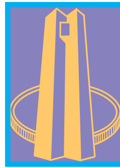
Annual Economic Report 2001



South African Reserve Bank

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Introduction

The most significant development during the past twelve months was the sudden downward change in the outlook for the world economy towards the end of 2000. This was mainly a consequence of developments in the United States, but it became sufficiently widespread to cause estimates of future global economic growth to be marked down quite substantially. Sharp falls in share prices also occurred in most of the prominent international financial markets.

The United States Federal Reserve System has moved quickly to ease monetary policy by lowering interest rates on six occasions since the beginning of 2001. These steps could not be expected to prevent a slowing in the economy, but were regarded as necessary for reducing the possibility of a recession. Easings of monetary policy soon followed in other countries and regions, such as the United Kingdom and the euro area, albeit in the latter case far less aggressively than in the United States.

The slowing United States' economy, and particularly the cutback of investment in computing and electronics equipment, affected exports from Asia, and then rippled out to commodity-producing economies. Despite the easing of monetary policies in the advanced economies, there has been little sign so far of greater confidence emerging in the financial markets that would point to a strengthening of global economic activity in the second half of 2001.

The South African economy had been recovering quite robustly from the setbacks suffered at the time of the international financial crises of 1997 and 1998 when world economic conditions began to deteriorate towards the end of 2000. Real gross domestic product was growing at an average annualised rate of some 3½ per cent in the second half of 2000, but when weaker international demand conditions began to spill over into South Africa, economic growth fell back to an annualised rate of about 2½ per cent in the first half of 2001. The depreciation in the value of the rand during the past year and a half cushioned the full impact of the weakening in the world economy on the domestic economy.

The slowdown in the domestic economy in the first half of 2001 was mainly confined to the supply side of the economy. Fixed capital formation, predominantly by private business enterprises in most of the production sectors, boosted domestic spending in real terms in the first half of 2001. Final consumption expenditure by households also grew further in the first half of 2001, albeit at a slightly slower pace than in the second half of 2000.

Although real gross domestic expenditure expanded in the first half of 2001, it has increased at a lower rate than real gross domestic product since the second half of 1999. During the two previous periods of economic recovery in 1986-89 and 1993-96 domestic expenditure increased faster than domestic production, creating imbalances in the economy and fuelling increases in the overall price level. The reversal in the relative growth rates of aggregate spending and production during the current recovery in economic activity undoubtedly contributed to the waning of inflationary pressures, and helped to improve the saving ratio of South African society.

The gross saving ratio has increased further in the past year and a half, mainly due to an improvement in general government finances and the saving performance of the corporate sector. Household saving was still constrained as households' consumption expenditure has remained relatively strong. In total, gross saving, which is meant to provide the wherewithal for capital formation, remained too low for economic growth to meet its full potential.

Despite the pick-up in overall economic activity since the second half of 1998, employment creation has remained sluggish. In fact, consistently constructed indicators of formal-sector employment point to further declines in 2000 and the opening months of 2001. More structurally, there was a serious deterioration in the relationship between economic growth and employment creation in the first half of the 1990s. A new relationship has been established since then, indicating that considerably stronger economic growth is now required than during the 1970s and 1980s in order to lift the overall level of employment by the same margin. This paucity of employment growth remains a serious issue that needs to be addressed comprehensively.

Declining employment levels almost inevitably led to higher unemployment, i.e. there was a rise in the number of people without a job but who are searching for work and are able to start shortly. The unemployment rate was officially estimated at 25,8 per cent for September 2000. In an efficiently functioning labour market, unemployment could be expected to influence wage pressures in various ways. For example, because the unemployed can potentially satisfy employers' demand for labour, they can impose some restraint on the wage negotiations of those who do have work. Also, when there is an abundant supply of labour, those employed are likely to be influenced by the possibility of a protracted period of unemployment if they are too aggressive in their wage demands. This suggests that high unemployment could be associated with lower wage pressures – precisely what has been occurring in the South African economy over the past two years or so when nominal compensation growth slowed down quite noticeably.

The influence of slower wage growth on changes in the overall price level was reinforced by the highest increase in measured non-agricultural labour productivity in thirty years. Because of this higher productivity, the growth in nominal unit labour cost in the manufacturing sector was compressed to well below 1 per cent in 2000. This counteracted the upward pressures on prices originating outside the domestic economic system, especially the price-raising effect of high international crude oil prices.

Overall, the relative stability of unit labour cost more than offset the effects of the exogenous random price shocks, resulting in CPIX inflation gradually drifting lower to the upper end of the inflation-target range of 3 to 6 per cent set for 2002. Lately there has been little evidence of strong domestically generated inflationary forces still at work in the economy, giving rise to the expectation that the inflation target for 2002 is likely to be attained. Progress towards the target could, however, be delayed by high rates of increase in the prices of goods and services in cases where regulatory agencies still have an important say in the price formation process.

The external sector has given extra impetus to the economy over the past eighteen months. More moderate but nevertheless continued world demand for South African goods, helped by the decline in the exchange rate of the rand, boosted export volumes, while the higher prices of imported goods from the start of 2001 held back the growth in imports. Gold export earnings, also boosted by the depreciation of the rand against the US dollar, rose solidly in the first half of 2001.

These developments combined to turn the current account of the balance of payments around from a sizeable deficit in the first half of 2000 to a healthy surplus in the first half of 2001. The total change in the balance on the current account was equivalent to roughly 1 per cent of gross domestic product.

South Africa's foreign debt declined relative to gross domestic product. National government and some of the parastatals were successful in raising funds on the international capital markets, but these were partially offset by net sales of South African fixed-interest securities by non-resident portfolio investors. South Africa has also fulfilled all its commitments in terms of a series of special arrangements entered into with foreign creditors over the years since 1985 when the country was forced into declaring a foreign debt standstill.

Portfolio capital flows over the past eighteen months were predominantly in the form of equity rather than debt. Foreign direct investment capital has also moved into the country in recent times, but in a somewhat uneven pattern and mostly as a consequence of financial transactions such as takeovers, mergers and acquisitions. "Greenfield" projects (e.g. the construction of new factories) financed by foreign investment capital remained rather sparse.

The surpluses on the current account of the balance of payments in the first half of 2001 and the inflows of capital through the financial account, especially the portfolio equity flows, helped the country to build up international reserves. At the end of June 2001 some 16 weeks' worth of imports of goods and services was covered by international reserves. The Reserve Bank also acquired foreign currency from various sources for delivery against its oversold foreign-exchange forward book, reducing the net open position in foreign currency by more than 60 per cent over the past eighteen months or so.

Essentially for reasons originating outside South Africa, the value of the rand has depreciated quite steeply over the past eighteen months. Overall, the depreciation of the rand has exceeded by a substantial margin the inflation differential between South Africa and its trading-partner countries, thus boosting the competitiveness of domestic producers in export markets. This depreciation contributed appreciably to the strengthening of the current account of the balance of payments at a time when steady inflows of capital through the financial account were somewhat elusive.

Over the past twelve months, growth in the broadly defined money supply (M3) accelerated robustly. In fact, M3 grew at an inordinately high rate in the second quarter of 2001 and this may indicate solid growth in future aggregate spending. The likely relationship between current money holdings and future aggregate spending depends, among other things, on how money balances had been accumulated. Over the past year a sizeable portion of the growth in M3 was concentrated in longer-term deposits and this might have been influenced by fears of losses on equity investments. The rise in broad money may therefore partly reflect shifts in the demand for money in asset portfolios, rather than intentions about future spending.

In contrast to the growth behaviour of the broad money supply, there was a slowdown in the growth in low interest-bearing narrow money (M1A), which may be interpreted as a signal of a future downturn in household spending. However, with measured inflation on the decline and expectations of inflation gradually waning, the easing of growth in M1A could also reflect a transition to a low inflation environment, requiring relatively smaller cash holdings for transaction purposes by the general public.

The measured growth in credit extension by banks over the past twelve months was somewhat randomly affected by changes in banks' accounting practices. Nevertheless, the overall impression is that bank credit extension expanded quite briskly. Asset-backed lending, in particular, increased strongly as households once again became sufficiently confident to step up their debt-to-income ratios, and businesses to increase their capital outlays. Unbacked lending, or "other loans and advances" by the banking sector, grew at a slower rate over the past twelve months. However, heightened activity in the primary corporate bond market and a strong increase in mortgage lending by banks suggest that firms are increasingly turning away from bank intermediated borrowing for meeting their funding requirements in favour of securitised borrowing in the corporate bond market and mortgage financing.

During the past year, numerous steps were again taken to strengthen regulatory and supervisory practices in the domestic securities markets. Care was taken that the standards and codes for sound accounting and market integrity formulated by international standard-setting agencies were closely adhered to. These measures were underpinned by the development of state-of-the-art electronic processing mechanisms for secure and efficient safe-keeping and settlement systems in the securities markets. New products were developed to broaden the product range and to make the domestic markets more competitive in the global context. These measures raised the stature of the securities markets and contributed greatly to the remarkably stable financial conditions in South Africa when stability in other emerging markets was under threat.

The strengthening of the regulatory and supervisory environment, alongside declining inflation expectations and the steady reduction in the borrowing requirement of the public sector, have contributed to a bull market in fixed-interest securities over the past year or so. Bond prices, which move inversely to bond yields, have increased by more than 30 per cent since May 2000 and bond yields have declined to their lowest levels in eighteen years. Also, estimates of long-term real yields, measured by rates at the ten-year horizon and using historical inflation for deflating purposes, fell virtually in tandem with nominal yields, reflecting an improved outlook for the balance between domestic saving and investment.

Foreign investors failed to capitalise on the prolonged bull market in bonds. Despite the attractive yields on bonds with a long maturity and the prospect of a significant capital appreciation, non-resident investors steered clear of the South African market, selling bonds on a net basis during the past eighteen months. Concern about future weakness in the external value of the rand was probably the single most important factor for this behaviour of international investors.

In the equity market, where price movements have been fairly volatile over the past eighteen months, non-residents participated eagerly in the lively trading conditions, pushing their share in total turnover to almost 40 per cent at times. On a net basis, non-resident investors have accumulated South African equities worth some R34 billion over the past year and a half. Simultaneously, investors sought protection against unpleasant market surprises, and dealings in warrants, futures contracts and options on futures contracts have grown strongly since the beginning of 2000.

The Monetary Policy Committee of the Reserve Bank kept the Bank's official rate on repurchase transactions fairly stable over the past eighteen months. Two rate adjustments during 2000 – a downward adjustment of 25 basis points in January that was reversed in October – were followed by a rate cut of 100 basis points in

June 2001. Following the reduction in June, the private banks initially lowered their lending rates by 75 basis points and a little later by a further 25 basis points. Other money-market interest rates broadly traced the movements of the repurchase rate and similarly displayed a fair degree of stability over time.

With only a relatively small change in short-term interest rates over the past year and a half, and a far more substantial decline in long-term interest rates, the slope of the yield curve flattened considerably over time. Whereas the steep upward inclination of the yield curve towards the beginning of 2000 still signalled some concern in the markets that monetary policy was too easy, the flattening of the yield curve towards the middle of 2001 gives evidence of greater consensus that the Bank's policy stance is appropriate for lowering inflation to the target range.

Under the guidance of the National Treasury, financial management was strengthened at all levels of government. A sound legal and administrative framework was laid down for all government entities to adhere to in due course. The principles of medium-term budgeting, transparent accounting and reporting standards, and output-based expenditure allocations are gradually becoming entrenched in the public domain. A strong commitment to accountability and responsibility in the management of public resources is being nurtured at all levels of public administration.

Public-spending aggregates are increasingly becoming an accurate reflection of initial budgetary intentions and, partly because of better administration, tax revenues often exceed budget projections, without adding to the overall tax burden of South African society. At the national government level, borrowing needs have been reined in to just 2 per cent of gross domestic product in fiscal 2000/01. Meaningful progress was made in curtailing the growth in debt-servicing costs, and the primary surplus on the accounts of national government (i.e. the excess of revenue over expenditure without interest payments) rose to 3,2 per cent in the past fiscal year.

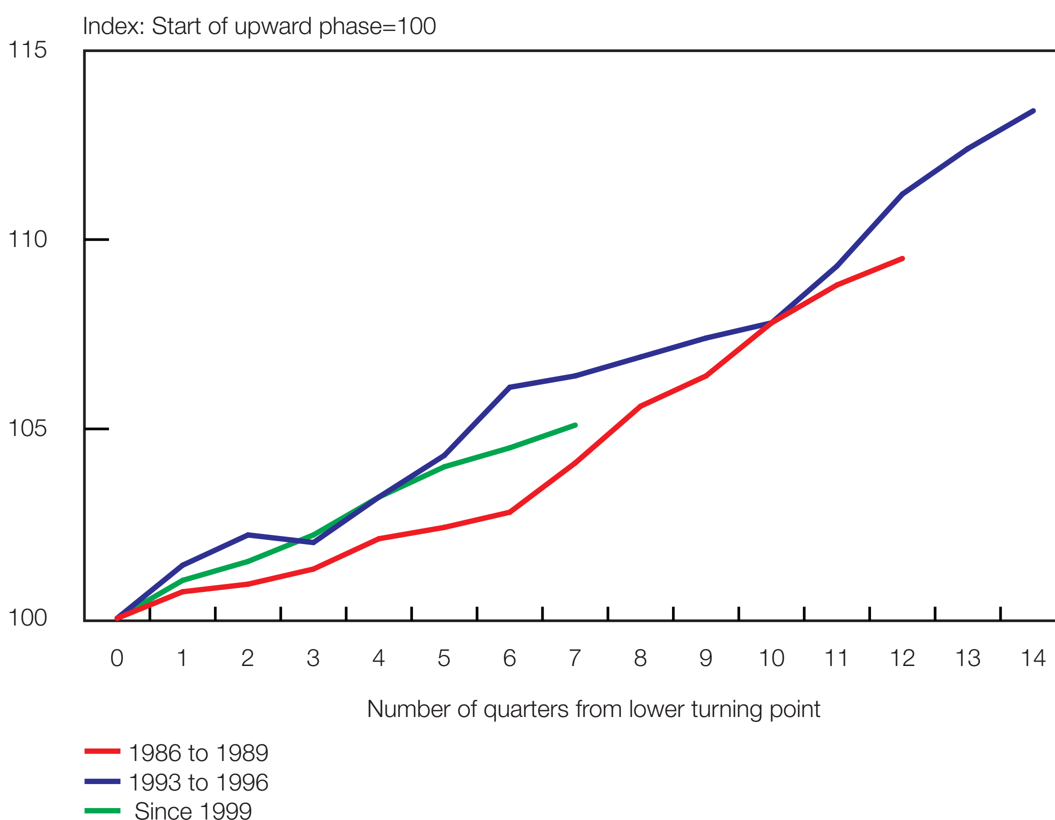
The careful management of current revenue and expenditure flows curbed the growth in public debt. Assisted by the proceeds expected from the restructuring of government assets, the healthy state of public finance could see the total loan debt of national government relative to gross domestic product decline to below 40 per cent in three years’ time. Only 8 per cent of total loan debt constituted foreign obligations at the end of March 2001 and the average maturity of foreign loans was extended to 98 months during the past fiscal year.

Domestic economic developments

Gross domestic production

The growth in *real gross domestic product* during the current economic recovery is broadly a repetition of the growth patterns of the previous two upward phases of the business cycle. Real gross domestic product grew at an average annualised rate of about 3 per cent over the past seven quarters, starting in the fourth quarter of 1999. In the first seven quarters of the 1986-1989 upward phase of the business cycle, average growth was also about 2½ per cent, and in the 1993-1996 upward phase it was only slightly higher at 3½ per cent.

Gross domestic product during economic recoveries



Over the past eighteen months, economic growth picked up quite robustly to annualised rates of 3½ per cent in the second half of 2000, but tapered off to 2½ per cent in the first half of 2001 when the slowdown in global economic activity began to spill over into South Africa. In particular, the growth in real value added by the manufacturing sector slowed down noticeably in the first half of 2001, whereas agricultural output declined from the high levels attained in the second half of 2000.

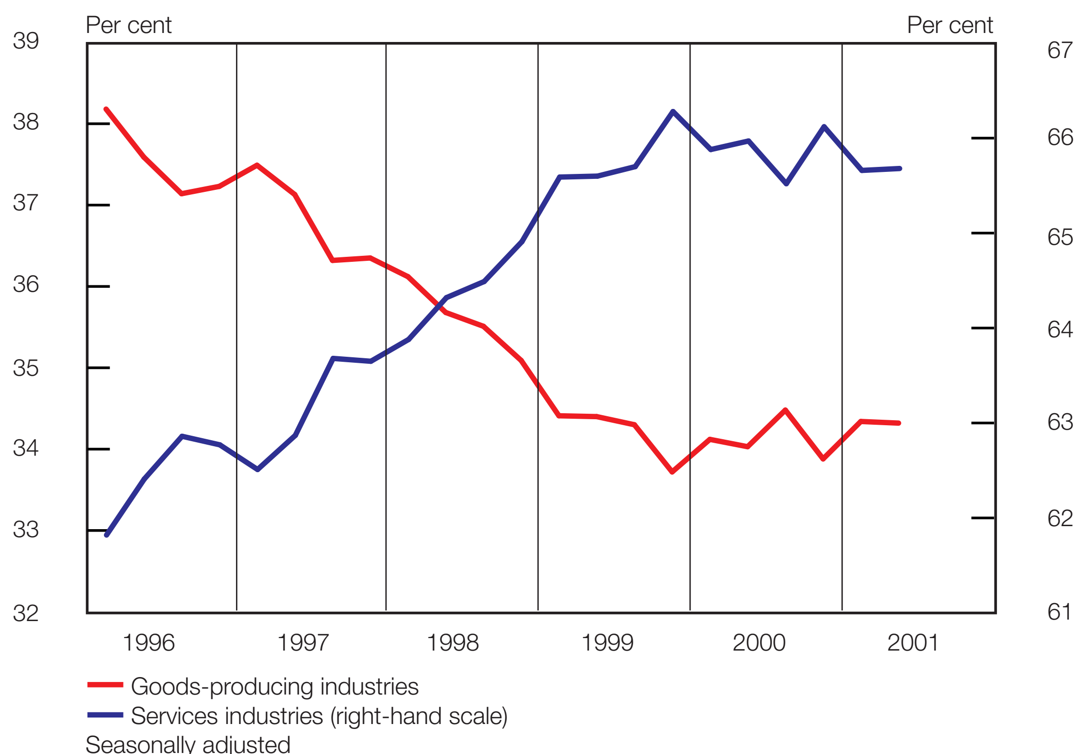
Real gross domestic product

Percentage change at seasonally adjusted annualised rates

Sectors	1999	2000			2001
	Year	1st half	2nd half	Year	1st half
Primary sectors	½	-2	4	½	-½
Agriculture	3½	-1	13½	4	-3
Mining	-1	-2½	-2	-2	1
Secondary sectors	-½	3	3½	3	2
Manufacturing	0	3½	3½	3½	2
Electricity, gas and water	2	3½	2½	4½	2
Construction	-4	-1	2½	-1	2½
Tertiary sectors	3½	3½	3½	3½	3
Commerce	1½	5	5	5	3½
Transport, storage and communication	7½	5½	6½	6½	5
Financial and other services	6½	4½	4	5	4
Non-agricultural sectors	2	3	3	3	2½
Total	**2**	**2½**	**3½**	**3**	**2½**

Somewhat at variance with the general behaviour of the other goods-producing industries, mining output strengthened slightly from the second half of 2000 to the first half of 2001, helping to lift the share of the goods-producing industries in total value added from 34 per cent in 2000 to 34½ per cent in the first half of 2001. As shown in the accompanying graph, the general decline in the relative size of the

Value added of goods-producing and services industries as percentage of total gross domestic product



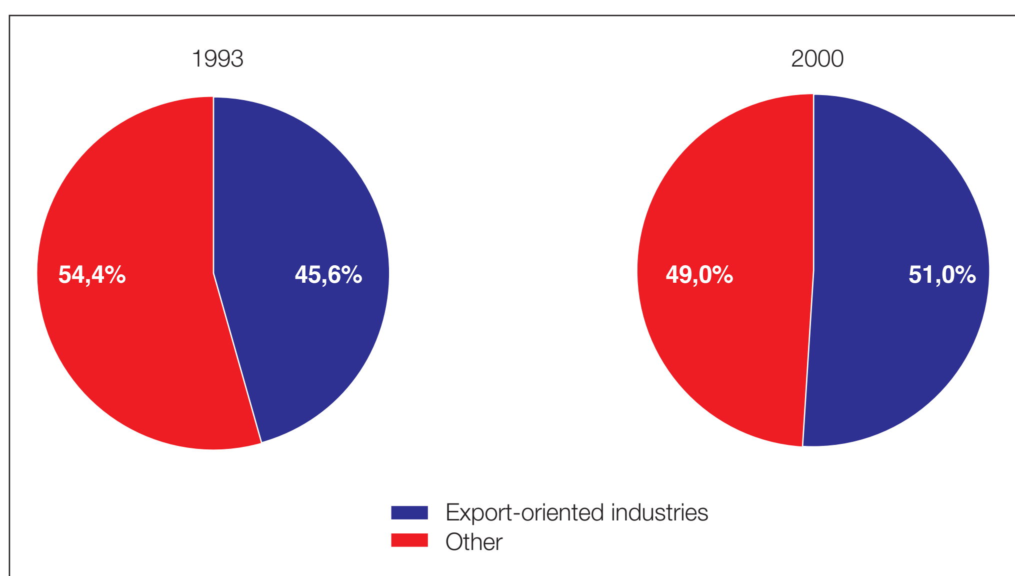
goods-producing industries may have been arrested around the beginning of 1999. The slight recovery in *mining production* in the first half of 2001 was largely concentrated in the platinum and diamond sectors of the industry. Gold-mining output volumes proceeded along their long-term downward trend.

The decline in agricultural production in the first half of 2001 followed exceptionally high output levels in the second half of 2000 and was partly a consequence of the poor weather conditions that adversely affected deciduous fruit production early in the year, and also because of a delay in the harvesting of the bulk of the maize crop. Wet soil conditions and a shortage of diesel fuel were mainly responsible for the postponement of the harvesting season. It is currently also estimated that the 2001 maize crop will be about 30 per cent below that of 2000.

The low level of the exchange rate of the rand since the beginning of 2000 has boosted manufactured exports, although weaker trading-partner growth has lately contributed to a slowing in the growth rate. *Manufactured output* responded to the growth in demand and expanded at an annualised rate of more than 3½ per cent in the second half of 2000, but then slowed down to about 2 per cent in the first half of 2001. Among the subsectors that benefited most from the strong export demand were car manufacturers, the basic metals industry and the manufacturers of chemical products and of electrical equipment.

From the beginning of the 1990s, boosted by the real depreciation of the rand, *export-oriented industries* (defined here as those industries producing chemicals and chemical products, basic metals and transport equipment) increased their share of total manufacturing output from about 45½ per cent to 51 per cent. This increase in relative importance came mainly at the expense of the shrinking shares of food, beverages and tobacco producers and of the clothing, textile and leather products industries.

Composition of gross value added by manufacturing



A slowdown in the generation of electricity caused the growth in the real value added by the sector supplying *electricity, gas and water* to decline to 2 per cent in the first half of 2001. The subdued domestic electricity supply was supplemented by an increased supply of electricity from Mozambique.

The *construction sector* recovered after a while from the setbacks of 1999 when construction activity was badly affected by the extremely high interest rates of 1998. The decline in the construction industry turned around when the real value added by this sector rose at an annualised rate of 2½ per cent in the second half of 2000. A number of shopping and entertainment centres were completed towards the end of 2000 and this, as well as the slow pace at which contracts for infrastructural development were awarded by provincial governments, marginally slowed down the expansion of the construction industry in the first half of 2001.

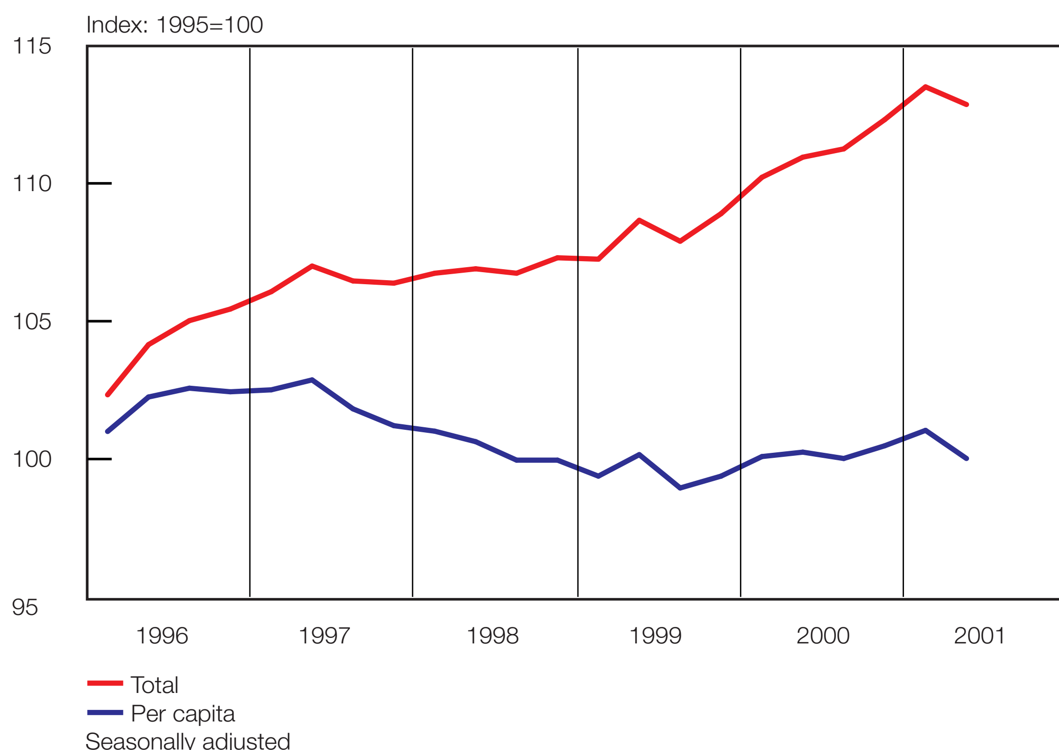
Growth in *retail trade* had been robust in 2000, but faltered in the first half of 2001. Although the survey of consumer confidence of the Bureau for Economic Research at the University of Stellenbosch showed signs of some improvement in consumer sentiment, consumers were generally concerned about future job security and the prospects of increases in real household income. They accordingly exercised some restraint in their spending behaviour. Retailers were also affected by a shift in consumer spending away from traditional household necessities to expenditure on cellular telephones, security services and on the national lottery.

The subsector *catering and accommodation* grew buoyantly throughout 2000 and in the first half of 2001 on account of strong growth in foreign tourism, partly encouraged by the low exchange rate which attracts tourists to visit South Africa. Growth in the *transport, storage and communication sector,* which had been very strong at 7½ per cent in 1999 and 6½ per cent in 2000, tapered off in the first half of 2001, as did growth in most of the production sectors of the economy. This slowdown was mostly felt in the transport subsector where high fuel prices are having a negative impact on long-haulage business. Harbour and dock activity also slowed down substantially as the growth in foreign trade volumes began to subside.

The real value added by the sector *financial intermediation, insurance, real estate and business services* grew at a robust rate of about 5 per cent in 2000 and maintained this momentum in the first half of 2001. Lively trading in the securities markets and a pick-up in transaction volumes in the real-estate market ensured the buoyancy of the financial services industry. The *government sector* made a smaller contribution to real gross domestic product in the first half of 2001 than in the second half of 2000, reflecting the decline in overall public-sector employment.

Real *gross national income* has been growing at an average annualised rate of about 3 per cent in 2000 but slowed down along with the general waning of economic growth to about 2½ per cent in the first half of 2001. The growth in national income in the first half of 2001 was underpinned by continued growth in the real gross domestic product and a slight improvement in the international terms of trade. *Per head of the population,* real gross national product increased at an annualised rate of ½ per cent in the first half of 2001.

Real gross national income



Gross domestic expenditure

Real gross domestic expenditure grew at a slower average rate during the current recovery than at the comparable stage of the two previous economic recoveries. Also, average annualised growth in the current recovery at 2 per cent is below the growth in real output, signalling that upward pressure on the aggregate level of prices because of excessive demand growth has subsided appreciably.

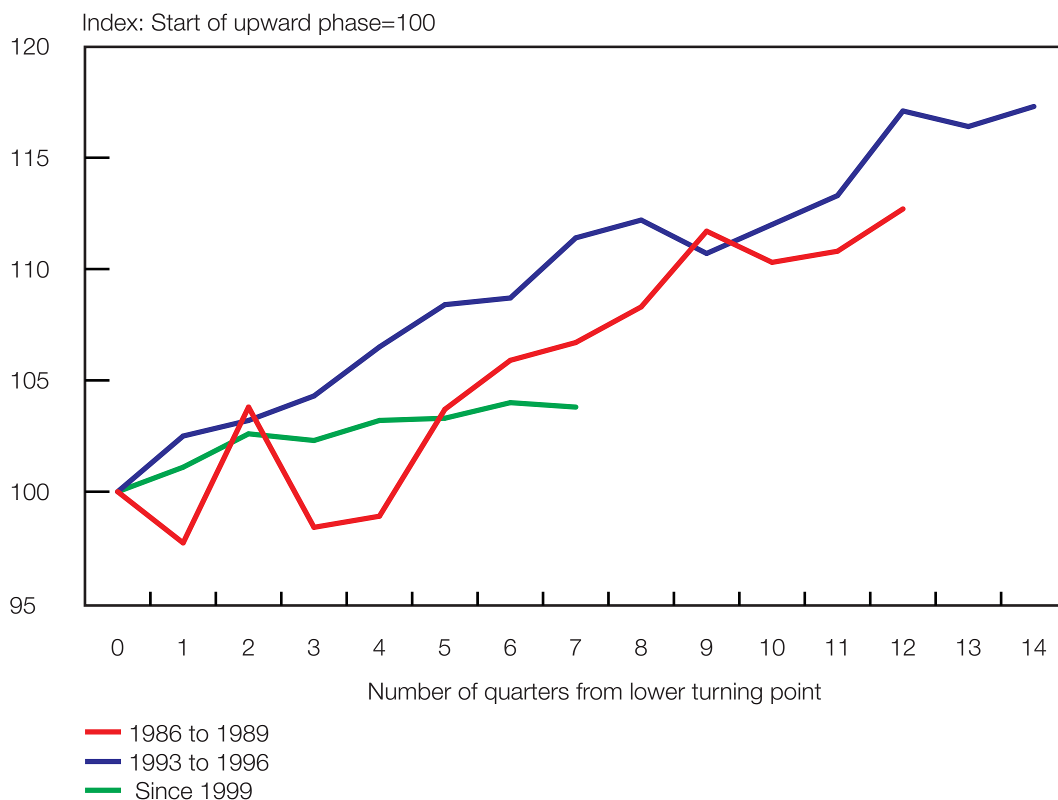
Annualised growth in real gross domestic expenditure slowed down to 1½ per cent in the second half of 2000, and 1 per cent in the first half of 2001. Real fixed capital outlays continued to increase at a sturdy pace in the first half of 2001, but net inventory investment declined and real consumption expenditure by households slowed down. Final consumption expenditure by general government remained rather flat.

Real gross domestic expenditure
Percentage change at seasonally adjusted annualised rates

	2000			2001
Components	1st half	2nd half	Year	1st half
Final consumption expenditure by households	3	3½	3	3
Final consumption expenditure by general government	-4½	1	-2½	1½
Gross fixed capital formation	2	5½	1½	6
Change in inventories (R billions*)	5,2	2,5	3,9	-2,4
Gross domestic expenditure	**4**	**1½**	**2½**	**1**

* 1995 prices

Gross domestic expenditure during economic recoveries



Final consumption expenditure by households

The growth in real final consumption expenditure by households, which accounts for about 63 per cent of aggregate gross domestic product, accelerated to an annualised rate of 3½ per cent in the second half of 2000, but moderated to 3 per cent in the first half of 2001 as households came to realise that the prospects of future income growth might be deteriorating.

The slowing in spending in the first half of 2001 was particularly noticeable in outlays on durable goods. In particular, purchases of furniture and household appliances were badly affected. Expenditure on semi-durable goods, non-durable goods and services continued to grow at a steady pace. Spending on new motorcars, an important component of spending on durable goods, was hesitant in the first half of 2001.

