US$70 per barrel after a senior official of Iraq's oil ministry was kidnapped. Futures prices suggest Brent crude oil prices of around US$74 per barrel in the fourth quarter of 2006.

Brent crude oil prices



A possible pandemic outbreak of avian influenza (also known as bird flu) remains a concern. While it is believed that the H5N1 virus can ordinarily only be spread to humans via infected poultry and birds, the *World Health Organization* (WHO) has already reported 225 human cases and 128 deaths since 2003.

Global current-account imbalances continued to widen in 2005 with the US current-account deficit reaching a level almost equal to the combined current-account surpluses of Japan, emerging Asia (including China) and the major oil-exporting countries (including Russia). At the recent IMF Spring Meetings it was agreed to address the issue of growing global imbalances through multilateral consultations. In this regard, the IMF's role will be strengthened to deal with global imbalances under a new Medium-Term Strategy.

Global headline inflation has inched higher in response to higher crude oil prices, while core inflation (headline inflation excluding energy prices) and inflationary expectations initially remain well contained. However, core inflation recently started to pick up in some countries. This has resulted in increased volatility in global financial markets, especially in the emerging-market countries.

Since the beginning of 2006 monetary policy has been tightened in Australia, Canada, Chile, China, Denmark, the euro area, Hong Kong, India, Israel, Malaysia, South Korea, Sweden, Switzerland, Taiwan, Thailand and the United States. The central banks of Brazil, Indonesia, Mexico and Poland, however, have lowered interest rates.

Current account[3]

Robust growth in gross domestic expenditure and a concomitant strong increase in the value of merchandise imports resulted in a sizeable deficit on the trade account of the balance of payments in the first quarter of 2006. At the same time, the country's export performance deteriorated somewhat, notwithstanding buoyant global demand and booming international commodity prices. The deficit on the trade account accordingly widened to no less than R36,5 billion in the first quarter of 2006 – the largest quarterly trade deficit on record.

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

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

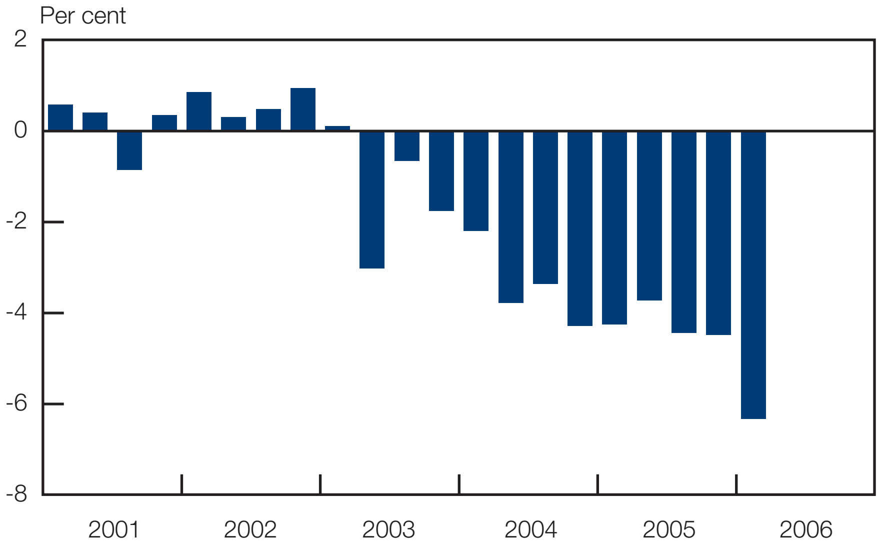
	2005					2006
	1st qr	2nd qr	3rd qr	4th qr	Year	1st qr
Merchandise exports	281,1	326,7	337,3	337,6	320,7	322,5
Net gold exports	24,9	25,9	26,0	31,3	27,0	29,3
Merchandise imports	-319,0	-356,8	-384,0	-378,9	-359,7	-388,3
Trade balance	**-13,0**	**-4,2**	**-20,7**	**-10,0**	**-12,0**	**-36,5**
Net service, income and current transfer payments	-49,2	-51,0	-47,7	-61,6	-52,4	-66,6
Balance on current account	**-62,2**	**-55,2**	**-68,4**	**-71,6**	**-64,4**	**-103,1**

The deficit on the trade account together with a larger shortfall on the country's services and income account with the rest of the world caused a marked widening of the current-account deficit in the first quarter of 2006. As a ratio of gross domestic product, the deficit on the current account amounted to 6,4 per cent in the first quarter of 2006, the highest ratio registered since 1982.

After having remained on a fairly high level in the second half of 2005, the value of merchandise exports lost some vigour and declined by 4½ per cent in the first quarter of

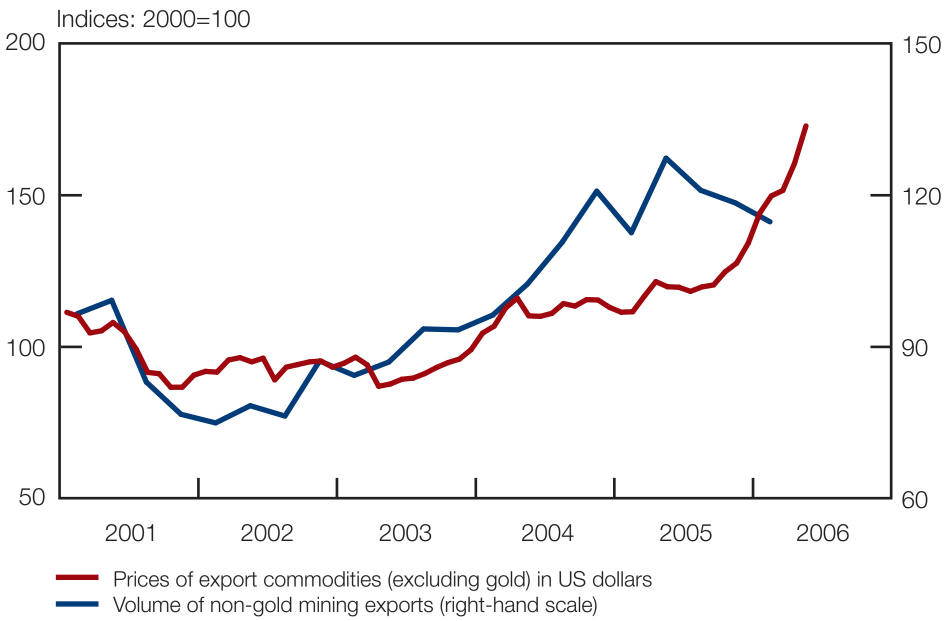
2006. This decline in the value of exported goods was mainly due to a decrease in the physical quantity of merchandise exports – the average rand price of exports increased somewhat over the period.

Ratio of current-account balance to gross domestic product



Strong global demand for international commodities raised the US dollar price of such commodities by almost 11 per cent in the first quarter of 2006. However, moderated by the strengthening of the external value of the rand, the average rand price of merchandise exports edged up by ½ a per cent over the period after having increased by 3½ per cent in the preceding quarter. This increase was more than neutralised by a decline of 5 per cent in the physical quantity of merchandise exports during the first quarter of 2006. The contraction was dispersed over all the main categories of merchandise exports – in particular, pronounced declines were registered in the

South Africa's export commodity prices and the volume of mining exports

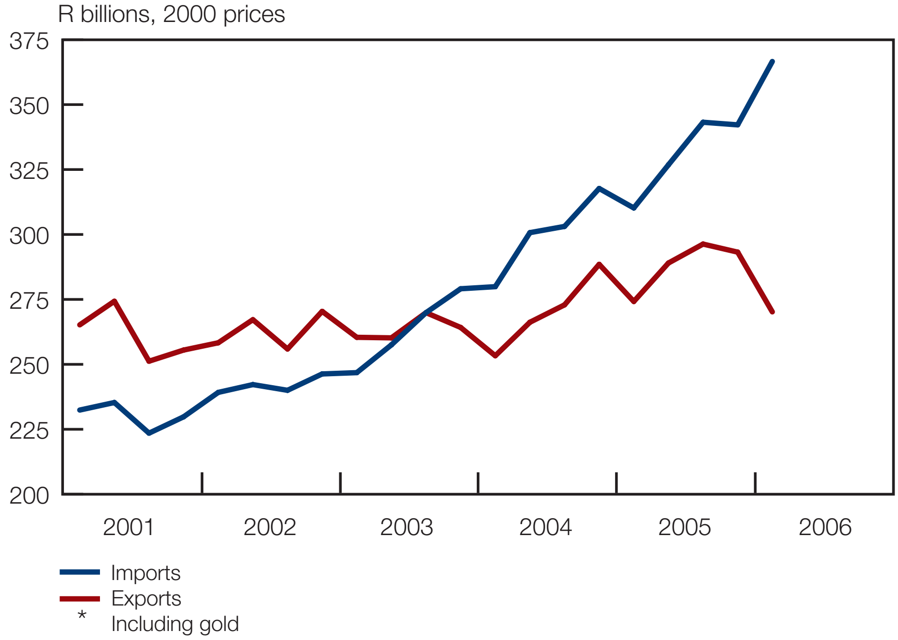


subcategories for mineral products, precious and semi-precious stones and pearls, and vehicles and transport equipment. In total, the volume of exported mining products declined by about 3 per cent in the first quarter of 2006. The competitive position of South African mining producers in international markets was probably partly compromised by the continued strengthening of the external value of the rand, alongside the long lags which usually characterise attempts by South African producers to lift production levels.

An increase of 8 per cent in the realised rand price combined with a 13½ per cent decline in the volume caused the *value of net gold export proceeds* to decline by almost 6½ per cent in the first quarter of 2006. The decline in the physical quantity of gold exports could be attributed to lower production levels and to the fact that in the fourth quarter of 2005 export volumes had been boosted by sales from inventories. The gold price rallied strongly in the first five months of 2006 against the backdrop of high international oil prices, uncertainty regarding the outlook for the US dollar as well as concern over Iran's nuclear plans. The average fixing price of gold on the London market rose from US$485 per fine ounce in the fourth quarter of 2005 to US$554 per fine ounce in the first quarter of 2006. In April and May 2006, the price of gold surged even further to an average of US$643 per fine ounce; a peak of US$725 per fine ounce was reached on 12 May before some profit-taking set in.

The slight contraction in the value of *merchandise imports* in the fourth quarter of 2005 was reversed in the first quarter of 2006 when this aggregate advanced by 2½ per cent. Imports of mineral products surged by no less than 24½ per cent over the period, while the value of chemical products and machinery and electrical equipment imported also posted significant increases. The higher value of such imported goods reflected the continued growth in fixed capital formation and solid demand for durable consumer goods.

Real imports and exports of goods* and services



Following a contraction of about 1½ per cent in the fourth quarter of 2005, the physical quantity of imported goods advanced by 3½ per cent in the first quarter of 2006. The growth in the physical quantity of imported goods fully matched the accelerated pace of growth in real gross domestic expenditure. The import penetration ratio accordingly remained unchanged in the first quarter of 2006. Relative subdued producer price inflation in South Africa's main trading-partner countries, together with the appreciation of the external value of the rand, resulted in a decline of 1 per cent in the rand prices of imports in the first quarter of 2006.

Net service, income and current transfer payments to non-residents increased by 8 per cent to R66,6 billion in the first quarter of 2006. The larger imbalance resulted mainly from higher payments for freight and insurance – associated with the high level of foreign trade – and larger dividend payments to foreign investors. Higher interest payments due to increased foreign-debt exposure of South African business concerns were almost offset by an increase in dividends received by South Africans on investments abroad.

Higher export prices of precious metals and industrial commodities contributed to an improvement in South Africa's terms of trade in the first quarter of 2006. Over the same period, increases in import prices were contained by the appreciation of the external value of the rand.

Financial account

The surplus on the financial account of the balance of payments widened in the first quarter of 2006 as non-residents stepped up investment in South Africa. Net financial inflows to the value of R33,4 billion were recorded in the first quarter of 2006, compared to a net inflow of R22,8 billion in the fourth quarter of 2005. The inflow of capital in the first quarter of 2006 could mainly be attributed to an increase in portfolio liabilities, although direct and other investment liabilities also rose significantly.

Net financial transactions not related to reserves

R billions

	2005					2006
	1st qr	2nd qr	3rd qr	4th qr	Year	1st qr
Change in liabilities						
Direct investment	1,4	1,4	32,2	5,7	40,7	8,4
Portfolio investment	7,8	25,3	7,3	-4,1	36,3	52,8
Other investment	22,3	-2,4	1,9	0,3	22,1	20,3
Change in assets						
Direct investment	-0,6	3,2	-1,7	-1,3	-0,4	1,8
Portfolio investment	2,3	-1,5	-3,2	-3,4	-5,8	-3,0
Other investment	-6,3	0,7	-26,4	9,2	-22,8	-33,8
Total financial transactions*	**16,3**	**35,1**	**24,2**	**22,8**	**98,4**	**33,4**

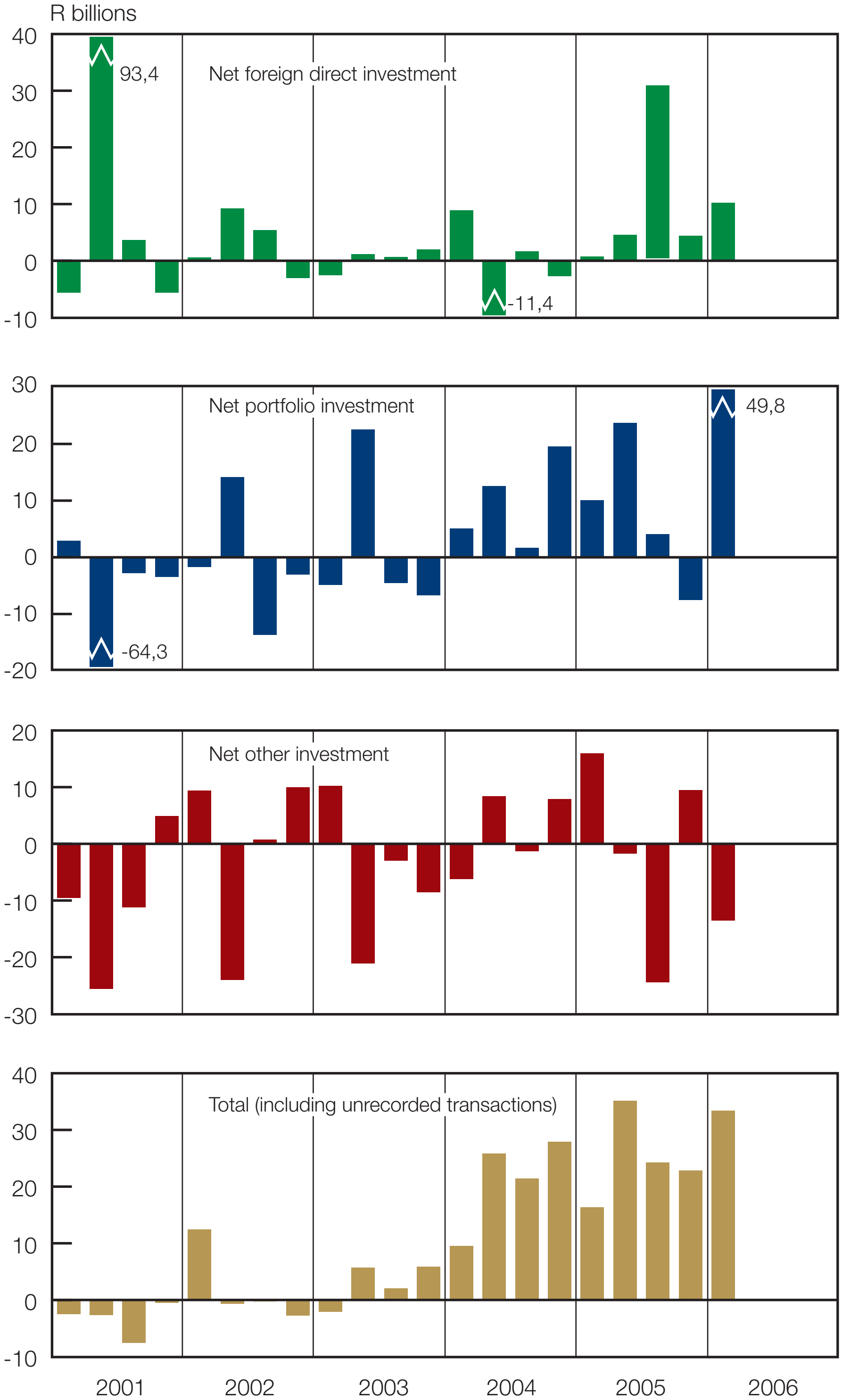
* Including unrecorded transactions

Foreign-owned assets in South Africa

Foreign direct investment into South Africa in the first quarter of 2006 was marked by the acquisition of a significant share in a South African cellular company by a non-resident company. This direct investment transaction, together with a few smaller transactions, brought about a gross capital inflow of more than R20 billion over the period. However, the inflow was partly countered by the sale of a non-resident direct investor's share in a South African gold-mining company, bringing the net inflow during the quarter to R8,4 billion.

The relative attractiveness of South Africa as an emerging-market economy also gave rise to a substantial inflow of *portfolio investment* into the country in the first quarter of 2006. Foreign portfolio investment switched from an outflow of R4,1 billion in the fourth quarter of 2005 to an inflow of no less than R52,8 billion in the first quarter when foreign investors vigorously increased holdings of South African equity. They simultaneously increased their holdings of debt securities, despite the national government's redemption of a rand-denominated bond and a foreign-currency denominated bond.

Financial account



Other foreign investment into South Africa amounted to a sizeable R20,3 billion in the first quarter of 2006, compared with R0,3 billion in the final quarter of 2005. The larger inflow was mainly due to a sharp increase in non-resident rand-denominated deposits with and foreign short-term loans extended to South African banks.

South African-owned assets abroad

Outward direct investment by South African entities changed from an outflow of R1,3 billion in the fourth quarter of 2005 to an inflow of R1,8 billion in the first quarter of 2006. The transactions underpinning the first-quarter decline in foreign direct investment assets included the repayment of short-term loans and trade finance.

South African institutional investors continued to diversify *portfolio investments* by acquiring foreign assets to the value of R3,0 billion in the first quarter of 2006. This outflow of capital followed the purchase of foreign portfolio assets to the value of R3,4 billion in the fourth quarter of 2005.

Other outward investment turned around from a net inflow in the fourth quarter of 2005 to an outflow of R33,8 billion in the first quarter of 2006. The accumulation of other investment assets mainly comprised an increase in the private banking sector's foreign-currency deposits with and loans advanced to non-resident banks.

International reserves and liquidity

South Africa's overall balance-of-payments position recorded a surplus in the first quarter of 2006, the tenth consecutive surplus to be registered since the third quarter of 2003. The improvement in the country's net international reserves of R11,6 billion in the first quarter of 2006, exceeded the surplus of R6,6 billion in the final quarter of 2005 by a significant margin.

Expressed in US dollar, the gross gold and other foreign reserves of the Bank increased from US$20,7 billion at the end of December 2005 to US$23,0 billion at the end of March 2006 and further to US$24,1 billion at the end of May. The short-term credit facilities utilised by the Bank remained broadly unchanged at around US$3,5 billion throughout this period.

Consistent with the steady accumulation of international reserves, the Bank's international liquidity position increased from US$17,2 billion at the end of December 2005 to US$19,5 billion at the end of March 2006 and further to US$20,4 billion at the end of May.