Real final consumption expenditure by households
Percentage change at seasonally adjusted annualised rates

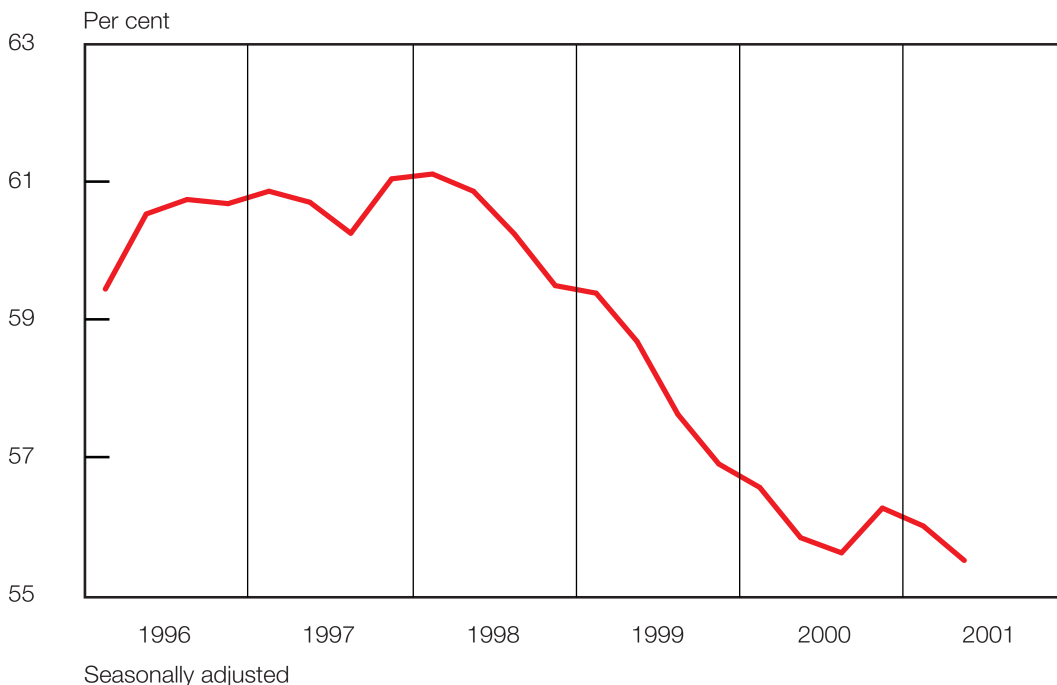
	2000			2001
	1st half	2nd half	Year	1st half
Durable goods	5½	8	7	3
Semi-durable goods	7	4½	6	4½
Non-durable goods	1½	1½	1	1½
Services	3½	4	4	3½
Total	3	3½	3	3

A number of factors probably contributed to the slowdown in consumption growth in the first half of 2001. Increased expenditure on petrol due to higher prices probably

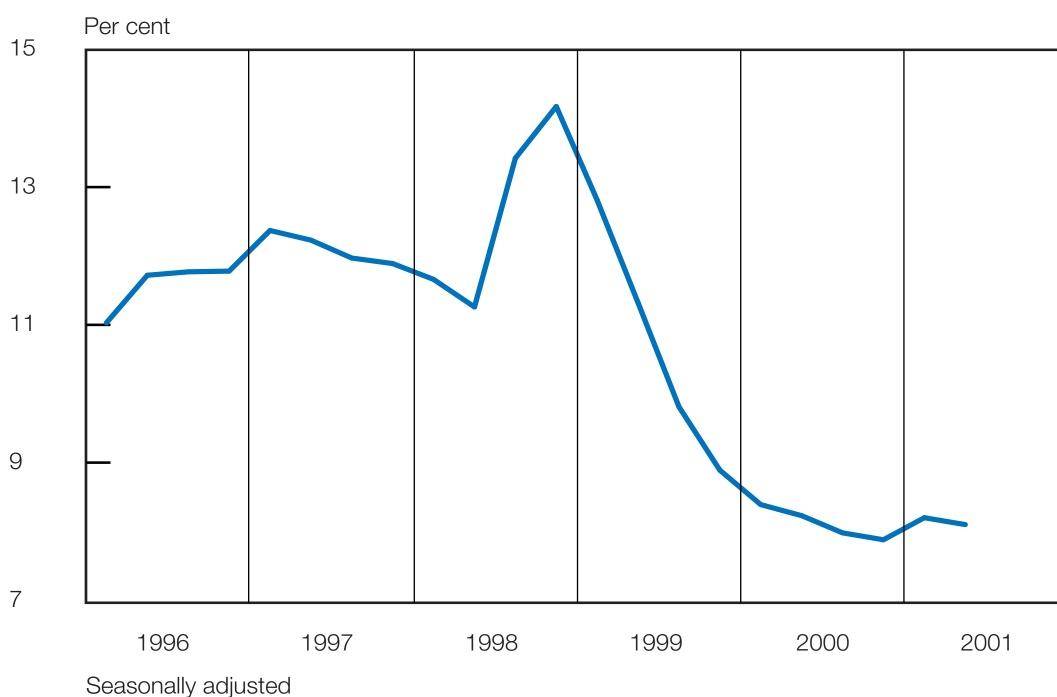
led to a reduction in real consumer spending in other areas. Similarly, increased spending on cellular telephones and on the national lottery led to the diversion of spending power away from the more traditional retail goods.

Consumers were also less inclined to incur debt, compared with previous periods of economic recovery. The slight upward movement in the debt-to-income ratio of households since the middle of 2000 has not been nearly comparable with the

Household debt as percentage of disposable income



Debt-servicing cost of households as percentage of disposable income

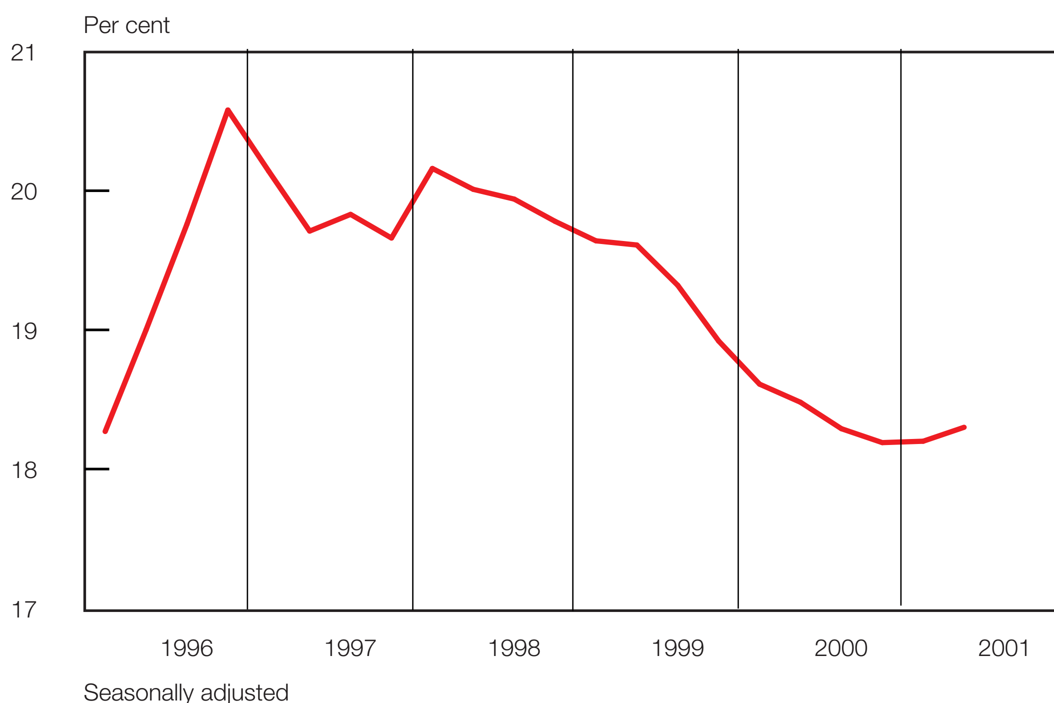


strong upward movement of this ratio during previous recoveries. Furthermore, during previous recoveries growth in consumption was supported by strong growth in the value of household assets, driven by both residential property and equity price increases. During the past year and a half, there was an increase in the value of residential property, but total household asset growth was held back by the relatively unimpressive growth of equity values. There were also indications that the growth in real household disposable income was tapering off. The growth in compensation of employees was slowing in line with the weakening conditions in the labour market and declining farm incomes. These factors, combined with news about the weakening global economic conditions and exchange-rate volatility, contributed to a mostly negative attitude towards spending among consumers.

Final consumption expenditure by general government

General government reduced its final consumption expenditure in real terms steadily from the second quarter of 1997 to the first quarter of 2000 as part of a broader strategy for establishing an environment for stronger economic growth and job creation. The steady decline was reversed around the middle of 2000 when real final government consumption expenditure began to increase at a modest pace. This increase lasted into the first half of 2001, but was too weak to raise the ratio of government consumption expenditure to gross domestic product. As a percentage of gross domestic product, real final consumption expenditure by general government declined to 18 per cent in the first half of 2001. As recently as 1998 this ratio was still at an average of 20 per cent.

Final consumption expenditure by general government as percentage of gross domestic product



Despite the recent rise in real final consumption expenditure by general government, government employment continued to decline as part of the ongoing process of

raising the efficiency levels in the public service. As a percentage of total consumption expenditure by general government, compensation of employees fell to 70½ per cent in the first half of 2001 from 73 per cent at the beginning of 2000.

Gross fixed capital formation

The change in real gross fixed capital formation turned around from a decline of 6 per cent in 1999 to an increase of 1½ per cent in 2000 which continued at an annualised rate of about 6 per cent in the first half of 2001. Private-sector companies and public-sector bodies both contributed to this recovery in fixed capital formation.

Real gross fixed capital formation by type of organisation
Percentage change at seasonally adjusted and annualised rates

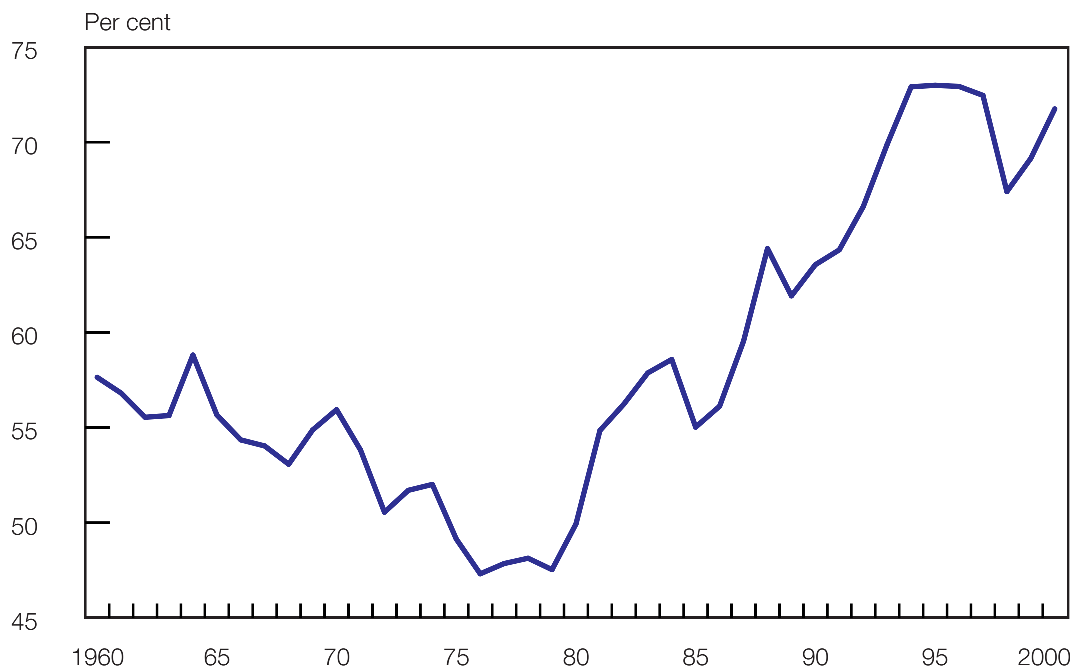
Components	2000			2001
	1st half	2nd half	Year	1st half
Private business enterprises	6	6	5	7½
Public corporations	-16½	10	-14	-½
General government	2½	-1½	0	5½
Total	2	5½	1½	6

Mainly to keep abreast of new developments in technology, fixed capital formation has remained concentrated in the installation of machinery and equipment, rather than in building new structures. Machinery and equipment include computers, other high-technology equipment and computer software. It is estimated that capital outlays on equipment related to information technology as a percentage of total outlays on machinery and equipment have increased to an average of about 12 per cent over the past two years from some 11 per cent in 1998. In part, this development reflects the need to replace obsolete capital stock, and not necessarily the expansion of existing productive capacity.

Investment in residential buildings also picked up during 2000 and the first half of 2001, reflecting the improvement in affordability following the declines in mortgage rates since 1998. Real outlays on transport equipment increased quite strongly in 2000 and the first half of 2001. This was underpinned by the relatively strong growth of the private transportation sector and increased demand by car-rental firms which have been delaying the renovation of their vehicle fleets for some time.

New investment in the *private sector* has now been increasing without interruption for two years. Private firms in all the major production sectors of the economy increased their spending on fixed capital formation in the first half of 2001. Export-oriented companies, in particular, added to their existing capacity in order to benefit from the depreciation of the rand and the freer access to the euro area and the United States markets, following the conclusion of trade agreements. The higher import content of motor vehicles on the domestic market necessitated new installations and re-tooling for the support infrastructure of motorcar dealers.

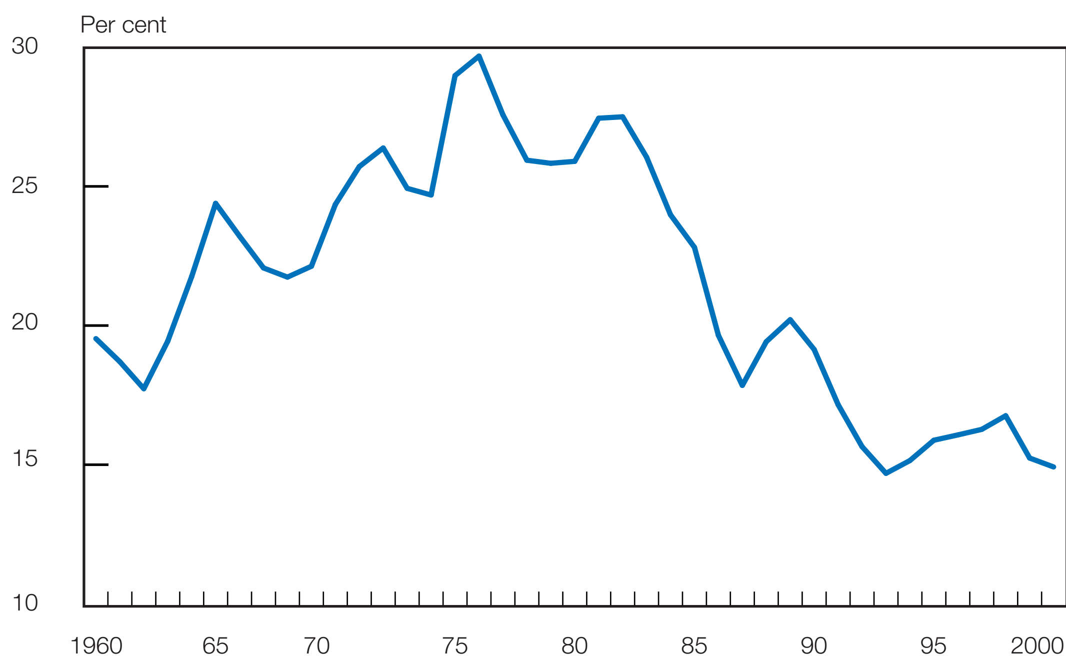
Private gross fixed capital formation as percentage of total gross fixed capital formation



Public corporations reduced their real fixed capital spending in the first half of 2001, following prior cutbacks of 15½ per cent in 1999 and 14 per cent in 2000. These measures form part of the strategy to strengthen balance sheets in the public-corporation sector and to improve efficiency overall.

Mainly as a result of the increase in real fixed capital formation in 2000 and the first half of 2001, total gross fixed capital formation as a percentage of gross domestic product

Gross fixed capital formation as percentage of gross domestic product

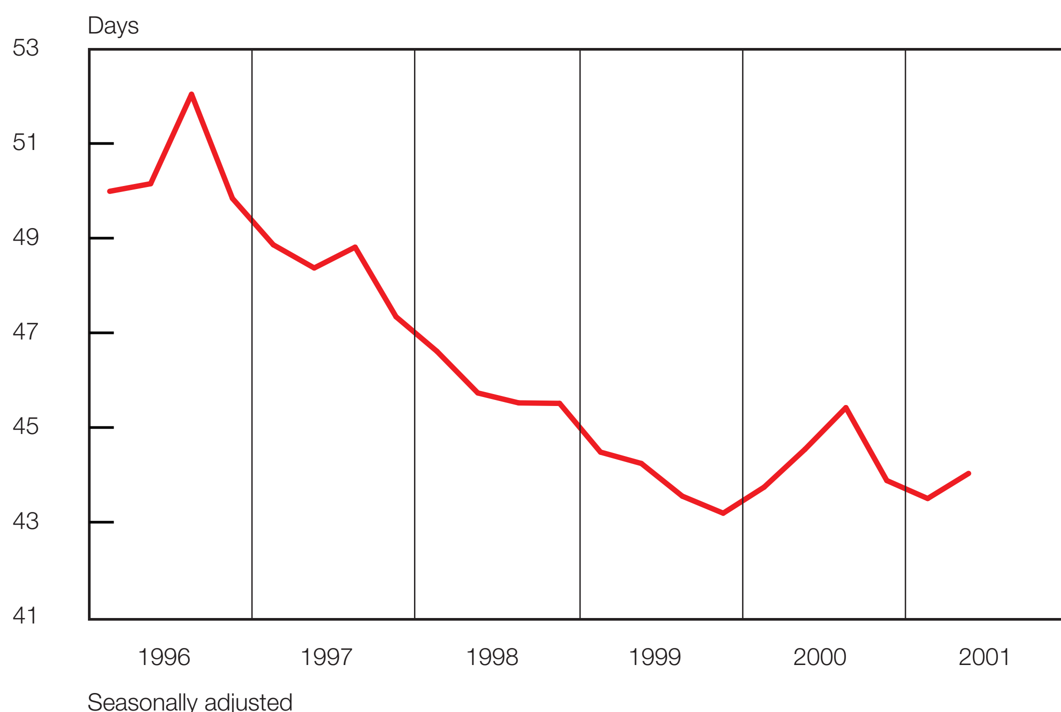


rose from 15 per cent at the end of 1999 to 15½ per cent in the first half of 2001. This is still far below the comparable ratios of 26½ per cent in the 1970s and 23 per cent in the 1980s. Closer inspection reveals that the decline in the investment ratio since the 1970s has been most pronounced in the general government sector. As a percentage of gross domestic product, general government's fixed capital formation fell from 9 per cent in the 1970s to 2½ per cent in the 1990s. On the one hand, the relatively low level of general government's capital formation is a reflection of government's determination over the past seven years to restore macroeconomic balance and ameliorate inflationary pressures. On the other hand, it also explains part of the backlogs that developed in the creation of economic and social infrastructure.

Change in inventories

Inordinately high interest rates during 1998, and expectations that aggregate demand growth would stay weak, prompted firms to ease production growth and to meet the needs of clients from inventory withdrawals. Inventories accordingly declined in 1999. When business sentiment began to improve towards the end of 1999, firms became increasingly prepared to replenish inventories in anticipation of a strengthening in demand. Initially, firms over-estimated the strength of demand and some unplanned inventory accumulation occurred in the first half of 2000, which subsequently led to more moderate inventory build-ups in the second half of 2000. Inventories were reduced in the first half of 2001. Consequently industrial and commercial inventories declined from the equivalent of 45½ days' sales at the end of September 2000 to roughly 44 days' sales at the end of June 2001.

Ratio of industrial and commercial inventories to sales



Net investment in inventories still added 1 percentage point to overall economic growth in 2000 but suppressed growth by 1½ percentage points on an annualised basis in the first half of 2001.

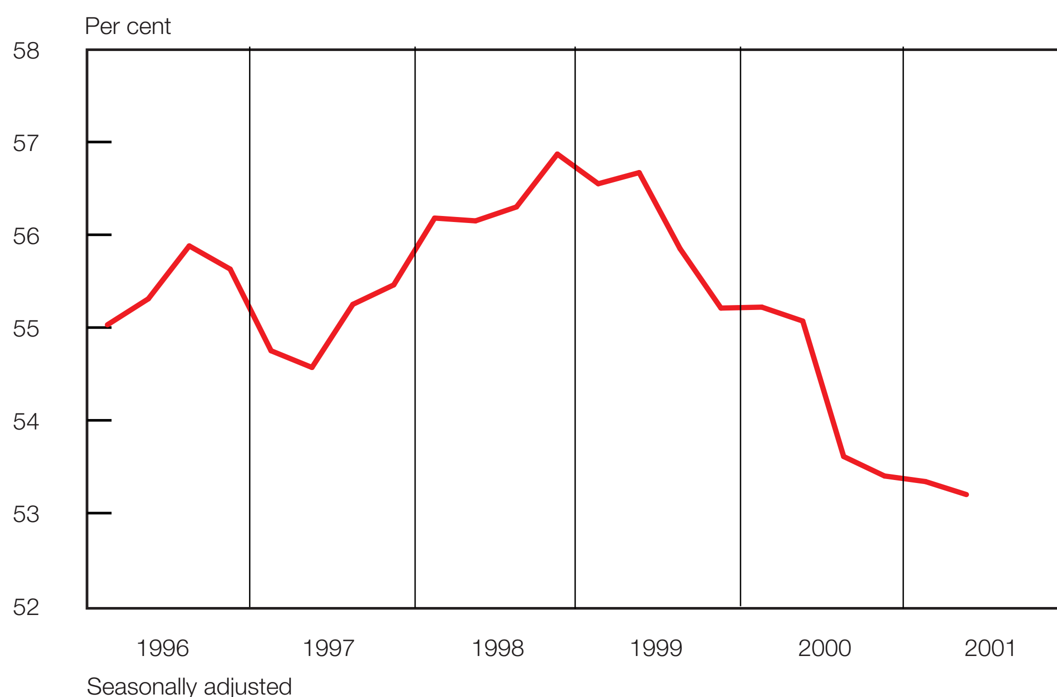
Factor income

The growth in nominal factor income accelerated from 8 per cent in 1999 to 10 per cent in 2000 and 10½ per cent on a year-on-year basis in the first half of 2001. Operating surpluses, rather than the compensation of employees, contributed most to the faster growth in factor income.

Total *compensation of employees* increased by 6½ per cent in 2000 and at a year-on-year rate of 7 per cent in the first half of 2001 – rates comparable with the low rates last encountered in the early 1960s. In the first half of 2001, stronger growth in labour compensation was recorded in all the main sectors of the economy, apart from the trade sector. The manufacturing sector was the leading sector in the first half of 2001 in this regard.

The need to contain cost in the presence of growing competition in an increasingly globalised environment forced firms to become more cost conscious and to rationalise their staff complements. In addition, employers generally tried to scale down salary and wage adjustments in line with lower inflation. As a consequence, the compensation of employees as a percentage of total factor income declined from 56½ per cent in the first half of 1999 to an average of 53½ per cent in the first half of 2001.

Compensation of employees as percentage of total factor income



The growth in aggregate nominal operating surpluses accelerated from 8½ per cent in 1999 to 14 per cent in 2000 and to a year-on-year rate of 15 per cent in the first half of 2001. All the major production sectors contributed to the strong expansion in

operating surpluses, with construction and manufacturing somewhat more pronounced. The factors boosting operating surpluses included stronger domestic and export demand, the increase in export earnings resulting from the depreciation of the rand and sharply rising output per worker.

The strength of operating surpluses is also reflected by the widening margin between the increase in output prices in the domestic manufacturing sector and the increase in unit labour cost.

Gross saving

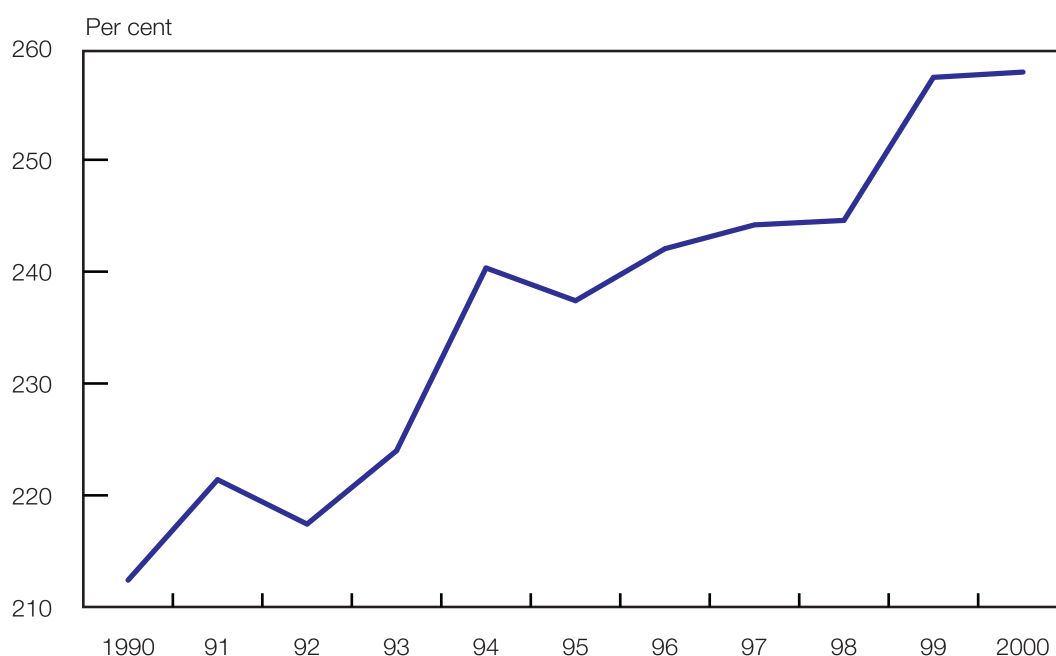
The overall *saving ratio* (i.e. gross saving expressed as a percentage of gross domestic product) improved from a historic low of less than 14½ per cent in 1998 to 15 per cent in 2000 and 15½ per cent in the first half of 2001. The gross saving of general government improved in the first half of 2001, but that of households remained weak, whilst that of the corporate sector deteriorated somewhat.

The high propensity of households to spend their current income kept gross household saving at a level equal to about 3 per cent of gross domestic product in 2000 and the first half of 2001. Over the same period, households' net saving as a percentage of household disposable income remained at about ½ per cent.

Over the longer run, households' saving relative to disposable income has declined almost incessantly from 5½ per cent in 1992 to ½ per cent in 2000. The counterpart of households' saving ratio is their propensity to consume, which has increased from 94½ per cent of current income in 1992 to 99½ per cent in 2000. Given that consumer confidence surveys currently indicate that households are somewhat uncertain about the future, it is perhaps puzzling why final consumption expenditure was still so strong and saving so weak in the first half of 2001.

When it is assumed that at any point in time consumption by households should also reflect their perceptions of wealth, the puzzle is largely resolved. New evidence on

Household wealth as percentage of disposable income



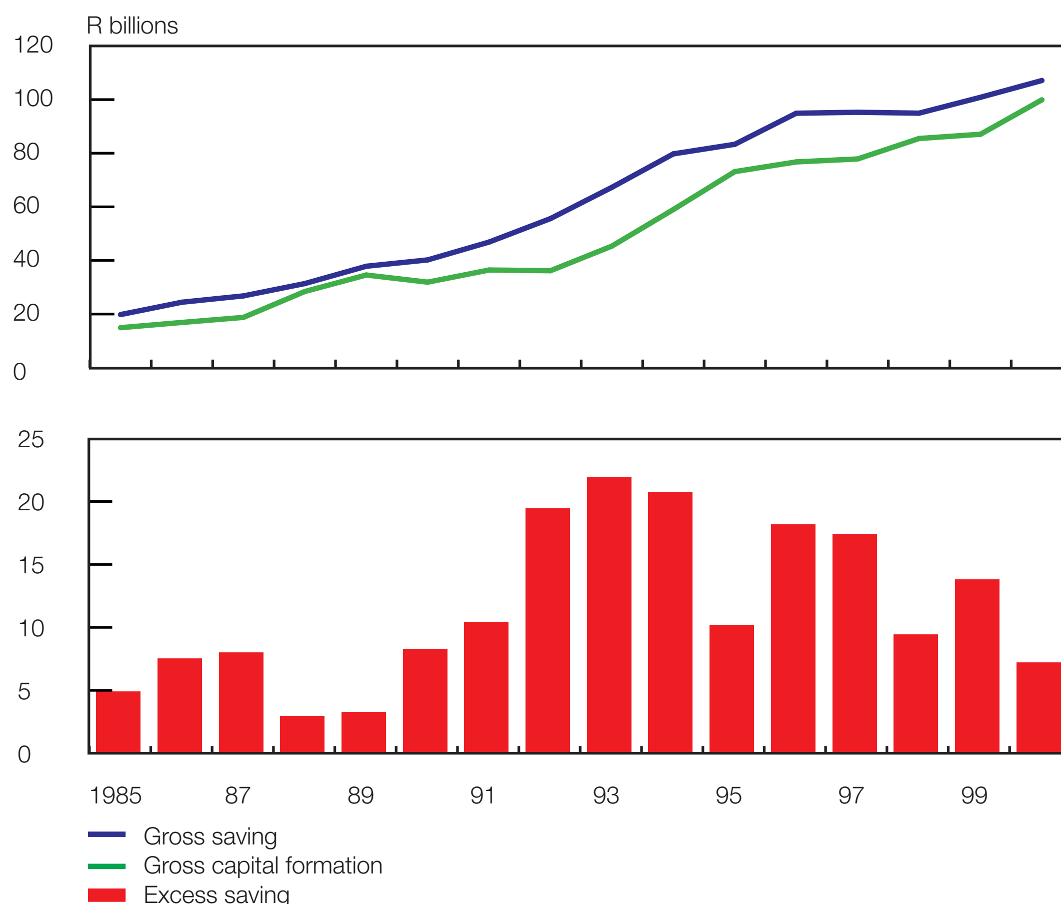
the evolution of households' net wealth over the years since 1992 indicates that they have accumulated wealth at a rapid pace without refraining from consumption on a grand scale. The estimated net wealth of households increased from 217 per cent of households' annual disposable income in 1992 to 258 per cent in 2000. As long as households' net worth grows at such a rapid rate, they will more than likely be willing to spend a greater proportion of their current income.

Gross saving by *general government,* which had been negative since 1991, turned positive in 2000 and was equivalent to about ½ per cent of gross domestic product in that year and in the first half of 2001. This improvement in gross saving by general government was primarily the net result of higher income tax revenue, lower interest payments on public debt and modest growth in government's outlays on goods and services.

Gross saving by the *corporate sector* as a percentage of gross domestic product weakened from 12½ per cent in 2000 to an average of 12 per cent in the first half of 2001. Growth in gross operating surpluses has been the main driver of corporate saving in the past year and a half.

Corporate saving is still the mainstay of gross saving in the economy and as a percentage of total gross saving, it increased from an average of 66½ per cent in the 1980s to 89½ per cent in the 1990s. At its highest, this ratio touched 100 per cent in 1994 before declining steadily to about 80 per cent in 2000 and 77 per cent in the first half of 2001.

Saving and capital formation in the corporate sector



Alongside corporate saving, gross capital formation by the corporate sector as a percentage of total gross capital formation was on average about 70 per cent during the 1990s. The corporate sector was thus generating saving in excess of its own capital needs. These excess funds were available for financing capital formation in the other institutional sectors of the economy.

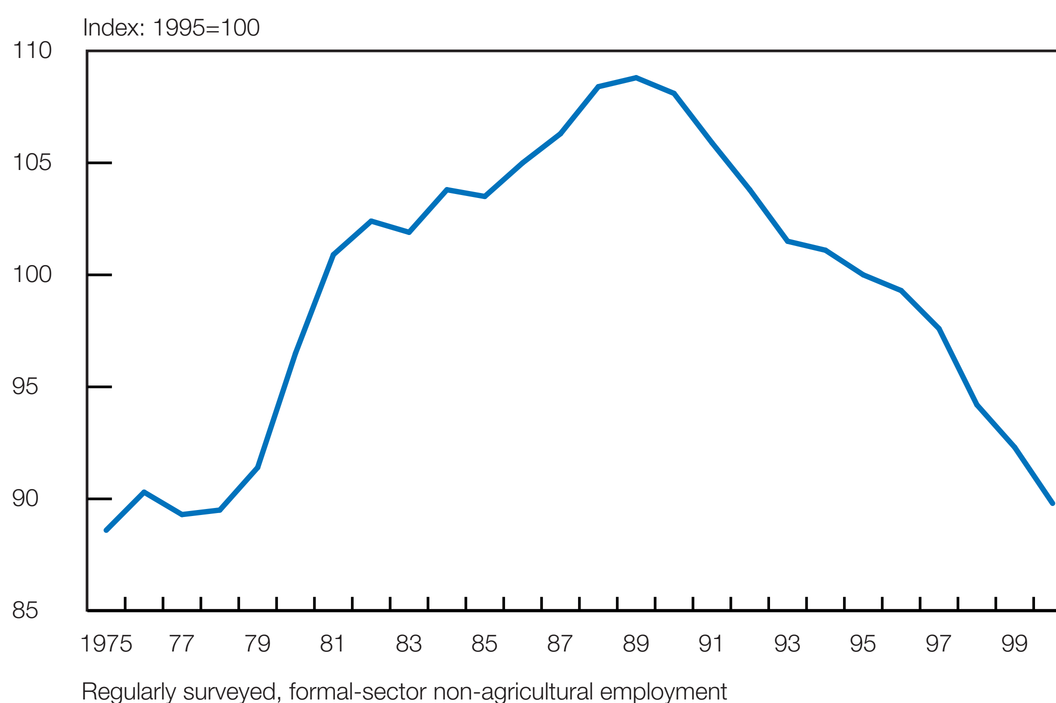
The excess of saving over capital formation in the corporate sector may be a result of companies' negative assessment of potential risk-return possibilities, leading to a low inducement to invest. Efforts to bolster corporate saving in the national interest should therefore only be considered when they are accompanied by measures to strengthen the inducement to invest.

Employment

Employment in the regularly surveyed formal non-agricultural sectors of the economy declined further in 2000 and the first three months of 2001, even though economic activity has been strengthening since the third quarter of 1998. There were signs of some recovery in private-sector employment in the fourth quarter of 2000, but this was not sustained in the first quarter of 2001.