Foreign debt

South Africa's outstanding foreign-currency denominated debt remained broadly unchanged from the third to the fourth quarter of 2005 at US$28,4 billion. The redemption in the final quarter of 2005 of a euro-denominated bond to the value of R1,6 billion by a South African parastatal largely countered increases in foreign loans and in non-resident investors' foreign-currency deposits with South African banks. Over the same period, however, South Africa's rand-denominated debt increased by US$0,2 billion. The country's total outstanding foreign debt accordingly increased marginally by US$0,3 billion in the fourth quarter of 2005.

As a result of the appreciation of the rand, the country's total outstanding foreign debt, measured in rand terms, declined marginally from a level of R293 billion in the third quarter of 2005 to R292 billion in the fourth quarter. Foreign debt as a ratio of gross domestic product amounted to 19,3 per cent at the end of 2005 compared with 23,0 per cent and 20,2 per cent at the end of 2003 and 2004, respectively.

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

	2004	2005			
	Year	1st qr	2nd qr	3rd qr	4rd qr
Foreign-currency denominated debt...	**27,9**	**28,8**	**28,3**	**28,3**	**28,4**
Bearer bonds	9,7	9,4	9,1	9,8	9,5
Public sector	4,9	4,6	4,5	4,6	4,6
Monetary sector	7,0	8,1	8,1	7,5	7,8
Non-monetary private sector	6,3	6,7	6,6	6,4	6,5
Rand-denominated debt	**15,4**	**17,0**	**16,8**	**17,6**	**17,8**
Bonds	5,5	5,4	6,3	5,7	6,0
Other	9,9	11,6	10,5	11,9	11,8
Total foreign debt	**43,3**	**45,8**	**45,1**	**45,9**	**46,2**

The table below, which depicts the ratio of foreign debt to gross domestic product, suggests that South Africa's outstanding debt commitments are modest compared to other developing economies.

Ratio of foreign debt to gross domestic product
Per cent

	2001	2002	2003	2004	2005
Africa	58,3	57,7	51,6	44,3	35,2
Sub-Saharan Africa	62,3	61,6	54,9	47,7	37,8
South Africa	**26,2**	**29,7**	**23,0**	**20,2**	**19,3**
Central and Eastern Europe	52,8	53,1	53,9	53,4	49,8
Commonwealth of Independent States	47,0	43,2	42,0	36,4	33,3
Developing Asia	27,2	25,1	23,2	21,6	20,9
Middle East	47,5	48,3	44,8	41,5	36,1
Western Hemisphere	40,9	47,0	47,5	41,9	33,3

Source: IMF *World Economic Outlook*, April 2006

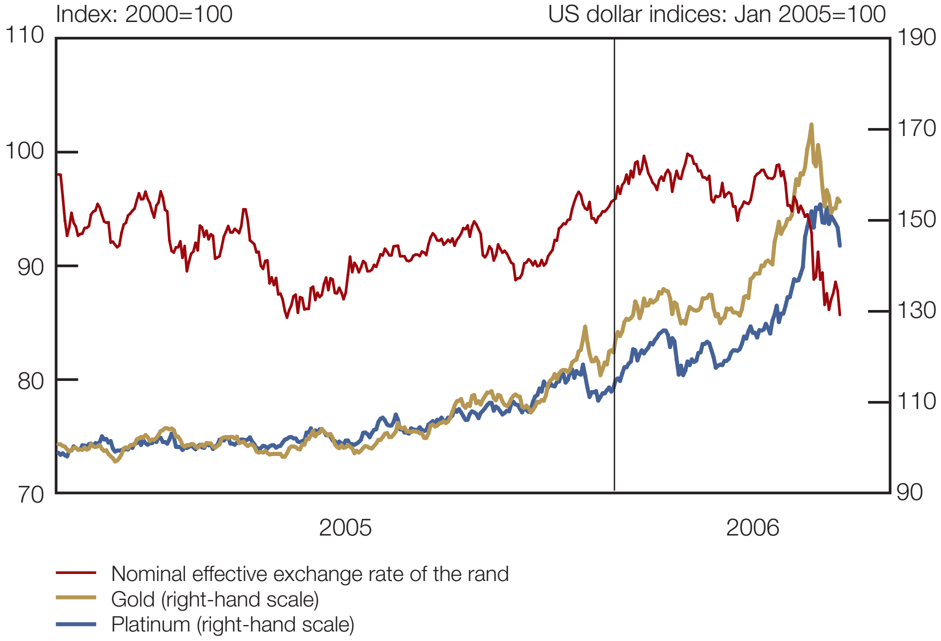
Exchange rates

The nominal effective exchange rate of the rand ended 2005 close to its highest levels recorded during the year. From this high base it fluctuated broadly sideways in the first four months of 2006, supported by continued strength in commodity prices and sizeable net inflows of portfolio and direct investment capital into the country. On balance, the rand depreciated by less than ½ a per cent from the end of December 2005 to the first week of May 2006.

A reassessment of risks and returns in emerging markets by international investors and a sharp fall in global commodity prices resulted in downward pressure on emerging-market currencies and stock markets from the second week of May 2006.

The nominal effective average rate of the rand accordingly weakened, on balance, by 9,4 per cent in the last three weeks of May 2006. Overall, the rand depreciated by 10,5 per cent from the end of December 2005 to the end of May 2006.

Nominal effective exchange rate of the rand, and the gold and platinum price



Following a period of strength in 2005, the US dollar showed renewed weakness against a wide selection of currencies in the early months of 2006, as indicated in the table. The rand and a number of other emerging-market currencies struggled to maintain their value against the ailing US dollar, for the reasons as outlined.

Exchange rate movements against the US dollar

Percentage change

	30 Dec 2005 to 31 May 2006
Swedish krona	10,2
British pound	8,8
Euro	8,5
Swiss franc	8,4
Thailand baht	7,9
Russian ruble	6,7
Indonesian rupiah	6,4
South Korean won	6,2
Canadian dollar	6,1
Polish zloty	5,9
Singapore dollar	5,5
Japanese yen	4,8
Malaysian ringgit	4,1
Australian dollar	3,8
Taiwan dollar	2,5
Brazil real	0,6
Indian rupee	-2,9
Rand	**-5,2**
Turkish lira	-14,2

Selected currencies. A positive value indicates that the currency involved appreciated against the US dollar

The real effective exchange rate of the rand strengthened by approximately 4½ per cent over the twelve months to March 2006, signalling a deterioration in South Africa's external competitiveness before the recent depreciation of the rand.

The average daily turnover in the domestic market for foreign exchange, which declined to US$12,0 billion in the fourth quarter of 2005, increased to US$13,0 billion in the first quarter of 2006 and to US$13,6 billion in April. Consistent with the strong non-resident interest in South Africa's securities, the value of foreign exchange transactions against the rand increased by 10 per cent from US$8,9 billion per day in the fourth quarter of 2005 to US$9,9 billion per day in the first quarter of 2006. Participation by resident parties also increased from an average of US$3,2 billion per day in the fourth quarter of 2005 to US$3,6 billion per day in the first quarter of 2006. The value of transactions in third currencies traded on the South African market for foreign exchange remained broadly unchanged over the period.

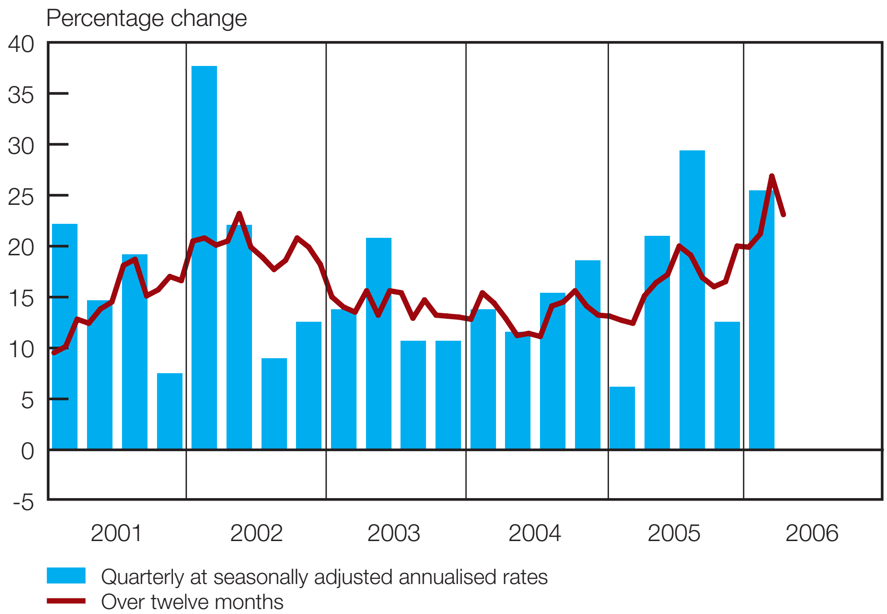
Monetary developments, interest rates and financial markets

Money supply[4]

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

In the early part of 2006 money supply recorded exceptionally strong growth. The annualised quarter-to-quarter growth in the broadly defined money supply (M3) accelerated from 12,5 per cent in the fourth quarter of 2005 to 25,6 per cent in the first quarter of 2006, reflecting the brisk pace of increase in domestic production, income and expenditure, the buoyant turnover in the financial markets, as well as the wealth effects emanating from rising prices of financial assets and real estate.

Growth in M3



On a twelve-month basis, growth in M3 accelerated from an already high level of 19,9 per cent in December 2005 to 21,1 per cent in February 2006, temporarily boosted as non-bank domestic parties banked their receipts from coupon interest payments on government bonds and the redemption of the final tranche of the R150 bond. Twelve-month growth in M3 accelerated further to 26,8 per cent in March 2006 supported by brisk expenditure and exceptionally strong increases in equity prices. From the end of February to the end of March M3 increased by an all-time high amount of R53 billion. Growth over twelve months in M3 receded to 23,0 per cent in April 2006, partly on account of a high base a year earlier.

The quarterly growth in the narrower monetary aggregates broadly resembled that of M3, accelerating significantly from the low levels recorded during the final quarter of 2005, as reflected in the table on the opposite page.

The corporate sector accounted for 92 per cent of the overall increase in M3 during the first quarter of 2006 and households accounted for the remainder. Not surprisingly, given the buoyancy of the financial markets, the bulk of the increase in corporate M3 holdings took the form of deposits by non-bank financial institutions, indicative of significant precautionary and speculative motives. Such deposit holdings were also bolstered by the strong flow of cash from the capital redemption and coupon interest payments on government bonds referred to earlier. The increase in the corporate sector's deposits was spread across the maturity spectrum but most prominent in the medium to long-term categories.

Monetary aggregates

Per cent at seasonally adjusted annualised rates

	Quarter-to-quarter growth	
	4th qr 2005	1st qr 2006
M1A	2,3	22,4
M1	8,4	12,8
M2	9,4	17,6
M3	12,5	25,6

The quarter-to-quarter seasonally adjusted and annualised growth in M3 exceeded growth in nominal gross domestic product by 19,8 percentage points in the first quarter of 2006. Consequently, the income velocity of circulation of M3 declined further from 1,50 in the fourth quarter of 2005 to a record low of 1,44 in the first quarter of 2006.

The M3 money supply increased by R105,7 billion from the end of the final quarter of 2005 to the end of the first quarter of 2006. The accounting counterparts of the change in M3 are reflected in the table below.

Counterparts of change in M3

R billions

	4th qr 2005	1st qr 2006
Net foreign assets	-7,3	37,6
Net claims on the government sector	-15,1	0,8
Claims on the private sector	54,1	77,2
Net other assets and liabilities	16,3	-9,9
Total change in M3	**48,0**	**105,7**

A substantial part of the increase in M3 for the first quarter of 2006 could statistically be explained by the increase in the banks' claims on the private sector, mainly reflecting strong growth in loans and advances. The net foreign assets of the monetary sector also rose markedly during this period.

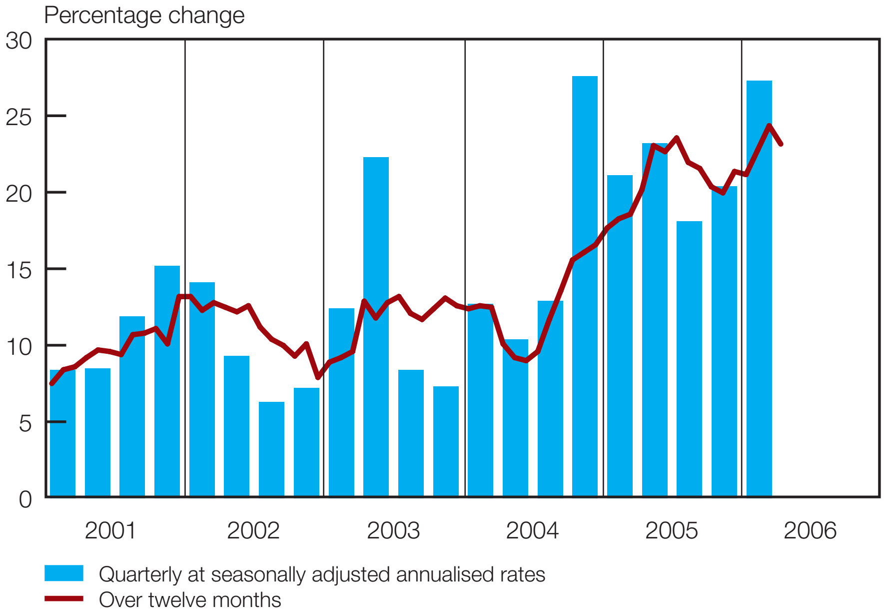
Credit extension

Despite a securitisation transaction, growth in banks' total loans and advances[5] extended to the private sector remained strong during the first quarter of 2006, supported by brisk demand for asset-backed credit and the increased use of bank-intermediated funding by the corporate sector. Credit extension to the private sector continued to benefit from the increase in real disposable income, lower and stable interest rate levels and wealth effects associated with the strength of asset prices. While debt-to-income levels stood at record highs, debt service costs remained well contained, nurturing the willingness of potential borrowers to incur further debt.

5 *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 quarterly growth in banks' total loans and advances accelerated from 20,4 per cent in the fourth quarter of 2005 to 27,3 per cent in the first quarter of 2006. Measured over twelve months, growth in total loans and advances accelerated from 21,3 per cent in December 2005 to 24,3 per cent in March 2006, edging lower to 23,0 per cent in April.

Total loans and advances to the private sector



Banks' total loans and advances extended to the private sector rose by R76,0 billion during the first quarter of 2006. The contribution to the increase by type of credit is reflected in the accompanying table.

Quarterly changes in banks' total loans and advances by type
R billions

	4th qr 2005	1st qr 2006
Mortgage advances	32,6	33,0
Instalment sale credit and leasing finance	9,0	7,9
Other loans and advances	13,0	35,1
Overdrafts	-5,5	11,3
Credit card advances	3,1	2,2
General advances	15,4	21,6
Total loans and advances	54,6	76,0

Against the backdrop of strong business and consumer confidence, brisk increases were recorded in all credit categories during the early part of 2006. Asset-backed credit accounted for 54 per cent of the overall increase in banks' total loans and advances in the first quarter of 2006, while other loans and advances accounted for 46 per cent.

Mortgage advances continued to benefit from the favourable lending and borrowing conditions as sustained increases in real-estate prices reinforced the strong demand for residential mortgages by the household sector. Favourable adjustments to the capital gains tax threshold applying in the case of a primary residence and fixed property transfer duties, announced in the February 2006 Budget, contributed to this strong demand. Growth over twelve months in the banks' mortgage book accelerated from rates of near 28 per cent in the fourth quarter of 2005 to 30,1 per cent in April 2006.

During the first quarter of 2006, instalment sale credit as measured on the banks' balance sheet was reduced by a R2,0 billion securitisation transaction involving the instalment sale credit book of one of the reporting banks. The sustained competitive trading environment, relatively stable prices of motor vehicles and other durable goods and more affordable financing costs nevertheless supported the brisk demand for *instalment sale credit and leasing finance.* Growth over twelve months in this credit aggregate has remained around 20 per cent since November 2005.

On balance, growth over twelve months in *other loans and advances* accelerated from 13,5 per cent in December 2005 to 15,6 per cent in April 2006. The strong growth in this credit category reflected the increased use of bank-intermediated funding by the corporate sector with its immediate need to finance working capital as well as its longer-term need to fund fixed investment projects.

The household sector's use of bank loans and advances rose by R40,1 billion in the first quarter of 2006 while that of the corporate sector increased by R35,9 billion over the same period.

Interest rates and yields

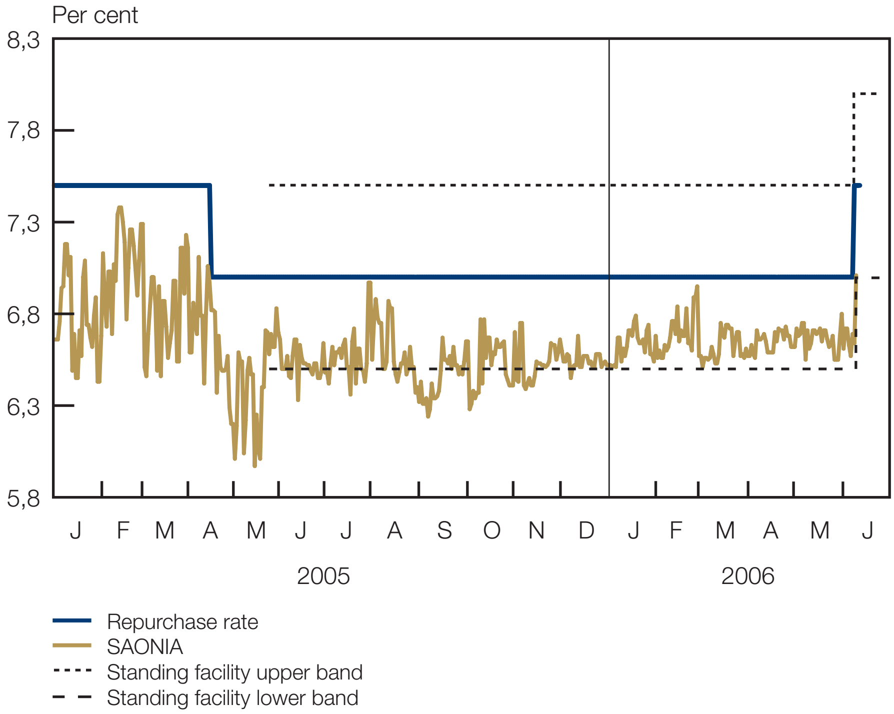
In a statement concluding the April 2006 Monetary Policy Committee (MPC) meeting, several factors which pointed to a benign inflation outlook were outlined. A number of risks were also highlighted, while the MPC decided to leave the repurchase rate unchanged at 7 per cent. At its June 2006 meeting the MPC increased the repurchase rate by 50 basis points to 7,5 per cent as the inflation outlook deteriorated and the upside risks to inflation worsened. The June 2006 MPC statement discussing the developments underlying the decision at the time is reproduced in full elsewhere in this *Bulletin.*

Given the change in the monetary policy stance, the private-sector banks increased their *prime overdraft rate and predominant rate on mortgage loans* by 50 basis points to 11 per cent.

During the first five months of 2006, the South African Overnight Interbank Average (SAONIA) rate continued to reflect considerable participation of international banks in the overnight interbank market. Throughout this period the SAONIA rate varied within the lower and upper bands set by the standing facilities, fluctuating within a range of 6,51 per cent to 6,95 per cent as shown in the graph on the following page. The rate increased to 7,01 per cent on 9 June 2006 due to an increase in the repurchase rate.

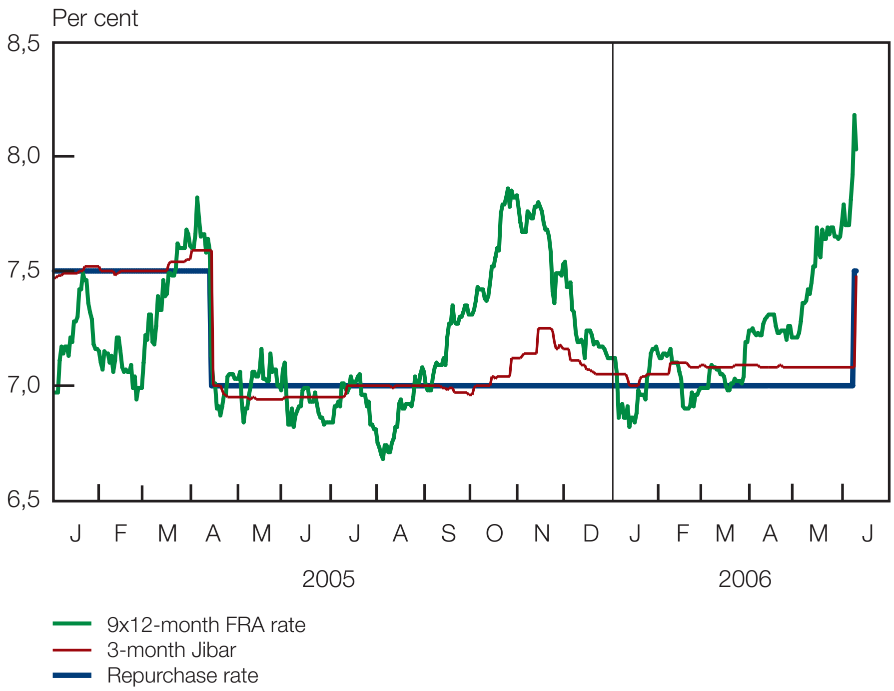
Movements in other money-market interest rates were generally subdued in the first five months of 2006, anchored by the unchanged repurchase rate on the one hand but also displaying some sensitivity to events having a potentially significant bearing on future inflation and the monetary policy stance, on the other hand. Subsequently, these rates moved higher as the repurchase rate was increased at the beginning of June 2006. For instance, the three-month Johannesburg Interbank Agreed Rate (Jibar) fluctuated within a narrow range around an average level of 7,02 per cent in the five months to the end of May 2006. The Jibar increased to 7,48 per cent on 9 June 2006.

Overnight interbank and repurchase rates



Contrary to other money-market interest rates, the tender rate on 91-day Treasury bills recorded a noteworthy decline of 27 basis points to 6,51 per cent during the first quarter of 2006. The movement was largely in response to the high demand for liquid assets in the weekly tender auctions, following the redemption of the R152 government bond at the end of February 2006. However, the rate on 91-day Treasury bills rebounded and increased to a level of 6,74 per cent on 28 April 2006 as the perceived scarcity of liquid

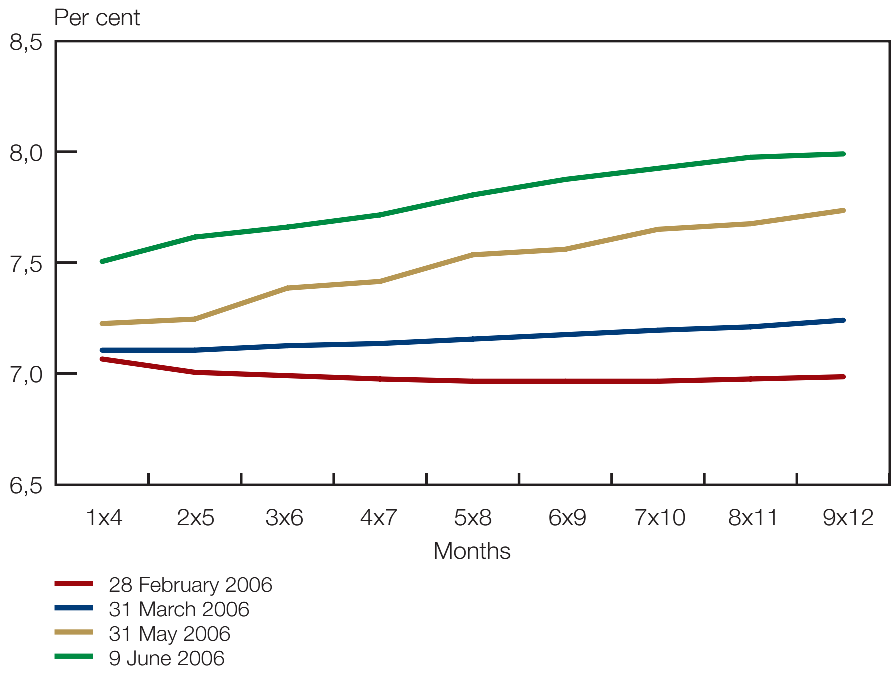
Money-market rates



assets abated. The rate amounted to 7,26 per cent on 9 June 2006. Similar trends were observed for the 181-day and 273-day Treasury bill tender rates over the same period.

Movements in rates on forward rate agreements (FRAs) provide valuable insight in the ebb and flow of sentiment and expectations in the money market. These are shaped by a variety of factors, such as uncertainties regarding international oil prices, the performance of the exchange value of the rand, developments in commodity prices, and pronouncements by senior officials. The 9x12-month FRA rate fluctuated between 6,82 per cent and 7,71 per cent during the first five months of 2006, as depicted in the graph on the previous page. The same trend was broadly mirrored in the shorter-term FRA rates. As shown in the accompanying graph on the FRA yield curve, money-market participants' expectations shifted from neutral (foreseeing an essentially unchanged repurchase rate) in February 2006 to a view in late May 2006 that an increase in money-market interest rates is quite likely. Following an increase in the repurchase rate in June, FRA rates continued to indicate expectations of further increases in money-market rates.

Forward-rate agreements yield curve

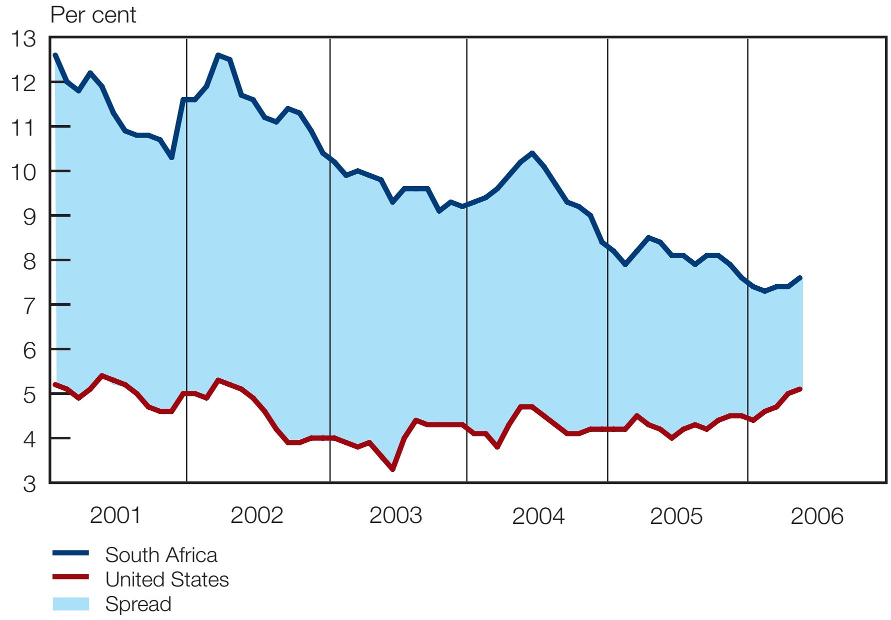


Having risen slightly towards the end of 2005, the *predominant rate on twelve-month fixed deposits* with the private-sector banks declined by 20 basis points to 6,2 per cent in February 2006, remaining unchanged in the subsequent months, before increasing to 6,3 per cent in May.

Priced off the yield curve, the *rates of interest on government retail bonds* were reduced by 25 basis points across the board from 1 March 2006. This brought the rate on the 2-year bond to 7,25 per cent, on the 3-year bond to 7,50 per cent and on the 5-year bond to 7,75 per cent.

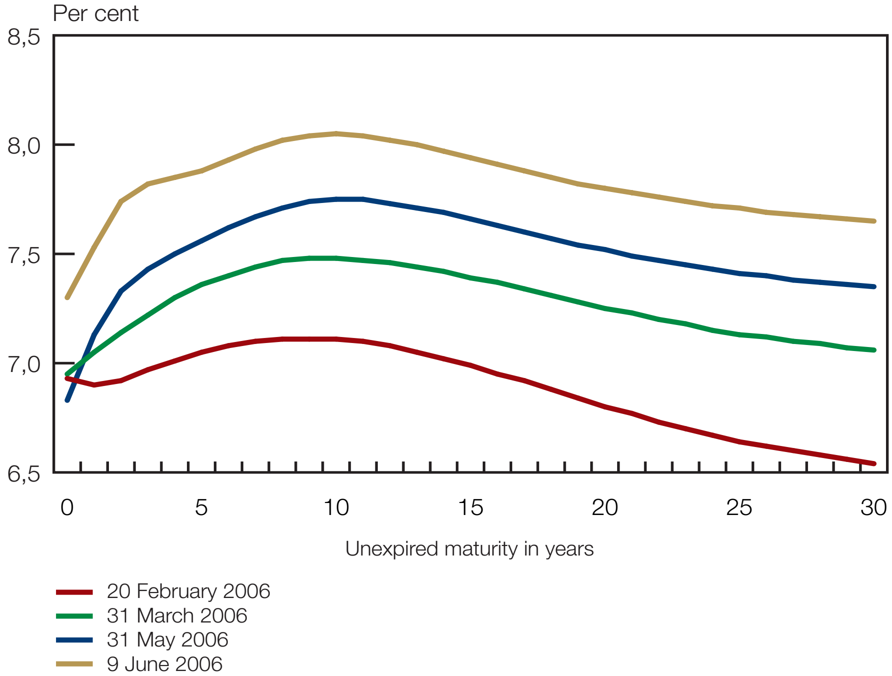
The *daily average yield* on the R157 long-term government bond (maturing in 2015) edged higher from a 36-year low of 7,13 per cent on 20 February 2006 and fluctuated around an upward trend in the subsequent months to 7,53 per cent on 3 May. This increase in bond yields could be attributed to movements in the exchange value of the rand which, together with the significantly higher international price of crude oil, exacerbated the risks to the domestic inflation outlook. Against these movements, the daily closing yield on US 10-year bonds rose somewhat, as shown in the accompanying graph. Accordingly, the spread between the South African R157 bond yield and the US 10-year bond yield narrowed from 273 basis points at the end of February 2006 to 265 basis points at the end of May. Subsequently, the daily average yield on the R157 bond increased to 8,03 per cent on 9 June 2006.

Yields on 10-year government bonds



Bond yields at the extreme short end of the yield curve remained anchored to the repurchase rate while, in line with the upward trend in yields of bonds with longer outstanding maturities, the level of the *yield curve* moved higher from its low level in

Yield curves



February 2006 and steepened significantly to 9 June. The *yield gap*, that is the difference between bond yields at the extreme long and short ends of the yield curve, became positive on 28 March 2006 and widened from 4 basis points to 100 basis points on 8 June 2006, before narrowing to 35 basis points on 9 June.

The monthly average *real yield* on the R189 inflation-linked government bond maturing in 2013 displayed little movement in late 2005 and in the first two months of 2006 and remained around 2,6 per cent. Subsequently, the real yield receded to 2,4 per cent at the end of March 2006, before edging back to 2,5 per cent in May. The *break-even inflation rate* within the four-to-seven-year maturity range fluctuated around an upward trajectory in the latter half of 2005 but fell back in February 2006 as nominal yields on conventional bonds reached 36-year lows. From a low of 4,3 per cent on 21 February 2006, the break-even inflation rate resumed a steady upward trajectory and increased to 5,1 per cent on 9 June. The slight deterioration in bond market participants' inflation expectations can, among other things, be attributed to the high international price of crude oil and depreciation of the rand.

Inflation expectations: Do survey results and interest rates on bonds give the same reading?

The R198 government bond is linked to the consumer price index (CPI) and matures in 2008. The difference between the yield on the conventional R194 government bond, which also matures[1] in 2008, and the real yield on the inflation-linked R198 bond is often used as a proxy for expected inflation. This difference is also referred to as the breakeven inflation rate. In April 2006 the two-year *breakeven inflation rate*, calculated in this way, amounted to 4,7 per cent per annum.

Inflation expectations can also be measured through inflation surveys. In April 2006 the Bureau for Economic Research conducted a survey in which respondents were asked to indicate the average CPI inflation rates which they expected for 2006, 2007 and 2008. Their average responses were 3,9 per cent, 4,5 per cent and 4,5 per cent for the respective years.

Taking into account that the R198 bond matures on 31 March 2008, the expected rate of inflation from the survey over the remaining maturity of the bond was estimated by giving weights of 0,75 to the surveyed average for 2006 (where at the time of the survey three-quarters of the year still lay ahead); 1,00 to the average for 2007; and 0,25 to the average for 2008. This gives an average surveyed expectation of 4,3 per cent per annum – quite close to the breakeven inflation rate.

However, it should be remembered that the breakeven inflation rate established in the bond market is not purely a reflection of expected inflation.

The nominal yield on a conventional bond can be decomposed into a number of elements:

nominal yield	=	*real yield*
	+	*expected inflation rate*
	+	*inflation variability risk premium (unexpected inflation risk)*
	+	*premium (or discount) for other risks*[2]

or $y_n = y_r + i_e + i_u + r_o$

It follows that $y_n - y_r = i_e + i_u + r_o$

The breakeven inflation rate therefore includes, apart from expected inflation, a premium for unexpected inflation risk embedded in the nominal bond yield, as well as a premium or discount for other risks. Since the default risk on both types of government bonds is the same while the liquidity of the nominal bond is higher than that of the index-linked bond, it is likely that r_o is negative.

The small difference between inflation expectations read from the expectations survey and break-even inflation suggests that i_u and r_o are fairly small or that they largely offset each other.

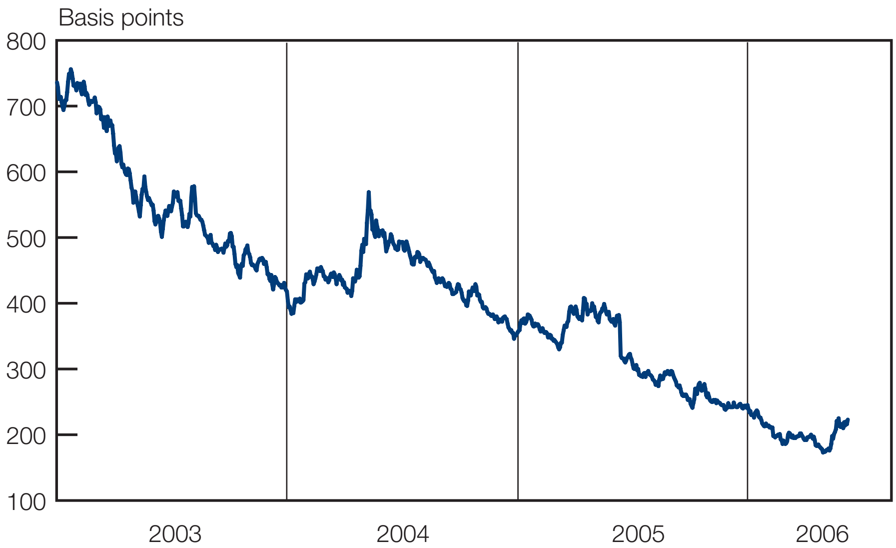
Z Nhleko

1 The R194 bond actually matures in three equal tranches, in 2007, 2008 and 2009.

2 The premium for other risks, r_o, provides for risks such as:
- *liquidity risk, the probability that investors will not be able to recover the principal of the bond over a relatively short period without incurring significant costs;*
- *marketability risk, the probability that the bid/offer spread will widen when selling the bond; and*
- *default or credit risk, the probability of not receiving the principal at maturity.*

Alongside a narrowing of emerging-market bond spreads in general, the *sovereign risk premium* on South Africa's foreign-currency denominated bonds trading in international markets reached a record low level of 68 basis points in February 2006. Subsequently, the yield differential between the eight-year US dollar-denominated bonds issued by the South African and United States governments widened to 88 basis points in April and further to 93 basis points in May. There were indications that the sovereign risk premia incorporated in the external-currency denominated debt of emerging markets started to rise from May 2006.

Emerging-market spread



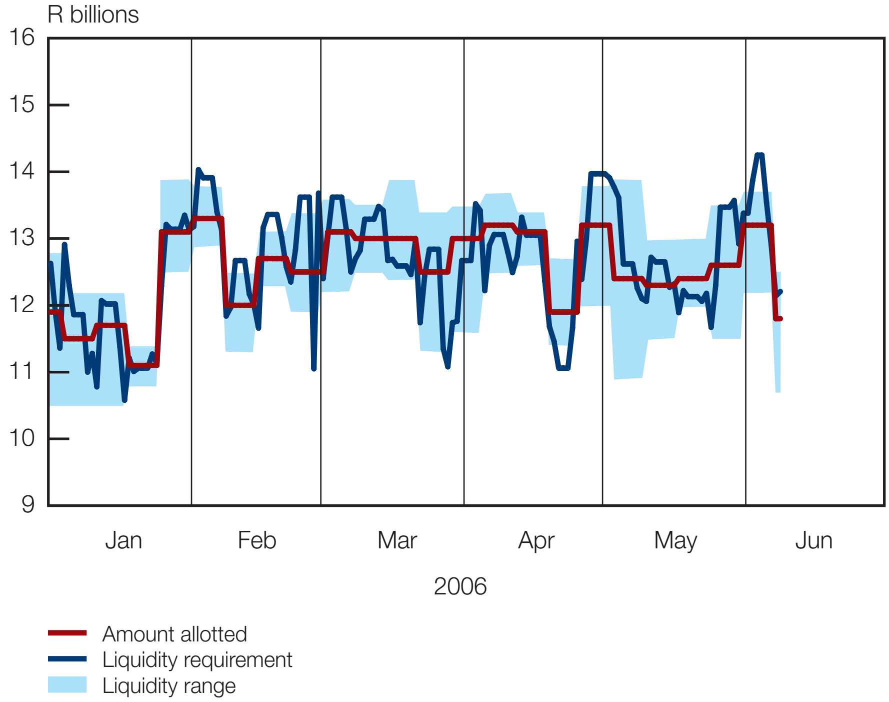
Difference between yield on US dollar-denominated emerging-market government bonds and yield on US government bonds, as measured by the JP Morgan EMBI+ index

The *currency risk premium* on South African government bonds, measured as the yield differential between South African rand-denominated government bonds in the nine-to-eleven year maturity range issued in the domestic market and South African dollar-denominated government bonds issued in the US market, contracted from 184 basis points in February 2006 to 116 basis points in April 2006, before increasing to 142 basis points in May 2006.