According to the *Survey of Employment and Earnings (SEE)* in selected industries by Statistics South Africa, approximately 4,67 million people were employed in the formal non-agricultural sectors in March 2001. This was 2,1 per cent less or about 100 000 employees fewer than in March 2000. In total, formal non-agricultural employment has now shrunk by about 1 million since the peak of the employment cycle in 1989.

Employment



Final results from the household-based *Labour Force Survey (LFS)* for September 2000 reflect a slightly brighter picture of labour market conditions. The official

unemployment rate declined from 26,7 per cent to 25,8 per cent in the seven-month period to September 2000. Furthermore, the expanded unemployment rate which includes discouraged job seekers (i.e. those who have not searched for jobs in the past month) was 35,9 per cent in September 2000, compared with a rate of 35,5 per cent in February 2000 – a change that is not viewed as significant in a statistical sense.

Estimates of employment levels in the formal sectors of the economy derived from the LFS exceed those derived from the SEE. This indicates that formal-sector employment is growing in those industries and sectors, especially the services sector, that are not comprehensively covered by the SEE. The discrepancy between the two estimates is also consistent with the increase in the relative importance of the services sector as the prime creator of employment opportunities in the formal sectors of the economy, and the waning contribution to economy-wide job creation made by the goods-producing industries.

Employment in the formal non-agricultural sector of the economy in September 2000

Thousands

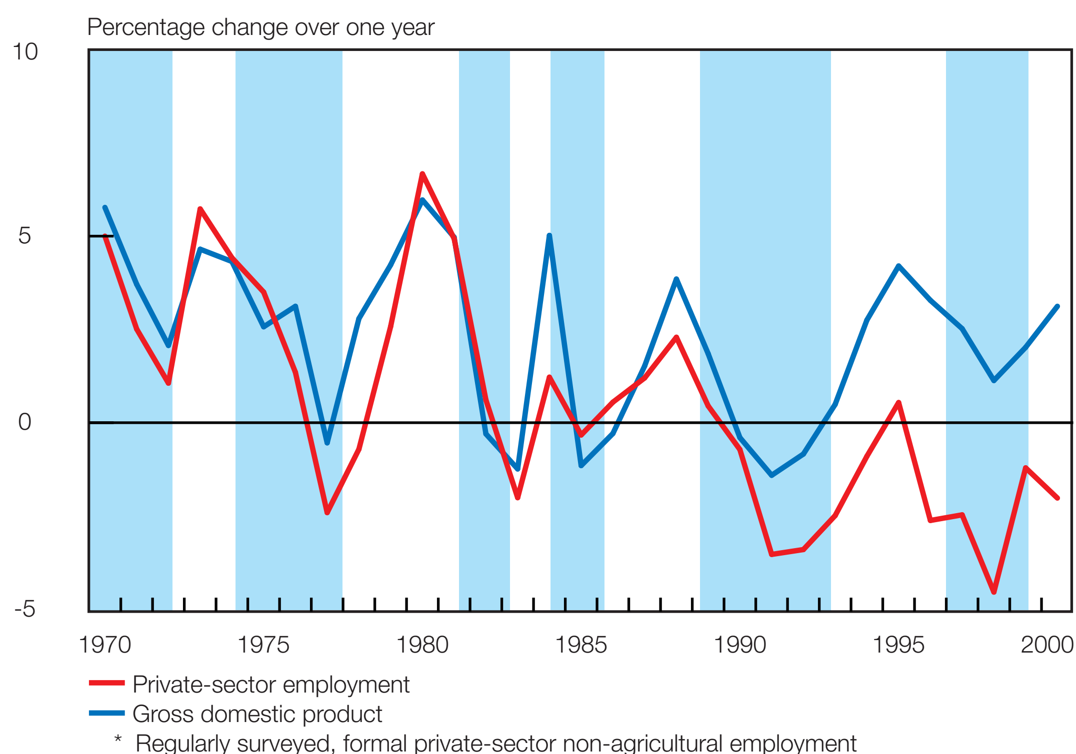
Labour Force Survey (LFS)	6 763
Survey of Employment and Earnings (SEE) in selected industries	4 685
Difference	2 078

The decline in formal-sector employment over the past twelve years can be attributed to the combined influence of a number of factors. These include the consistent pressure on domestic producers to be competitive in an increasingly globalised market, the slow pace of foreign direct investment into the economy, increasing rates of capital intensity and determined efforts on the part of the government to reduce the overall size of the public sector.

The structural changes in the South African economy during the 1990s left a mark on the historical relationship between changes in formal-sector employment and growth in the real gross domestic product. During the 1970s and 1980s economic growth and employment growth broadly moved in tandem (see accompanying graph). Since the early 1990s there has been a definite widening of the margin between economic growth and changes in the measured level of employment in the formal sectors of the economy: a given rate of economic growth has become associated with a considerably smaller change in formal-sector employment growth than before. In other words, ensuring the full absorption of the supply of labour into gainful employment would require an economic growth rate considerably higher than the rate indicated by the historical relationship between growth and job creation based on data for the 1970s and 1980s.

Industrial action declined markedly in 2000. According to NMG-Levy Consultants and Actuaries, a private-sector labour consultancy, the number of workdays lost due to strikes and other forms of work stoppages declined from 3,1 million in 1999 to 500 000 in 2000. Subsequently there was an increase in the number of workdays lost from 125 000 in the first half of 2000 to 235 000 in the first half of 2001. However, these figures should not detract from the downward trend in strike activity which was apparent over the past few years as 410 000 workdays were lost in the

Private-sector employment* and gross domestic product



* Regularly surveyed, formal private-sector non-agricultural employment

first half of 1999 and 310 000 in the corresponding period of the previous year. Alongside the decline in industrial action, union membership fell from 3,8 million in 1998 to 3,3 million in 1999 (the latest information available).

The share of *private-sector* employment in measured formal-sector non-agricultural employment reached a low point in 1998. In the ensuing period, employment in the non-agricultural private sector as a percentage of total non-agricultural employment rose by a full percentage point to 66 per cent in 2000, signalling that private-sector economic activity is re-establishing itself as the main provider of employment opportunities in South Africa.

Year-on-year change in non-agricultural private-sector employment in 2000

Sector	Percentage change
Gold mining	-6,8
Non-gold mining	-0,6
Manufacturing	-1,4
Electricity supply	-6,4
Construction	-4,6
Trade, catering and accommodation services	-0,8
Transport, storage and communication*	2,3
Financial intermediation and insurance	-3,9
Washing and dry-cleaning services	-1,5
Total private sector	**-2,0**

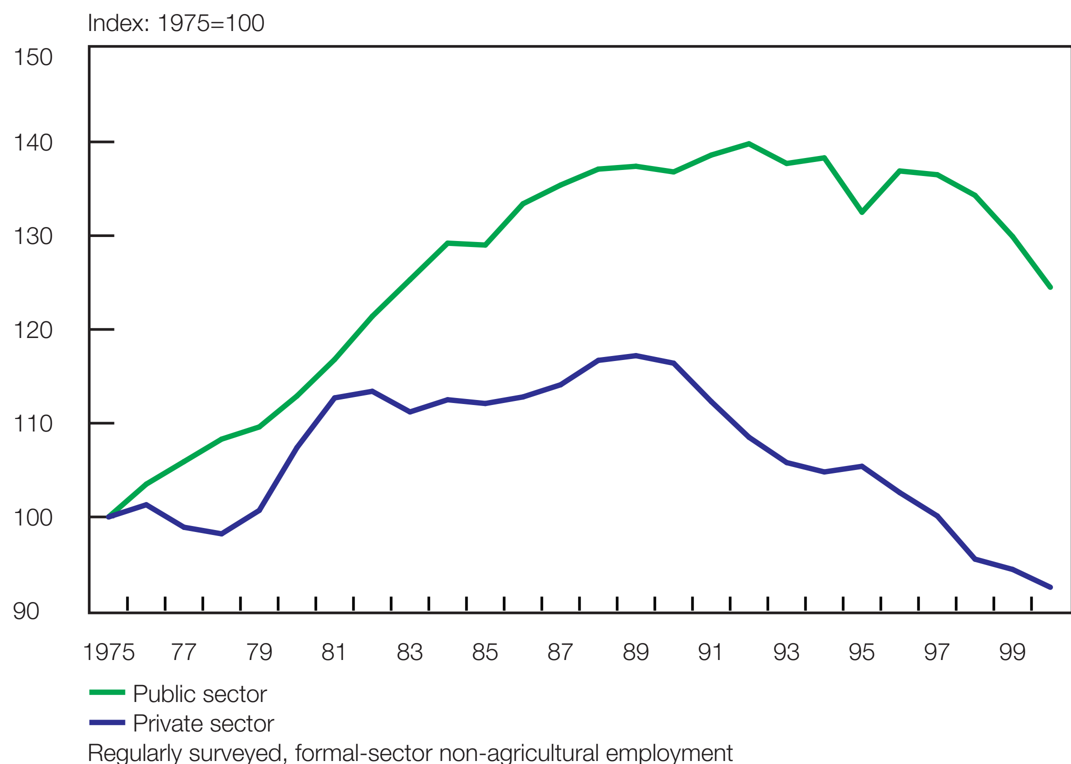
* Non-governmental institutions only

Private-sector employment as percentage of total employment

Regularly surveyed, formal-sector non-agricultural employment

Despite the recent increase in the relative importance of the private sector as a job provider, the average number of private-sector jobs still declined by 2,0 per cent in 2000, following a decline of 1,2 per cent in 1999. The decline in private-sector employment opportunities during 2000 was spread widely over most of the

Non-agricultural employment



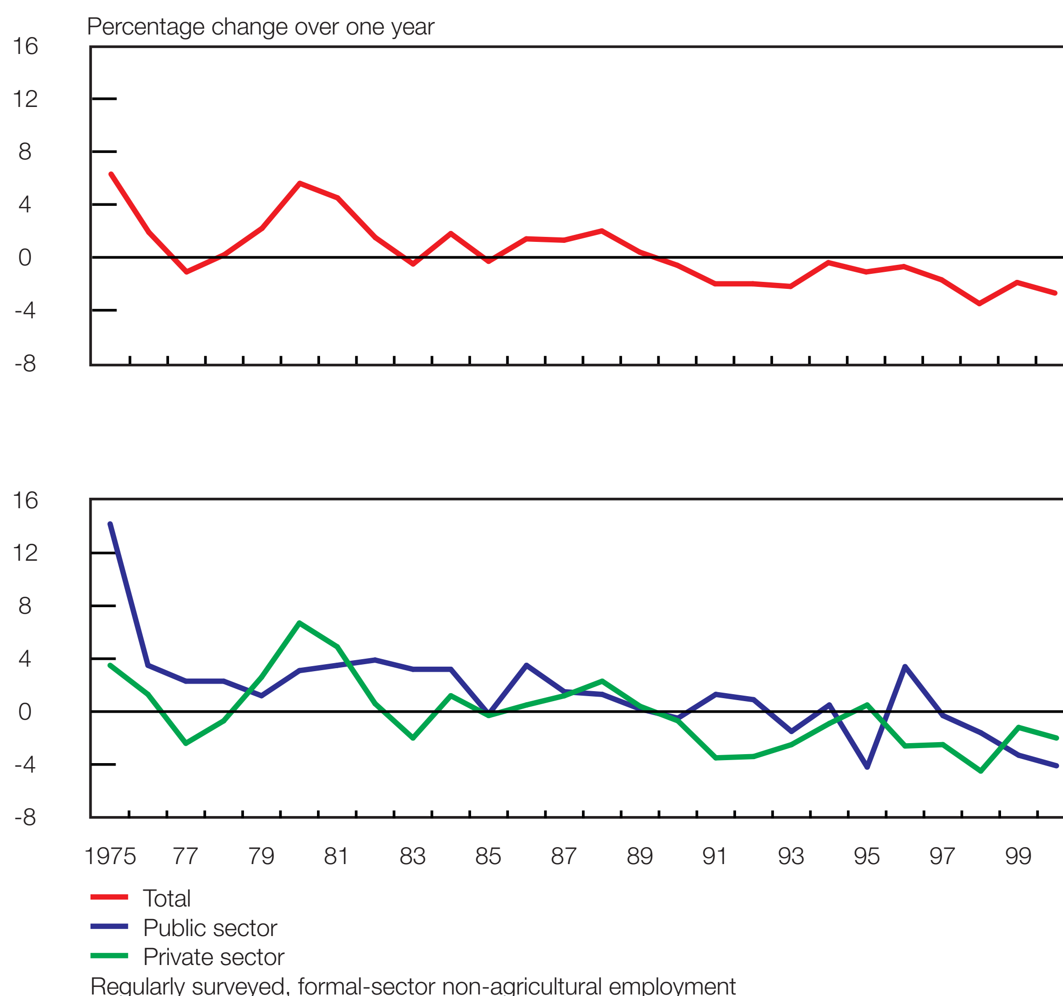
Regularly surveyed, formal-sector non-agricultural employment

production sectors of the economy, but was more pronounced in the mining, construction and electricity-generating sectors. By contrast, an increase of about 2 per cent was recorded in the transport, storage and communications sector during 2000 – the second consecutive year of increase in this sector. During the opening months of 2001, employment in electricity generating, non-gold mining and trade, catering and accommodation services sectors improved somewhat when compared with the levels measured a year earlier.

Almost 7 per cent fewer gold-mining employment opportunities were available in 2000 than in 1999. The employment losses in the gold-mining sector can be directly attributed to the need to cut costs, mainly following the relatively weak dollar gold price. The pace of decline in construction-sector employment abated from around 16 per cent in 1999 to around 5 per cent in 2000 as growth in fixed capital formation accelerated. Contrary to the general slowdown in employment losses during 2000, employment in the electricity-generating sector, which had been increasing during 1998 and 1999, declined by 6,4 per cent in 2000.

Mirroring the increase in the relative contribution of private-sector employment to total non-agricultural employment in the past two years, *public-sector* employment contracted by about 7 per cent or 127 000 jobs over this period. Furthermore, the pace of job-shedding accelerated from 1,6 per cent in 1998 to 4,1 per cent in 2000.

Public-sector and private-sector employment



This faster pace of employment reduction in the public sector resulted primarily from a process of "right-sizing" which is aimed at raising the quality of public service delivery. Declines in employment were recorded at all levels of the public sector in 2000, ranging from 0,3 per cent in local government departments to 8,4 per cent in governmental transport, storage and communication. A spate of resignations and early retirements of employees aggravated the decline in public-sector employment as well as the termination of part-time labour contracts by universities, technikons and provincial governments. Public-sector employment contracted further at a rate of 3,3 per cent in the year to March 2001.

According to the latest *World Competitiveness Report* by the International Institute for Management and Development, published in June 2001, South Africa was rated 42nd out of a total of 49 countries – one position better than the previous year. South Africa's weakest areas include the country's unemployment rate, the prevalence of industrial disputes which is still regarded as too high by international standards, the lack of skills of its labour force and the high pupil-teacher ratio.

In an effort to address the inadequacies pointed out in the *World Competitiveness Report*, the government has put forward various strategies during the past year or so. These strategies include:

- the introduction of an employment subsidy, which will reward employers for the number of jobs created;
- the introduction of a wage-related tax incentive – final details will be released in the coming months;
- the implementation of the skills development levy (at a rate of 1 per cent on the payrolls of companies from 1 April 2001), intended to enhance the acquisition of needed skills and to stimulate employment creation;
- an extension of tax privileges to small businesses which will enhance the potential of private-sector employment creation;
- the launch of a national skills development strategy that sets out targets for the number of jobs to be created for the unemployed; and
- the launch of a learnership programme designed to replace apprenticeships and to bridge the gap between trades and professions.

The *World Competitiveness Report* places South Africa in fifth position in terms of public expenditure on education. This rating gives recognition to the government's commitment to education and training. Furthermore, an Immigration Bill was tabled in Parliament which aims, among other things, to facilitate the recruitment of skilled foreign workers to South Africa. Cabinet has also proposed that the Department of Home Affairs be solely responsible for migration control, in order to better facilitate the acquiring of skills from abroad.

Further developments in the labour market during the past year or so, relate to proposed statutory amendments to the Labour Relations Act, Basic Conditions of Employment Act and the Insolvency Act. Designated large-scale employers were required to submit employment equity plans on 1 June 2000 and designated medium-sized employers on 1 December 2000. In addition, the Unemployment Insurance Fund Bill was gazetted in March 2001, and is aimed at increasing the reserves of the Fund and extending benefits to all employees.

The HIV/Aids pandemic has become a significant factor that is likely to impact seriously on the South African labour market. Predicting the macroeconomic impact of HIV/Aids requires *a priori* knowledge about the infection rate and certain micro

responses, e.g. how would the saving and investment decisions of poor households be influenced when one or more family members contract the disease. Few research findings currently exist on which to base any definite conclusions. However, it can be assumed that economic growth could slow down because of the reduced supply of labour.

Labour costs and productivity

Growth in the *nominal compensation per worker* in the formal non-agricultural sectors of the economy has slowed down in recent years, contributing meaningfully towards the containment of price inflation. The year-to-year growth in nominal remuneration per worker in the formal non-agricultural sectors of the economy was 8,8 per cent in 2000, substantially down from wage growth of 22 per cent in 1992 and 14 per cent in 1998. Nominal remuneration per worker in the public sector rose by 9,4 per cent in 2000 and that of workers in the private sector by 8,7 per cent.

The slowdown in remuneration growth in the *private sector* was sustained during the opening months of 2001 from a year-on-year rate of increase of 8,2 per cent in the fourth quarter of 2000 to 5,1 per cent in the first quarter of 2001. Remuneration growth within the private sector was not uniform and differed substantially between subsectors. Average nominal remuneration per worker in the construction sector increased at a year-on-year rate of 3,6 per cent in 2000, but employees in the financial, intermediation and insurance industry received increases of around 15 per cent. The skills-intensive financial services sector evidently had to compete in a segment of the labour market where supply was limited. Structural changes in the economy have also resulted in a disproportionate increase in the demand for skilled workers relative to the unskilled. It is not yet clear whether the recent problems in the information and communications technology sectors are likely to release labour resources and ease part of the current constraints on the availability of skilled labour.

The recent slowdown in private-sector nominal wage growth is corroborated by information obtained from the Automated Clearing Bureau on the salaries, wages and pensions deposited into the accounts of nearly 5 million salaried and retired workers. According to these statistics, nominal wage growth declined from 8,3 per cent in 1999 to 6,1 per cent in 2000. Furthermore, according to the Steel and Engineering Industries Federation of South Africa, the increase in actual labour costs in the steel and engineering industry slowed down from 8,8 per cent in 1999 to 5,3 per cent in 2000. NMG-Levy Consultants and Actuaries also reported that the average rate of wage settlements in collective bargaining agreements declined from 8,0 per cent in the first half of 2000 to 7,5 per cent in the first half of 2001.

Salary and wage increases granted by the public sector were, on average, more generous than those granted by the private sector in 2000. The growth in average nominal compensation per worker in the public sector doubled from 4,6 per cent in 1999 to 9,4 per cent in 2000, but varied considerably within the public sector. For instance, workers employed by parastatals, universities and technikons and other public corporations received average increases in excess of 10 per cent during 2000, compared with those employed by local governments whose pay increased by only some 5 per cent.

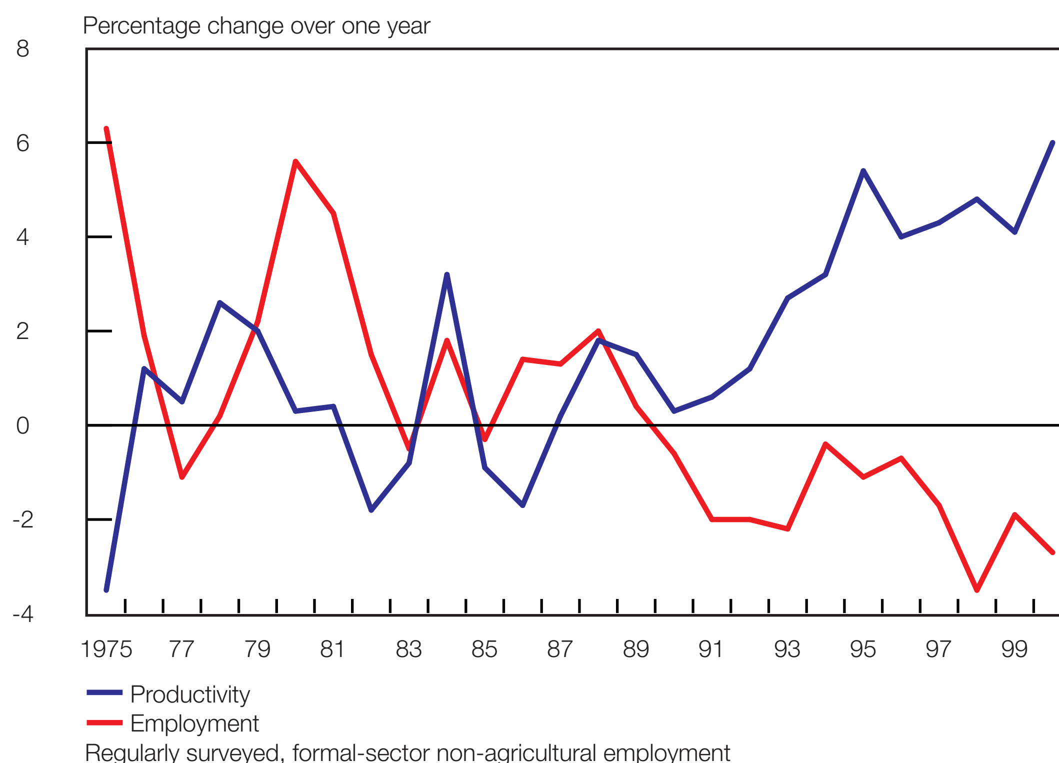
Despite the slowdown in nominal wage growth, the rise in nominal remuneration per worker exceeded that of output prices during 2000 and in the opening months of 2001. Consequently, the year-to-year rate of increase in the ratio of remuneration per

worker to output prices as reflected by the price deflator for the non-agricultural gross domestic product, amounted to 2 per cent in 2000. Measured over periods of four quarters, the growth in *real remuneration per worker* amounted to 1,4 per cent in the first quarter of 2001.

Real wage growth usually implies a shift in the distribution of income in favour of labour and away from operating surpluses in the absence of an accompanying rise in labour productivity. Labour productivity growth was, however, exceptionally strong during the second half of the 1990s. For the period 1994 to 2000, the average annual rate of increase in labour productivity in the formal non-agricultural sectors amounted to 4,5 per cent, which was 1,4 percentage points higher than the growth in real remuneration per worker.

The growth in *output per worker* in the formal non-agricultural sectors of the economy amounted to 6,0 per cent in 2000 – the highest rate of increase in the past thirty years. This compares with rates of increase of 4,0 per cent in 1999 and 4,8 per cent in 1998. The rise in labour productivity since the early 1990s has, however, been accompanied by declining employment levels in the regularly surveyed formal non-agricultural sectors of the economy. Still, it should always be remembered that estimates of productivity growth based on the number of employed people may sometimes give a misleading impression since they take no account of the intensity of labour usage as reflected in the number of hours worked by employees.

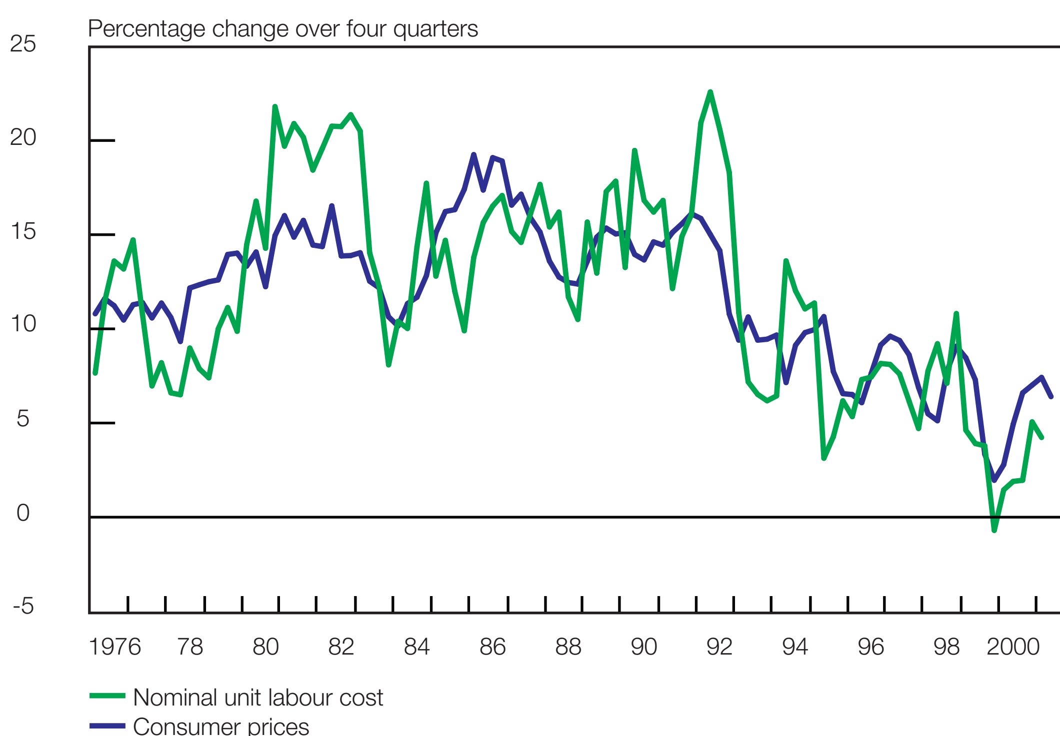
Employment and labour productivity



The rate of change in *nominal unit labour costs,* i.e. the ratio of nominal compensation per worker to output per worker, remains an important component of the inflation process. Changes in nominal unit labour costs normally precede or coincide with

changes in consumer-price inflation. When nominal remuneration growth in the economy exceeds labour productivity growth, inflationary pressures in the labour market are evidenced by the rise in unit labour cost. Robust growth in labour productivity compressed the growth in non-agricultural nominal unit labour cost to a historically low rate of only 2,6 per cent in 2000. In the manufacturing sector, the growth in nominal unit labour cost was confined to just 0,7 per cent in 2000, and to 0,5 per cent in the year to the first quarter of 2001. The low rates of increase in nominal unit labour cost played a major role in subduing the potential inflationary impact that high energy prices and the depreciation of the rand could have had on the domestic economy.

Nominal unit labour cost and consumer prices

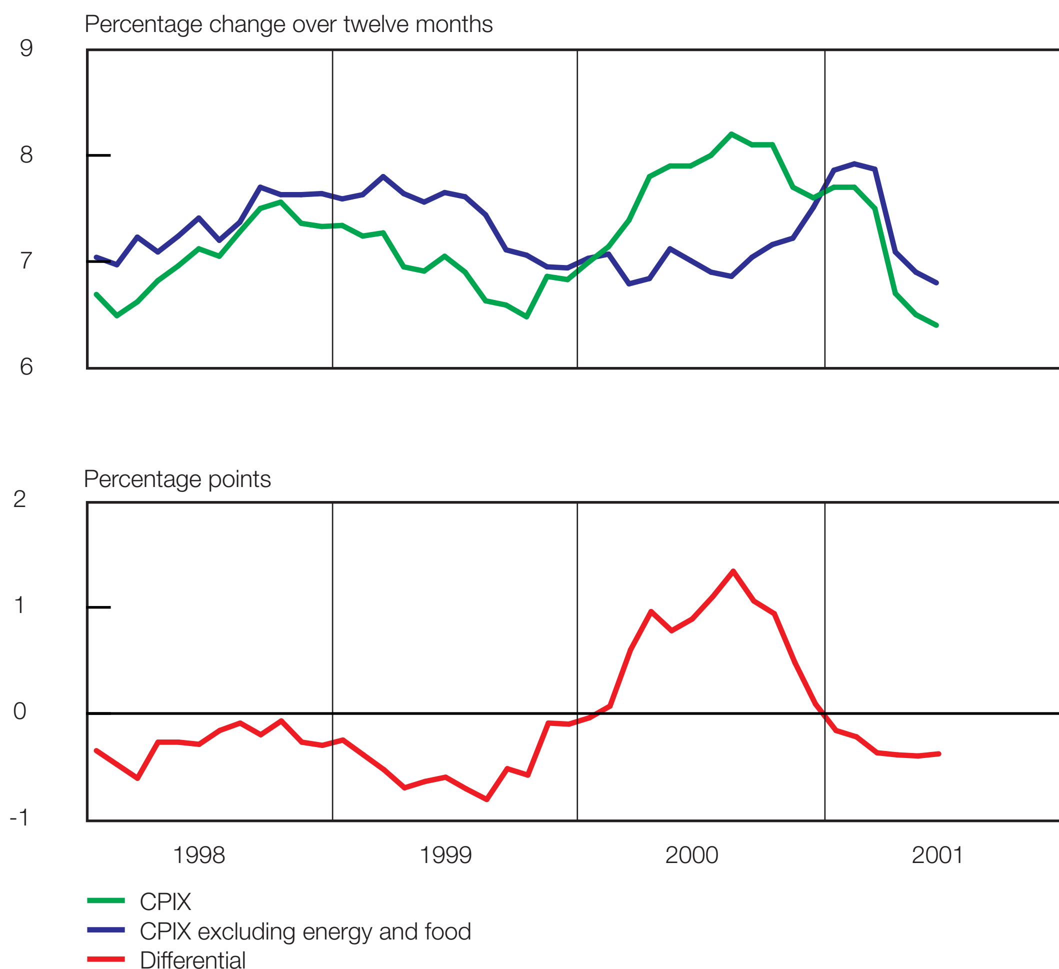


Inflation

South Africa formally adopted an inflation-targeting monetary policy framework in February 2000. As a monetary policy framework, inflation targeting is principally characterised by the announcement of a numerical target for the inflation rate to be achieved over a specified period of time. The inflation target has been set at an average rate of increase in CPIX (i.e. the overall consumer price index for metropolitan and other urban areas, excluding the influence of mortgage interest costs) of between 3 and 6 per cent to be achieved in 2002.

Following the introduction of the new monetary policy framework, CPIX inflation initially retraced its course somewhat from the low levels attained during the opening months of 2000, rising from 7,0 per cent in January to 8,2 per cent in August. Subsequently, inflationary forces started to wane, lowering CPIX inflation to 6,4 per cent in June 2001 – just 0,4 percentage points higher than the upper end of the inflation target range set for 2002.

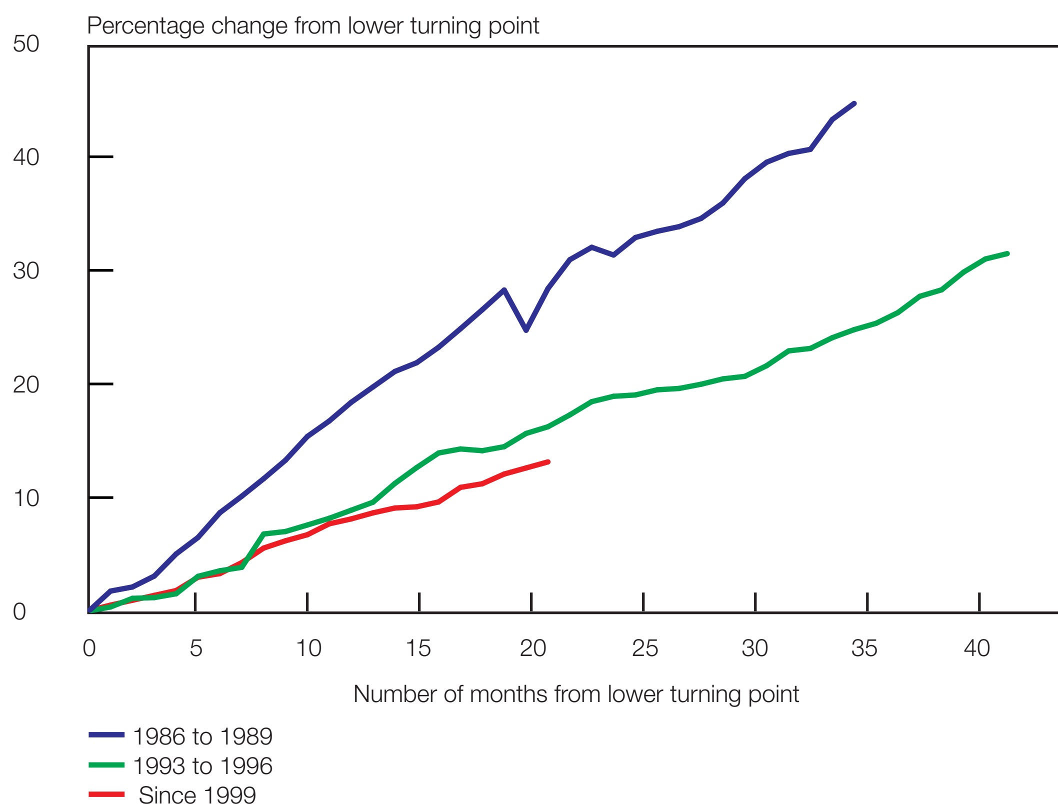
The acceleration in CPIX inflation in the first eight months of 2000 can be attributed to developments in the external environment and unfavourable developments affecting food prices during the early part of that year. The rise in the domestic prices of petrol and diesel due to the higher rand price of imported crude oil, and the effects of higher food prices following flood damage to crops in the early months of 2000, were estimated to have added 130 basis points to CPIX in August 2000. After August 2000, inflation benefited from the moderation in the rates of increase in the prices of petrol, diesel and food, and CPIX inflation moved steadily closer to the target range.



An acceleration in inflation during the upward phase of the business cycle is typical of the South African economy. During each of the upward phases of the business cycle since the 1970s, the rate of inflation tended to accelerate, but the acceleration has been more muted during the current upswing of the business cycle than during any of the previous upswings.