Money market

During the first five months of 2006 the amount of liquidity provided at the weekly main refinancing tender varied between R11,1 billion and R13,1 billion. The highest and lowest limits of the liquidity range – the weekly range within which the Bank expects the daily liquidity requirement to vary, as announced prior to the weekly main repurchase tender – during the first five months of the year came to R13,9 billion and R10,5 billion. On occasion the daily liquidity requirement of the private-sector banks moved beyond the liquidity range, usually due to extraordinary short-term note flows. These episodes were generally short-lived, as depicted in the graph on the opposite page. In order to bridge the differences between the liquidity provided and the liquidity required, banks mainly relied on their cash reserve accounts with the Bank and only occasionally utilised the standing facilities.

Liquidity requirement, ranges and amounts alloted



The statistical counterparts of the money-market liquidity flows from January to May 2006 are summarised in the accompanying table.

Money-market liquidity flows

R billions (easing +, tightening –)

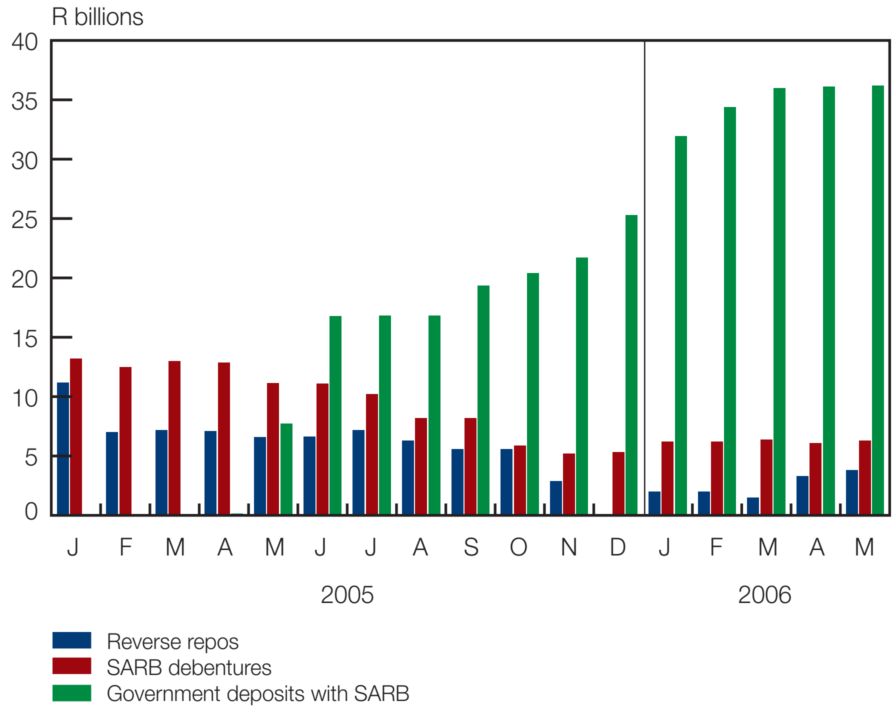
	Jan–Mar 2006	Apr–May 2006
Notes and coin in circulation	1,4	0,4
Required cash reserve deposits	-2,2	-0,8
Money-market effect of foreign exchange transactions of the SARB	12,9	3,6
Government deposits	-10,7	-0,2
Use of liquidity management instruments*	0,5	-2,2
Government redemption and interest payments to SARB	-3,1	0,0
Redemption of foreign loans by National Treasury	-1,3	-0,2
Other items net	3,4	-0,9
Banks' liquidity requirement (decrease +; increase -)	**0,9**	**-0,3**

* SARB debentures and reverse repurchase transactions

The accumulation of foreign exchange through net purchases from the market by the Bank expanded the money market by R16,5 billion in the five months to May 2006. Against this, the major offsetting factor was the draining of liquidity through a further build-up of government deposits with the Bank. Such deposits rose by R10,8 billion during the five months concerned.

Fairly limited use was made of the other interest-bearing liquidity-draining instruments at the disposal of the Bank, i.e. long-term reverse repurchase agreements and SARB debentures in maintaining liquidity at levels deemed appropriate. The following graph illustrates the developments in money-market intervention instruments utilised.

Liquidity-draining operations – outstanding balances



Following the usual seasonal pattern, notes and coin in circulation declined from a peak of R57,4 billion in December 2005 to R51,3 billion at the end of January 2006, easing liquidity conditions. However, during February and March 2006 notes and coin on balance increased by R1,5 billion, thereby tightening liquidity conditions. Notes and coin rose by R1,5 billion in April but fell steeply by R1,9 billion in May as the impact of the earlier confluence of public holidays dissipated.

The size of the Reserve Bank's portfolio of government bonds declined notably at the end of February 2006, following the redemption of the final tranche of the R150 government bond. The Bank's holdings of such bonds receded from R12,7 billion at the end of January to R9,7 billion at the end of February 2006.

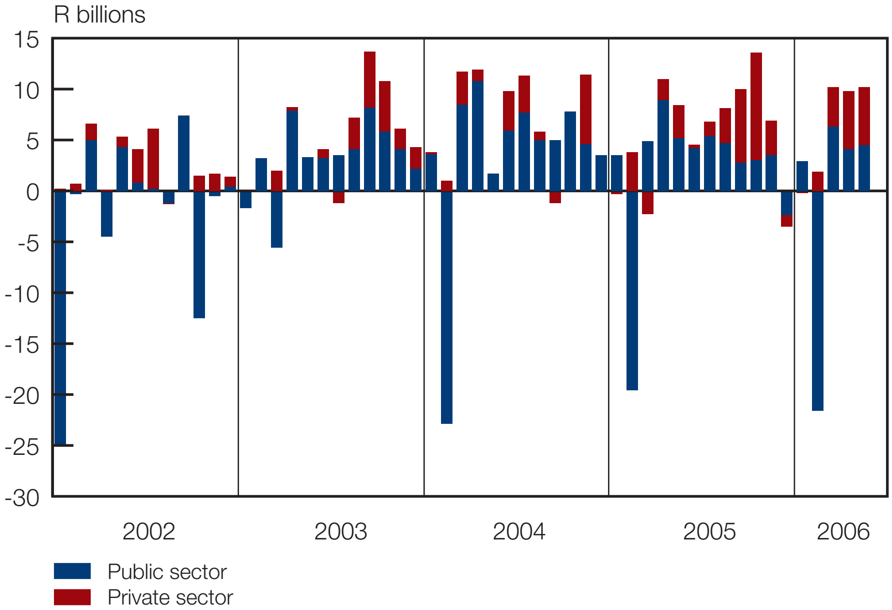
Bond market

The low supply of public-sector bonds is evident in the total net issues of fixed-interest securities by *public-sector borrowers* in the domestic primary bond market which amounted to only R22,5 billion in fiscal 2005/06, compared to an amount of R40,8 billion raised in fiscal 2004/05. In March 2006 the state-owned power utility, Eskom, issued a R2,5 billion bond maturing in 2033 in the primary market.

Net redemptions of government bonds amounted to R21,6 billion in February 2006 and included the repayment of the final daughter tranche of the R150 government bond, namely the R152, which matured on 28 February 2006. Net government bond redemptions in February 2005 amounted to R19,6 billion.

Private-sector funding activity in the domestic bond market remained lively in the first months of 2006. The *outstanding nominal value of private-sector loan stock* listed on the Bond Exchange of South Africa (BESA) rose by R31,5 billion in 2005. A further R17,0 billion was raised in the first five months of 2006, bringing the outstanding nominal value to R126,3 billion.

Funding in the primary bond market



The value of *commercial paper* listed on BESA increased by R10,7 billion in the twelve months to December 2005 and by a further R2,1 billion to May 2006.

Public-sector borrowers raised funds in the *international bond markets* in March 2006 when Eskom issued a €500 million seven-year bond and as National Treasury issued a €750 million ten-year bond with a coupon rate of 4,5 per cent at a spread of 81 basis points over equivalent German government bonds.

Non-resident issuer interest in rand-denominated bonds in the international bond markets waned in the early part of 2006 as net issues of R6,5 billion in 2005 were followed by net redemptions of R0,8 billion in the five months to May 2006.

The net issuances of *Uridashi bonds* – foreign-currency bonds sold by non-Japanese issuers to Japanese retail investors which generally offer yields that are more attractive than those offered on similar bonds issued in Japanese yen – continued to expand in the first five months of 2006, albeit at a slower pace than before. Launched in the Uridashi market for the first time in July 2004, rand-denominated bonds amounting to R0,8 billion were issued in the five months to May 2006 compared to R2,9 billion in the same period in 2005. Should current expectations of an increase in Japanese yields be realised, it could dampen the robustness of issues into this market.

In the first five months of 2006, trading activity on BESA was boosted by, among other things, volatility in bond prices and strong non-resident participation. Turnover in the *domestic secondary bond market* in the five months to May 2006 came to a daily average of R49 billion, 25 per cent more than in the corresponding period of 2005. The average daily turnover recorded a new high of R55 billion in April 2006.

The electronic settlement of *non-listed commercial paper* on BESA, introduced in April 2005, reached a total amount of R16,4 billion to May 2006 from a total of 964 trades.

Having sold South African bonds to a net amount of R23,4 billion from July 2005 to January 2006, *non-resident* investors reverted to being net purchasers to an amount of R11,1 billion in the subsequent months to May 2006. Non-resident participation in trading on BESA, measured as the sum of non-residents' purchases and sales of bonds as a percentage of total bond purchases and sales, increased from 16 per cent in 2005 to 19 per cent in the first five months of 2006.

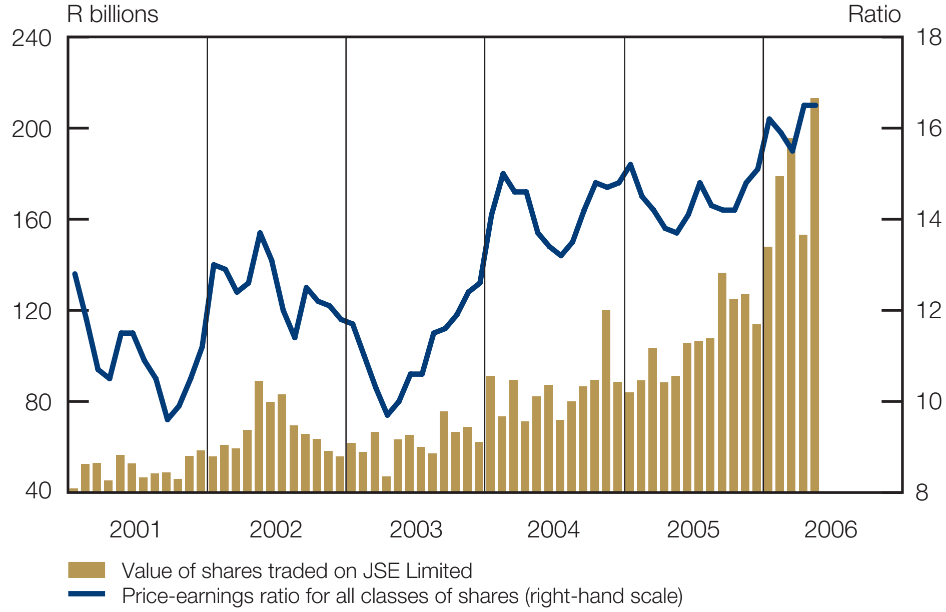
Share market

The total value of equity capital raised in the domestic and international *primary share markets* by companies listed on the JSE Limited (JSE) gathered further momentum in 2006. Equity financing amounted to R41,9 billion in the first five months of 2006, or 307 per cent higher than in the corresponding period of 2005. The acquisition of assets accounted for 72 per cent of the increase in 2006 as dual-listed companies acquired complementary businesses. Equity financing through an initial public offering occurred in April 2006, used for the first time since March 2003, when two new Satrix Exchange Traded Funds (ETFs) listed on the JSE. The Satrix Resi tracks the FTSE/JSE Africa Resources 20 index and the Satrix Swix Top 40 tracks the Shareholder Weighted Top 40 index.

The rising level of confidence in the equity market contributed to 19 new listings during 2005, while the number of de-listings declined from 39 in 2004 to 35 in 2005. Eleven new listings were recorded in the first five months of 2006. The number of securities listed on the JSE increased from 873 at the end of 2004 to 984 at the end of 2005 and 1 041 in May 2006.

Buoyed by record-high share prices, turnover in the *secondary share market* increased from R277 billion in the first quarter of 2005 to a record high of R522 billion in the first quarter of 2006. The value of turnover in the first five months of 2006 was 95 per cent higher than in the corresponding period of 2005. The average daily turnover reached a record high of R9,5 billion per day in May 2006 from R4,2 billion in May 2005.

Turnover in the secondary share market

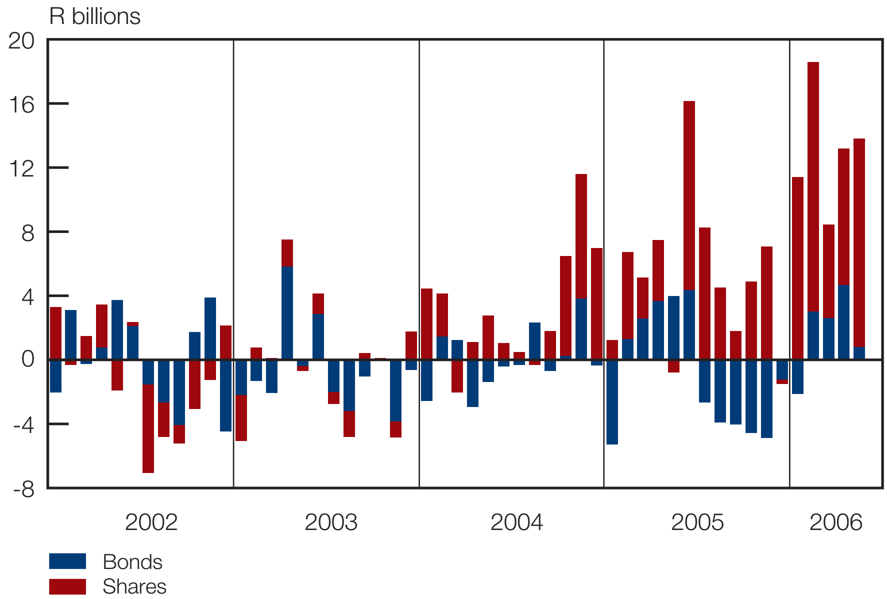


The total market capitalisation of the JSE rose to successive new record high levels in 2005 and 2006 as share prices soared. The market capitalisation increased by 48 per cent from R2 851 billion at the end of May 2005 to an all-time high of R4 233 billion in April 2006 before declining slightly to R4 104 billion in May. The World Federation of Exchanges ranked the market capitalisation of the JSE number 17 in the world league. Market liquidity, measured as the annualised turnover as a percentage of market capitalisation, continued to rise and averaged 53 per cent in the first five months of 2006 compared with 41 per cent in the same period in 2005.

Alt^x, the JSE bourse for small to medium-sized companies, recorded strong growth in its first two-and-a-half years of existence. The number of companies listed on Alt^x reached 19 at the end of May 2006. The combined market capitalisation of all the companies listed on Alt^x increased from R0,9 billion in April 2005 to R3,5 billion in May 2006. Turnover on Alt^x amounted to R318 million in the five months to May 2006, an increase of 595 per cent over the R46 million recorded in the corresponding period of 2005.

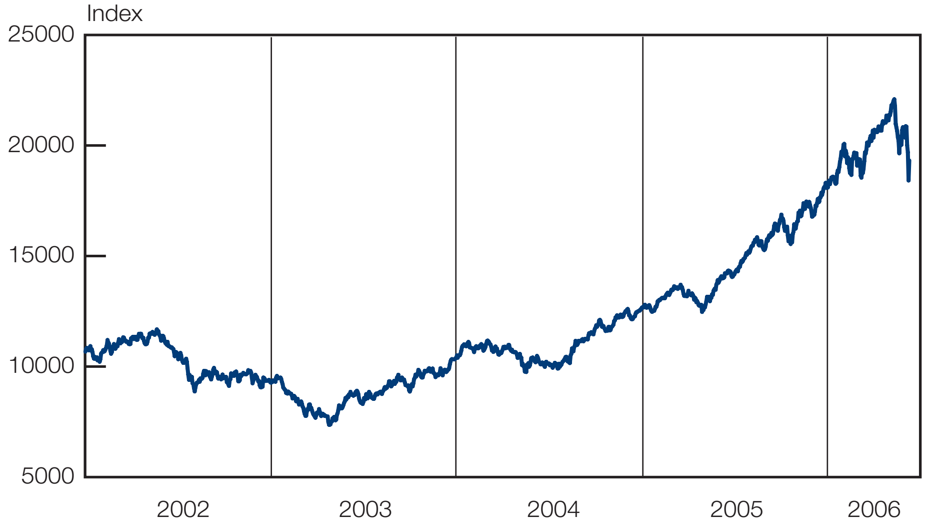
Non-residents' strong interest in shares listed on the JSE supported share prices. Net purchases of shares by non-residents amounted to R54,3 billion in the first five months of 2006 compared to R50,2 billion for 2005 as a whole. Thus far in 2006, non-residents' participation in the share market, measured as their total purchases and sales of shares as a percentage of the total value of shares traded on the JSE, amounted to an average of 22 per cent, compared with 20 per cent in 2005 as a whole.

Net purchases of shares and bonds by non-residents



The *daily closing level of the all-share price index* gained 77 per cent from its recent low on 28 April 2005 to its all-time high on 11 May 2006, of which 22 per cent was recorded in 2006. This could be attributed to buoyant commodity prices, relatively low interest rates, positive growth prospects, non-residents' continued positive sentiment towards emerging markets and stronger international share markets. With the change in sentiment, share prices fell by 13 per cent to 9 June. While the monthly average level of the all-share price index increased by 55 per cent from May 2005 to May 2006, gold and resource shares recorded the most sparkling performance as these indices respectively increased by 86 per cent and 84 per cent over the same period.

Daily share prices – all classes



Source: JSE Limited (FTSE/JSE Africa Index Series)

Mirroring increases in share prices, the *dividend yield* on all classes of shares declined from 2,5 per cent in December 2005 to 2,3 per cent in April 2006 – its lowest level since February 2000 – before edging higher to 2,4 per cent in May. The *earnings yield* on all classes of shares declined from 6,6 per cent in December 2005 to 6,1 per cent in May 2006. Following the decline in the earnings yield and the increase in share prices, the *price-earnings ratio* of all classes of shares increased from 15,1 in December 2005 to 16,5 in May 2006, reaching its highest level since May 1998. A significant reversal of these ratios and yields was recorded in early June 2006.

Market for derivatives

The buoyancy in the financial derivatives market on the JSE continued well into 2006, spurred on by the continued strength of the underlying share market. As shown in the accompanying table, the cumulative value of turnover of *financial futures and options on futures* more than doubled in the five months to May 2006 compared with the same period in 2005. Turnover in *warrants* recorded an even stronger pace of increase, whereas turnover in *commodity futures and options* grew comparatively slowly.