Overall consumer price inflation, which also reflects the effect of changes in mortgage rates in addition to the price measures included in CPIX, rose quite steeply from its nadir of 1,7 per cent in October 1999 to 7,8 per cent in February

CPIX inflation during economic recoveries

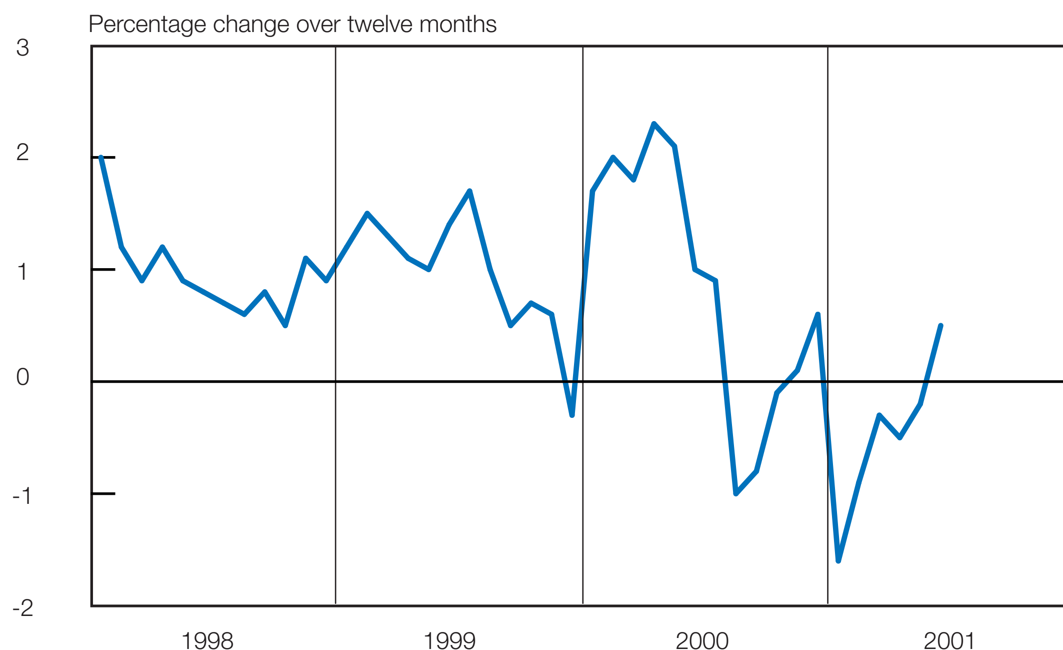


2000, but then fell back to 6,3 per cent in June 2001. The recent decline in inflation can primarily be attributed to falling food prices and the slowdown in the rate of increase in the running cost of transport. Inflation in the prices of consumer services also subsided from a year-on-year rate of 8,9 per cent in February 2001 to 6,7 per cent in June.

Year-on-year inflation in the prices of consumer goods fell from 8,7 per cent in August 2000 to 5,8 per cent in June 2001, pushed lower by waning inflation in the prices of food and energy, and also by lower inflation in the prices of other goods which constitute about 30 per cent of the weighting of the overall consumer goods category. Practically no inflation was recorded in the prices of clothing and footwear products. In fact, measured over periods of twelve months, prices in this expenditure category have been falling since August 2000.

Inflation in production prices used to serve as a leading indicator of future changes in consumer prices, but lost some of its predictive power during 2000. The heightened volatility in crude oil prices in recent years is reflected almost immediately in changes in the production price index, more specifically in the import component of the index. But these changes are not fully passed on as changes in the prices of petrol and diesel entering the consumer price index. Changes in the pump prices of petrol and diesel are generally only a fraction of the change in the price of imported crude oil because of the high indirect tax content of the end user price of petrol and diesel. Indirect tax changes occur rather infrequently, thus suppressing the transfer of price changes in the production price index of crude oil to the pump price of petrol and diesel.

Prices of clothing and footwear products



The year-on-year increase in the all-goods production price index rose, on balance, from 2,3 per cent in March 1998 to 10,0 per cent in December 2000, but slowed down to 8,1 per cent in April 2001 and 8,6 per cent in May and June. The acceleration in production price inflation up to December 2000 was first and foremost a consequence of the rising prices of imported goods, driven by the steep increase in the international price of crude oil, the decline in the value of the nominal effective exchange rate of the rand over the past year and a half, and a pick-up in wholesale

Production prices

Percentage change over twelve months

Period		Domestically produced goods	Imported goods	All goods
2000:	Jan	6,5	13,1	8,2
	Feb	6,5	14,4	8,4
	Mar	6,7	14,6	8,6
	Apr	8,0	16,2	10,1
	May	7,1	13,5	8,7
	Jun	7,0	14,0	8,8
	Jul	6,6	14,0	8,6
	Aug	7,2	15,2	9,3
	Sep	7,9	13,3	9,4
	Oct	7,8	14,2	9,6
	Nov	8,0	14,8	9,9
	Dec	7,9	15,0	10,0
2001:	Jan	7,7	13,2	9,2
	Feb	7,7	12,4	9,1
	Mar	7,5	12,3	8,9
	Apr	6,9	11,2	8,1
	May	7,5	11,8	8,6
	Jun	7,9	10,0	8,6

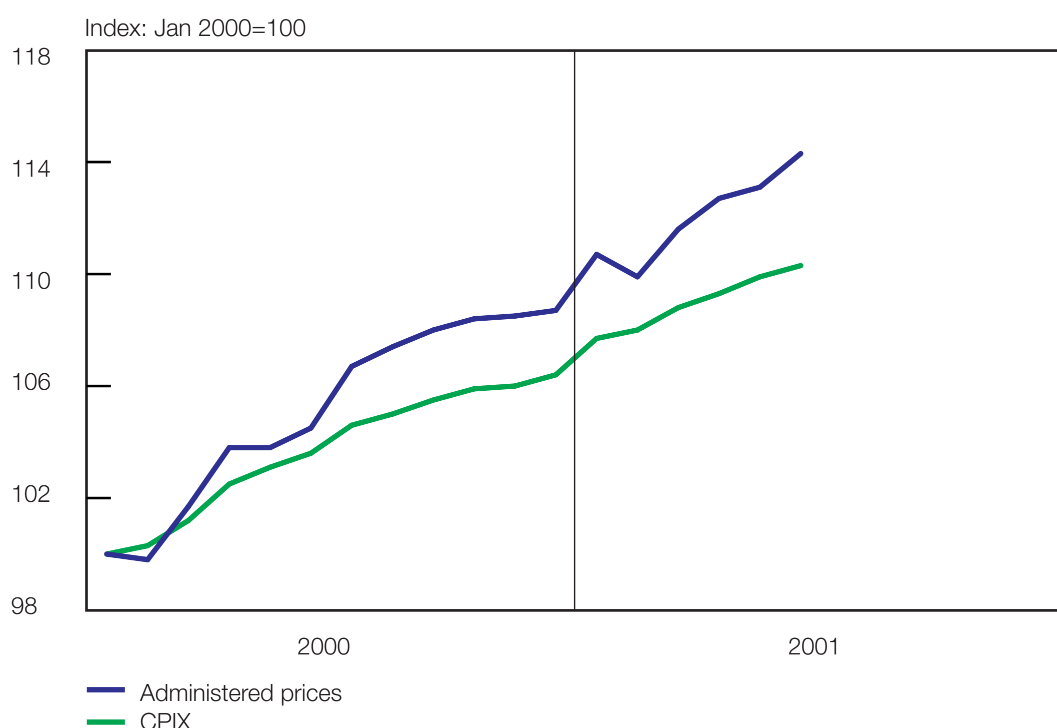
price inflation in South Africa's main trading-partner countries – the increase in the composite wholesale price index in trading-partner countries accelerated from 0,3 per cent in March 1999 to around 7 per cent by the end of 2000. These factors raised inflation in the prices of imported goods to as high as 16,2 per cent in the year to April 2000, but later it tapered off to a still high level of 10 per cent in June 2001.

Partly as a consequence of the rising cost of intermediate imports in the production process, inflation in the prices of domestically produced goods accelerated from 3,2 per cent in March1998 to 8,0 per cent in November 2000. Subsequently the impact of slower growth in labour cost took hold and, assisted by declining food prices, inflation in the prices of domestically produced goods moderated to 6,9 per cent in April 2001 and 7,9 per cent in June. This slowdown was dispersed evenly throughout most of the subcategories of the all-goods production price index. The slight pick-up from April to June 2001 was essentially caused by energy price rises, in the areas of both petroleum and electricity generation, and food price increases at the manufacturing level.

From a global perspective, South Africa, like many other countries, could not escape the inflationary consequences of rising international crude oil prices over the past two years. All things considered, South Africa has apparently been able to withstand the inflation impulses far better than many other countries. Whereas average inflation rose by more than two-thirds in industrialised countries from 1,4 per cent in 1999 to 2,4 per cent in 2000, average consumer price inflation in South Africa barely changed from 5,2 per cent in 1999 to 5,3 per cent in 2000. A variety of counter-inflationary forces in South Africa prevented inflation from escalating to the extent of industrialised-country inflation. These were

- the consistent application of conservative counter-inflationary monetary policies, culminating in the adoption of a formal inflation target to be achieved in 2002;

CPIX and administered prices



- the moderation of nominal remuneration demands and gradually declining wage settlements;
- solid productivity growth which has been sustained for a considerable period of time;
- the slow growth in nominal unit labour cost which has had a significant impact on end-product prices;
- continued trade liberalisation which prevented domestic producers from raising prices in the face of increased competition by international suppliers; and
- government's commitment to fiscal prudence and greater efficiency in public-service delivery.

Overall, the inflationary bias of the economy is gradually waning. However, price formation in those areas of the economy where government agencies still have an important say, is delaying progress towards greater price stability. Over the past seventeen months these "administered prices", representing some 22 per cent of the overall consumer price index, rose by 14 per cent or at an average annualised rate of 9,9 per cent.

Foreign trade and payments

Policy issues and trade reforms

South Africa broadened regional and international economic co-operation during the past year and a half, mainly by entering into various multilateral and bilateral trade agreements. The implementation of some of these agreements is already having positive effects on the South African economy. Further progress with exchange control liberalisation also helped South Africa's reintegration into the world economy. Through specific exchange-control relaxations, domestic corporates are encouraged to expand their assets globally, particularly in the Southern African Development Community (SADC) and in the rest of Africa.

An agreement was reached in principle between South Africa and ten other SADC member states to facilitate economic co-operation in the southern African region by dismantling the existing tariff and non-tariff barriers, leading to the establishment of a free trade area by September 2004. When fully implemented, this agreement will strengthen trade, investment and industrial linkages in the region. In terms of this agreement, the members of the Southern African Customs Union will eliminate tariffs on most intra-SADC imports within five years, whereas the other members of the newly formed trade bloc will do so within eight years.

In his 2001/2002 Budget Speech, the Minister of Finance announced further exchange-control relaxations. These concessions relate mainly to the financial account of the balance of payments and include the following:

- The amount that South African corporates are allowed, on application, to transfer for investment in the SADC is increased from R250 million to R750 million. This amount will also be allowed for investment elsewhere in Africa;
- South African corporates may now also apply to invest R500 million outside Africa instead of the R50 million which was previously allowed for investment outside the SADC;
- corporates may apply for part of their local cash holdings to finance up to 10 per cent of approved new foreign investments where the costs of these investments exceed the current limits;
- foreign investments by way of corporate asset or share swaps may also be applied for;
- up to 10 per cent of outstanding foreign debt raised to finance foreign investment may be repaid with local cash holdings, subject to the precondition that the foreign debt should have been in existence for at least two years; and
- the travel allowance applicable to residents travelling abroad was increased to R140 000 per person over the age of twelve and R45 000 per child under the age of twelve years.

The Minister also announced the termination of the asset swap mechanism which has allowed South African institutional investors (i.e. long-term insurers, pension funds, the unit trust industry and fund managers) to diversify their asset portfolios internationally. Institutional investors now have to finance foreign portfolio investments through currency transfers from South Africa. These transfers are limited to 10 per cent of the net inflow of funds in 2000 and will be subject to the overall limits that apply to

institutional investors. These limits are 15 per cent of total assets for long-term insurers and pension funds, 15 per cent of total assets under management for fund managers and 20 per cent of total assets under management for unit trusts through unit trust management companies.

In August 2000, Government announced a strategy for the restructuring of state-owned enterprises with the aim of increasing the efficiency of such corporations. Sizeable inflows of foreign capital can be expected if this strategy is successful. The inward movement of capital will probably provide stability to the financial account of the balance of payments as most of the inflows will be classified as direct investment which has proved to be far more resilient than portfolio and other investments during times of financial crises.

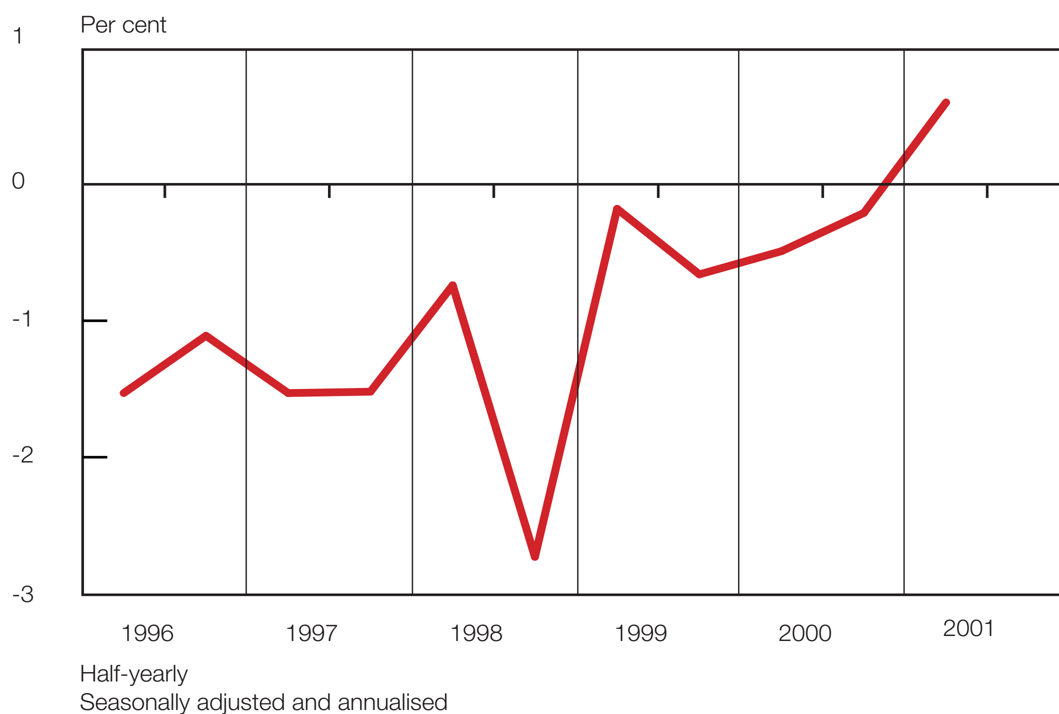
Balance on current account

The external sector has given considerable impetus to the economy, contributing a full percentage point to the growth in real gross domestic product over the year to

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

	2000		2001
	1st half	2nd half	1st half
Merchandise exports	177,9	204,8	227,9
Net gold exports	26,5	27,8	28,2
Merchandise imports	-178,1	-199,9	-211,7
Net service, income and current transfer payments	-30,5	-34,6	-39,0
Balance on current account	-4,2	-1,9	5,4

Ratio of current-account balance to gross domestic product



Half-yearly
Seasonally adjusted and annualised

the second quarter of 2001. Although world growth faltered in the first half of 2001, the depreciated exchange rate boosted export volumes, while the slowing in domestic demand, alongside the exchange-rate induced rise in import prices, held back growth in import volumes.

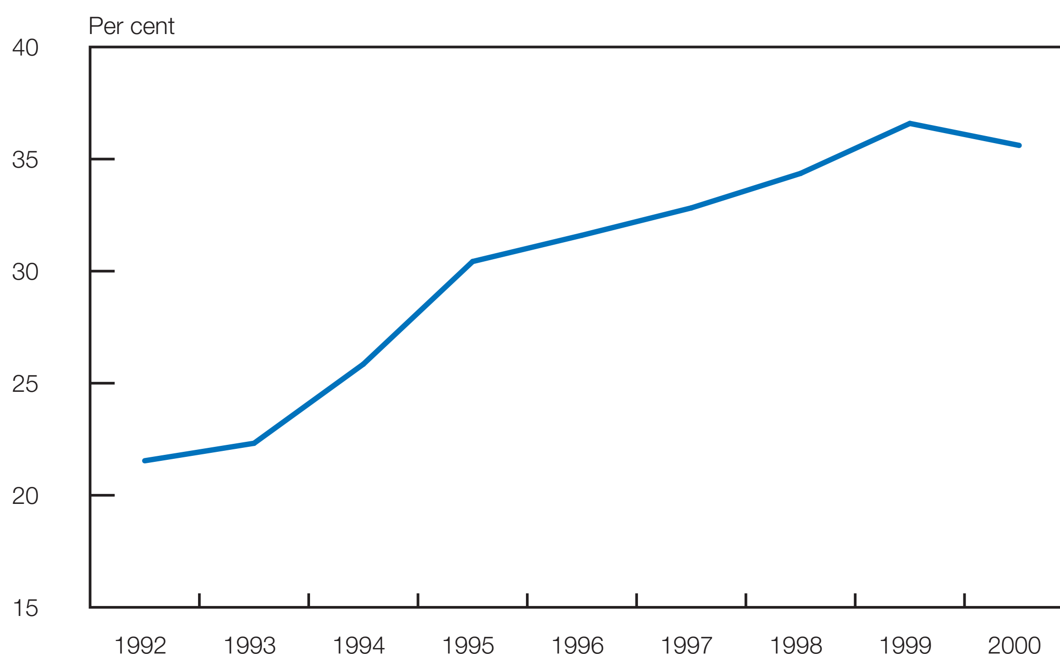
The economy adjusted impressively to the changing external environment and the lower exchange rate of the rand, moving from a seasonally adjusted and annualised deficit on the current account of the balance of payments of R4,2 billion in the first half of 2000 to a surplus of R5,4 billion in the first half of 2001. This implies a turnaround in the external accounts from a deficit equal to 0,5 per cent of gross domestic product in the first half of 2000 to a surplus of 0,6 per cent in the first half of 2001.

Exports

The seasonally adjusted value of merchandise exports (excluding gold) rose by 28,1 per cent from the first half of 2000 to the first half of 2001. The physical quantity of merchandise exports, responding to the relatively strong international demand and the greater competitiveness of South African exporters, rose by 10½ per cent over the year to the first half of 2001. Global demand faltered somewhat, causing the growth in export volumes to slow down to about 4 per cent in the first half of 2001, but the rand prices of exported goods roughly maintained the upward momentum of the second half of 2000.

Apart from the effect of the depreciation in the value of the rand, the prices of South Africa's main export commodities have recovered modestly on international markets over the past eighteen months, contributing to the steady improvement in export earnings. The country's terms of trade improved by about 1 per cent from the first half of 2000 to the first half of 2001, signalling that the same volume of exports from the country can now be exchanged for a larger volume of imports than previously.

Exports of manufactured goods as percentage of total export earnings

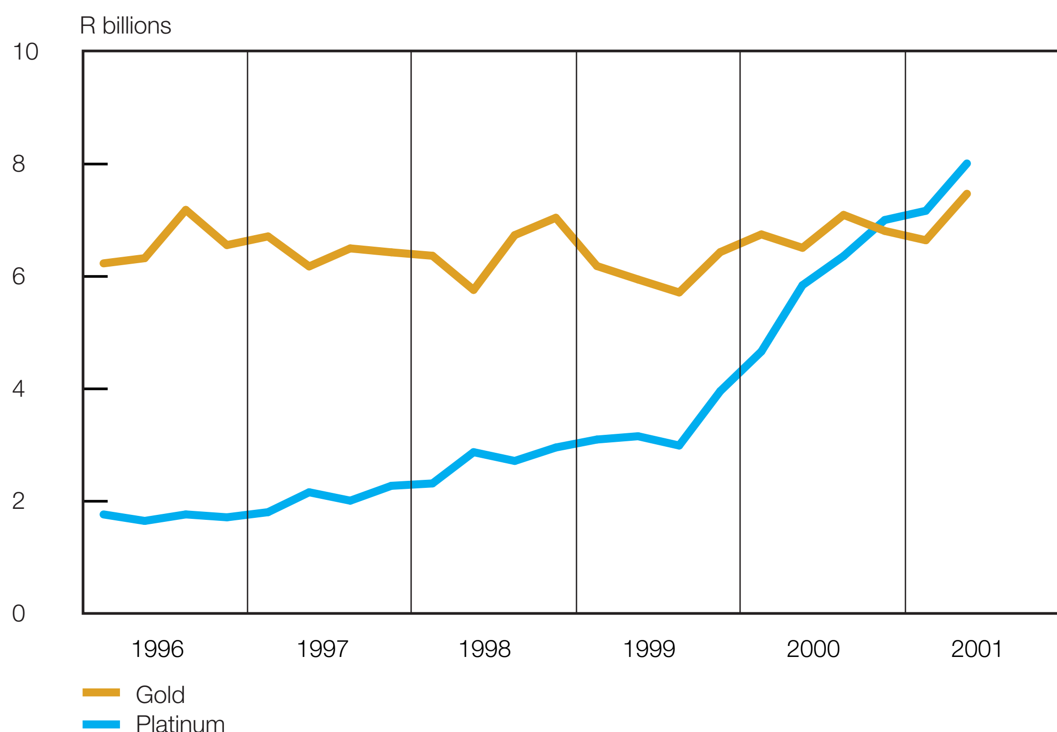


Higher prices of platinum and increased earnings from the export of mineral products maintained the share of mining exports in the total value of exports at about 59 per cent in 2000. The exports of manufactured goods were helped by the lower value of the rand and maintained their share in the overall value of exports at about 36 per cent in 2000.

The value of gold exports increased by 6,4 per cent from the first half of 2000 to the first half of 2001, mostly because of the depreciation of the rand. As a percentage of overall exports of goods, gold exports constituted 11 per cent in the first half of 2001 compared with 50 per cent in 1980.

Gold production fell from 449 tons in 1999 to 428 tons in 2000 and to an annualised rate of 420 tons in the first half of 2001. Ore quality drifted down further from 4,6 grams of gold per ton in 1999 to 4,5 grams in 2000 and an estimated 4,1 grams in the first half of 2001. The quantity of gold ore milled has declined far more substantially in recent years.

Exports of gold and platinum group metals



The price of gold in US dollars remained weak in an environment where the role of gold in international reserves management strategies is becoming less and less important. The average fixing price of gold on the London market fell from US$388 per fine ounce in 1996 to US$279 in 1999 and 2000, and US$266 in the first half of 2001. The depreciation of the rand against the US dollar nonetheless pushed the rand price of gold higher by about 12,3 per cent from the first half of 2000 to the first half of 2001.

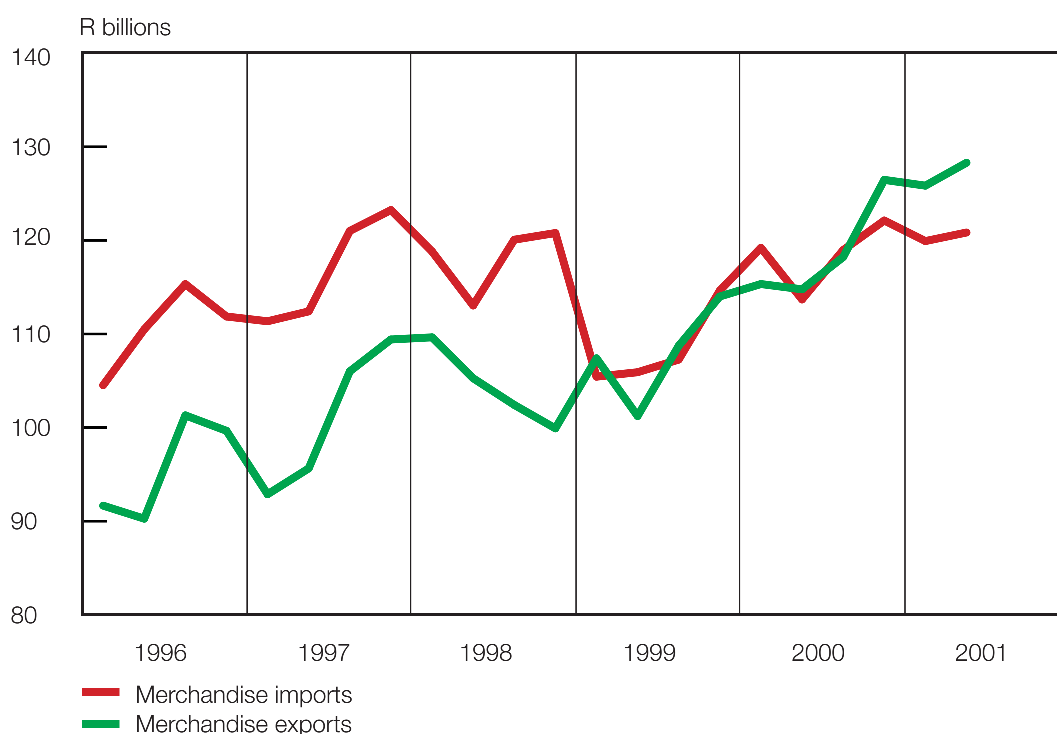
The lacklustre performance of gold exports and the vibrancy in the demand for platinum group metals in recent times led to a reversal of the roles of these two metals as contributors to the country's export effort. Gold used to dominate as the

most prominent export industry until the third quarter of 2000. Platinum group metals surpassed gold as the main earner of foreign currency and became the leading export sector in the fourth quarter of 2000.

Imports

Broadly consistent with the continuing expansion of domestic demand and the higher prices of imported goods, the seasonally adjusted value of merchandise imports rose by 19 per cent from the first half of 2000 to the first half of 2001. However, there was quite a sharp slowdown in the growth in nominal merchandise imports from the second half of 2000 to the first half of 2001.

Exports and imports at constant 1995 prices



Merchandise import volumes, underpinned by increases in real gross domestic expenditure, grew solidly by about 3½ per cent in the second half of 2000. When the slight weakening in economic activity became manifest in the first half of 2001, the volume of merchandise imports declined marginally. This was not solely the result of slower growth in domestic demand, but was also a response to higher import prices, which usually tend to discourage the importation of relatively expensive foreign produced goods while simultaneously encouraging expansion of output by domestic import-competing industries. Import penetration (i.e. the ratio of real merchandise imports to real gross domestic expenditure), which had increased from 18,7 per cent in 1999 to 19,9 per cent in 2000, accordingly levelled off in the first half of 2001. This indicates that a greater part of aggregate domestic demand was satisfied by domestic suppliers.

Import prices rose strongly in 2000, fuelled by an acceleration in wholesale price inflation in South Africa's most important trading-partner countries and the

depreciation of the rand. International oil prices, which had been relatively steady at a high level during 2000, declined in the first half of 2001. Despite this decline the weak rand contributed to an increase of about 6 per cent in the average prices of imported merchandise from the second half of 2000 to the first half of 2001.

The composition of South Africa's merchandise import basket changed quite considerably after international oil prices had risen so strongly in recent years. Oil imports relative to total merchandise imports increased from 9 per cent in 1999 to 13 per cent in 2000. Manufactured imports as a percentage of total merchandise imports, mirroring the increase in the relative size of oil imports, declined from 75 per cent in 1999 to 72 per cent in 2000.

Net service, income and current transfer payments

The net income deficit with the rest of the world widened fairly substantially from the first to the second half of 2000. This has been the trend over the past few years, determined mainly by the entry of non-resident portfolio investors into the domestic bond and equity markets. The increase in interest and dividend payments to non-resident portfolio and other investors was only partly offset by the repatriation of offshore earnings of South African portfolio and direct investors.

The deficit on the services and income account widened from R30,5 billion (annualised) in the first half of 2000 to R34,6 billion in the second half. Steady inward investment, mostly through the acquisition by non-resident investors of equity listed on the JSE Securities Exchange, caused dividend payments to the rest of the world to rise strongly in the second half of 2000. Tourist expenditure by foreigners visiting the country also rose solidly, but interest payments to the rest of the world declined as non-resident investors reduced their holdings of domestic bonds.

There was an increase in dividend payments to non-resident shareholders in the first half of 2001, partly related to the restructuring of shareholdings in the De Beers Diamond Corporation. Mainly because of this increase, the deficit on the services and income account widened to an annualised level of R39,0 billion in the first half of 2001.

Over the past two calendar years, the strong growth in dividend payments to non-resident shareholders has resulted in the ratio of interest and dividend payments to total export earnings rising from 12,4 per cent in 1999 to 12,9 per cent in 2000. This ratio increased despite the strong expansion of export values.

Financial account

On an annual basis, South Africa has recorded net inflows of capital through the financial account since 1994, but these flows have proven to be highly volatile. Portfolio investment flows became the main drivers behind the financial account surpluses, which not only financed deficits on the current account but also contributed to the strengthening of the country's international reserves. However, these flows remain susceptible to external forces, especially in other emerging markets, and consequent changes in investor sentiment towards the country. For this reason it is important for the country to attract a larger share of global direct investment flows so that it becomes less vulnerable to volatile portfolio capital flows.

Foreign direct investment is generally viewed as far less volatile and more resilient during financial crises than are portfolio investment flows. Foreign direct investment

flows are seldom reversed abruptly. Apart from their relative stability, foreign direct investment offers recipient countries benefits such as

- transfers of production technologies that cannot be achieved through financial investments or trade in goods and services;
- employee training in the operating of new businesses, which contributes to human capital formation;
- higher tax revenues from the corporate profits generated by foreign direct investment; and
- modernising business practices by introducing best practices in corporate governance and accounting rules.

The South African economy could not benefit in full from an inflow of foreign direct investment capital in the past eighteen months. Firstly, the inflows of foreign direct investment capital fluctuated fairly widely from one period to the next; secondly, inflows of foreign direct investment capital were partly offset by outward investments by South African companies expanding their activities in other countries and thirdly, the inflows of foreign direct investment capital were mostly destined for financing take-overs, mergers and acquisitions, and not for “greenfield” projects such as the construction of new factories. Financial investment, as opposed to “greenfield” investment, has a smaller effect on real capital formation and job creation. In fact, it is often associated with rationalisation and job losses in the short run.

Net financial transactions not related to reserves

R billions

	2000		2001
	1st half	2nd half	1st half
Liabilities			
Direct investment	5,6	0,5	54,6
Portfolio investment	5,5	6,3	-23,7
Other investment	9,0	1,1	-11,0
Assets			
Direct investment	-6,8	2,9	32,8
Portfolio investment	-15,5	-10,1	-37,1
Other investment	-1,8	-6,2	-14,0
Total financial transactions*	**-1,3**	**9,8**	**2,4**

* Including unrecorded transactions

Foreign direct investment inflows into South Africa declined from R5,6 billion in the first half of 2000 to only R0,5 billion in the second half. The inflows during the first half of 2000 were essentially related to a single transaction involving a United States corporation taking over a domestic information technology company. Inflows of foreign direct investment capital picked up once more in the first half of 2001 to R54,6 billion when a financial holding company with its headquarters in Luxemburg acquired full ownership of the De Beers Diamond Corporation which was then delisted from the JSE Securities Exchange.

Foreign direct investment outflows from South Africa by resident companies were reversed from R6,8 billion in the first half of 2000 to an inward movement of R2,9 billion in the second half when substantial equity holdings in a United Kingdom property company were sold by a South African-based company. In the first half of

2001, South African companies once more reduced their total asset holdings in other parts of the world. There were two prominent transactions during that period: a South African petrochemical company bought a European chemicals group, i.e. an outflow of capital, and the restructuring of the shareholding of the De Beers Diamond Corporation in the Anglo American Corporation, which led to a reduction in offshore assets or an inflow of capital. The net effect was an inflow of foreign direct investment capital of R32,8 billion in the first half of 2001.

On a net basis, i.e. offsetting changes in foreign direct investment liabilities against foreign direct investment assets, foreign direct investment flows changed from an outflow of R1,2 billion in the first half of 2000 to inflows of R3,4 billion in the second half and R87,4 billion in the first half of 2001.

Portfolio investment capital into South Africa moved at a rate of R5,5 billion in the first half of 2000, R6,3 billion in the second half, but flowed out at a rate of R23,7 billion in the first half of 2001. During 2000, non-resident investors continued to purchase shares of companies listed on the JSE Securities Exchange on a net basis and government and some of the parastatals issued bonds in the international capital markets. In addition, a South African information technology company listed on the London Stock Exchange, prompting some foreign fund managers and other non-resident investors to satisfy their demand for these shares on the JSE Securities Exchange. Most of these portfolio flows persisted in the first half of 2001, but they were offset by capital payments to non-resident shareholders in the De Beers Diamond Corporation.

Outward portfolio investment flows declined from R15,5 billion in the first half of 2000 to R10,1 billion in the second half and R37,1 billion in the first half of 2001. Institutional investors were accumulating offshore assets in terms of the asset swap mechanism in 2000 while individuals availed themselves of earlier exchange control relaxations in order to reduce risk by diversifying their assets.

South Africa's foreign portfolio investments increased appreciably when residents were awarded shares in the London-listed Anglo American Corporation in the first half of 2001. A substantial amount of equity in a United States company was also issued to a South African resident in 2000 as compensation for a majority interest in the domestic information technology company referred to previously. Some of these shares were sold in the first half of 2001. The asset swap mechanism was discontinued on 21 February 2001, slowing down the accumulation of foreign assets by domestic institutional investors and fund managers. Institutional investors are now allowed to acquire foreign portfolio assets only by means of foreign currency transfers linked to institutional cash flows in the preceding calendar year.