Derivatives turnover, January to May 2006

	R billions	Change over one year Per cent
Financial futures and options on futures	988	133
Warrants	4	256
Agricultural commodity futures and options	49	46

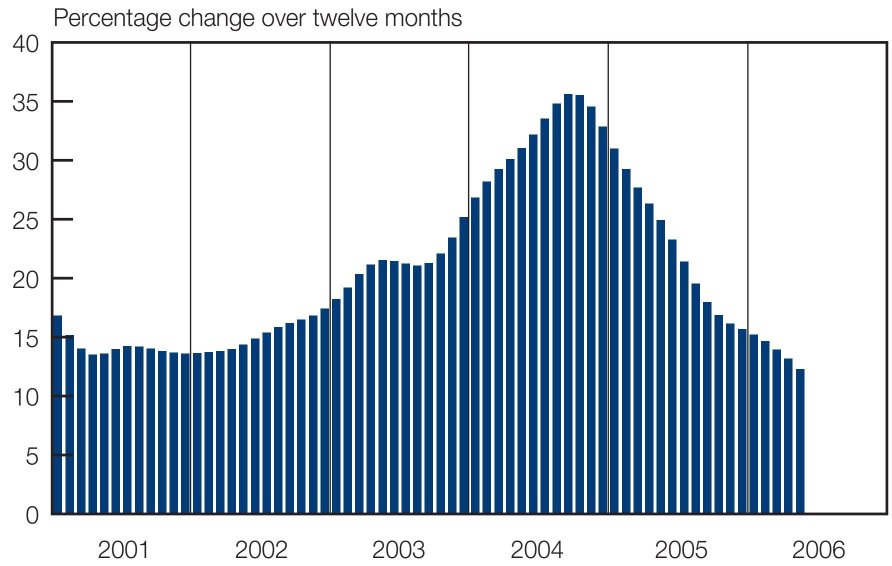
The number of contracts traded on *Yield-X*, the interest rate derivative platform of the JSE which started trading in February 2005, came to 6 706 contracts in the period February to May 2006. In value terms, turnover amounted to R10,3 billion, or 185 per cent higher compared with the same period in 2005.

Real-estate market

Despite the slowdown in the rate of increase in house prices, as measured by Absa, *real-estate market* conditions remained buoyant in the first five months of 2006. The recent increase in the thresholds for *transfer duty* exemption, announced by the Minister of Finance in the 2006/07 Budget, was positive for the fixed property market as it entailed tax savings of up to R35 600 on the acquisition of real estate.

The year-on-year rate of increase in house prices decelerated from 15,2 per cent in January 2006 to 12,3 per cent in May. Similarly, the month-on-month rate of increase declined from 1,1 per cent to 0,5 per cent during the same period. The substantial cumulative increase in house prices impacted negatively on affordability, partly explaining the slowdown in the rate of increase of house prices in recent months. At the same time the level of household indebtedness, measured as household debt as a percentage of household disposable income, has also increased to unprecedented levels.

House prices



Source: Absa

Non-bank financial intermediaries

Non-bank financial intermediaries have generally benefited from the rally in share, real-estate and bond prices. The total assets of these entities rose by no less than 24 per cent over the year to March 2006, as detailed in the accompanying table.

Total assets of selected non-bank financial intermediaries

	31 March 2005 R billions	31 March 2006 R billions	Percentage change
Public Investment Corporation	374	436	16
Collective investment schemes	319	449	41
Private pension and provident funds	346	410*	19
Insurers	1 025	1 267*	24
Total	**2 064**	**2 562**	**24**

* Estimate

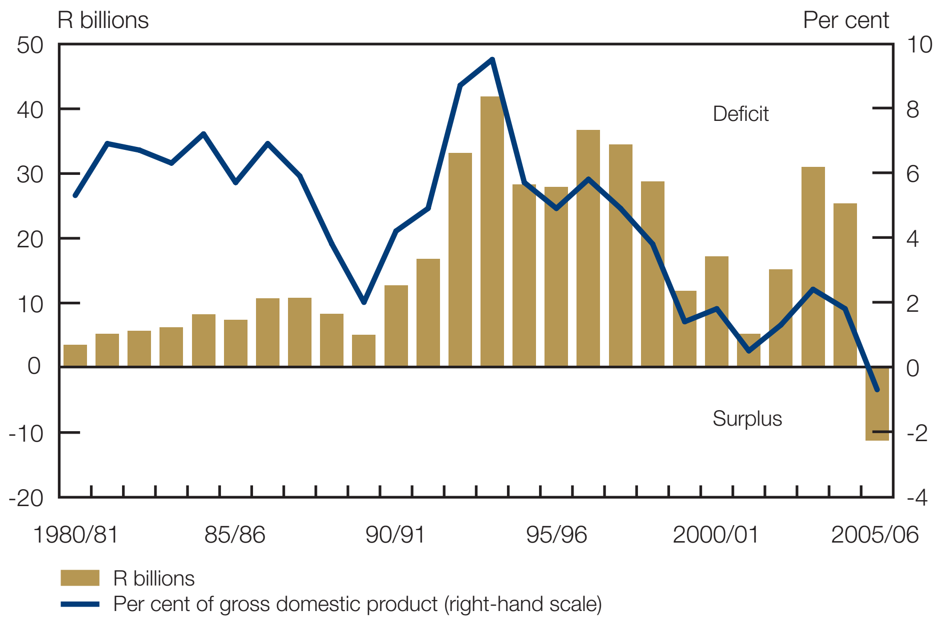
It should be kept in mind that beneficial ownership of the bulk of these entities' assets actually vests with the household sector.

Public finance

Non-financial public-sector borrowing requirement

The activities of the *non-financial public sector* (i.e. the consolidated central government, provincial and local governments and non-financial public-sector business enterprises) resulted in a cash surplus of R11,1 billion in fiscal 2005/06, indicating a significant turnaround from the previous fiscal year. As a ratio of gross domestic product, the non-financial public-sector cash *surplus* amounted to 0,7 per cent in fiscal 2005/06 compared to a revised *deficit* of 1,8 per cent in fiscal 2004/05.

Non-financial public-sector borrowing requirement



As shown in the accompanying table, the most important contributors to the turnaround in the public-sector finances in 2005/06 were national government and the non-financial public enterprises. The first public-sector surplus ever was recorded in the 2005/06 fiscal year, in stark contrast to a long history of public-sector deficits which rose as high as 9,5 per cent of gross domestic product in 1993/94.

Non-financial public-sector borrowing requirement
R billions

Institutional level	2004/05*	2005/06*
National government	32,6	6,9
Extra-budgetary institutions	-1,7	-1,1
Social security funds	-3,5	-6,5
Provincial governments	-2,3	-0,3
Local governments	10,6	8,0
Non-financial public enterprises	-10,2	-18,1
Total	25,5	-11,1

* Deficit +, surplus -

The cash surplus of the *non-financial public enterprises* increased from R10,2 billion in fiscal 2004/05 to R18,1 billion in fiscal 2005/06. Included in the calculation of the 2005/06 cash surplus was an amount of R2,0 billion transferred to Denel (Pty) Ltd for recapitalisation, restructuring and refocusing of its business. Net investment in non-financial assets by the major non-financial public enterprises amounted to R25,9 billion in fiscal 2005/06, growing by 22,3 per cent compared to the previous fiscal year. This bears testimony to the increased infrastructure investment announced in the *Budget Review 2005.*

The tax revenue of national government in 2005/06 outstripped the original budget projections by a substantial margin. An analysis of *national government* finance statistics indicated that cash receipts from operating activities increased by 19,3 per cent in fiscal 2005/06 when compared to the previous fiscal year. During the period under review, cash payments for operating activities increased by only 10,7 per cent. The net cash flow from operating activities of national government, together with the net investment in non-financial assets, resulted in a cash deficit to the amount of R6,9 billion in fiscal 2005/06, compared to a cash deficit of R32,6 billion recorded in the previous fiscal year.

Preliminary indications are that the financial surplus of the *extra-budgetary institutions* receded somewhat in fiscal 2005/06, recording a cash surplus of R1,1 billion compared to a surplus of R1,7 billion recorded in fiscal 2004/05. *Social security funds* recorded a cash surplus of R6,5 billion in fiscal 2005/06 compared to a cash surplus of R3,5 billion in the previous fiscal year. Included in the surplus of social security funds is an amount of R2,7 billion which was transferred from national government to the Road Accident Fund to proceed with scheduled payments to successful claimants and to settle an outstanding payment to the South African Revenue Service.

An analysis of the *Provincial Revenue Fund Statements* indicates that provincial governments recorded a cash *deficit* of R10,1 billion in the January-March quarter of 2006, bringing the cash surplus to R0,3 billion for fiscal 2005/06 as a whole. This is significantly lower than the cash surplus of R2,3 billion recorded in fiscal 2004/05. The main source of provincial governments' cash receipts – grants from national government – amounted to R208,1 billion in fiscal 2005/06 or 12,4 per cent more than in the preceding fiscal year. Included in the grants are the equitable share of nationally raised revenue allocated to provinces as well as the conditional grants that are earmarked for specific purposes such as capital expenditure on provincial hospitals. Cash payments for operating activities amounted to R201,6 billion in fiscal 2005/06, representing an increase of 12,8 per cent when compared to the previous fiscal year. Net investment in non-financial assets by provincial governments increased by 29,1 per cent, confirming the improvement in provincial spending on infrastructure.

Provincial governments' bank deposits with the private-sector banks decreased from R12,7 billion at the end of March 2005 to R8,4 billion at the end of March 2006 while their deposits with the Corporation for Public Deposits (CPD) increased from virtually nil to R2,2 billion over the same period. Over the same period, their overall indebtedness to banks also decreased from R3,9 billion to R0,5 billion.

The estimated cash deficit of *local governments* amounted to R8,0 billion in fiscal 2005/06, compared to a deficit of R10,6 billion in fiscal 2004/05. Improved revenue collections accounted for the decrease in the deficit. Preliminary data show that capital investment in infrastructure amounted to R18,0 billion in fiscal 2005/06 – R1,4 billion more than in the previous fiscal year.

Budget comparable analysis of national government finance

Unaudited data indicate that national government expenditure in fiscal 2005/06 amounted to R416,8 billion – R1,0 billion less than the original budgetary provision and R2,2 billion less than the revised estimate presented to Parliament by the Minister of Finance in February 2006. This resulted in a year-on-year rate of increase in national government expenditure of 13,1 per cent in fiscal 2005/06, which was closely aligned with the original budget target of 13,4 per cent. The year-on-year rate of increase in national government expenditure in fiscal 2005/06 was higher than the increase of 12,1 per cent recorded in the previous fiscal year. In real terms national government expenditure increased at a year-on-year rate of 8,9 per cent in fiscal 2005/06 compared with a rate of increase of 8,1 per cent recorded a year earlier.

National government expenditure as a ratio of gross domestic product amounted to 26,7 per cent in fiscal 2005/06, slightly higher than the ratio of 26,0 per cent recorded in the preceding fiscal year. This ratio was slightly lower than the originally budgeted ratio of 27,3 per cent and almost the same as the revised ratio indicated in the *Budget Review 2006.*

Interest paid on national government debt was well contained, increasing by 4,5 per cent to R50,9 billion in fiscal 2005/06. Interest payments were originally budgeted to increase at a rate of 8,9 per cent in fiscal 2005/06. This saving was the result of prudent debt management, lower borrowing requirements and lower interest rates. The appreciation in the exchange value of the rand also reduced the interest debt service cost of foreign-currency denominated debt of national government in rand terms. In fiscal 2005/06 interest payments as a ratio of gross domestic product amounted to 3,3 per cent, compared to 3,4 per cent in fiscal 2004/05.

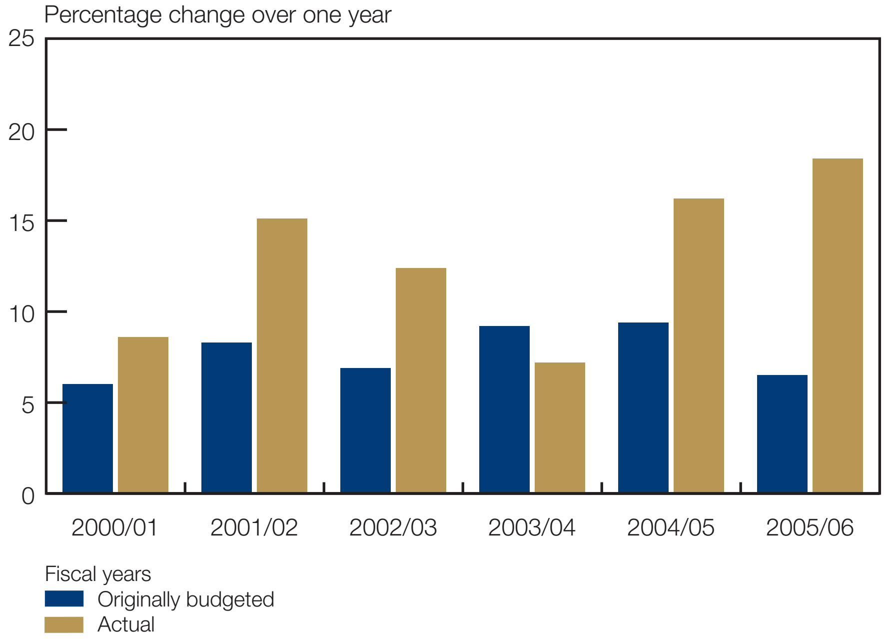
National government transferred R134,7 billion, equivalent to 32,3 per cent of its total expenditure, to provincial governments during 2005/06 as their equitable share of nationally raised revenue. This transfer was significantly lower than the transfer recorded in the previous fiscal year due to the shifting of social grant pay-outs previously included in the equitable transfer to provinces and now transferred as a conditional grant to provincial governments. Also included in the strong rate of increase of transfers and subsidies were the amounts paid to Denel (Pty) Ltd and the Road Accident Fund mentioned previously.

Payments for capital assets amounted to R7,2 billion in fiscal 2005/06, or 45,0 per cent more than in the previous fiscal year. This rate of increase was significantly higher than the originally budgeted increase of 24,2 per cent provided for the full fiscal year. The *Budget Review 2005* projected that payments for capital assets would amount to R6,2 billion for fiscal 2005/06 as a whole. The higher capital expenditure at national government level is indicative of the improved capability of this level of government to successfully roll out planned programmes.

After allowing for cash-flow adjustments (i.e. transactions recorded as a result of timing differences between the recording of transactions and bank clearances, and late departmental requests for funds), national government's cash-flow expenditure amounted to R413,3 billion in fiscal 2005/06, which was 13,6 per cent higher than in the previous fiscal year. The difference between the cash book and cash-flow expenditure is mainly the surrenders of R2,1 billion for 2004/05 paid back to the National Revenue Fund in fiscal 2005/06.

The *Statement of the National Revenue, Expenditure and Borrowing* indicates that unaudited national government revenue in fiscal 2005/06 increased by 18,4 per cent to R411,2 billion – R41,3 billion more than the original budget estimate. This rate of increase was significantly higher than the rate of increase of 6,5 per cent originally envisaged in the Budget for fiscal 2005/06 and slightly higher than the revised increase of 18,3 per cent stated in the *Budget Review 2006*. It was also higher than the 16,2 per cent rate of increase recorded in the previous fiscal year.

Revenue of national government



As shown in the table on the next page, almost all the components of revenue outperformed the original budget projections. The growth in taxes on income, profits and capital gains reflected the strong growth in corporate income tax collections – especially from the retail and financial sectors. This was the result of the increased profitability of companies as well as continued improvements in tax-collection efficiency. Although rising less rapidly than before, taxes on property continued to reflect the robust trading activity in the real-estate market. Domestic taxes on goods and services also grew strongly, indicating the continued buoyancy in consumer spending. The strong growth in taxes on international trade and transactions reflects the rising import volumes stemming from the buoyant domestic expenditure and the relative strength of the exchange value of the rand.

National government's cash-flow revenue (adjusted for timing differences between the recording of transactions and bank clearances) amounted to R412,2 billion in fiscal 2005/06, which was 18,5 per cent higher than in the previous fiscal year. As a ratio of gross domestic product, national government revenue amounted to 26,3 per cent in fiscal 2005/06, moderately up from the ratio of 24,5 per cent recorded in the previous fiscal year. National government revenue was originally budgeted to amount to 24,2 per cent of gross domestic product in the February 2005 budget estimates, but was revised to 26,4 per cent in the *Budget Review 2006*.

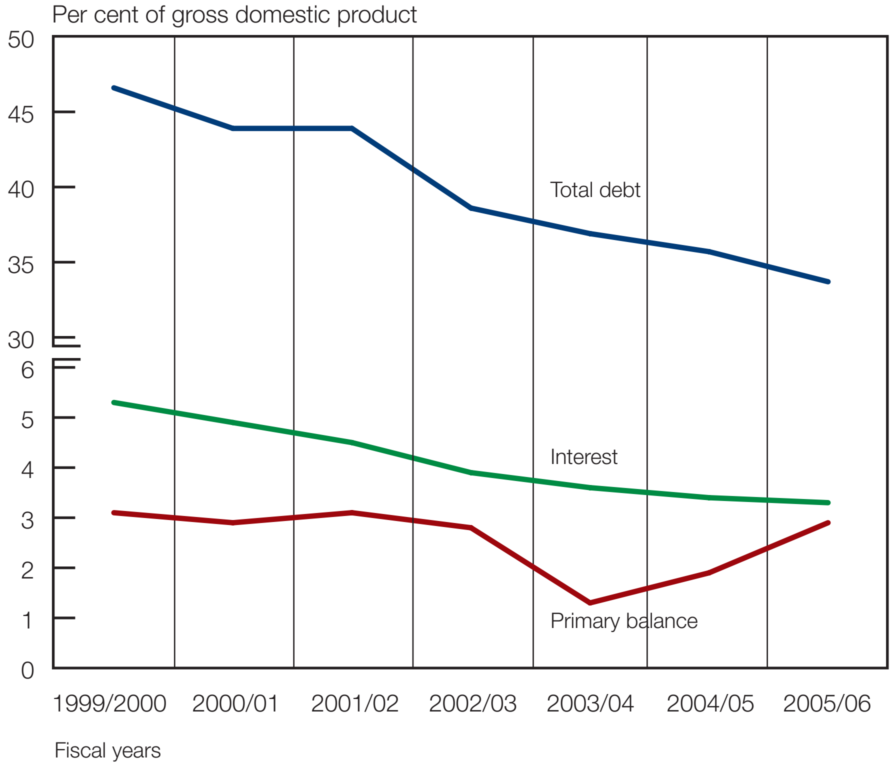
National government revenue in fiscal 2005/06

Revenue source	R billions	Percentage change	
	Actual	Originally budgeted	Actual*
Taxes on income, profits and capital gains	230,9	2,9	18,3
Payroll taxes	4,9	10,5	10,0
Taxes on property	11,1	9,0	23,6
Domestic taxes on goods and services	150,7	8,8	14,7
Taxes on international trade and transactions	18,2	-0,7	37,0
Other revenue	9,5	38,4	29,2
Less: SACU** payments	14,1	-9,6	6,1
Total revenue	411,2	6,5	18,4

* Fiscal 2004/05 to fiscal 2005/06
** Southern African Customs Union

The net result of the higher-than-budgeted revenue and lower-than-budgeted expenditure in fiscal 2005/06 was a *cash book deficit* of R5,6 billion compared with a deficit of R21,3 billion recorded a year earlier. This deficit was substantially lower than the originally budgeted deficit of R48,0 billion, and also lower than the revised estimate of R7,9 billion presented to Parliament in February 2006. The national government deficit before borrowing and debt repayment as a ratio of gross domestic product amounted to 0,4 per cent in fiscal 2005/06 compared to a ratio of 1,5 per cent recorded in the previous fiscal year. The *Budget Review 2005* had projected a deficit relative to gross domestic product ratio of 3,1 per cent.

National debt sustainability indicators



Consistent with government's borrowing and debt sustainability strategy, the debt of national government as a ratio of gross domestic product receded substantially. This contributed to lower interest cost and resulted in a lower borrowing requirement. As a result the *primary balance* (i.e. the deficit recalculated by excluding interest payments from total expenditure) reached a surplus of 2,9 per cent of gross domestic product in fiscal 2005/06, higher than the 1,9 per cent recorded in the previous fiscal year. The higher primary surplus also released further resources for infrastructure and other essential spending.

The *cash-flow deficit* in fiscal 2005/06 amounted to R1,0 billion compared with a cash-flow deficit of R15,9 billion in the previous fiscal year. National government's net borrowing requirement in fiscal 2005/06 was partly impacted by extraordinary payments and receipts. Extraordinary payments essentially consisted of R4,5 billion paid to the Bank to defray losses on the Gold and Foreign Exchange Contingency Reserve Account (GFECRA). Extraordinary receipts included special dividends from Telkom to the amount of R1,0 billion in July 2005. In August 2005, Eskom paid special dividends to the amount of R0,7 billion to national government. Foreign exchange amnesty proceeds to the amount of R2,7 billion were received in fiscal 2005/06. Due to these extraordinary transactions, the net borrowing requirement of national government came to only R1,5 billion in fiscal 2005/06, compared to a net borrowing requirement of R27,0 billion recorded a year earlier.

National government financing in fiscal 2005/06

R billions

Item or instrument	Originally budgeted	Revised estimates	Actual
Deficit	**48,0**	**7,9**	**1,0***
Plus: Extraordinary payments	7,0	8,9	4,5
Cost on revaluation of foreign loans at redemption	0,7	0,5	0,5
Less: Extraordinary receipts	1,0	4,5	4,5
Net borrowing requirement	**54,7**	**12,8**	**1,5**
Treasury bills	5,0	5,9	5,7
Domestic government bonds	26,3	25,3	22,1
Foreign bonds and loans	12,8	1,2	1,0
Change in available cash balances**	10,6	-19,6	-27,3
Total net financing	**54,7**	**12,8**	**1,5**

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

The greater part of the net borrowing requirement of national government in fiscal 2005/06 was financed through the issuance of bonds in the domestic capital market, as indicated in the table above. Domestic long-term funding in 2005/06 was obtained at an average interest rate of 7,9 per cent per annum. Domestic short-term instruments were sold at an average interest rate of 6,8 per cent per annum.

The average maturity of national government's domestic marketable bonds decreased slightly from 99 months at the end of March 2005 to 98 months at the end of March 2006.

Net issues of foreign bonds and use of foreign loans amounted to R1,0 billion during fiscal 2005/06. Net foreign funding included amounts drawn on the export credit facilities which had been arranged for the financing of the Strategic Defence Procurement

Programme to the amount of R2,9 billion. The average maturity of the foreign marketable bonds of national government decreased from 78 months at the end of March 2005 to 68 months at the end of March 2006.

The financial activities of national government, notably the increased revenue collections, resulted in an increase in government's bank balances from R30,9 billion at the end of March 2005 to R58,2 billion at the end of March 2006.

The net borrowing requirement of the national government, together with the discount on new government bonds issued, led to an increase in the total loan debt of national government from R502 billion at the end of March 2005 to R528 billion at the end of March 2006. The share of foreign loans in the total loan debt decreased slightly from 13,8 per cent at the end of March 2005 to 12,6 per cent at the end of March 2006. Since fiscal 2003/04 foreign debt revalued at prevailing exchange rates has been lower than the rand value of foreign debt as at the time of issue. This stood in contrast to the four fiscal years preceding 2003/04, and reflected the effect of the strengthening exchange rate of the rand on the outstanding value of foreign bonds and loans in rand terms.

Gold and Foreign Exchange Contingency Reserve Account

	R billions
Balance as at 31 March 2005	5,3*
Less payment by National Treasury, April 2005	4,5
Less forward cover and revaluation profits, 2005/06	2,5
Balance as at 31 March 2006	-1,7*

* Loss +, profit -

It was also announced that the unaudited realised *profits* on the Gold and Foreign Exchange Contingency Reserve Account amounted to R1,7 billion at the end of March 2006 compared with *losses* of R5,3 billion at the end of March 2005. These transactions brought the total debt of national government to R527 billion at the end of March 2006 compared to R507 billion at the end of March 2005. As a ratio of gross domestic product, total national government debt decreased from 35,7 per cent at the end of March 2005 to 33,7 per cent at the end of March 2006. Government-guaranteed debt also declined from R76,0 billion at the end of March 2005 to R70,5 billion at the end of December 2005.

Statement of the Monetary Policy Committee
13 April 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

Strong consumer demand and rising international oil prices continue to pose a threat to the inflation outlook. Household consumption spending has continued to grow at high levels, and there are few signs of moderation. Consumer confidence is at an all-time high, and this has been reflected in higher household debt, strong credit extension and a widening of the current-account deficit of the balance of payments.

These developments have occurred against a backdrop of resurgent international oil and other commodity prices, and a strongly growing world economy. Robust global growth, persistent international imbalances and the perceived need for caution going forward have resulted in further monetary policy tightening by many of the world's major central banks, and the general expectation is that the international interest rate cycle has not yet reached its peak. World inflation, however, remains under control at low levels.

Recent inflation developments

Inflation as measured by the consumer price index for metropolitan and other urban areas excluding the interest cost on mortgage bonds (CPIX) increased by 4,5 per cent in February of this year, having measured 4,0 per cent and 4,3 per cent in the previous two months, respectively. Petrol price increases are the main cause of this upward trend in inflation. If petrol prices were excluded, CPIX inflation would have averaged 3,4 per cent in December 2005 and 3,3 per cent in both of the subsequent two months. Transport running costs increased at year-on-year rates of 21,5 per cent and 24,6 per cent in January and February 2006, respectively.

Services price inflation has continued to decline steadily, to the extent that in January and February this year it was lower than goods price inflation. In February, services price inflation measured 4,0 per cent compared to goods price inflation of 4,8 per cent. Administered price inflation excluding petrol is now significantly lower than overall CPIX inflation, and measured 3,6 per cent and 3,5 per cent in January and February, respectively. Some categories of goods continued to contribute significantly to the favourable inflation outcome. Of note were the price declines in the categories of clothing and footwear, and furniture and equipment. By contrast, food price inflation edged up further at rates of 4,3 per cent and 4,5 per cent in January and February, respectively. This was mainly as a result of significant year-on-year increases in the prices of meat, fish and fruit. Prices of grain products however rose at very low rates, despite the sizeable increase in maize prices during the latter part of 2005.

Production price inflation remained unchanged at 5,5 per cent in February compared to January. Imported goods inflation measured 6,4 per cent and 6,9 per cent in these two months, while prices of domestically produced goods increased by 5,2 per cent and 5,1 per cent, respectively. The higher imported price inflation is primarily due to the impact of increased energy prices. If energy costs were excluded, production price inflation would have measured 3,5 per cent in both January and February.

The outlook for inflation

The inflation outlook remains benign, although there are significant risks. The most recent central forecast of the Bank is similar to that seen at the February 2006 meeting of the Monetary Policy Committee (MPC). According to the forecast, inflation is expected to peak at a level just below 5 per cent in the first quarter of 2007, then decline to a level of around 4,6 per cent, and to remain there until the end of the forecast period in 2008.

A number of factors have contributed to this positive inflation outlook. Wage settlements thus far have continued to be generally well contained and in line with the inflation target range. In the fourth quarter of 2005, nominal unit labour cost in the formal non-agricultural sector of the economy increased over four quarters at a rate of 2,5 per cent, compared to a revised figure of 4,5 per cent in the previous quarter. For the year as a whole, unit labour cost increased by 3,3 per cent, compared to 6,5 per cent in 2004. The latest Andrew Levy Employment Publications report shows that wage settlements averaged 6,3 per cent in the first quarter of 2006.

These wage developments reflect to some extent entrenched expectations that inflation will remain within the inflation target range. Further evidence of this is contained in the latest inflation survey conducted by the Bureau for Economic Research (BER) at the University of Stellenbosch. According to this survey, all respondents expected inflation to decline further in the first quarter of 2006. CPIX inflation expectations for 2006 declined from an average of 5,2 per cent in the fourth quarter of the past year to an average of 4,4 per cent in the first quarter of 2006. When expectations regarding 2006 were recorded in the first quarter of 2004, the expected average inflation rate was 6,4 per cent. According to the survey, CPIX inflation is expected to remain below 5 per cent over the forecast period to the end of 2008. Inflation expectations as indicated in the long-term break-even inflation rates, measured as the yield differential between conventional bonds and inflation-linked bonds, also continue to reflect expectations that inflation will remain within the inflation target range.

The exchange rate of the rand fluctuated somewhat in the period since the previous MPC meeting. In line with emerging-market and commodity currencies, the rand depreciated against the US dollar, reaching a level of almost R6,40 in the third week of March. Thereafter it appreciated, and in early April it briefly fell below the R6,00 to the US dollar level, before settling at its current level of around R6,12. This is similar to the level prevailing at the previous MPC meeting. On a trade-weighted basis, the rand has not changed much since the previous meeting, but has appreciated by around 2 per cent since the beginning of the year. The reasons for these movements include changes in the exchange rate of the US dollar against the euro; changes in investor sentiment towards emerging markets; and continued inflows to the domestic foreign exchange market. In addition, strong commodity price movements, in particular gold and platinum prices, have generally supported the exchange rate of the rand.

Fiscal policy is expected to remain supportive of monetary policy, with a moderate deficit of 1,5 per cent of GDP forecast for the 2006/07 fiscal year. Higher-than-expected tax revenue collection in the past financial year resulted in a revised estimated deficit of 0,5 per cent of GDP, compared to an initial estimate of 3,1 per cent.

South Africa's GDP growth, although still robust, has shown some signs of moderation in the past few months to levels more in line with potential output. Growth in 2005 measured 4,9 per cent, the highest growth rate since the early 1980s. However, by the fourth quarter of the past year, the quarterly annualised growth rate had declined to 3,3 per cent, mainly due to a contraction in the mining sector and a slowdown in the manufacturing sector. Indications are that both manufacturing and mining real growth remain under pressure in the first quarter of 2006. Overall business confidence nevertheless remains high: For example, the latest RMB/BER Business Confidence Index shows that the index is marginally below the record high measured in late 2004.

Despite the positive elements in the inflation outlook, there are a number of significant risks, all of which are seen to be on the upside. Consumer demand continues to grow at a brisk pace and shows few signs of abating. In 2005 household consumption expenditure grew by 6,9 per cent. Similar levels of growth have been recorded since the middle of 2003 when nominal interest rates began to decline. The latest FNB/BER consumer confidence index for the first quarter of 2006 surpassed its previous high in the previous quarter. Growth in motor vehicles sales has moderated slightly, but the levels are still high. Consumer demand is also underpinned by wealth effects arising from strong asset price growth. Prices on the JSE Securities Exchange continued to reach new highs, and according to the Absa house price index, house prices also continued to increase, although at a slower year-on-year rate of 13,7 per cent in March.

Growth in credit extension to the private sector reflects the increase in consumer expenditure. Growth over twelve months in total loans and advances accelerated from 21,3 per cent in December 2005 to 22,2 per cent in February 2006. Asset-backed credit growth accelerated from 25,5 per cent to 27 per cent over the same period. These developments have, among other things, contributed to a further decline in gross national savings to 13 per cent of GDP, and an increase in household indebtedness: The ratio of household debt to disposable income had risen to just below 66 per cent in the final quarter of 2005. The cost of servicing this debt, while still low, nevertheless increased from 6¾ per cent of disposable income in the third quarter of 2005 to 7 per cent in the fourth quarter.

Developments on the current account of the balance of payments are becoming an increasing source of concern to the MPC. The current-account deficit as a percentage of GDP averaged 4,2 per cent in 2005, compared to 3,4 per cent in 2004. In the fourth quarter, the deficit had risen to 4,5 per cent of GDP, despite a contraction in the trade deficit during this period. This was due to increased interest and dividend payments, an inevitable consequence of increased capital inflows. As noted in previous statements, current-account deficits are a reflection of higher domestic expenditure and are not in themselves inflationary. There is, however, a possible risk to the exchange rate if the deficits are perceived to be unsustainable, particularly if the deficits are reflecting higher consumption expenditure. To date, the deficits have been more than financed by capital inflows which, in turn, are being attracted in part by the improved growth prospects in the economy. These inflows enabled the Bank to further increase its holdings of foreign exchange reserves. By the end of March, official gross foreign exchange reserves had increased to US$23 billion, while the international liquidity position had increased to US$19,5 billion.

International factors also pose a risk to the inflation and interest rate outlook. In February the price of Brent crude fell to around US$55 per barrel. This respite was short-lived, and as a result of renewed geopolitical tensions and tight demand and supply conditions, international oil prices have risen significantly. Brent crude is currently trading at levels of almost US$70 per barrel. The price of 93 octane petrol increased by R0,22 per litre in April, which more than offset the R0,11 per litre decline in March. Currently the under-recovery on the petrol price is averaging around R0,30 per litre.

Monetary policy stance

The MPC perceives the risks to inflation to be on the upside. In particular, the MPC is mindful of the threats posed by strong credit extension, consumer demand, the widening current-account deficit and rising international oil prices. Nevertheless, given the benign inflation outlook at present, and having considered all the relevant factors, the committee has decided to keep the repo rate unchanged at 7 per cent per annum.

Statement of the Monetary Policy Committee

08 June 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

The risks to the previously benign inflation outlook in South Africa have increased over the past few weeks. Uncertainties relating to the future movements of US interest rates have had reverberations in international financial markets, with negative consequences for a number of emerging markets in particular. This has put some downward pressure on commodity prices and has contributed to a marked depreciation of the rand since the previous meeting of the Monetary Policy Committee (MPC). These events have occurred at a time of continued geopolitical tensions which have driven international oil prices to new record highs.

Domestically, consumer demand has remained robust, and there are few signs of moderation. Growth in credit extension has continued at a brisk pace and household debt has continued to rise, while the current-account deficit of the balance of payments has widened further. Domestic output growth in the first quarter of 2006 returned to a level more in line with potential output following the improved performance of the manufacturing sector in the first quarter of 2006.

Recent inflation developments

Inflation as measured by the consumer price index for metropolitan and other urban areas excluding the interest cost on mortgage bonds (CPIX) increased by a 3,7 per cent year-on-year rate in April, having measured 3,8 per cent and 4,5 per cent in the previous two months, respectively. Petrol price movements continue to account for much of the volatility in CPIX inflation. If petrol prices were excluded, CPIX inflation would have fluctuated within a band of 3,0 per cent and 3,7 per cent since July 2004, and would have averaged 3,3 per cent in April 2006. Motor vehicle running costs declined to year-on-year rates of increase of 13,7 per cent and 9,5 per cent in March and April. This can be compared to respective increases of 21,5 per cent and 24,6 per cent in the previous two months.

Goods price inflation declined to 4,1 per cent and 3,9 per cent in March and April, respectively, compared to 4,8 per cent in February. The lower trend of goods price inflation was influenced by the lower rates of increase in vehicle running costs, and the continued decline in the prices of clothing and footwear, furniture and equipment and motor vehicles. Food price inflation increased further, measuring 5,5 per cent and 6,2 per cent in March and April, respectively. The main categories contributing to the higher food price inflation were meat, fish and vegetables. Although grain price increases remained relatively low, there were signs of acceleration in this category, as the impact of the higher maize prices began to be felt at the consumer level. Grain product prices increased by 3,9 per cent in April, compared to a modest fall in prices in January. Services price inflation remained below that of goods inflation and measured 3,5 per cent in both March and April of this year. Administered prices increased at a year-on-year rate of 5,2 per cent in April, while administered prices excluding petrol increased by 3,3 per cent.

Production price inflation has remained relatively stable at around 5,5 per cent for the first four months of 2006. Imported goods prices increased by 6,7 per cent and 6,1 per cent in March and April, respectively, while prices of domestically produced goods increased by 5,0 per cent and 5,5 per cent in these months, respectively.

The outlook for inflation

Compared to the previous forecast of the Bank, the latest forecast shows a marked deterioration in the inflation outlook, particularly in the short term. Whereas the previous forecast projected CPIX inflation to peak at a level just below 5 per cent in the first quarter of 2007, it is now expected to breach the upper end of the target range and to peak at a level of 6,2 per cent at that time. CPIX inflation is then expected to fall below the upper end of the target by the next quarter, and by the third quarter it is projected to decline further to 5,2 per cent. Inflation is then expected to continue to moderate gradually to reach 4,8 per cent by the end of 2008. The main reason for the deteriorating outlook is a significant upward revision of the international oil price assumptions.

The most recent inflation expectations survey of the Bank conducted by the Bureau for Economic Research at the University of Stellenbosch shows that expectations for 2006 have remained more or less unchanged, although there has been a slight deterioration in expectations for 2007 and 2008. The revisions were mainly a result of an upward adjustment of expectations of trade unionists, and this brought them in line with the expectations of analysts and business executives. Inflation is now expected to average 4,9 per cent in both 2007 and 2008, compared to expectations in the first quarter of 2006 of 4,6 per cent and 4,8 per cent for these two years, respectively. These expectations are in line with the inflation expectations as indicated in the long-term break-even inflation rate, measured as the yield differential between conventional bonds and inflation-linked bonds, which measured 4,8 per cent at the end of May 2006.

Favourable factors to the inflation outlook include the continued fiscal discipline, the moderate trend in unit labour costs and the benign world inflation. The International Monetary Fund expects world inflation to decline from a projected 3,8 per cent in 2006 to 3,5 per cent next year, despite higher international oil prices.

South Africa's growth performance improved during the first quarter of 2006 to a rate of 4,2 per cent, compared to the revised 3,2-per-cent growth in the fourth quarter of last year. The improved performance occurred despite contractions in both agriculture and mining. The manufacturing sector made a good recovery and grew by 4,3 per cent following a mild contraction in the final quarter of 2005. The latest Investec/BER Purchasing Manager's Index indicates that this improved performance may continue in the second quarter, despite the downturn recorded in April. Overall growth in 2006 is expected to remain more or less in line with potential output.

Although inflation is expected to remain within the target range for most of the forecast period, the risks are still seen to be on the upside. Household real consumption expenditure increased in the first quarter of 2006, at a rate roughly the same as that in the previous quarter, and in line with the 6,9 per cent increase in 2005. Motor vehicle sales remain at a high level although on a month-on-month basis a 4,1-per-cent decrease was recorded in May of this year.

These developments continue to be reflected in the growth of credit extension. Twelve-month growth in bank loans and advances extended to the private sector measured

23,1 per cent in April compared to 24,3 per cent in March, while asset-backed credit extended to the private sector continued to grow strongly at a year-on-year rate of 27,2 per cent in April, reflecting strong growth in mortgage advances. This has resulted in a further increase in consumer indebtedness. In the first quarter of 2006, the ratio of household debt to GDP had risen to approximately 68 per cent, compared to 65½ per cent the previous quarter. The cost of servicing the debt has remained fairly stable at around 7 per cent.