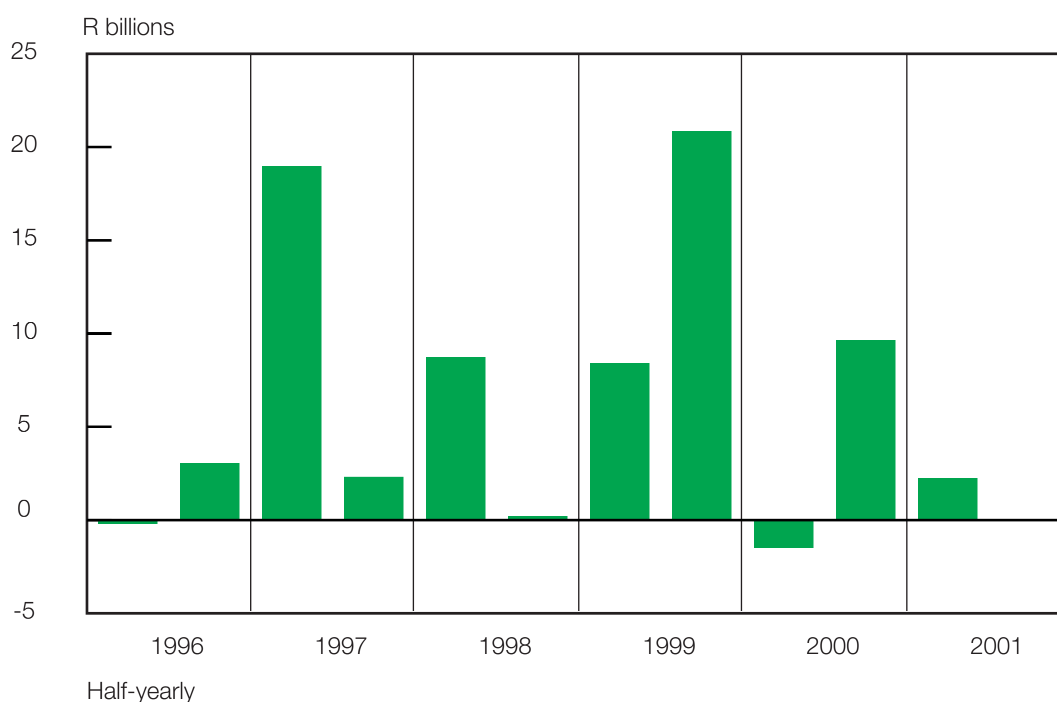
On a net basis, portfolio investment outflows declined from R10,0 billion in the first half of 2000 to R3,8 billion in the second half, but rose to R60,8 billion in the first half of 2001.

Other foreign investment into South Africa (defined as changes in the foreign-loan, trade-finance and deposit liabilities of South African residents) declined from R9,0 billion in the first half of 2000 to R1,1 billion in the second half, and turned into an outflow of R11,0 billion in the first half of 2001. Simultaneously, *outward* investment from South Africa in this investment category strengthened from R1,8 billion in the first half of 2000 to R6,2 billion in the second half and R14,0 billion in the first half of 2001. The strong improvement in exports from the country probably contributed

towards the increased trade financing provided to non-resident trading partners, whereas expectations of the depreciation of the rand against the US dollar encouraged the repayment of short-term foreign liabilities and the accumulation of foreign-currency denominated assets.

Net other foreign investment, i.e. the net movement of capital when changes in liabilities are offset against changes in assets, amounted to an *inflow* of R7,2 billion in the first half of 2000. The accumulation of short-term foreign assets became dominant in the second half of 2000, resulting in a *net outflow* of other foreign investment of R5,1 billion, followed by a further *net outflow* of R25,0 billion in the first half of 2001.

Total net foreign capital movements not related to reserves



In total, the balance on the financial account of the balance of payments including unrecorded transactions but excluding reserve-related transactions, improved from a deficit of R1,3 billion in the first half of 2000 to surpluses of R9,8 billion in the second half of 2000 and R2,4 billion in the first half of 2001.

Foreign debt

South Africa's *total outstanding rand-denominated and foreign-currency denominated foreign debt* declined from US$38,8 billion at the end of 1999 to US$36,9 billion at the end of 2000. This decline in the country's foreign debt liabilities resulted mainly from a deterioration in foreign investor sentiment towards South African fixed-interest securities. Net sales by non-resident investors of domestic bonds helped the country's rand-denominated external debt to decline from US$14,9 billion at the end of 1999 to US$12,0 billion at the end of 2000. Foreign-currency denominated debt increased by about 4 per cent over the period.

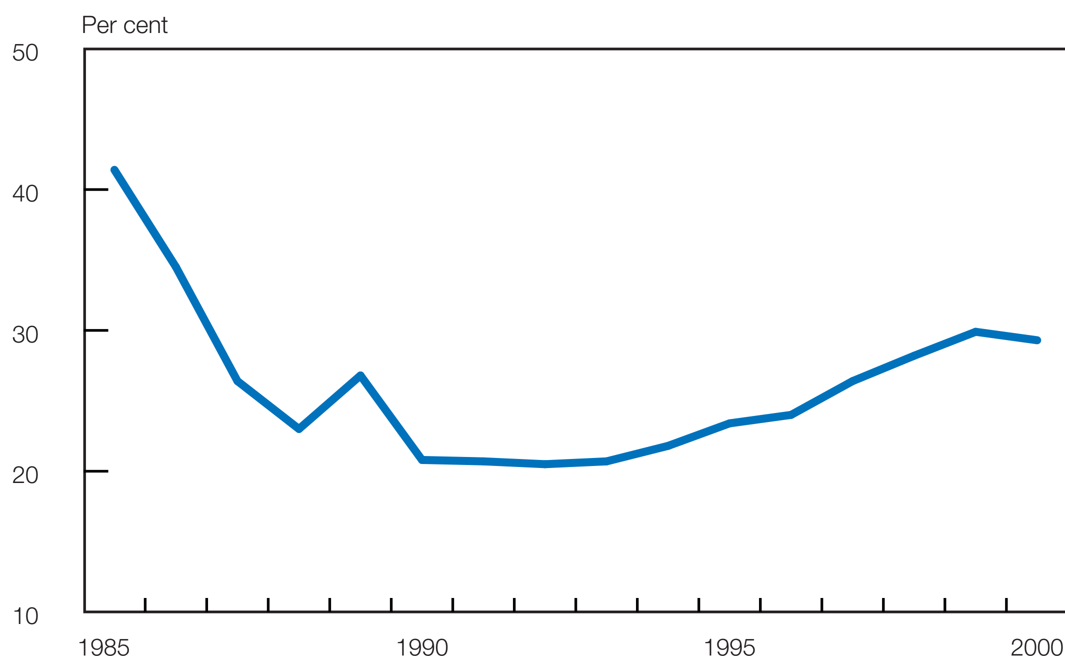
Foreign debt of South Africa
US$ billions at end of year

	1996	1997	1998	1999	2000
Renegotiated debt	**2,7**	**2,5**	**2,3**	**1,5**	**0,8**
Public sector	1,3	1,2	1,2	0,8	0,4
Monetary sector	0,3	0,2	0,1	0,1	0,1
Non-monetary private sector	1,1	1,1	1,0	0,6	0,3
Other foreign-currency denominated debt	**23,3**	**22,7**	**22,6**	**22,4**	**24,1**
Bearer bonds	4,0	4,0	4,3	4,8	5,5
Converted long-term loans	2,1	1,3	0,8	0,4	0,2
Public sector	4,7	4,2	3,6	3,2	3,8
Monetary sector	6,6	7,5	8,8	8,2	8,3
Non-monetary private sector	5,9	5,7	5,1	5,8	6,3
Total foreign-currency denominated debt	**26,0**	**25,2**	**24,9**	**23,9**	**24,9**
Rand-denominated debt	**8,5**	**14,0**	**12,5**	**14,9**	**12,0**
Bonds	6,3	10,4	7,6	9,8	7,6
Other	2,2	3,6	4,9	5,1	4,4
Total foreign debt	**34,5**	**39,2**	**37,4**	**38,8**	**36,9**

Renegotiated debt (i.e. debt renegotiated in terms of successive standstill arrangements with foreign creditors) declined from US$1,5 billion at the end of 1999 to US$0,8 billion at the end of 2000. Valued at the exchange rate prevailing on 31 August 1985, the outstanding amount of renegotiated debt has been reduced by US$12,8 billion since September 1985. South Africa's obligations for this type of debt were met in full on 15 August 2001.

Other foreign-currency denominated external debt rose from US$22,4 billion at the end of 1999 to US$24,1 billion at the end of 2000. The bulk of this increase could be attributed to bond issues by national government and Telkom. Renegotiated debt

Foreign debt as percentage of gross domestic product



which had previously been converted to longer-term loans in terms of the rescheduling agreements was reduced from US$0,4 billion at the end of 1999 to US$0,2 billion at the end of 2000.

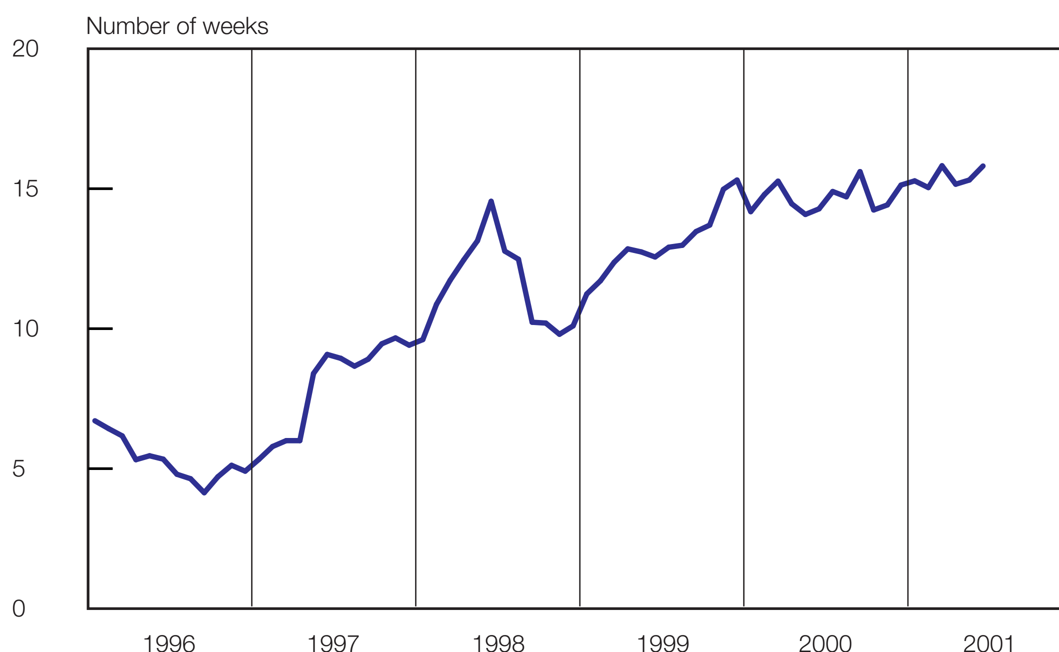
Owing largely to the depreciation of the rand against the US dollar, the country's total foreign debt, measured in rand, increased from R239,2 billion at the end of 1999 to R279,0 billion at the end of 2000. As a ratio of gross domestic product, total external debt declined from 29,9 per cent to 29,3 per cent over the same period. Strong growth in South Africa's export performance ensured that the ratio of total foreign debt to total export earnings fell from 110,3 per cent at the end of 1999 to 95,1 per cent at the end of 2000.

Foreign reserves

The *net international reserves* of South Africa improved by R12,5 billion from the end of 1999 to the end of June 2001, following an improvement of R25,9 billion in 1999. The generally smaller surpluses on the financial account of the balance of payments, essentially a consequence of the sharp decline in the inward movement of portfolio capital into the economy, have caused the slower accumulation of international reserves over the past year and a half.

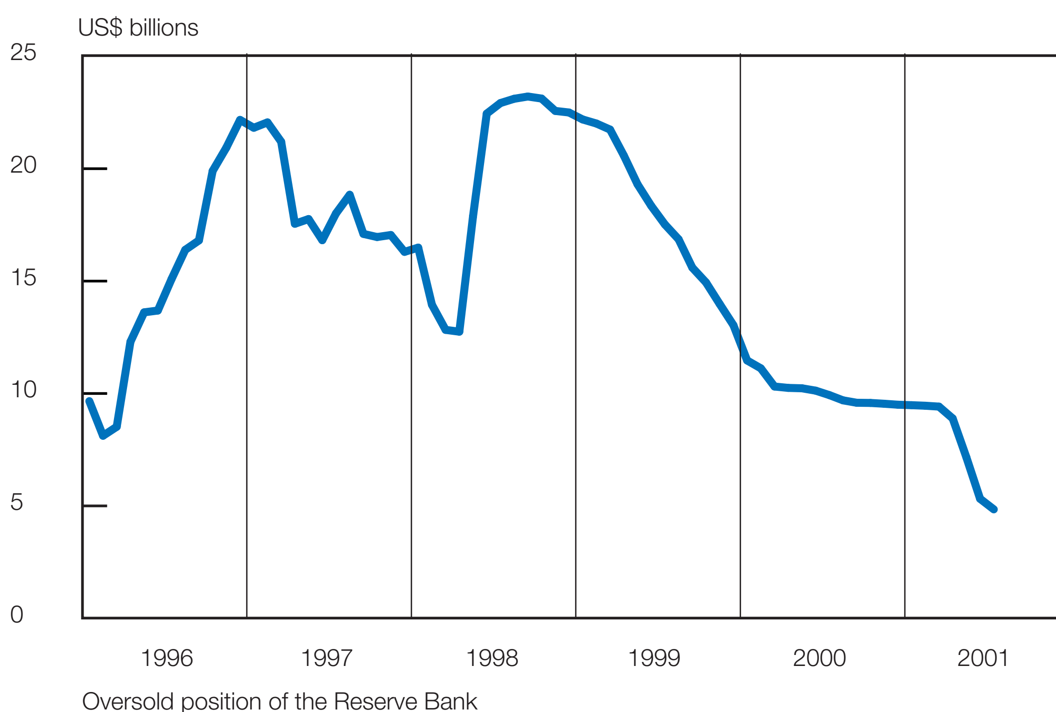
The country's gross gold and other foreign reserves declined marginally from US$11,2 billion at the end of December 1999 to US$11,1 billion at the end of December 2000, but improved to US$12,0 billion at the end of June 2001. When valued in rand, there was a substantial increase in the gross gold and other foreign reserves from R69,1 billion at the end of 1999 to R84,2 billion at the end of 2000 and R96,6 billion at the end of June 2001. This increase, in part, improved the country's import cover (calculated as gross international reserves relative to the value of imports of goods and services) from 15½ weeks at the end of 1999 and 15 weeks at the end of 2000 to 16 weeks at the end of June 2001.

Imports covered by international reserves



At the end of June 2001, US$7,5 billion of the country's international reserves was held by the South African Reserve Bank, marginally higher than the US$7,4 billion held at the end of 1999. Over the same period, the Reserve Bank substantially lowered its oversold forward position in foreign currency, reducing in the process its *net open position in foreign currency* from US$13,0 billion at the end of 1999 to US$4,8 billion at the end of July 2001. A sizeable portion of the foreign-currency loans of national government and the proceeds of the buy-out of minority shareholdings in the De Beers Diamond Corporation were employed to reduce the Bank's oversold forward book.

Net open position in foreign currency



Exchange rates

Buffeted mostly by disturbances in other emerging markets, and non-economic occurrences in other parts of sub-Saharan Africa, the rand depreciated on a nominal

Exchange rates of the rand
Percentage change

	30 Dec 1999 to 29 Dec 2000	29 Dec 2000 to 30 June 2001
Weighted average*	-12,4	-0,2
Euro	-12,1	2,9
US dollar	-18,7	-6,2
British pound	-11,8	-0,5
Japanese yen	-8,7	1,8

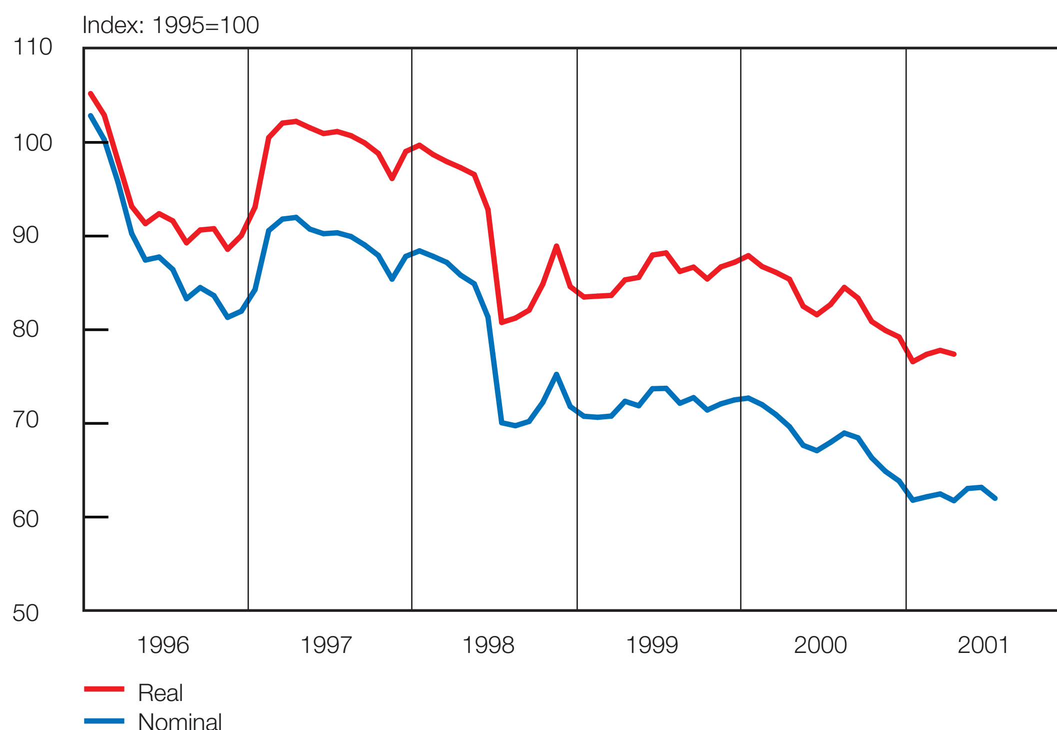
* The weighted exchange-rate index is calculated with reference to a basket of 14 currencies

effective basis by 12,4 per cent from the end of December 1999 to the end of December 2000. In the first half of 2001, news of the restructuring of the De Beers Diamond Corporation and the eventual inflow of foreign capital into South Africa, as well as confirmation early in the year that an investment grade credit rating had been confirmed for the country by Standard and Poor's, stopped the steep downward slide in the nominal effective exchange rate. From the end of December 2000 to the end of June 2001 the weighted exchange value of the rand depreciated by only 0,2 per cent.

Over the past year and a half, the value of the rand exhibited a fair degree of volatility around its steadily declining medium-term trend. In most instances, rumours originating outside the country were responsible for the fluctuations in the external value of the rand. Among the more often cited explanations for the medium-term trend were

- declining asset prices in other emerging and some developed markets;
- non-economic events in other parts of the African continent; and
- the strength of the US dollar in global currency markets.

Effective exchange rates of the rand

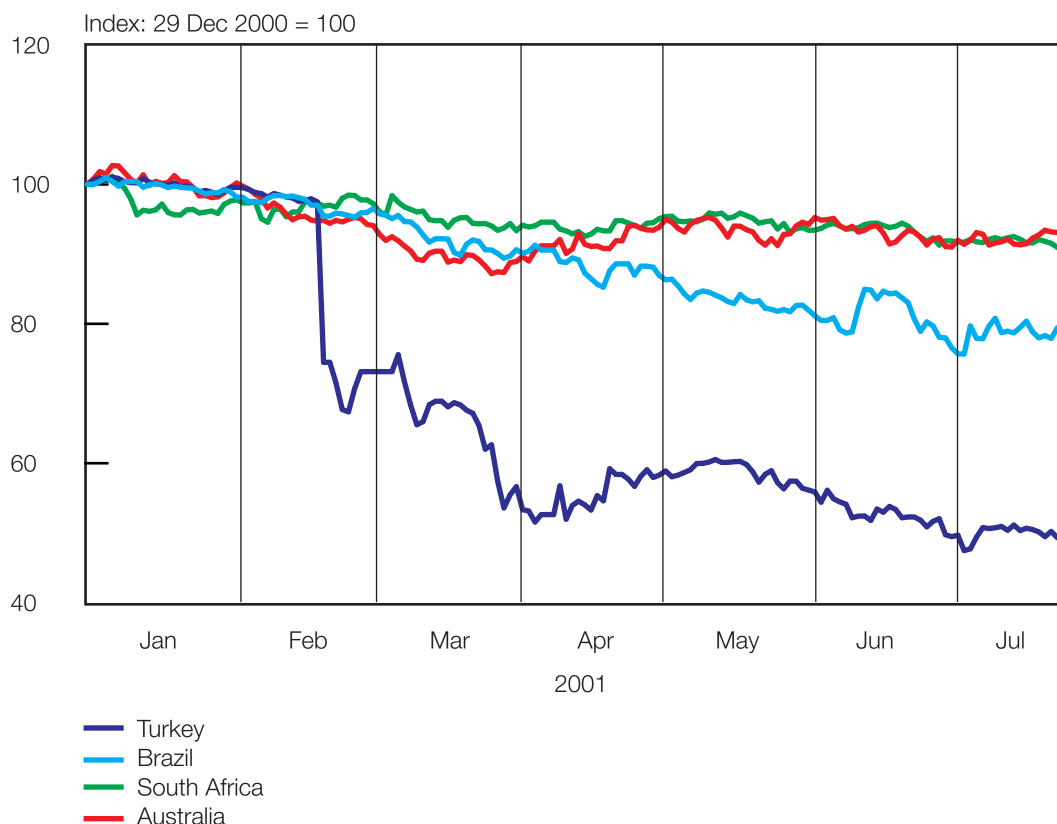


The rand has depreciated by 6,2 per cent against the US dollar from the beginning of the year to the end of June 2001. The rand's adjustment against major currencies other than the US dollar was substantially smaller than against the dollar. The fall against the British pound was only 0,5 per cent whilst against the euro and the Japanese yen the rand actually appreciated by 2,9 per cent and 1,8 per cent respectively. The appreciation against the euro, in particular, is at odds with market analysts' generally bullish predictions for the euro at the beginning of 2001.

The decline in the exchange rate of the domestic currency in the first half of 2001 was not unique to South Africa. The currencies of some of the other emerging-

market economies and of Australia are depicted in the accompanying graph. Compared with the currencies of these economies, the rand has displayed a good measure of resilience since the beginning of 2001.

Exchange rates (US dollar per domestic currency)



The average daily turnover in the domestic market for foreign exchange was US$9,5 billion during 2000, but with the heightened volatility of the exchange rate in the first half of 2001 and the higher participation by non-resident investors in the domestic securities markets, the average turnover increased to US$10,1 billion. Non-resident participation in the domestic market for foreign exchange increased from 57,4 per cent in the first half of 2000 to 62,3 per cent in the second half and 62,9 per cent in the first half of 2001.

Since 1998, South African exporters have benefited from a succession of declines in the inflation-adjusted effective exchange rate of the rand. The real effective exchange rate of the rand declined on average by 5,1 per cent in 1999, 3 per cent in 2000 and was 10,8 per cent lower in the first four months of 2001 compared with the first four months of 2000.

Monetary developments and interest rates

The changing conduct of monetary policy and financial stability

An important change in global macroeconomic performance in the past two decades has been the systematic decline in inflation in many parts of the world. South Africa joined this process of disinflation at the beginning of the 1990s when the Reserve Bank formally adopted the containment of inflation as the overriding objective of monetary policy decisions. Though many factors contributed to the current state of low inflation in the world, the growing commitment of central banks to ensuring price stability on a sustainable basis has undoubtedly played a part in this disinflation.

In attempting to control inflation, central banks worldwide have found it hard to identify reliable indicators to guide them in the setting of policy variables. Before the breakdown of the Bretton Woods system, monetary policy decisions had been directed by the need to maintain a fixed exchange rate against the United States dollar. After the demise of the international monetary system of fixed exchange rates, monetary aggregates were widely used for two purposes. Firstly, to influence inflation expectations by announcing a desired growth rate for a monetary aggregate. Secondly, monetary aggregates were seen to contain reliable information with which to guide interest-rate policy decisions when actual monetary growth deviated from the targeted growth rate.

Financial liberalisation and innovation in most countries during the 1980s reduced the reliability of monetary aggregates as indicators of future economic developments and price movements. Central banks increasingly had then to rely on a variety of variables for guiding their policy decisions. In South Africa the Reserve Bank had also adopted such a broad-based approach, generally referred to as an "eclectic approach" to the conduct of monetary policy.

Following the weakening of the predictive ability of monetary aggregates, many countries adopted a targeted future inflation rate as the anchor for monetary policy decisions. South Africa also became one of the inflation-targeting countries early in 2000. The adoption and pursuit of announced inflation targets in South Africa were intended to provide a transparent and credible framework within which to implement a monetary strategy.

Since the introduction of the inflation-targeting monetary policy regime in February 2000, monetary policy has been characterised by a high degree of interest rate stability. The rate on repurchase transactions was adjusted by the Reserve Bank's Monetary Policy Committee on only two occasions: in October 2000 from 11,75 per cent to 12 per cent, when the committee was concerned primarily about the potential inflationary consequences of a depreciation in the exchange value of the rand and rising crude oil prices, and from 12 per cent to 11 per cent in June 2001, when hard evidence had accumulated that inflation was tapering towards the target range set for 2002.

At the international level, the adoption of recognised standards and codes of good practice in policy making came to be seen as a mechanism for improving economic policy making throughout the world, and also for strengthening the international

financial system. It is believed that countries will be able to minimise the costs of financial crises and achieve economic stability, if they observe certain international codes and standards. At the same time, adherence to such codes and standards may reduce the extent to which financial crises spread across international boundaries. It is anticipated that investors and markets may begin to discriminate against countries that adhere to lower standards than those found acceptable by the developed financial markets.

Domestically, the observance of recognised codes and standards will contribute to maintaining financial stability and reducing or eliminating systemic risk. Systemic risk is the risk that the default of one institution in the financial system may lead to the default of one or more otherwise sound institutions, thus threatening the stability of markets and the economy as a whole.

The International Monetary Fund (IMF) and the World Bank have recently identified eleven areas where standards and codes are important for ensuring macroeconomic and financial stability. These areas are
- data dissemination,
- fiscal practices,
- monetary and financial policy transparency,
- banking supervision,
- insurance supervision,
- securities market regulation,
- payments systems,
- corporate governance,
- accounting,
- auditing, and
- insolvency regimes and creditor rights.

The IMF and the World Bank have begun to assess the implementation of codes and standards in individual countries. The assessment of standards has now been systematised in the form of Reports on the Observance of Standards and Codes (ROSCs). These reports provide information to markets about the condition of a country's economic infrastructure. The various country practices are weighed against the relevant internationally recognised standard as formulated by international standard-setting agencies.

The comprehensive set of regulations with which banks must comply was thoroughly reviewed during the past two years and the amended regulations were implemented from the beginning of 2001. Long-term government bonds received liquid-asset status, giving them a status similar to short-term government bonds and Treasury bills, thus recognising the highly liquid nature of the secondary market in government bonds of all maturities.

Money supply

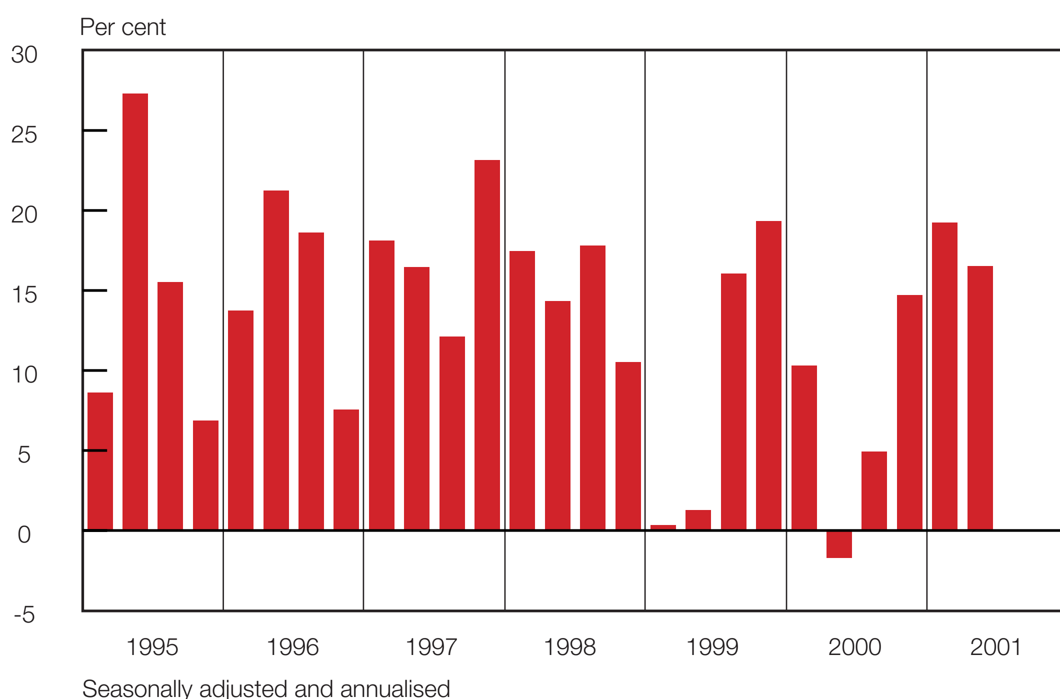
Even though inflation now serves as the explicit nominal anchor for monetary policy decisions, and monetary aggregates feature less prominently, money and credit data can still provide useful indications about likely current and future spending in the economy and therefore of the degree of latent inflationary pressure.

The *broadly defined money supply* (M3) declined at a seasonally adjusted annualised rate of 1,7 per cent in the second quarter of 2000, reflecting the downward

distortion associated with the unwinding of the increased cash holdings around the millennium date change. In the third quarter of 2000, growth in M3 was still subdued at 4,9 per cent, but it accelerated briskly in the ensuing period, reaching 16,5 per cent in the second quarter of 2001. This acceleration was underpinned by

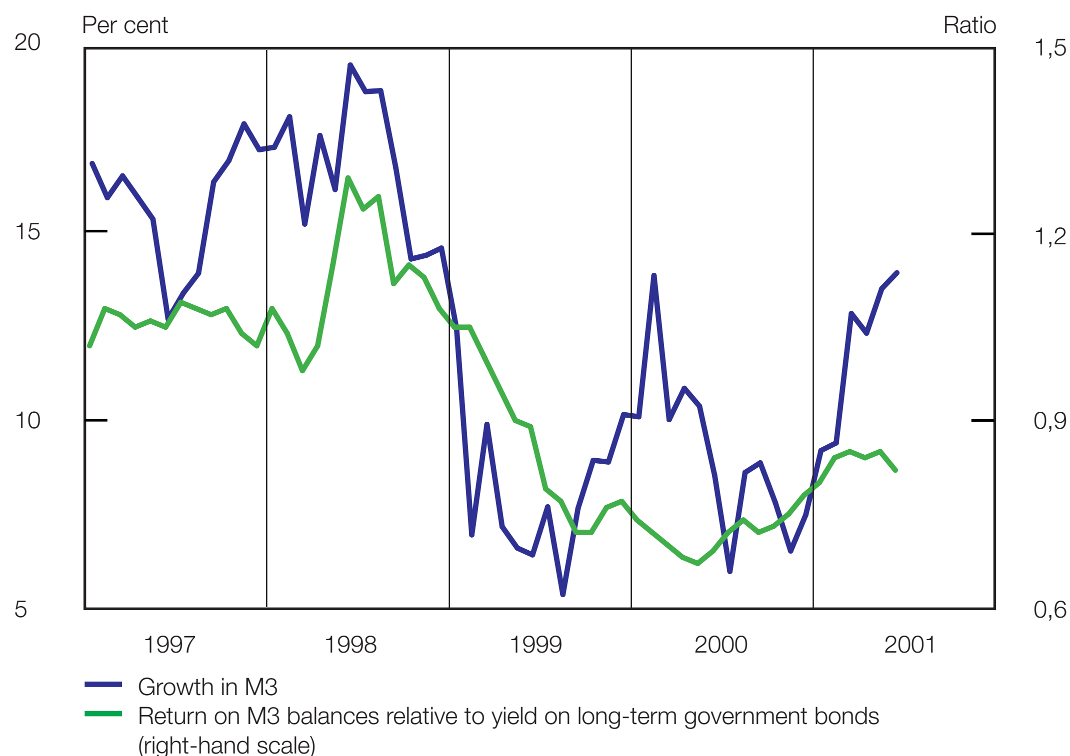
- stronger growth in real gross domestic product, especially in the second half of 2000;
- rising real gross domestic expenditure, albeit at a somewhat uneven or erratic pace of growth;
- rising personal disposable income;
- brisk growth in nominal gross operating surpluses since the middle of 2000; and
- the reduction in the opportunity cost of holding money brought about by an increase in the relative return on M3 balances which is associated with lower inflation.

Quarter-to-quarter growth in M3



Growth in the broad money supply continues to be influenced by changes in aggregate income and the relative return on M3 deposits. As shown in the accompanying graph, the slowdown in economic activity up to August 1999 coincided with a sharp contraction in the return on M3 assets relative to the yield on long-term government bonds, curtailing the growth in M3 during the second half of 1998 and the first half of 1999. This downward drift of the growth in M3 was temporarily interrupted by the accretion of liquidity prior to the millennium date change, but when this was run down in the first half of 2000, growth in M3 fell back to levels similar to those of early 1999. From around the middle of 2000, the relative return on M3 money holdings began to improve steadily as yields on long-term government bonds moved lower. M3 growth rates subsequently responded quickly and strengthened quite perceptibly.

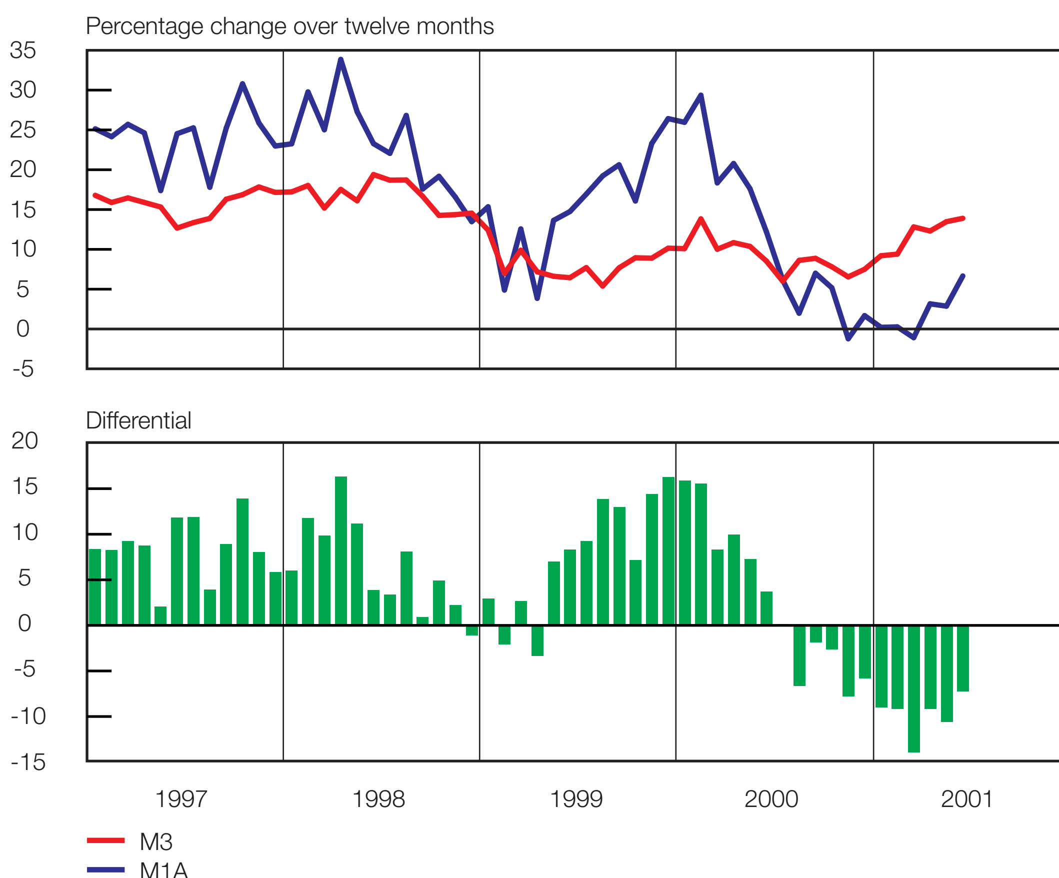
Relative return on M3 balances and growth in M3



A sizeable component of the growth in M3 can be attributed to a comparatively strong demand for long-term deposits by the general public, and this demand may have arisen because of the risk of losses on equity investments and the increase in the relative return on M3 deposits during 2000 and the first half of 2001. The recent rise in the broad money supply may therefore partly reflect shifts in the demand for money in asset portfolios, rather than short-term spending intentions.

The relatively strong growth in holdings of long-term deposits with banks opened quite a wide gap between the growth rates in the broad and narrower monetary aggregates. The growth over twelve months in M3 moved within a range of between 6,0 per cent and 9,4 per cent from June 2000 to February 2001, but then accelerated to more than 12 per cent in the four months to June. By contrast, growth over twelve months in M1A fell from 29,4 per cent in February 2000 to negative rates of 1,2 per cent in November and 1,1 per cent in March 2001, before strengthening somewhat to 6,7 per cent in June.

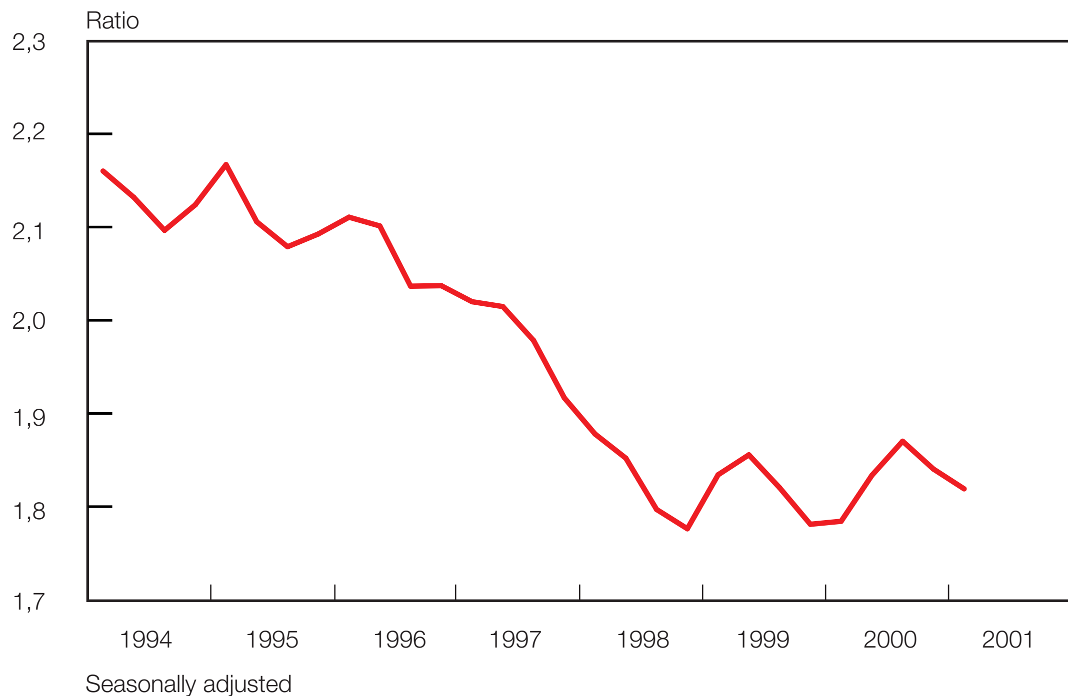
M1A consists of notes and coin in circulation plus cheque and transmission deposits of the domestic private sector with monetary institutions. As these mostly earn little or no interest, they are primarily held for transactions purposes and may contain information about future spending trends. Moderating growth in M1A may therefore indicate a prospective easing of consumption expenditure by households and a slower pace of growth in purchases by the business sector. However, the easing of growth in M1A could also partly reflect the transition to a low-inflation environment where spending and cash needs for transactions purposes are no longer increasing at the excessively high rates that prevailed previously. The slowdown in the growth of M1A should therefore not be seen as a portent of decreasing household spending and a slowing in the pace of economic activity.



The usefulness of monetary aggregates as indicators of aggregate nominal spending depends on the predictability of the relationship between nominal expenditure (or income) and money supply. Growth of M3 has generally outpaced the growth of nominal gross domestic product since 1995, so that the income velocity of circulation of broad money has fallen. More recently, since the end of 1998, the fall in income velocity has been halted by slower growth in M3 and the general pick-up in overall economic activity. Over the past three years or so, velocity has consequently tended to move around a rather flat medium-term trend. If this trend persists, the broad money supply could regain some of its former usefulness as a predictor of nominal spending.

In the second half of 2000, growth in the M3 money supply had as its largest statistical counterpart the growth in domestic credit extension to the private sector, whereas in the first half of 2001 the increase in net other assets was the prominent entry on the asset side of the banks' consolidated balance sheet. Over the twelve months to June 2001, aggregate lending by banks increased far less than the increase in banks' deposit liabilities. With lending or asset growth in the banking sector falling short of deposit growth, resources were available for the accumulation of other assets or the reduction of other liabilities. The banks have accordingly increased their *net other assets* by R15,1 billion in the past twelve months. Deficits accruing from the Reserve Bank's transactions in the forward foreign-exchange market contributed materially to this increase. In addition, banks accumulated net foreign assets of R10,1 billion from June 2000 to June 2001.

Income velocity of circulation of M3



Accounting counterparts of change in M3
R billions

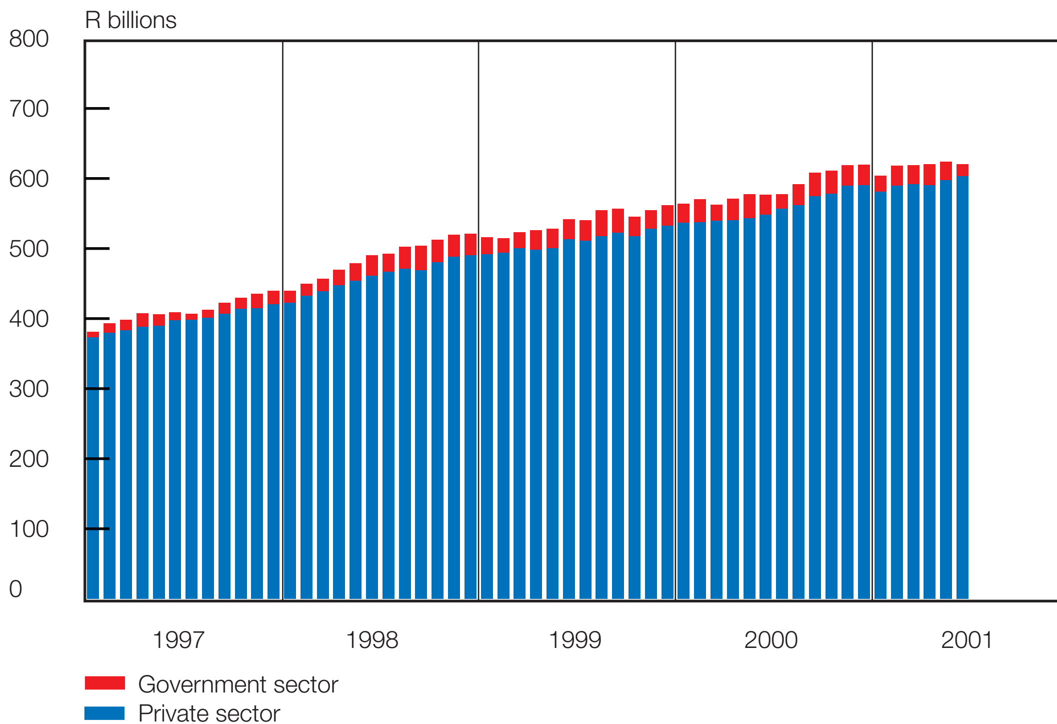
	Year to end June	
	2000	2001
Net foreign assets	19,9	10,1
Net claims on government sector	-0,5	-11,7
Gross claims	0,6	0,8
Deposits (increase -)	-1,1	-12,5
Claims on the private sector	35,0	52,3
Net other assets	-17,2	15,1
Total change in M3	**37,2**	**65,8**

Credit extension

Consistent with the strengthening in overall economic activity, the growth in domestic credit extension (i.e. the total credit extended by banks to the non-bank private sector and net claims of banks on the government sector) accelerated considerably in the year to June 2001. Overall, credit extension increased by R40,6 billion in the year to June 2001, compared with R34,5 billion in the year to June 2000. Bank credit to the private sector rose by R52,3 billion in the twelve months to June 2001, implying that net credit extension to the government sector has shrunk by some R11,7 billion.

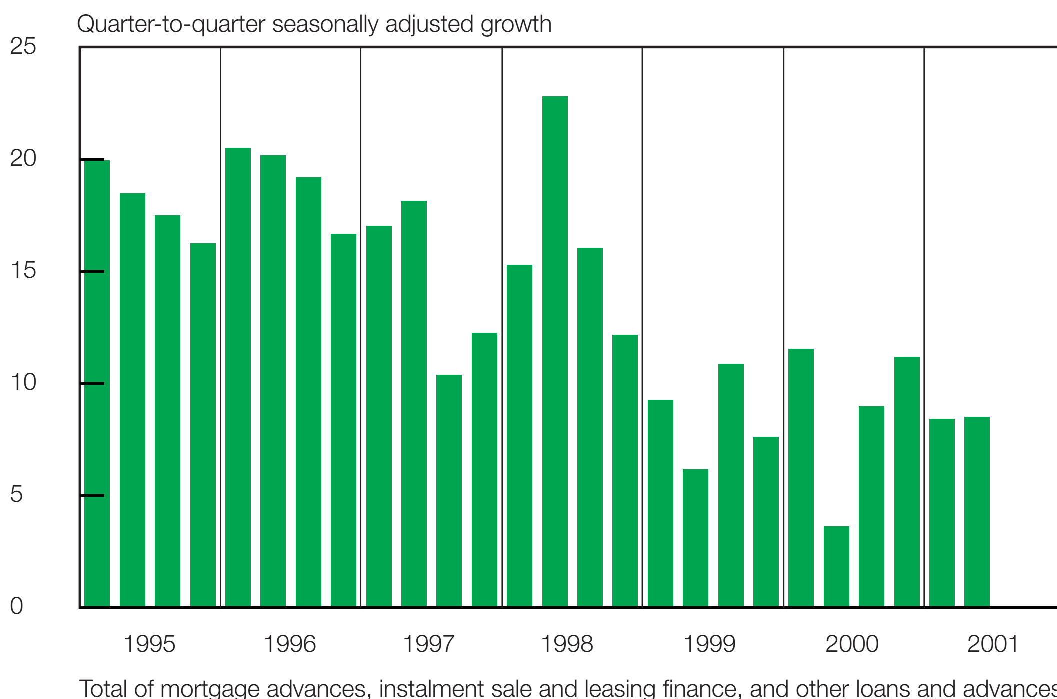
The year-on-year growth in bank credit extended to the private sector gathered momentum from single-digit levels in the first eight months of 2000 to rates of between 10 and 12 per cent in the ensuing four months, but sank below the 10 per

Banks' claims on private and government sector



cent mark in January 2001. The stronger credit extension to the private sector in the second half of 2000 was to some extent influenced by the implementation of a change in accounting practice by some of the banks. This change has had the effect of overstating the growth rate in the aggregate balance sheet of banks by an average of one percentage point since September 2000. The decline in growth in January

Banks' loans to the private sector

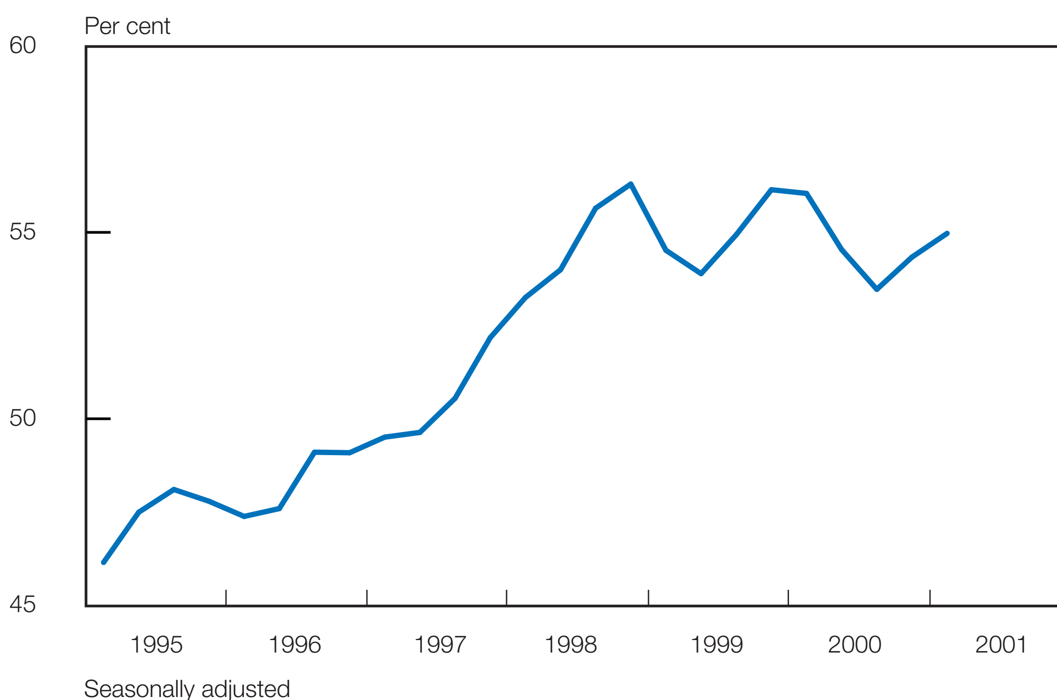


2001 was also caused by a change in accounting practice which required banks to report derivative transactions in a way that allows interbank transactions to be offset against each other. This caused a one-off decline in the recorded level of bank credit to the private sector. Fairly strong demand for bank credit, especially from the household sector, subsequently pushed back the year-on-year growth in banks' claims on the private sector to 9,5 per cent in both June and July 2001.

When stripped of investments and bills discounted, banks' loans and advances to the public sector were affected far less by the changes in accounting practices than the total claims of banks on the private sector. Over the past year, the growth over twelve months in banks' loans and advances to the private sector has remained fairly solid (in contrast to the volatility in the growth in banks' total claims on the private sector) and even accelerated, on balance, from 6,8 per cent in June 2000 to 9,3 per cent in June 2001.

Despite the volatility in the growth of banks' claims on the private sector over the past three years or so, this growth has been broadly consistent with the expansion of nominal expenditure on gross domestic product. As a consequence, the ratio of private-sector credit extension to nominal gross domestic product has moved around a virtually horizontal medium-term trend in the past three years and remained largely unchanged from the second quarter of 2000 to the second quarter of 2001.

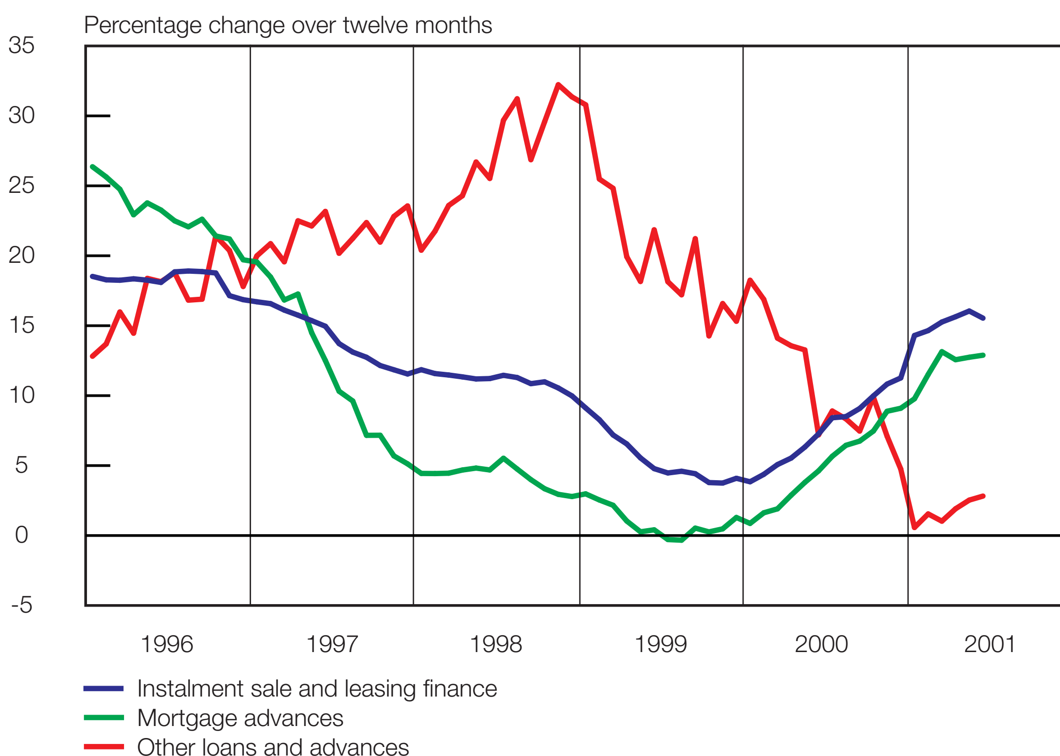
Ratio of private-sector credit to gross domestic product



During the past twelve months, mortgage advances surpassed "other loans and advances" as the largest main component of total credit extended to the private sector. The growth over twelve months in mortgage lending has declined steadily since the beginning of 1996, but spurred by the easing of monetary policy since the fourth quarter of 1998 and a recovery in the real-estate market, the demand for

mortgage financing has picked up since the beginning of 2000. Growth over twelve months in mortgage advances accelerated from 3,8 per cent in January 2000 to 15,5 per cent in June 2001. Of the total increase in banks' claims on the private sector in the year to June 2001, mortgage advances contributed some 40,7 per cent.

Credit extended to private sector by type of credit



Other loans and advances, including overdrafts on current accounts and credit card advances, relinquished the position as the most important component of banks' claims on the private sector and fell back to second position in January 2001. Growth over twelve months in *other loans and advances* fell from 32,2 per cent in November 1998 to just 0,6 per cent in January 2001, but strengthened somewhat to 2,8 per cent in June 2001. The reduction in the public-sector borrowing requirement and the steady fall in long-term interest rates, together with the lacklustre performance of the equity market, encouraged a growing number of companies to satisfy their capital needs in the rapidly expanding corporate bond market. The outstanding nominal value of private-sector loan stock listed on the Bond Exchange of South Africa has

Composition of credit extended to the private sector by type of credit
Per cent of total

	June 2000	June 2001
Mortgage advances	38,5	40,7
Instalment sale credit and leasing finance	14,1	14,5
Other loans and advances	41,3	38,8
Investments and bills discounted	6,1	6,0
Total	**100,0**	**100,0**

accordingly increased more than threefold in the past two and a half years. At the same time, only 12,2 per cent of the overall growth in banks' claims on the private sector in the year to June 2001 could be attributed to *other loans and advances.*

Essentially reflecting the relative strength of private households' demand for durable goods, *instalment sale credit and leasing finance* gained momentum over the past twelve months. The growth over twelve months in this credit category picked up from 4,6 per cent in June 2000 to 13,1 per cent in March 2001 and 12,9 per cent in June. New payouts of such credit reached a record high of R15,8 billion in the first quarter of 2001, before slowing slightly to R15,4 billion in the second quarter of 2001.

At the end of the second quarter of 2000, the stock of credit extended to the household sector roughly equalled the corporate sector's indebtedness to the bank sector. In the ensuing twelve months, credit extended to the household sector rose by R20,9 billion whereas credit to the corporate sector rose by R31,4 billion. At the end of the second quarter of 2001, the corporate sector had absorbed some 50,7 per cent of all bank credit extended to the private sector while that extended to the household sector was 49,3 per cent.

Interest rates and yields

The yields on long-term bonds have generally declined since the second half of 1998. From time to time this downward movement in long-term interest rates was interrupted by sudden, mostly short-lived reversals of the longer-term trend. The change in bond yields over the past three years has been strongly influenced by the gradual realisation among investors that public-sector borrowing needs and inflation have adjusted to permanently lower levels.

The *monthly average yield on long-term government bonds* fell by 480 basis points from 18,3 per cent in September 1998 to 13,5 per cent in January 2000 as the after-effects of the international financial crises of 1997 and 1998 faded, and domestic monetary conditions eased. From then on, bond yields increased to 14,8 per cent in May 2000 in response to, among other things, the weakness of the rand against the United States dollar, uncertainties about the future direction of changes in short-term interest rates and concerns about the accumulation of inflation pressures.

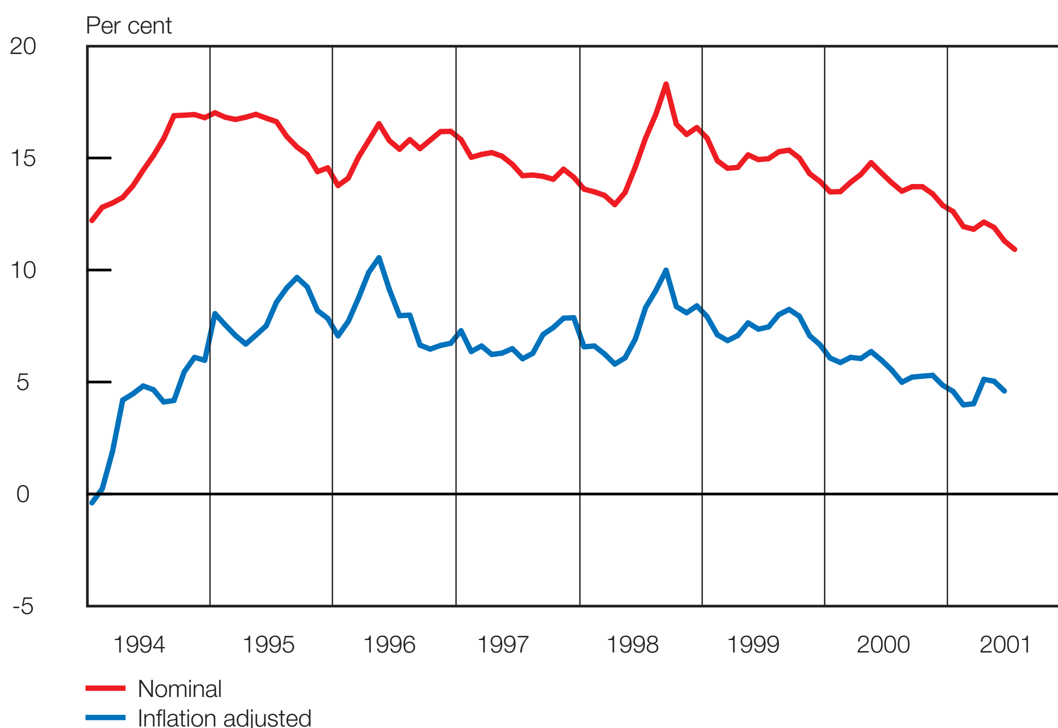
Bond yields declined again from May 2000 to August as the market responded positively to an apparent improvement in inflation expectations, some strengthening of the rand against the US dollar and non-resident investors' return to the domestic bond market as net purchasers. Reflecting these positive sentiments, the monthly average yield on long-term government bonds declined from 14,8 per cent in May 2000 to 13,5 per cent in August.

Perceptions changed again in September 2000 as sentiment in the bond market became affected by events in other parts of sub-Saharan Africa and by fears that second-round reactions to rising crude oil prices and the depreciation of the rand would lead to higher inflation. Long-term bond yields retraced part of their earlier declines and the monthly average yield on long-term government bonds rose to 13,7 per cent in September and October 2000.

Inflation concerns were allayed by an increase of 25 basis points in the Reserve Bank's repurchase rate in mid-October 2000. The long-term yield on government bonds declined to 12,9 per cent in December 2000, when it returned to the level

reached in April 1998 immediately before the international financial market crises, and to 11,8 per cent in March 2001 when it was at its lowest level since February 1983.

Yield on long-term government bonds



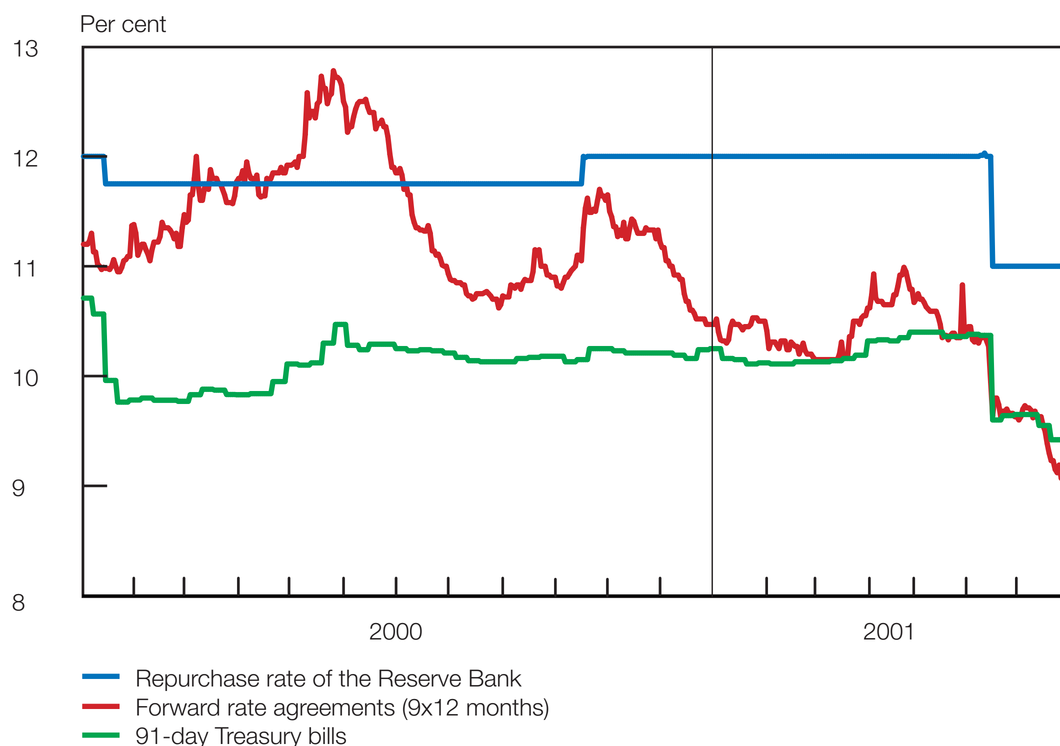
Towards the middle of March 2001 some uncertainty crept back into the market when the depreciation of the rand and high international petroleum prices again fuelled inflation fears, lifting long-bond yields to an average level of 12,1 per cent in April 2001. News of falling inflation domestically, and improved sentiment in the world securities markets, subsequently encouraged some buying interest to return to the market, resulting in the monthly average bond yield declining to 11,3 per cent in June 2001 – a level it had last reached in January 1983. The endorsement of lower inflation expectations by the Reserve Bank when the repurchase rate declined by 100 basis points gave impetus to the decline in bond yields which traded at 10,85 per cent on 2 July 2001. Some profit-taking followed which, alongside mounting concerns about macroeconomic stability in Argentina, Brazil and Turkey and negative foreign perceptions arising from unlawful threats to property rights in the country, caused yields to rise, on balance, to 11,24 per cent on 13 July 2001. As global market conditions settled down again and the property-rights issue was resolved, the yield on long-term government bonds fell back to 10,61 per cent by the end of July 2001.

The *inflation-adjusted* or real yield on long-term government bonds declined almost in step with the nominal rates from 10,0 per cent in September 1998 to 5,0 per cent in August 2000. Since August 2000, nominal yields have declined quicker than inflation, causing the inflation adjusted yield to decline to 4,0 per cent in February and March 2001 – lower than at any time since 1994. After March, year-on-year CPIX inflation declined so rapidly that the calculated real yield climbed to 4,6 per cent in June 2001.

The rate on repurchase transactions by the Reserve Bank was reduced again by 100 basis points to 11 per cent on 15 June 2001. Prior to the meeting of the

Monetary Policy Committee, the repurchase rate had briefly moved above 12 per cent, because uncertainties about the timing of money flows, following the buy-out of minority shareholders in the De Beers Diamond Corporation, had prompted one or two banks to tender at rates higher than 12 per cent. The Reserve Bank assisted the return of the repurchase rate to 12 per cent by overproviding in the private banks' liquidity needs by R20 million on 11 June 2001 and R100 million on 12 June.

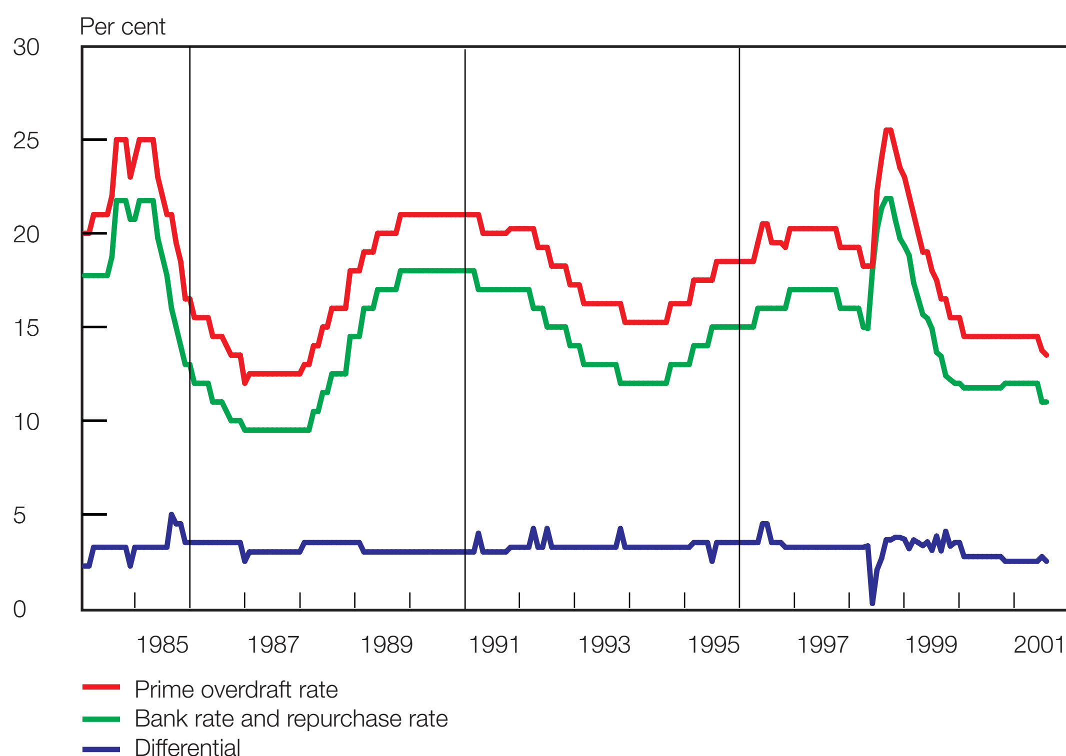
Money-market interest rates



Other money-market interest rates roughly followed the movements in the repurchase rate. The three-month bankers' acceptance rate dipped below 10 per cent in January 2000 but moved back to a high point of 10,31 per cent in October when the repurchase rate rose by 25 basis points. The three-month bankers' acceptance rate subsequently moved lower and traded at around 9,42 per cent in July 2001 after the repurchase rate had declined to 11 per cent.