High levels of expenditure contributed to the continued widening in the deficit on the current account of the balance of payments in the first quarter of 2006. This has arisen in part as a result of weak export volume growth and higher volumes and values of crude oil imports, particularly in January and February, when signficantly large trade deficits were recorded. The widening deficit has nevertheless been more than financed by capital inflows. These inflows enabled the Bank to further increase its holdings of foreign exchange reserves. By the end of May, official gross gold and other foreign exchange reserves had increased to US$24,1 billion, while the international liquidity position had increased to US$20,4 billion.

The international environment has posed increased risks to the inflation outlook. Since the previous meeting of the MPC the exchange rate of the rand has come under pressure as a result of developments in international financial and commodity markets. Previously the relative exchange rate stability had contributed to the positive inflation outlook. In the past weeks, the rand has depreciated against all the major currencies at a time when the US dollar has been weakening against other major currencies. The decline in commodity prices and the re-rating of emerging market risk contributed to the depreciation of the rand from around R6,12 to the US dollar at the time of the previous MPC meeting to current levels of around R6,80, and from R7,42 to the euro to current levels of around R8,65. On a trade-weighted basis, the rand has depreciated by approximately 13 per cent since the previous MPC meeting.

The continued uncertainties on the international financial and commodities markets add to inflation risk, but may be a part of the adjustment to changing risk perceptions of emerging markets. Of significance is the fact that South Africa's spreads have not widened by as much as those of a number of other emerging markets and there does not appear to be a strong exodus by non-residents from the domestic bond and capital markets. In fact over the past few weeks, non-residents have remained net buyers of South African bonds and equities. However, in line with a number of other markets internationally, share prices on the JSE Securities Exchange have come under pressure, and the all-share index has retreated from a recent all-time high of just over 22 000 in May to current levels just below 20 000.

According to the IMF, world growth is expected to average a robust 4,9 per cent this year compared to the previous forecast of 4,3 per cent, and 4,7 per cent next year. Uncertainties arise, however, in the interpretation of recent events in the international markets. It is unclear at this stage whether they are simply a reflection of a temporary correction in the markets, or a more sustained period of volatility which could undermine world growth in general and in emerging markets in particular.

Adding to the uncertainty is the continued risk posed by international oil prices. Since the previous meeting of the MPC, the price of Brent crude oil has averaged around US$70 per barrel and fluctuated between a new record high of just below US$75 per barrel in the third week of April and the current level around US$68. These developments have been a result of tight supply and demand conditions, as well as continued geopolitical tensions, which have kept the oil price at a high level. These higher oil prices have been felt domestically in the pump price of petrol. The R0,22 per litre increase in April was followed by increases of R0,39 and R0,36 per litre in May and June, respectively. Approximately R0,14 of the most recent increase is a result of exchange rate movements.

Monetary policy stance

On the basis of the detailed analysis of the economy which is summarised above, the MPC has decided that a moderate adjustment in the repo rate is warranted at present. Accordingly the repo rate is increased by 50 basis points to 7,5 per cent per annum with immediate effect. The MPC will continue to monitor economic developments and all the relevant risks which might have a bearing on the continued attainment of the inflation target.

Estimating household-sector wealth in South Africa

by J Aron, J Muellbauer and J Prinsloo[1]

1. Introduction

Substantial changes in equity values and the value of residential real estate over the past decade have generated new interest around the world in the potential influence of household-sector wealth on the final consumption expenditure of private households (Aoki et al., 2002; Boone et al., 2001 and Catte et al., 2004). This is equally true in South Africa. Final consumption expenditure by households relative to gross domestic product rose from an average of 56 per cent in the 1980s to an average of 62½ per cent between 1990 and 2005. By contrast, gross saving as a percentage of gross domestic product declined from an average of 24½ per cent during the 1980s to only 16 per cent on average between 1990 and 2005. Likewise, gross saving by the household sector relative to gross domestic product declined from 6½ per cent to 3½ per cent on average during these respective periods. Household balance sheet evidence is likely to help explain these phenomena; see Aron and Muellbauer (2000a) and Prinsloo (2000) for more detailed discussions.

Official balance sheet estimates for the household sector are not currently available in South Africa, as is the case with many emerging-market and most developing economies (see OECD, 2004, for the availability among OECD countries). Yet with South Africa's well-developed financial sector and deep capital markets, asset-market channels are likely to be important in the determination of aggregate consumer spending and saving, consumers' demand for credit and their broad money holdings. The incorporation of household balance sheet aggregates in macroeconometric models could improve the modelling of expenditure, inflation, debt and the like, thereby enhancing analysts' understanding of economic behaviour and policy-makers' attempts to find the most appropriate policy settings. Household balance sheets are also required for an assessment of the distribution of wealth and liquidity. This motivates the effort to construct time series of market value data for the main components of household-sector wealth.

This brief article aims to highlight recent research on estimates of household balance sheets for South Africa. A more comprehensive exposition of the research on households' balance sheets will be published in a forthcoming Working Paper of the South African Reserve Bank by the same three authors.

The net wealth estimates obtained from the household-sector balance sheet are derived with quarterly frequency utilising the measures constructed in Aron and Muellbauer (2006a). The main balance sheet categories distinguished are tangible assets and financial assets – the latter including both liquid assets and various categories of illiquid financial assets – and, on the other side of the balance sheet, household debt and net worth.

The historical data for liquid assets and long-term insurers from 1975 to the early 1990s were constructed using the methodology in Aron and Muellbauer (2006a), as were private pensions up to 1998. The methods rely, where relevant, on accumulating flow-of-funds data using appropriate benchmarks and, where necessary, converting book to market values using appropriate asset price indices. Thereafter these estimates are linked to data published in the *Quarterly Bulletin*. For ordinary shares, government and corporate stocks and official pension funds, these methods provide data up to 2003.

Debt estimates and comprehensive estimates of tangible assets for households and unincorporated businesses were mainly compiled using money and banking, and national accounts statistics obtained from the Bank.

1 Dr Aron is from the Centre for the Study of African Economies, Oxford University; Prof Muellbauer from Nuffield College, Oxford University; and Mr Prinsloo from the Research Department, South African Reserve Bank. *The authors are grateful to M Kock and D Meyer of the South African Reserve Bank for data discussions. This collaborative research was funded by the Department for International Development (UK), grant number R8311 and the South African Reserve Bank. The UK Department for International Development (DFID) supports policies, programmes and projects to promote international development. DFID provided funds for the study as part of this objective but the views and opinions expressed are those of the authors alone. A similar disclaimer applies in respect of the South African Reserve Bank's provision of resources towards this study. See also http://www.csae.ox.ac.uk/ and link to* "The South African Macroeconomic Research Programme".

The balance sheet measures exclude assets from some important areas. The first is household-sector ownership of foreign assets, the acquisition of which was made difficult or illegal by South Africa's capital controls, that have been progressively relaxed since 1995. The second is some of the financial assets of unincorporated businesses, and ownership of corporations not publicly quoted on the stock exchange. In common with other countries' published estimates of household wealth, the present study also excludes the value of social security-related benefits. Nevertheless, the assets and debts included in the estimates are measured with reasonable accuracy and capture the main components of wealth relevant for consumer spending and portfolio decisions by South African households.

An overview of the data sources and methodology is presented in Section 2. Section 3 deals with the trends in wealth and liabilities displayed by the estimated balance sheet data for the household sector in South Africa, and Section 4 concludes.

2. The estimation of household balance sheet aggregates

The first part of this section explains the data sources and methodology for estimating the value of fixed and financial assets of the household sector. The second part addresses the liability side, particularly the main components of household debt, namely mortgage advances and other credit extended to households.

2.1 Assets

2.1.1 Tangible assets

The fixed or tangible assets of households comprise the market value of residential buildings and the capital stock (derived from fixed capital formation, and the book value of inventories) of unincorporated business enterprises.

Residential buildings and land

The asset value of residential buildings owned by households, including unincorporated business enterprises in the agricultural sector, is derived from the existing capital stock at constant values using the Perpetual Inventory Method (PIM). The capital stock at constant prices for private dwellings[2] is inflated by an average house price index[3] obtained from one of the larger banks, Absa. These calculations provide a fairly reliable proxy of the market value of residential buildings owned by households.

The land value of residential property is calculated, using an average ratio of the land value for existing and new houses relative to the purchase prices of the buildings excluding the value of the land. An average ratio of 32,7 per cent was obtained from unpublished surveys conducted by Absa between 1966 and 2004.

Non-residential buildings and non-residential land

Unfortunately, the asset value of fixed investment of non-residential buildings and other fixed assets by unincorporated business enterprises can only be estimated indirectly. By the use of the information obtained from the Economic Activity Surveys (EAS) per industry, conducted annually by Statistics South Africa since 1998, it is possible to make a split between incorporated and unincorporated business enterprises. Fixed ratios (per

2 Note that since private dwellings include some residential rented property owned by corporations, pension funds and non-residents, this will overstate the ownership by the household sector.

3 The average house price index is based on the total purchase price of houses, comprising small, medium and large houses within a range of 80 – 400m^2. The index covers all nine provinces.

industry) as calculated by the National Accounts Division of the Bank from the most recent EAS surveys, are applied to capital stock data[4] obtained from the National Accounts Division, to allocate a certain portion of fixed assets (per industry) to the household sector.

4 *The capital stock data are based on the PIM of non-residential buildings and other fixed assets in the private sector.*

There are no appropriate official price indices to define market values, so the stock of non-residential buildings at constant values is inflated by a derived price index of the market value of non-residential buildings. This annual index from 1974 is calculated from rental values and capitalisation rates of industrial buildings, offices and shopping centres in the larger metropolitan areas.

The value of the land (in the case of non-residential property) is estimated from unpublished balance sheet ratios calculated from the 2002 EAS. The ratio of the book value of land relative to non-residential buildings for the various industries (excluding agriculture) – which is estimated at an arithmetic average of about 14 per cent – is applied to the derived market value of non-residential buildings of unincorporated business enterprises, to obtain an approximate value of the land.

Other fixed assets

Estimates of the replacement value (a proxy for market value) for vehicles, plant and machinery, construction works (structures) and cultivated assets recorded in the balance sheet of the household sector are derived from net capital stock measures (calculated using the PIM per industry, as compiled by the National Accounts Division of the Bank). The allocation of the asset value of these types of assets is derived using the ratios between incorporated and unincorporated enterprises by industry, as discussed above, from the EAS.

Likewise, these ratios are also used to obtain a split of the market value of inventories between incorporated and unincorporated enterprises. The value of inventories is available from quarterly surveys conducted by Statistics South Africa.

2.1.2 Financial assets

The financial assets incorporated in the calculation of wealth estimates for households in South Africa are deposits with banks and mutual banks, interest in pension funds and long-term insurers, participation mortgage bond schemes, unit trusts, equities, as well as government and public-enterprise stocks and corporate bonds. In addition, an assumption regarding the value of coin and banknotes in possession of the household sector (i.e. in circulation outside the monetary sector) is also included. Unfortunately, only limited information exists on individual ownership of foreign assets and only for recent years; these have been included in the balance sheet estimates.

Liquid asset stocks

Household liquid asset data include deposits of individuals, unincorporated enterprises and non-profit organisations with banks and mutual banks, the Postbank and the Land and Agricultural Bank. It also includes deposits with non-monetary financial institutions. These deposits cover the entire maturity spectrum; from cheque and transmission accounts to long-term fixed and notice deposits.

The Bank publishes a quarterly analysis of bank deposits by type of depositor in its *Quarterly Bulletin,* but only from the third quarter of 1991[5]. Prior to the third quarter of 1991, in the absence of other data, the methodology in Aron and Muellbauer (2006a) was employed to cumulate the relevant flow-of-funds categories[6] using a benchmark for the fourth quarter of 1969 and matching the third quarter of 1991 benchmark.

Other deposits

In the flow of funds, one further type of deposit is listed: 'Deposits with other institutions', such as households' deposits with municipalities. This is a very small category throughout the period. It was decided to group this category with directly held illiquid financial assets. The series is derived by cumulating the relevant flow-of-funds category (item 14) with respect to a benchmark for 1969, as in Aron and Muellbauer (2006a).

Interest in pension funds

Households' vested interest in pension funds comprises the accumulated funds of official as well as private self-administered pension and provident funds.

Data for both private and official pension funds are obtained from returns submitted to the Bank by the relevant institutions, and are published in the *Quarterly Bulletin*. However, in the case of private funds, data at market value became available only from March 1999, while data for official pension funds are still reported at book value. Book value data for both categories of pension funds were accordingly adjusted to market values employing the methodology in Aron and Muellbauer (2006a).

To derive the corresponding market values, the net holding gains by the end of the period on the market value of the stock at the beginning of the period have to be added, as well as any holding gains on net purchases made during the period. The revaluation adjustment can be explained as follows: Let A_{t-1} be the market value of an asset at the end of period $t-1$. Let π_{t-1} be the corresponding price index. Let NPA_t be net purchases of the asset during period t. Then

$$A_t = A_{t-1} (\pi_t / \pi_{t-1}) + (NPA_t)(\pi_t / \tilde{\pi}_t) \qquad (1)$$

where $(\pi_t / \tilde{\pi}_t)$ is the revaluation adjustment of net purchases made in period t, and $\tilde{\pi}_t$ is the average price level recorded during the period of purchases, since it is assumed that purchases are spread over the period. Given an asset benchmark at an initial date, data on the net purchases in the period and the corresponding price indices, the revaluation adjustment in Equation (1) can be used to derive market-value data.

For private self-administered pension and provident funds, there are quarterly data on the portfolio composition of assets from 1963, and annual data from 1958, both on a book-value basis. There are seven groups of assets subject to revaluation. The adjustment of the book value of the assets to market value was made by applying Equation (1), and using end-1961 benchmarks and constructed price indices for each of the seven groups. Details on price index construction are provided in Aron and Muellbauer (2004, Appendix 2).

For official pension funds, which provide pension care for public-sector employees, there are annual book-value portfolio composition data from 1974. Prior to 1974, there

5 The published data are augmented by some unpublished information; see Aron, Muellbauer and Prinsloo (2006) for details.

6 "Liquid assets" comprise the following flow-of-funds categories as published in the Quarterly Bulletin *of the Bank: (10) Cash and demand monetary deposits, (11) Short/medium-term monetary deposits, (12) Long-term monetary deposits, (13) Deposits with other financial institutions. An adjustment was made for missing data on unincorporated businesses (see Aron and Muellbauer, 2006a).*

are annual data for total assets at book value, from1948. These funds started investing in ordinary shares, other company securities and fixed property only in 1990, when quarterly data began. Prior to 1990, government, local authority and public-enterprise bonds accounted for more than 85 per cent of total assets purchased. To convert book to market values throughout the period, end-1961 benchmarks were employed with Equation (1) on quarterly interpolated data.

Interest in long-term insurers

Households' interest in long-term insurers is derived from the pension activities of long-term insurers. Around half the liabilities of long-term insurers represent personal-sector pension assets[7]. The pension business represents those activities of the long-term insurers conducted on behalf of the pension funds and the underwriting of annuities.

The data for unmatured policies of pension business by long-term insurers are directly surveyed from the relevant institutions by the Research Department of the Bank and published in the *Quarterly Bulletin.* However, as with the pension funds, the earlier data are reported at book rather than market value. The first reliable market-value data are reported from the fourth quarter of 1991. Consequently, data prior to this were adjusted to reflect market values using the methodology in Aron and Muellbauer (2006a).

Equities and other illiquid financial assets

Directly held illiquid financial securities are defined as the sum of households' holdings of all government and private bonds, deposits with participation mortgage bond schemes, equity and "other deposits" (i.e. longer-term deposits, see above).

Participation mortgage bond schemes are in some respects similar to unit trusts. A pool of funds of a large number of smaller lenders is constructed in order to finance large mortgage loans. The participation is similar to long-term deposits of five years or longer. Investors are largely households seeking high, yet secure returns on their capital. Deposits received from participants (individuals) are directly reported in the *Quarterly Bulletin* of the Bank.

In the absence of other data, the flow-of-funds data were used to construct measures of government and public enterprise stocks, using the methodology outlined in Aron and Muellbauer (2006). The government and public enterprise components of the flow of funds comprise short-term and long-term government stock, and the securities of local authorities and public enterprises.

The benchmarks for short-term and long-term government stocks come from data on the ownership of end-1969 stocks in *Public Finance Statistics* of the Bank; while quarterly figures on the personal-sector ownership of the securities of local authorities and public enterprises are available from 1970 in *Capital Market Statistics* of the Bank.

All these figures are on a book-value rather than on a current market-value basis, and require the revaluation adjustment using Equation (1). The methodology for estimating price indices for fixed-interest securities is described in Aron and Muellbauer (2004, Appendix 1)[8].

An accurate assessment of the direct investment in shares by households is one of the most difficult calculations to make, due to the lack of reliable information in South Africa.

7 The non-pension business of long-term insurers, which is a conditional liability, is excluded because in this paper it was assumed that it did not contribute to personal-sector assets.

8 Historical data on government bond price indices from the Johannesburg Stock Exchange (JSE) – and more recently from the JSE Securities Exchange – begin in 1980, while the Bank has published a bond price index only from 1999. Aron and Muellbauer (2004; 2006a) therefore use standard price-yield relationships to derive price indices for short and long-duration government bonds before 1980. Coupons and maturities are held fixed for quarter-to-quarter comparisons, and these indices are chained.

The available data on ownership by the personal sector are unsatisfactory, since surveys of share registers and of household finances carried out in the US and UK are not carried out in South Africa. Limited data on share transactions are, however, available.

Thus, the stock of shares directly held by households for the whole period was estimated using the flow-of-funds data regarding ordinary shares held by households, from the methodology in Aron and Muellbauer (2006). The flow-of-funds categories were cumulated using a benchmark of the value of ordinary shares held by households in 1969, estimated from relevant ratios in the UK and US. Conversion from book to market value of stocks was carried out using the JSE all-share index, adjusted for assumed trading or management costs – see Aron and Muellbauer (2006a).

For ordinary shares, estimates are sensitive to the chosen benchmark for 1969. The assumptions made in this paper imply that households owned 41 per cent of the market capitalisaton of the JSE at the end of 1969 and 18 per cent at the end of 1997 (see details in Aron and Muellbauer, 2006a).

2.2 Liabilities

On the liability side of the household-sector balance sheet, the two main components of debt are mortgage advances and other credit extended to households. The latter, sometimes referred to as "consumer credit" is, in turn, subdivided into open account credit, personal loans extended by banks, credit card facilities, instalment sale transactions and lease agreements, other personal loans and non-bank loans. Van der Walt and Prinsloo (1993) and Prinsloo (2002) published detailed charts of total household debt and its main components, and information on the institutional framework underpinning household debt and the data sources and methods used in its estimation.

The bulk of household debt is borrowings from the banking sector. Relevant data are obtained from monthly and quarterly returns to the Bank Supervision Department of the Bank, in compliance with section 90 of the Banks Act, 1990 (Act No. 94 of 1990).

3. Balance sheet estimates and trends in wealth

Real household spending has recorded brisk increases in recent years, and is partly explained by trends in the net wealth of the household sector (see Table 1). Although net wealth as a percentage of personal disposable income of households fell from an average level of 315 per cent in 1980 – 1998 to an average of 283 per cent for 1999 – 2003, preliminary estimates indicate that this ratio has increased again and in 2005 actually exceeded the high average levels reached during the 1980s and 1990s.