The call rate on interbank funds and the prime lending rate of banks did not respond to the change in the repurchase rate in October 2000. Both rates remained unchanged at their levels of January 2000: 9,50 per cent in the case of the interbank funds call rate and 14,50 per cent in the case of the prime lending rate. The interbank funds call rate and the prime lending rate of banks were both lowered by 75 basis points in June 2001 when the repurchase rate of the Reserve Bank declined by 100 basis points. With the prime lending rate adjusting by less than the repurchase rate, the margin between these two rates was restored to 275 basis points – the level that had prevailed before 17 October 2000 when the repurchase rate had risen by 25 basis points. The private banks lowered their prime lending rate by another 25 basis points on 16 July 2001, narrowing the margin between the prime lending rate and the Reserve Bank repurchase rate to 250 basis points.

Prime rate and Reserve Bank refinancing rate



The rate on 9x12-month forward rate agreements (FRAs) was at 12,78 per cent on 25 May 2000. This relatively high level was strongly influenced by negative perceptions of political stability in a number of countries on the African continent, and expectations of rising inflation spurred by the depreciation of the rand against the US dollar and by high international petroleum prices. As it gradually became clear that inflation would not escalate and that political stability in South Africa was not threatened by events on the continent, the FRA rate gradually drifted lower. Barring the period leading up to the increase in the repurchase rate in October 2000, the FRA rate declined during most of the last three quarters of 2000, reaching 10,47 per cent by the end of December 2000.

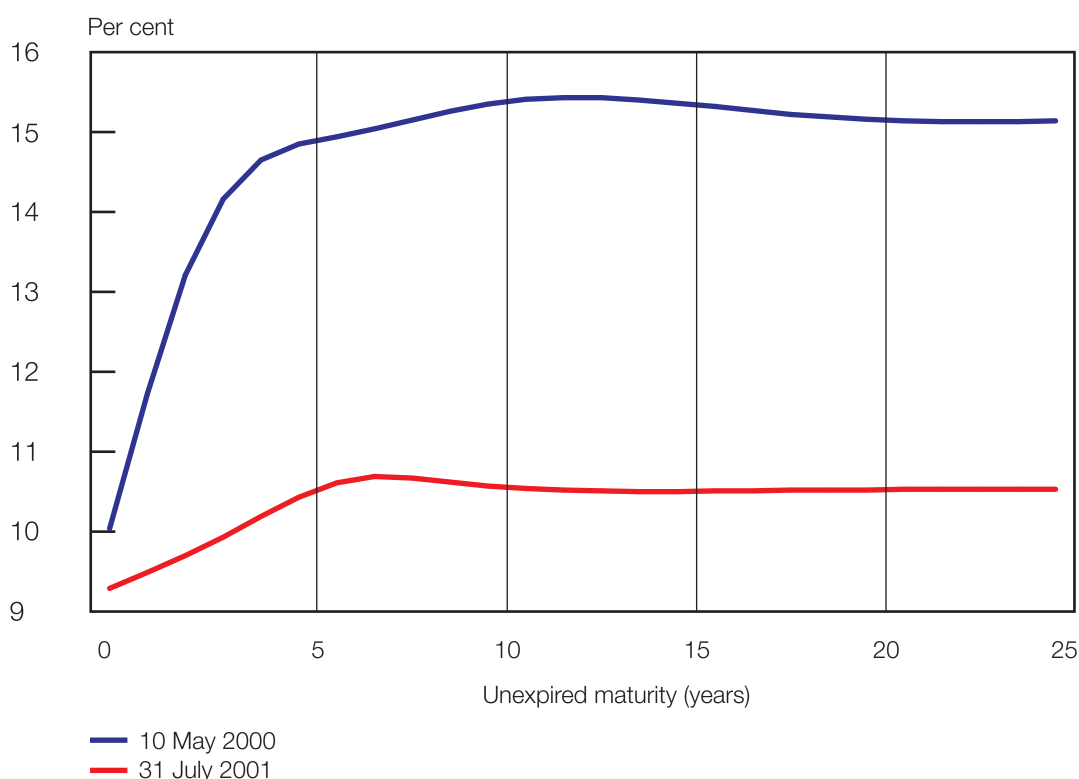
In June 2001, following the decline in the repurchase rate and the Reserve Bank's positive assessment of the outlook for inflation, the FRA rate declined to below 10 per cent and was at 9,66 per cent on 29 June. The market rate on three-month bankers' acceptances was at 9,64 per cent on 29 June, indicating that market participants generally expected money market rates to maintain their current levels in the remainder of the year.

The tender rate on Treasury bills of 91 days was at 9,76 per cent on 14 January 2000 and rose to 10,47 per cent on 26 May. Subsequent trading kept the Treasury bill rate in a narrow range of between 10,13 per cent and 10,29 per cent up to the time when the repurchase rate declined to 11 per cent in June 2001. The Treasury bill rate then fell below 10 per cent and was at 9,38 per cent on 31 July.

The *yield curve,* i.e. a graphic depiction of the relationship between the yield on bonds of the same quality but different maturities, had a steep upward slope when bond yields peaked for 2000 on 10 May. In part, this was a reflection of market con-

cerns that inflation would remain high and that monetary policy might have been eased too much. As time went by market participants became convinced that the monetary policy strategy of the Reserve Bank was appropriate for ensuring a steady decline in CPIX inflation to within the 3 to 6 per cent target range set for 2002. Whereas short-term interest rates stayed in close proximity to the Reserve Bank's repurchase rate, yields on long-term government stock fell by 461 basis points between 10 May 2000 and 31 July 2001. The yield curve flattened considerably, reflecting the greater certainty that inflation would probably decline further. By the end of July 2001, the yield differential between short-dated and long-dated bonds was still 124 basis points, signalling that there were still some lingering concerns that the inflation psychosis had not been broken yet.

Yield curves

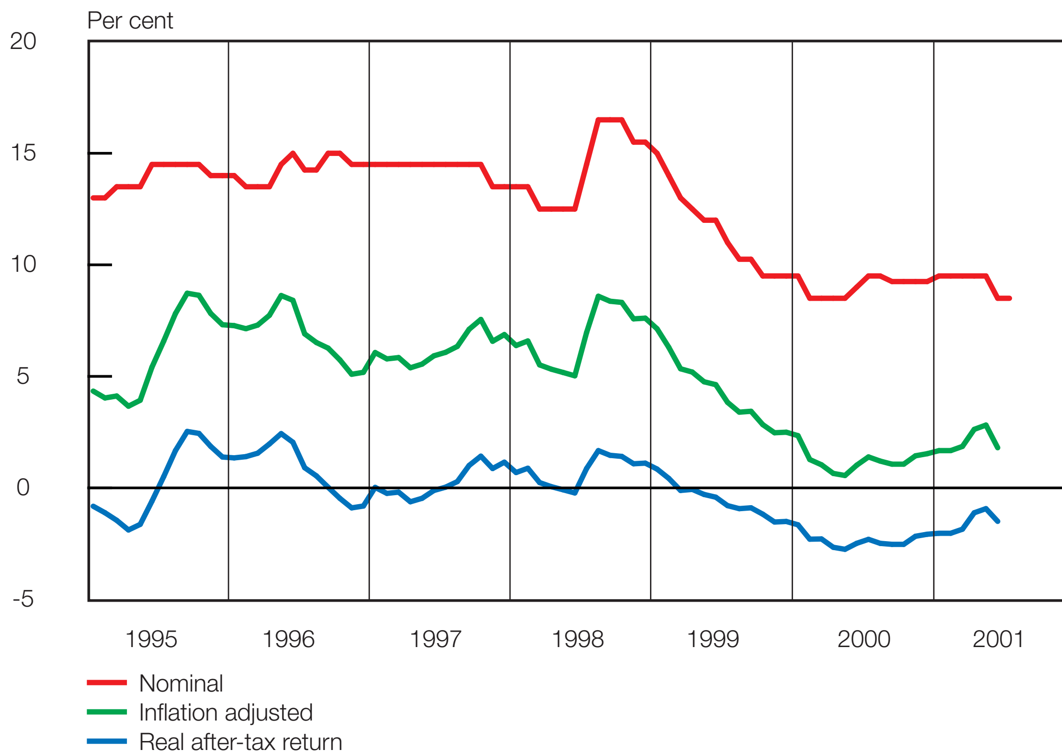


Other lending and deposit rates broadly traced the changes in the Reserve Bank's repurchase rate. The *predominant rate on twelve-month fixed deposits* showed some autonomous variation when it declined to 8,5 per cent in February 2000 – its lowest level since March 1981 – only to be increased again, on balance, to 9,5 per cent in January 2001. With the general reduction in deposit rates following the decline in the Reserve Bank's repurchase rate in June 2001, the rate on twelve-month fixed deposits was again cut by 100 basis points to 8,5 per cent.

The *marginal after-tax real return* on twelve-month fixed deposits for savers in the highest income tax bracket has been negative since March 1999. In May 2000, the real after-tax return on twelve-month deposits was as low as -2,8 per cent, implying that savers were actually being penalised for postponing spending. Since May 2000, real after-tax returns have improved somewhat as nominal returns were increased

and inflation declined, but they were still negative in June 2001, providing no incentive for increased saving in the higher income categories where the bulk of household saving usually occurs.

Return on 12-month fixed deposits



Financial markets

Regulatory and structural changes in market arrangements

With the rapid development of electronic communication and instantaneous processing services over the past two decades, financial markets around the world became increasingly interconnected, allowing for the development of more complex financial instruments, tradeable simultaneously in a number of markets. South Africa's financial markets were sufficiently sophisticated and flexible to keep abreast of these developments, and this helped to integrate the domestic markets into the international financial network. This brought a heightened awareness of the interdependence of economies and the inherent fragility of the international financial system.

A number of steps were taken during the past year to promote the safe and sound operation of the domestic financial markets, and to limit the cross-border spreading of financial crises. At the same time, care was taken to avoid stifling the innovative and creative spirit of financial market agents.

The measures taken in the past year were specifically aimed at achieving the following:
- Strengthening the financial regulatory and supervisory framework;
- improving and harmonising the listings and disclosure requirements;
- improving the level of investor information;
- improving financial market infrastructure;
- forming strategic alliances;
- broadening the range of financial instruments;
- facilitating financial intermediation;
- managing the liberalisation of capital flows; and
- changing the structure of the tax system.

The strengthening of the *financial regulatory and supervisory framework* helps to enhance the competitiveness and efficiency of markets and supports the stability of institutions. It also safeguards the interests of investors. The integration of international financial markets, in turn, leads to a significant increase in investment options for South African residents and expands the number of foreign institutions soliciting investments from resident investors. However, these measures also introduce more complex risks, requiring a more stringent regulatory framework. To this end, the *legislative* programme of the Financial Services Board for 2001 includes the following:
- The Pension Funds Second Amendment Bill which provides for the apportionment of actuarial surpluses in pension funds and the payment of minimum benefits on transfer, retrenchment and in other circumstances.
- The Collective Investment Schemes Control Bill which regulates all types of collective investment schemes where assets are pooled on behalf of investors.
- The Financial Institutions (Protection of Funds) Bill which regulates the investment, safe custody and administration of funds and trust property by financial institutions.
- The Financial Advisory and Intermediary Services Bill which provides for the authorisation of providers of advice and intermediary services, codes of conduct and other enforcement measures.

- The Security Services Bill which provides for the consolidation of the Stock Exchanges Control Act, 1985, the Financial Markets Control Act, 1989, the Custody and Administration of Securities Act, 1992, the Insider Trading Act, 1998 and certain amendments to the Companies Act, 1973.
- The Financial Services Ombudschemes Bill which provides for the statutory recognition of voluntary ombudschemes and regulates situations where consumer complaints fall outside an ombud arrangement.

Listings and disclosure requirements are now being brought in line with international best practice in an effort to improve investor confidence in the South African market. The JSE Securities Exchange South Africa (JSE) introduced a revised set of listings requirements in October 2000 that provides for greater disclosure. In May 2001, the Bond Exchange of South Africa (BESA) also announced a comprehensive review of listings and disclosure requirements to provide for the growing number of corporate bond issues and greater foreign interest in listed bonds. These new listings and disclosure requirements will greatly enhance the *level of investor information.* Access to price and market information was facilitated by the alignment of the JSE's information dissemination procedures to international standards. The quality and availability of economic and financial data in South Africa were favourably assessed by the International Monetary Fund in terms of the country's subscription to the Special Data Dissemination Standard (SDDS) of the Fund.

South Africa's *exchanges* for financial instruments improved their international standing through significant advances in the area of *financial market infrastructure.* The JSE is currently implementing efficient and transparent trading, clearing and settlement systems. The new netting model of STRATE (Share Transactions Totally Electronic) went live in November 2000 and the JSE intends to change all listed counters to the electronic settlement environment by December 2001. This enables the dematerialisation of equity scrip in a Central Securities Depository, facilitates settlement and transfer of ownership by electronic book entry and permits rolling settlement on a five-day basis. The JSE is also implementing a direct processing facility between institutional investors and exchange members.

In the bond market, BESA has made substantial progress with implementing the electronic processing of instructions for settlement, with the ultimate goal of attaining final delivery and payment in its daily settlement process. All government securities listed for electronic settlement were dematerialised in the Central Securities Depository Limited in May 2001.

The JSE has also established *strategic domestic and international affiliations*. A partnership between the JSE and the London Stock Exchange (LSE) was established and formalised in a business agreement in July 2001 whereby the LSE would provide core technology services to the JSE. The JSE decided to acquire the South African Futures Exchange (SAFEX) in order to extend its range of products and services.

The range of *financial instruments* traded in the South African securities markets was broadened and aligned more closely with the instruments of mature international financial markets. The increased sophistication of the *bond market* was reflected in the growing number and variety of fixed-interest securities and issuers. The BESA, in collaboration with the Actuarial Society of South Africa (ASSA), launched the BEASSA Total Return Indices in August 2000. This suite of bond indices provides an accurate measure of total return and benchmarks historical

performance. In September 2000 a private-sector issuer introduced "stripped bonds" – i.e. subdividing a bond into a series of zero-coupon bonds. The National Treasury introduced a switch auction programme which allowed for the issuance of a liquid bond as payment for the purchase of an illiquid bond. In May 2001 South Africa's second inflation-linked government bond was listed and in the corporate bond market the number of private-sector issuers increased from six in June 2000 to nine in June 2001.

In the *market for derivatives,* SAFEX responded to developments in the bond market with the listing of futures and options on the BEASSA Total Return Government Bond Index in August 2000 as part of the suite of interest rate derivative products. In August 2000, the range of individual equity futures (IEFs) and options on futures contracts was expanded to full coverage of all the underlying shares included in the ALSI 40 and INDI 25 indices of the JSE. The number of IEFs consequently increased from 7 in June 2000 to 52 in June 2001. The JSE created a separate sector for *capital protection warrants* and *discount warrants*. Capital protection warrants guarantee a minimum capital value upon maturity, and discount warrants enable investors to buy a share at a discount price, having paid a premium when purchasing the warrant. Compound warrants, i.e. warrants issued on underlying warrants, which are in turn issued on underlying shares or indices listed on the JSE, were introduced to the South African market in March 2001.

In the *share market,* new products include the listing of the first exchange-traded fund (SATRIX 40) in November 2000. The listing of SATRIX 40 led to the launch of the SATRIX Investment Plan in June 2001, aimed primarily at the retail investor as a conduit for investment and savings. An alternative investment vehicle was introduced in June 2001 with the launch of the first hedge fund of funds. The JSE and FTSE, which is partly owned by the LSE, announced in May 2001 an agreement to create a suite of indices in line with international investment standards for introduction by mid-November 2001.

The 2000 Budget introduced proposals for the *structural reform of the tax system*. The introduction of residence-based income tax on 1 January 2001 was necessitated by the process of globalisation and the integration of South Africa into the world economy. The introduction of capital gains tax on 1 October 2001 will create greater neutrality between the treatment of income of a revenue nature versus income of a capital nature. However, this tax will add to transaction costs in the securities markets.

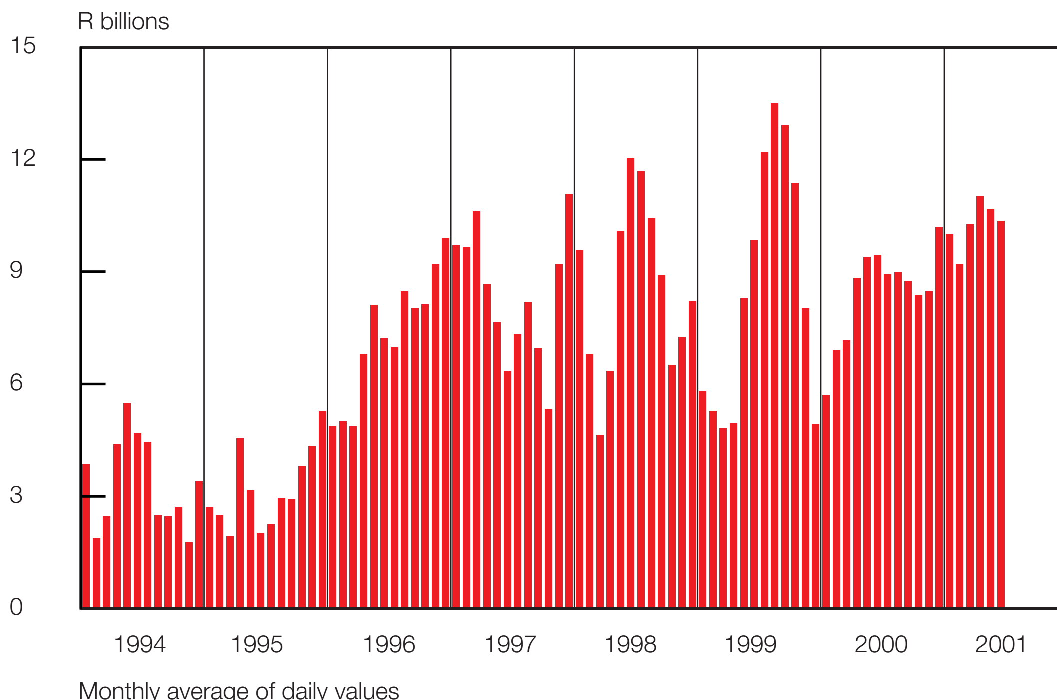
Money market

Conditions in the money market were generally tranquil throughout 2000 and the first seven months of 2001. The average daily liquidity requirement of the private banks rose from R7,2 billion in March 2000 to R10,2 billion in December. In the ensuing seven months, the cash needs of banks varied between R9,2 billion and R10,4 billion. This relatively small variation in the banks' liquidity requirement was achieved mainly through the active intervention of the Reserve Bank which neutralised the influence of the Bank's forward book on banks' liquidity holdings.

During the first quarter of 2000 the Reserve Bank's liquidity draining operations were reinforced by profits arising from the Bank's operations in the forward foreign-exchange market. From the beginning of the second quarter of 2000, the Bank incurred losses on its forward foreign-exchange transactions and

progressively added to its holdings of foreign assets. In total, the losses on forward foreign exchange transactions and the increase in net foreign assets of the Reserve Bank added some R17,1 billion to market liquidity from April 2000 to July 2001.

Total liquidity provided



Monthly average of daily values

Liquidity-draining operations of the Reserve Bank
R billions

	Amounts outstanding at:		
	30 Jun 2000	31 Dec 2000	30 Jun 2001
Foreign-currency swaps with deposits	10,9	15,2	25,0
Reserve Bank debentures	4,0	3,0	4,9
Reverse repurchase transactions	4,0	3,8	3,3
Total	**18,9**	**22,0**	**33,2**

The Reserve Bank engaged the private banks in foreign-currency swap arrangements with associated deposits as a mechanism to sterilise the excessive liquidity build-ups. The outstanding amount of such foreign currency swap arrangements increased, on balance, from R4,3 billion at the end of December 1999 to R25 billion at the end of June 2001.

In addition, the Reserve Bank increased the outstanding amount of its own debentures from R1 billion in January 2000 to R4 billion in April and allowed the outstanding

amount to fluctuate between R3,0 billion and R4,0 billion for the remainder of 2000. The Bank also stepped up its outstanding reverse repurchase transactions in government securities with private-sector parties from R1,0 billion in January to R4,0 billion in May 2000 and kept the outstanding amount between R3,8 billion and R5,0 billion in the remaining months of 2000.

Since the beginning of 2001, the outstanding amount of Reserve Bank debentures has been maintained in a range of between R3,0 billion in January and R4,9 billion in June. Outstanding reverse repurchase transactions were initially increased from R3,8 billion at the beginning of the year to R6,2 billion in May, but later decreased to R3,3 billion in June 2001.

Unlike the systematic influence on market liquidity of Reserve Bank operations in the forward foreign-exchange market and the accumulation of net foreign assets, notes and coin in circulation outside the Reserve Bank only occasionally had a strong effect on the private banks' indebtedness to the Reserve Bank. At the height of the summer holiday season, notes and coin in circulation outside the Reserve Bank recorded a peak value of R34,7 billion on 27 December 2000 compared with a previous peak of R33,3 billion at the time of the millennium date change. In order to alleviate these seasonal market pressures, the Reserve Bank scaled down its liquidity-draining operations by reducing to low levels the outstanding amounts of its own debentures and of the reverse repurchase transactions in government securities.

The Reserve Bank has continuously accommodated in full the liquidity needs of private banks from 8 September 1999 to 16 October 2000, signalling to the other market participants its satisfaction with the behaviour of the rate on repurchase transactions. After a special meeting convened on 16 October 2000 to review the potential inflationary consequences of the depreciation of the rand and high international petroleum prices, the Monetary Policy Committee of the Bank announced that an increase of 25 basis points in the repurchase rate was warranted as a signal that second-round price effects would not be accommodated by an easing of monetary policy. This announcement was reinforced when the Bank underprovided in the private banks' estimated liquidity needs by an amount of R50 million at the auction of repurchase financing on 17 October 2000. The rate on Reserve Bank repurchase transactions duly increased by 25 basis points to 12 per cent.

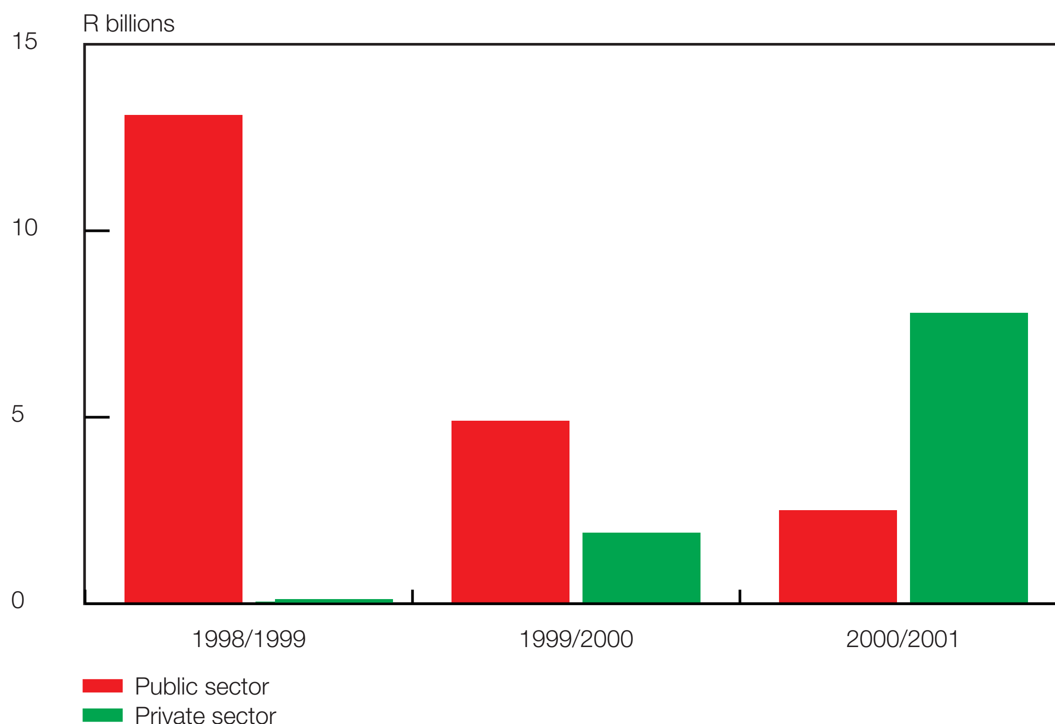
At the meeting of the Monetary Policy Committee on 13 and 14 June 2001 it was concluded that international and domestic macroeconomic conditions had changed to such an extent that there was only a small risk that the Reserve Bank would not achieve the inflation target of between 3 and 6 per cent in 2002. The committee indicated that the repurchase rate should decline by 100 basis points to 11 per cent. Without being prompted by any overproviding of liquidity, the private banks submitted tenders at the auction of 15 June 2001 which took the average repurchase rate down to the desired level.

Bond market

The outstanding feature of the *domestic primary bond market* over the past number of years was the sharp decline in net borrowing by public-sector organisations and the livelier market in corporate debt securities. The *private sector* dominated in this market during fiscal 2000/01 when the *change* of R7,8 billion in the outstanding nominal value

of private-sector loan stock listed on the Bond Exchange of South Africa (excluding "stripped bonds") exceeded the total net issues of public-sector domestic marketable debt over the same period.

Net borrowing in the domestic primary bond market



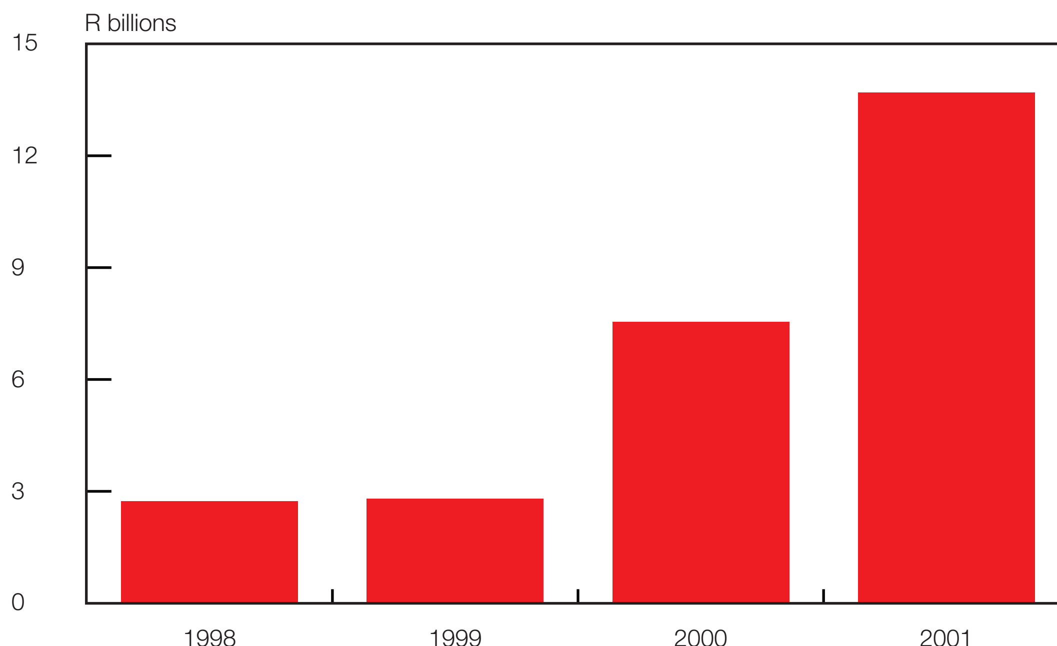
The decline in net borrowing in the domestic primary bond market by *public-sector borrowers* reflected, among other things, the commitment of the national government to reducing its demand on scarce domestic saving resources through prudent management of both revenue and spending. One-off revenues from the restructuring of state assets, major redemptions of debt, emphasis on funding by means of lower-cost Treasury bills and increased recourse to offshore borrowing, all contributed to the fall in the public-sector's demand for domestic debt financing. The *net issuance of fixed-interest securities* at R2,5 billion in fiscal 2000/01 was half of the R5,0 billion borrowed in fiscal 1999/2000, which in turn was almost two-thirds less than the net amount of R13,1 billion in public-sector bonds issued in fiscal 1998/99.

Fiscal policy during the past three years has limited the potential for *crowding out* the private sector as the public-sector's reduced demand for loanable funds left ample resources available for private-sector borrowers. This is evident from *institutional cash flows* (measured as the aggregated domestic current income surplus of long-term insurers and pension funds and the net sales of units by unit trusts) which have continued to exceed the financing needs of the public sector by a substantial margin, even though cash flows to institutions have declined over the past three fiscal years.

Activity in the corporate bond market picked up as the *private sector* began to fill the void left by public-sector borrowers. The private sector increasingly targeted the

primary bond market to meet its financing needs and the *outstanding nominal value of private-sector loan stock* listed on the Bond Exchange of South Africa (excluding "stripped bonds") increased more than threefold from R3,8 billion at the end of 1999 to R13,7 billion in June 2001.

Listed private-sector bonds at end of June

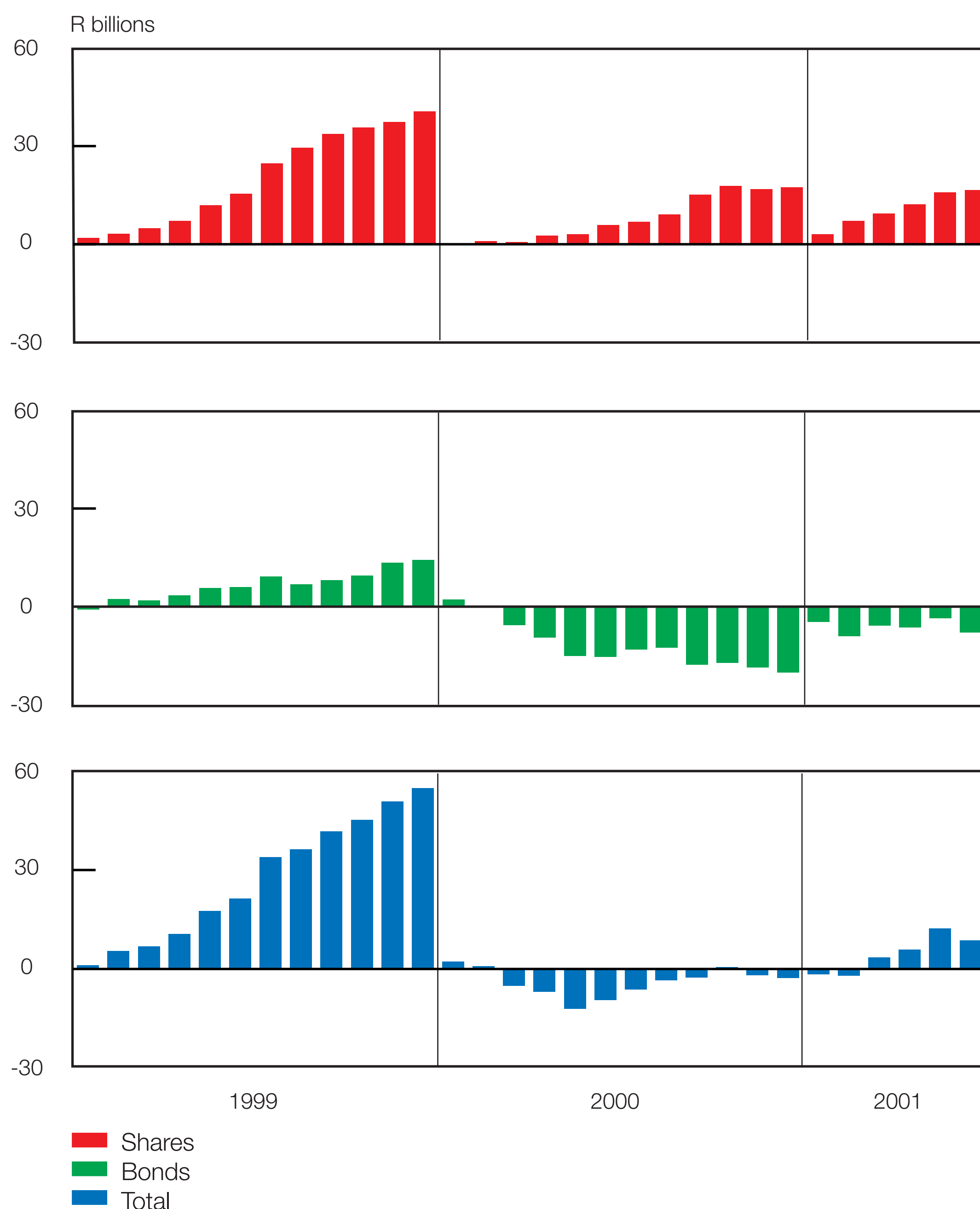


South Africa has been assessed as an investment-grade issuer in 2000, encouraging the *public sector* to tap the *international financial markets* through the issuance of *foreign-currency denominated bonds. National government* raised R13,1 billion and public corporations R4,5 billion in fiscal 1999/2000. Government again mobilised R1,9 billion in the fiscal year 2000/01 and R9,5 billion in the period April to July 2001. The proceeds of the three bond issues so far in the current fiscal year accounted for more than 80 per cent of the budgeted total foreign borrowing programme of R11,3 billion. *Other domestic public-sector borrowers* have steered clear of the international bond market since April 2000, presumably because of uncertainties about future movements in the exchange rate of the rand and mounting fears of the potential spill-over effects of financial problems in Argentina and Turkey.