The recent strong growth in household wealth can mainly be attributed to substantial increases in asset prices, particularly in the private property and equity markets.

The fluctuations in the total net wealth (conventionally excluding consumer durables) of the household sector are shown in the graph on the facing page, relative to disposable income[9] of households. The relatively high wealth-to-income ratio in the early 1970s, associated with strong economic growth and high gold price, declined in the mid-1970s as the world economy faltered and as domestic political difficulties increased.

The ratio rose following a large gold price boom around 1980, when buoyant share prices were followed by rising house price and investment booms. When economic and political difficulties increased in the 1980s, and the debt crisis of 1985 and international trade and financial sanctions severely constrained access to capital and trade, growth

9 In modelling household expenditure or portfolio decisions in the current quarter, one would normally use asset data at the end of the previous quarter, and current quarter personal disposable non-property income rather than the moving average of personal disposable income (PDI), see Aron and Muellbauer (2000a,b). However, PDI is more comparable internationally, while its non-property variant is subject to approximations of varying complexity; see Blinder and Deaton (1985).

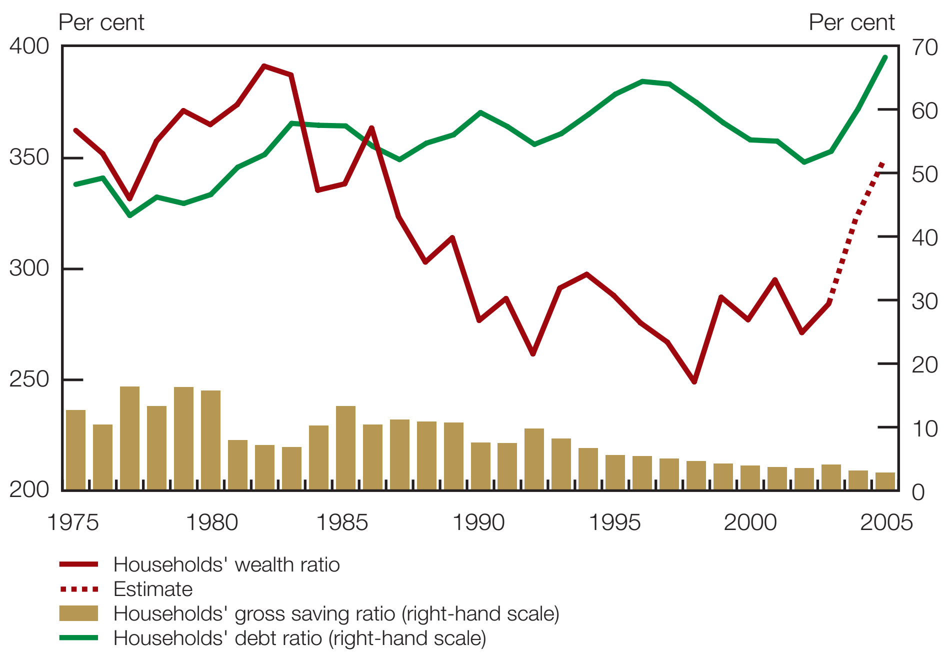
Table 1 Balance sheet of the household sector for selected years
R billions

Year ended 31 December	1975	1980	1985	1990	1995	2000	2005*
Total assets	**64,5**	**139,5**	**287,0**	**607,6**	**1 226,5**	**1 921,0**	**3 969,1**
Tangible assets	35,9	65,3	123,7	219,4	315,5	504,2	1 225,0
Residential buildings	18,5	34,8	73,0	136,8	211,4	363,2	1 005,3
Other tangible assets	17,3	30,5	50,6	82,6	104,2	141,0	219,8
Financial assets	28,6	74,2	163,4	388,3	911,0	1 416,8	2 744,1
Liquid assets	15,4	30,4	60,5	97,3	152,4	296,4	686,3
Interest in pension fund and long-term insurers	8,7	25,8	70,9	200,2	537,0	851,4	1 420,1
Other assets	4,5	18,0	32,0	90,7	221,5	269,0	321,9
Total liabilities and net worth	**64,5**	**139,5**	**287,0**	**607,6**	**1 226,5**	**1 921,0**	**3 969,1**
Mortgage advances	4,5	8,9	19,0	50,6	119,4	176,9	398,3
Other credit	3,6	7,8	24,7	57,4	98,5	147,4	262,4
Net worth	56,4	122,8	243,3	499,6	1 008,6	1 596,6	3 308,4
Net worth including durable consumer goods (memo item)	**61,9**	**132,7**	**264,3**	**543,6**	**1 094,8**	**1 742,7**	**3 579,6**

Individual items may not add to totals due to rounding
* Preliminary estimates

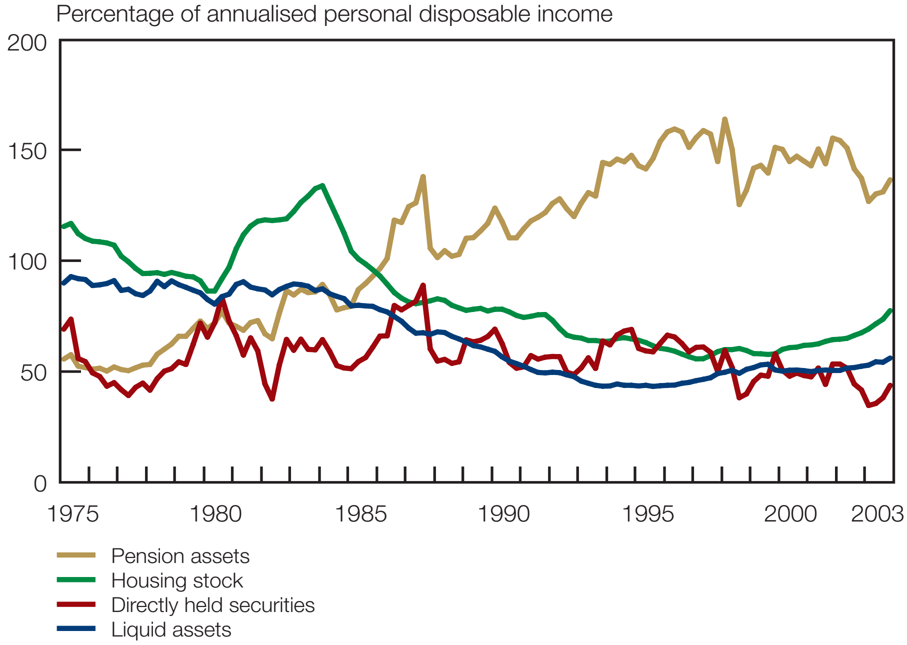
weakened and real house prices began a long-term decline. A gold price recovery in the late 1980s brought a temporary rise in the wealth-to-income ratio; but since 1988, the ratio has fluctuated in a relatively narrow range, despite the positive political changes in South Africa. However, current indicators suggest that a lower turning point in the wealth-to-income ratio was reached in 1998, as the increase in the market value of total assets outweighed the increase in household debt and disposable income during the period 1999 to 2005.

Households' saving, debt and net wealth as percentage of personal disposable income



However, the relative importance of the components of net wealth underlying these trends showed substantial changes over the past three decades. Most striking are the rise in the value of pension wealth, the downward trend in the value of directly-held securities relative to disposable income, the decline and recent recovery of housing wealth, the rise in household debt (see previous graph) and the concomitant decline of liquid assets from the early 1980s to the present. The other components as ratios to income are shown in the graph below.

Selected assets of the household sector

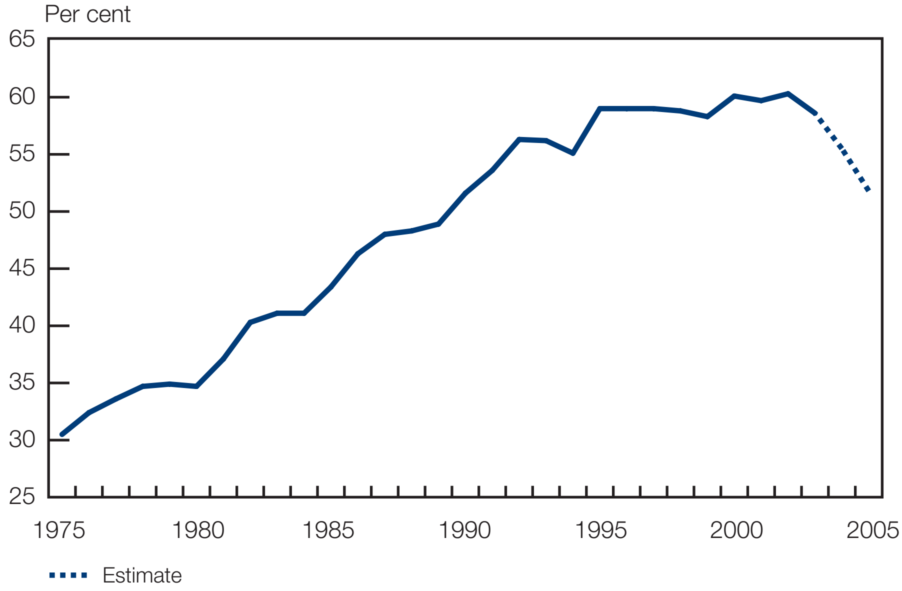


Households' interest in pension funds and long-term insurers relative to total financial assets rose from an average of 39 per cent in the beginning of the 1980s to an average of approximately 58 per cent between 2000 and 2005. By contrast, the share of total liquid assets in financial assets declined from about 42 per cent to 23 per cent over the corresponding period. For details on the role of comparative asset returns, taxation treatment and regulation on the trends in holdings of liquid assets, directly held assets and pension assets, see Aron, Muellbauer and Prinsloo (2006).

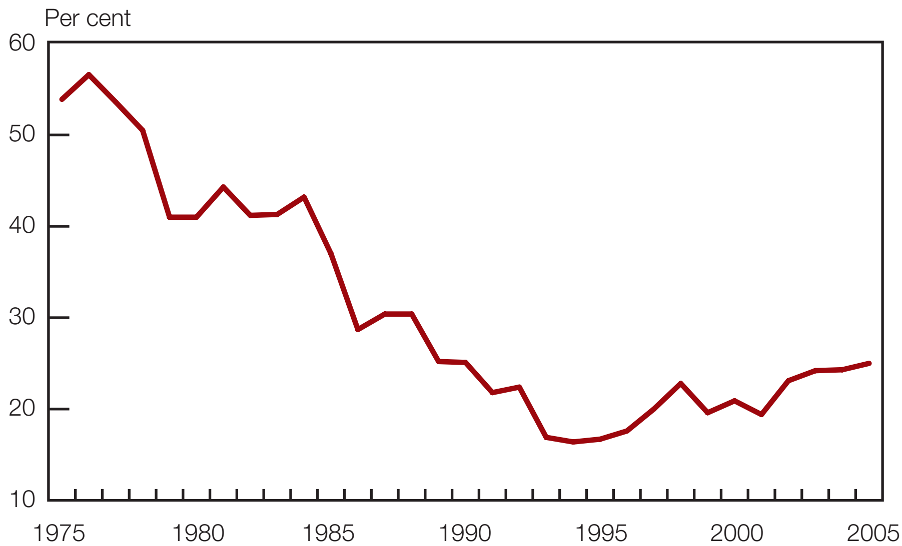
Most of the rise in the early 1980s and subsequent decline in the value of housing assets relative to income is due to the rise and then decline in the real house price index. Despite an increase at an average annual rate of 8 per cent between 1999 and 2003, the real value of houses at the end of 2003 still remained about 22 per cent below the peak in 1984. The subdued real rate of return over a long period on investment in fixed property seemed to have encouraged households to concentrate their saving in risk-averting institutions and financial assets rather than in riskier undertakings and fixed assets. However, from 2003 to the end of 2005, South Africa has seen exceptionally strong house price rises, alongside rising income, reductions in nominal interest rates, and buoyant consumer and business confidence.

In South Africa, as in many other countries, the increase in the household debt-to-income ratio over the past three decades can largely be attributed to three factors: The financial deregulation from the beginning of the 1980s; the reduction in interest rates, both in nominal and real terms; and the rise in wealth-to-income ratios.

Households' interest in pension and life insurance funds as percentage of total financial assets

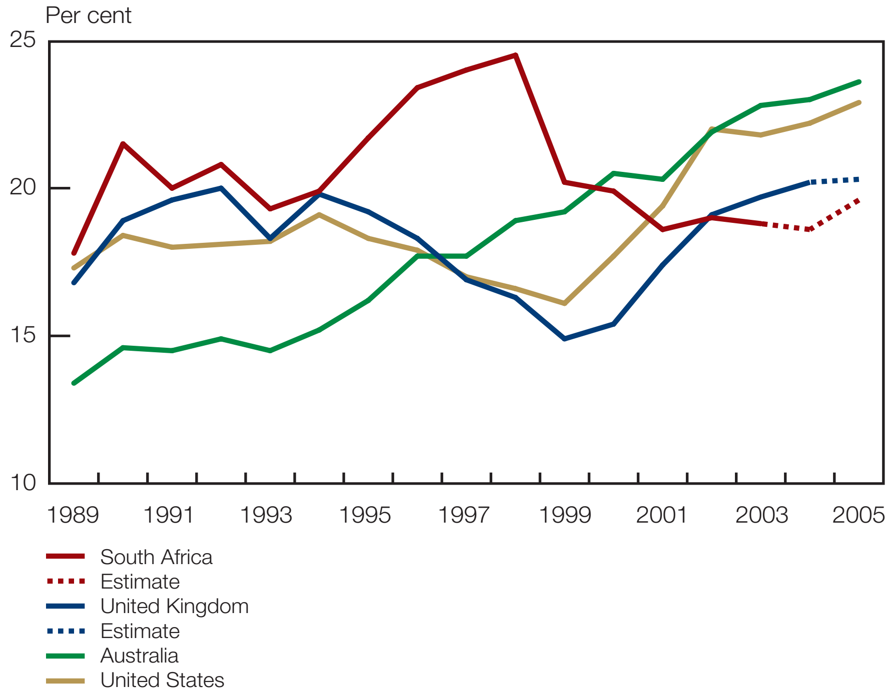


Households' liquid assets as percentage of total financial assets



An international comparison shows that although South Africa's ratio of household debt to disposable income increased strongly in the 1980s and again in the first half of the 1990s, it was lower than the corresponding ratios in most of the Organization for Economic Cooperation and Development (OECD) countries, and significantly lower than in the United States of America, Japan, Canada and the United Kingdom, where household debt recorded values well above 100 per cent of disposable income. However, household debt as a percentage of net wealth was relatively high in South Africa until the late 1990s. The moderation in South Africa's debt-to-net-wealth ratio since 1998 was the net result of a slowdown in the growth of household debt until 2002 and the subsequent acceleration in asset prices, particularly in residential housing during 2003 and 2004. In addition, households' net wealth received a further boost in 2005 on account of a surge in equity prices. However, the recent surge in the growth in household debt was strong enough to result in a modest increase in the debt-to-net-wealth ratio of the household sector in 2005; this ratio would also obviously be vulnerable to any downward movements in asset prices.

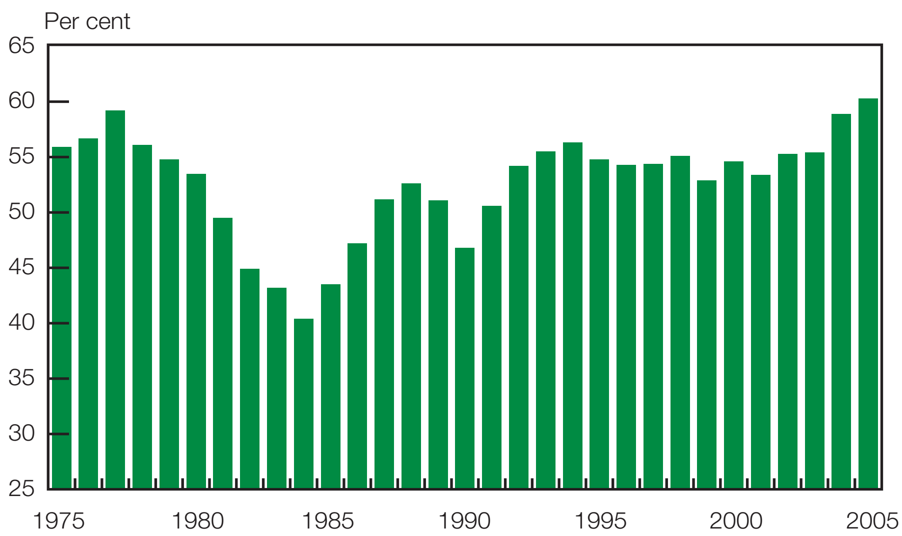
Households' debt as percentage of net worth



Source: Federal Reserve Statistical Release, Flow-of-Fund Accounts of the United States; Australian Bureau of Statistics, National Accounts; and Office of National Statistics, United Kingdom, National Accounts (various issues)

The composition of households' liabilities has changed significantly over time. For instance, the relative importance of mortgage debt fell in the early 1980s, while the ratio of consumer credit to total household debt increased to a high of 54 per cent in 1984. These developments were driven by the asset boom of the early 1980s, and the

Mortgage debt as percentage of total household debt



beginnings of financial deregulation. The government initiated financial liberalisation following the De Kock Commission reports (1978, 1985), which advocated a more market-oriented monetary policy (see Aron and Muellbauer, 2002). Interest and credit controls were removed in 1980, and banks' prescribed minimum liquidity ratios were reduced substantially between 1983 and 1985. However, the early deregulation affected consumer credit growth and not the mortgage market, which only caught up in the mid-1980s when competition rose in the mortgage market following the 1986 Building Societies Act, amendments to the Act in 1987 – 1988, and various innovations.

The share of mortgage debt in total debt remained relatively steady in the 1990s, but subsequently rose alongside the appreciation of housing wealth, the introduction of more flexible home loan products and the entry of numerous new first-time buyers to the housing market.

4. Concluding observations

There is universal recognition of the strategic importance of the household sector and the influence it has on consumption and saving in the economy. The availability of balance sheet data for the household sector can make a significant contribution to the effective assessment of households' consumption behaviour and provides valuable insights regarding the management of a country's national wealth.

While saving and borrowing flows provide a window on how the household sector is adjusting its balance sheet, the balance sheet itself – the stock position – adds significantly to the assessment of the economic outlook. From the balance sheet the magnitude and composition of household-sector wealth can be established and used in the analysis of consumer behaviour, such as household consumption expenditure as well as portfolio adjustments. With balance sheet data, a more comprehensive measure of income comprising consumption plus the change in net wealth can be calculated, thereby incorporating the effect of developments such as capital gains and extending the conventional national accounts analysis. Furthermore, the additional information may also help to improve the quality and analysis of existing national accounts statistics.

This study presents a brief review of the methodology used to construct the main balance sheet aggregates of the South African household sector in time series format. It also highlights a number of the most significant developments which may be observed in the balance sheet data, including the increase in the net wealth-to-income ratio from 1999, largely as a result of the buoyancy of asset markets. Incorporating wealth effects and balance sheet information in the analysis of consumer behaviour enhances the depth of such analysis, and is set to remain an important research topic internationally. It can now also be taken further with respect to South Africa (see recent estimates in Aron and Muellbauer, 2006b).

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Statistical tables