Exchange rate concerns and the associated deterioration of foreign investor sentiment towards rand-denominated investments had a dampening effect on funding through *rand-denominated bonds* in the *eurobond market.* South African public-sector borrowers have made no new issues of rand-denominated bonds in the eurobond market since the last issue in March 1999. In fact, a small redemption of R0,1 billion was made in 2000. *Non-resident entities* still issued new bonds in this market, but only in diminishing amounts: R9,7 billion in 1999, R4,8 billion in 2000 and R2,9 billion in the first half of 2001. What is more, redemptions by foreign borrowers in 2000 exceeded new borrowings by R3,0 billion and by R0,2 billion in the first six months of 2001.

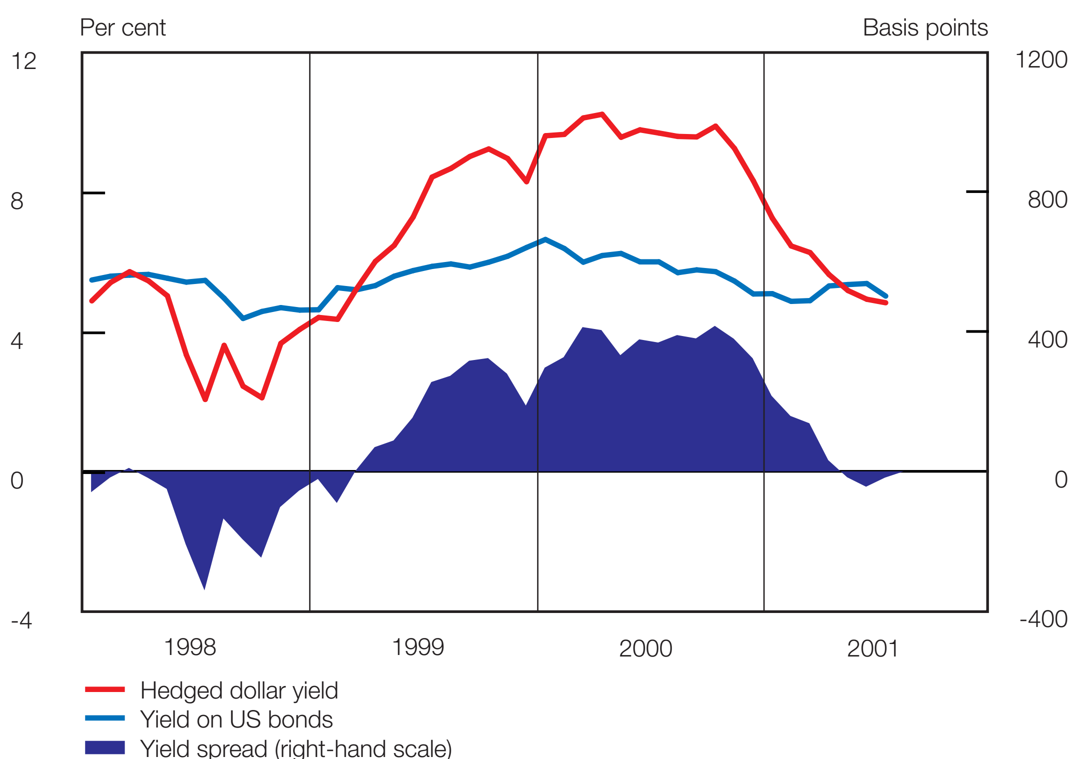
Increases and decreases in *non-resident* holdings of bonds that traded on the *domestic secondary bond market* reflect changes in foreign investor sentiment and expected returns. On a *net basis*, non-residents bought bonds to the value of R14,2 billion in 1999 when the exchange value of the rand was relatively stable and bond prices were generally rising. Heightened volatility in the exchange rate subsequently increased the risk of investing in rand-denominated bonds. This, along with expectations that the decline in bond yields had run its course, motivated non-resident investors to sell bonds, on a net basis, to the value of R20,2 billion in 2000 and R7,9 billion in the first half of 2001.

Annual cumulative non-resident net purchases in the secondary securities markets



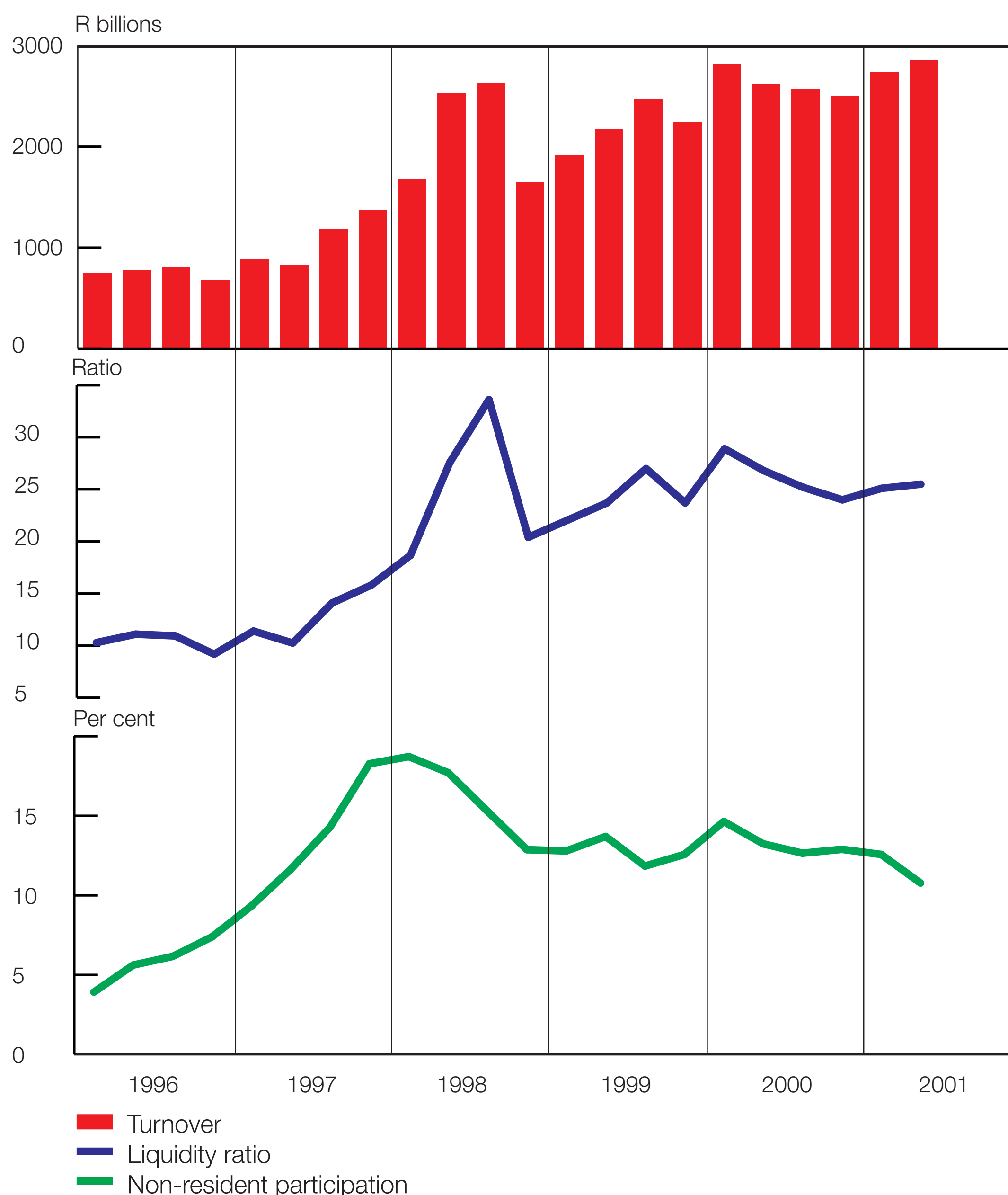
From the perspective of a US investor, the *hedged dollar yield* on South African bonds (measured as the rand yield adjusted for the forward premium or discount) decreased from 9,9 per cent in October 2000 to 4,9 per cent in July 2001. As a consequence, the *spread* between the hedged dollar yield on SA government bonds and the yield on US government bonds reversed from 416 basis points in October 2000 to an inverse spread of 19 basis points in July 2001. This reduction in the incremental return on a *hedged* investment in SA bonds and the negative impact of the deterioration in the exchange value of the rand on the return of an *unhedged* position in bonds have also contributed to the net sales of bonds by non-resident investors since the fourth quarter of 2000.

Yield spread and non-resident net purchases of bonds



Purchases and sales of bonds by non-residents as a percentage of total purchases and sales of bonds have averaged almost 13 per cent since 1999. The sustained foreign participation, along with yield volatility and the need for portfolio adjustments along a changing yield curve, added liquidity to the market. An unprecedentedly high annual turnover of R10,5 trillion was recorded in 2000, followed by a turnover of R5,6 trillion in the first half of 2001. Rising turnovers were also reflected in the *annualised liquidity ratio* (measured as the nominal value of bonds traded relative to the nominal capital value of bonds listed on the Bond Exchange of South Africa), which rose from 23,9 in 1999 to 25,8 in 2000 and 25,1 in the first half of 2001.

Liquidity in the bond market



Share market

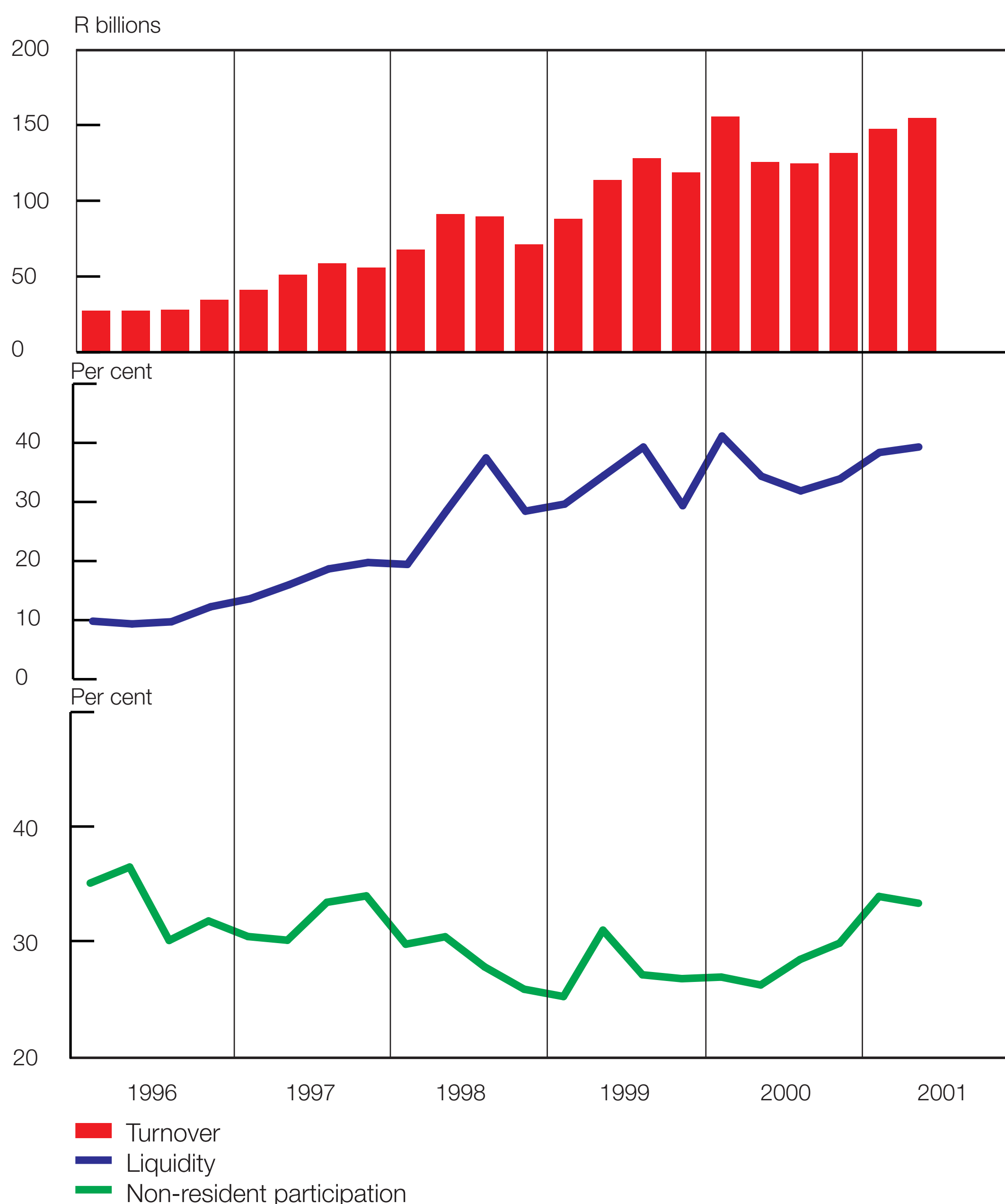
Funding sought by listed private-sector companies in the *primary share market* increased strongly in 2000 when the upturn in economic activity gained momentum, but abated quite sharply in the first half of 2001 when share price movements were highly volatile. The *total value of share capital raised* on the JSE Securities Exchange, at R74 billion in 2000, was almost double the R39 billion raised in 1999. The value of capital raised fell to R6 billion in the first half of 2001, compared with R31 billion in the first half of 2000.

Of the total value of capital raised in the eighteen months to June 2001, 65 per cent was earmarked for the *industrial sector* whereas 57 per cent was related to the

acquisition of unlisted assets. Mergers and acquisitions contributed to the decline in the *number* of listed companies and 100 companies were delisted from the Exchange. There were only 16 new listings in the eighteen months from January 2000 to June 2001.

Volatile price movements throughout the eighteen months to June 2001 boosted trading activity in the *secondary share market.* The value of shares traded on the JSE Securities Exchange in 2000 was 20 per cent higher than the previous record set in 1999. In the first half of 2001 the value of shares traded rose again and was 7 per cent higher than in the first half of 2000. On account of this rise in value and the volatility in share prices, *market liquidity* (measured as annualised turnover relative to market capitalisation) increased from 28 per cent in 1999 to 35 per cent in 2000 and 38 per cent in the first half of 2001. During this period, *market capitalisation* declined from R1 616 billion in December 1999 to R1 551 billion in December 2000 and R1 571 billion in June 2001.

Liquidity in the share market



Non-resident investors traded actively in the secondary share market and the value of their purchases and sales of listed shares broadly kept pace with the growth in total turnover on the JSE Securities Exchange. On average, *non-resident participation* accounted for 28 per cent of the value of all shares traded in 1999 and 2000 and 34 per cent in the first half of 2001. A shift in *cross-border portfolio investment* from investing in bonds to investing in shares supported the high level of non-resident participation in the secondary share market. The value of non-resident gross share transactions as a percentage of their gross bond transactions accordingly increased from an average of 7 per cent in 1998 to 11 per cent in 1999 and 2000 and 16 per cent in the first half of 2001.

Non-resident interest in South African listed shares weakened considerably from 1999 to 2000 as the net purchases of listed shares by non-resident investors declined from R40,6 billion in 1999 to R17,4 billion in 2000. This decline in net purchases is best explained by the turnaround in the year-on-year percentage change in the dollar value of the all-share index from an increase of 49,8 per cent in 1999 to a decline of 20,7 per cent in 2000. Subsequently, foreign investor interest strengthened once more as share prices in dollar terms increased by 3,9 per cent from December 2000 to June 2001. Non-residents stepped up their acquisition of shares to the amount of R16,5 billion in the first half of 2001.

The performance of the South African share market in *dollar terms* compares favourably with its counterparts in developed and emerging markets over the past thirty months, despite the depreciation of the rand against the US dollar. The accompanying table shows that the South African market gained at a rate that was close to the average gain in developed and emerging markets in 1999, and that the price loss on the JSE Securities Exchange in 2000 was also close to the average price loss in these markets in 2000.

Share price performance[1)]
Percentage change

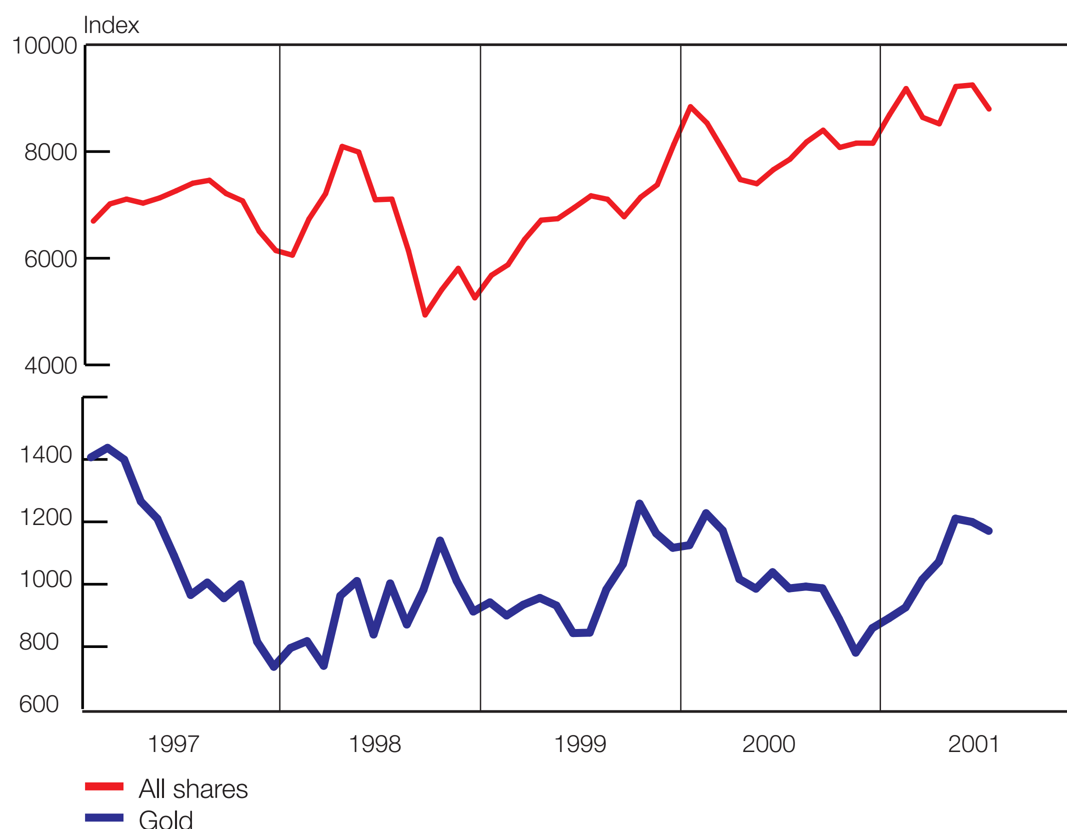
Period	United States	Emerging markets	South Africa	
	S&P500[2)]	S&P/IFCI[2)] Composite	JSE All-share price index[3)]	
	US dollar			SA rand
Dec 1998 to Dec 1999	19,5	63,4	49,8	57,3
Dec 1999 to Dec 2000	-10,1	-33,0	-20,7	-2,5
Dec 2000 to Jun 2001	-7,3	0,1	3,9	10,8
Dec 1998 to Jun 2001	-0,4	9,6	23,4	69,8

1) Based on closing values of share price indices at end of period.
2) Standard and Poor's S&P500 and S&P/IFCI composite indices.
3) JSE all-share price index converted to dollars.

The increase in South African shares in dollar terms in the first six months of 2001 was well ahead of the price movements in emerging markets and developed markets. Over the entire thirty-month period, the South African share market outperformed the S&P500 by a substantial margin.

Share-price movements on the JSE Securities Exchange were quite volatile during most of 2000 and the first six months of 2001. The *average monthly price level of all classes of shares* fell at first by 16 per cent from January to May 2000, rose again by 24 per cent to February 2001, declined by 7 per cent from February to April and then increased by 8,5 per cent to an all-time high in June 2001. Overall, there was a net gain in prices of 25 per cent from May 2000 to June 2001.

Monthly average share prices

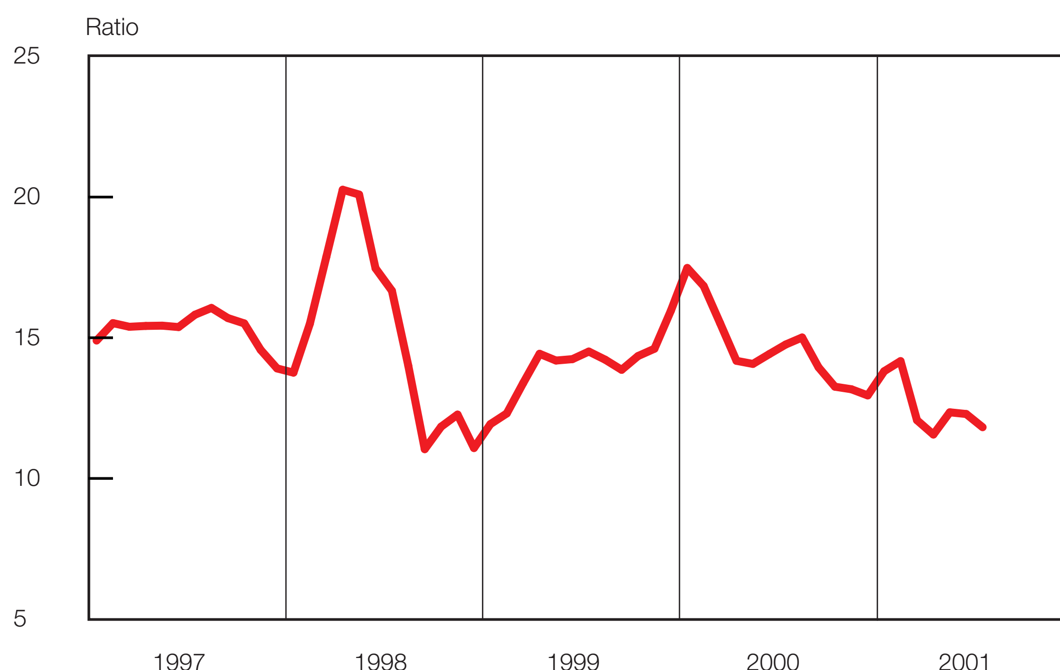


Share prices faltered from early September 2000 to the beginning of December because of, among other things, the weakness of the rand against the US dollar, inflationary concerns and the volatility of share prices in the major international markets. A vigorous but brief recovery then began, but lasted only until February 2001. A sharp downward correction occurred from mid-February 2001 to early April as uncertainty about global economic growth again led to large and contagious share market corrections around the world. When the global market settled down again, share prices on the JSE Securities Exchange strengthened on a net basis in June 2001, but in July the domestic market followed the global markets downwards again. Uncertainty in the international financial markets and the weakness of the rand against the US dollar positively influenced the share prices of gold-mining companies. The monthly average price of *gold-mining shares* recorded an increase of 55 per cent from November 2000 to May 2001, but has subsequently receded by 1 per cent in June 2001.

Strong growth in earnings took the *price-earnings ratio* of all classes of shares in April 2001 to its lowest level since the last quarter of 1998 when markets had been

disrupted by the international financial crisis of that year. The price-earnings ratio declined from 17,5 in January 2000 to 12,3 in June 2001 as average earnings per share strengthened by 240 basis points and the monthly average level of the all share price index gained 4,6 per cent. The monthly average *dividend yield* on all classes of shares increased from a low 1,9 per cent in January 2000 to 2,9 per cent in April before receding slightly to 2,7 per cent in June 2001.

Price-earnings ratio: all shares



Market for derivatives

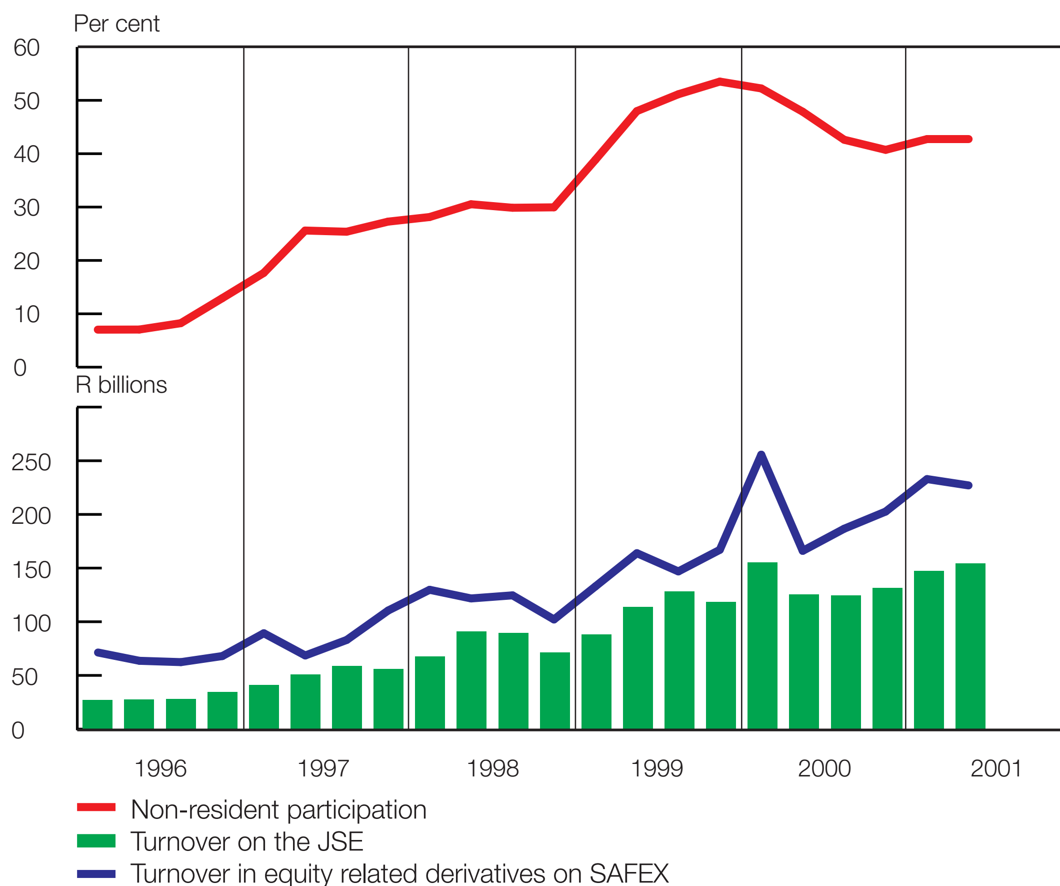
The rising level of trading activity in the *formal market for derivative products* reflected the increased use of derivative instruments in the management of exposure to price volatility in the underlying securities markets. Trading was also underpinned by lively non-resident participation. Participation by *non-residents,* measured as a percentage of open interest, peaked at an average of 48 per cent in 1999 before levelling off at a relatively high 46 per cent in 2000 and 43 per cent in the first half of 2001.

Trading on the SAFEX was concentrated in *equity index futures* and *options on futures contracts* which together with *individual equity futures and options on such contracts* accounted for an average of about 99 per cent of the overall value of all SAFEX trades in financial derivative instruments over the past year and a half. As trading activity in shares and equity-related derivatives tracked one another, the value of these derivative contracts as a *ratio* of turnover on the JSE Securities Exchange increased from 1,3 in the second quarter of 2000 to an average of 1,5 over the four quarters to June 2001.

The total combined number of *futures* and *options on futures contracts* traded on the SAFEX increased by 30 per cent to 24,2 million in 2000, and by 60 per cent from 9,9 million in the first half of 2000 to 16 million in the first half of 2001. Growth on the JSE Securities Exchange in the *warrants market,* a complementary product to equity options, was even more substantial. The number of warrants traded increased

from 2,8 billion in 1999 to 9,9 billion in 2000. In the first half of 2001 the 10,9 billion warrants traded had already surpassed the number traded in the whole of 2000.

Market for derivatives



The *commodity futures* and *options on futures contracts* traded in the Agricultural Market Division of the SAFEX mainly consisted of *maize* contracts, which accounted for 95 per cent of all commodity-related trading in the eighteen months to June 2001. Uncertainties about the domestic and international supply and demand of maize and volatility in the exchange rate of the rand, provided the main thrust for the heightened volatility in the spot price of maize and the strong increase in the number of agricultural commodity contracts traded. The total number of commodity contracts traded increased by 82 per cent from 250 000 in 1999 to 455 000 in 2000 and amounted to almost 400 000 in the first half of 2001.

Real-estate market

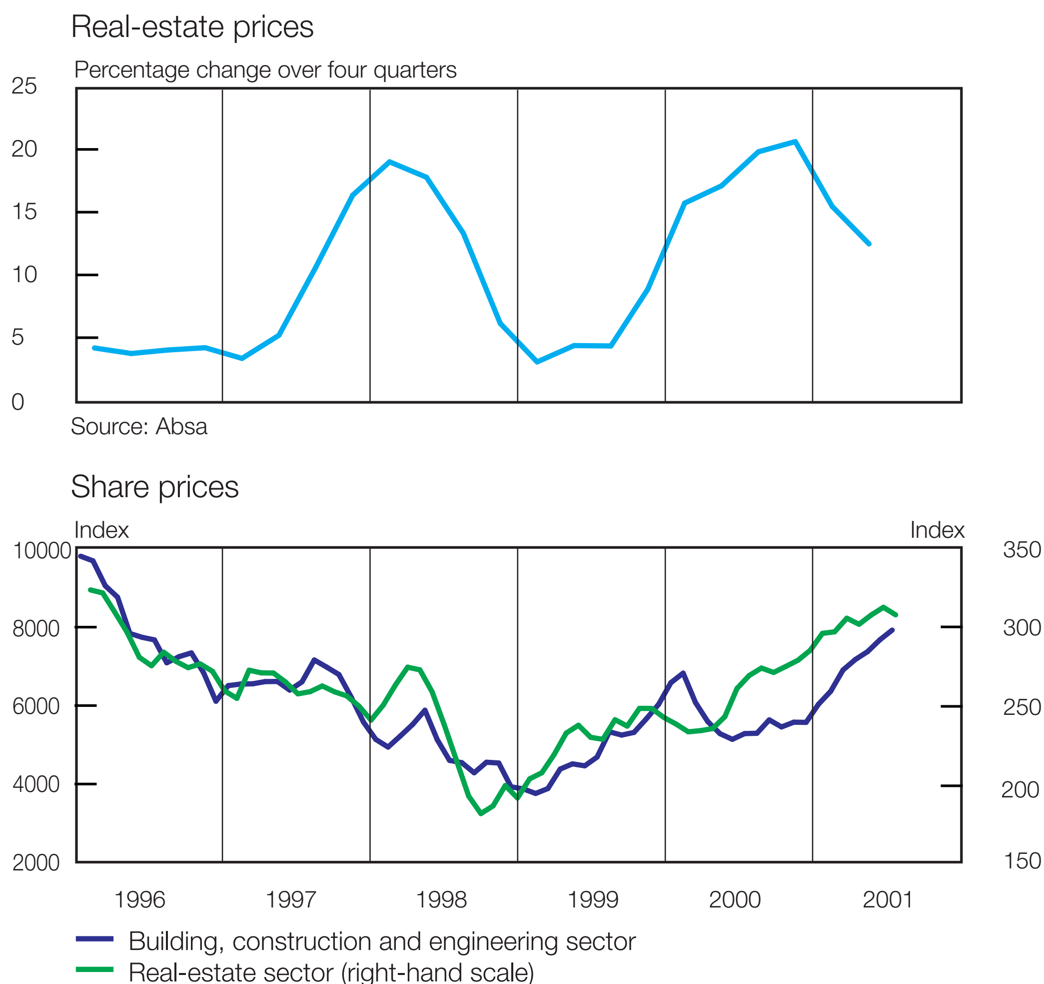
The decline in the cost of mortgage finance and stronger growth in real economic activity were prominent factors behind the resurgence in trading activity in the *real-estate market* and the gains in residential property and real-estate share prices over the past two-and-a-half years. The recovery in the demand for housing also stimulated growth in the home loan market.

The *value* of real-estate transactions increased by about 34,0 per cent in 2000, following year-on-year declines of 9,5 per cent in 1999 and 5,9 per cent in 1998. The seasonally adjusted quarterly value of transactions increased from a recent low

of R5,9 billion in the first quarter of 1999 to R9,9 billion in the first quarter of 2000, before levelling off at this relatively high level for the remainder of 2000.

The rate of change over four quarters in the average *nominal price of houses* (measured by Absa, a private-sector banking corporation) picked up from 3,0 per cent in the first quarter of 1999 to 20,6 per cent in the fourth quarter of 2000, before slowing down to still high levels of 15,4 per cent in the first quarter of 2001 and 12,5 per cent in the second quarter. The year-on-year increase in the *inflation-adjusted* or *relative price of houses* turned positive in the first quarter of 2000 for the first time since the third quarter of 1998. In the ensuing period, the rise in relative house prices accelerated to 11 per cent in the fourth quarter of 2000 before falling back to 7,7 per cent in the first quarter of 2001 and 7,2 per cent in the second quarter.

Real-estate market

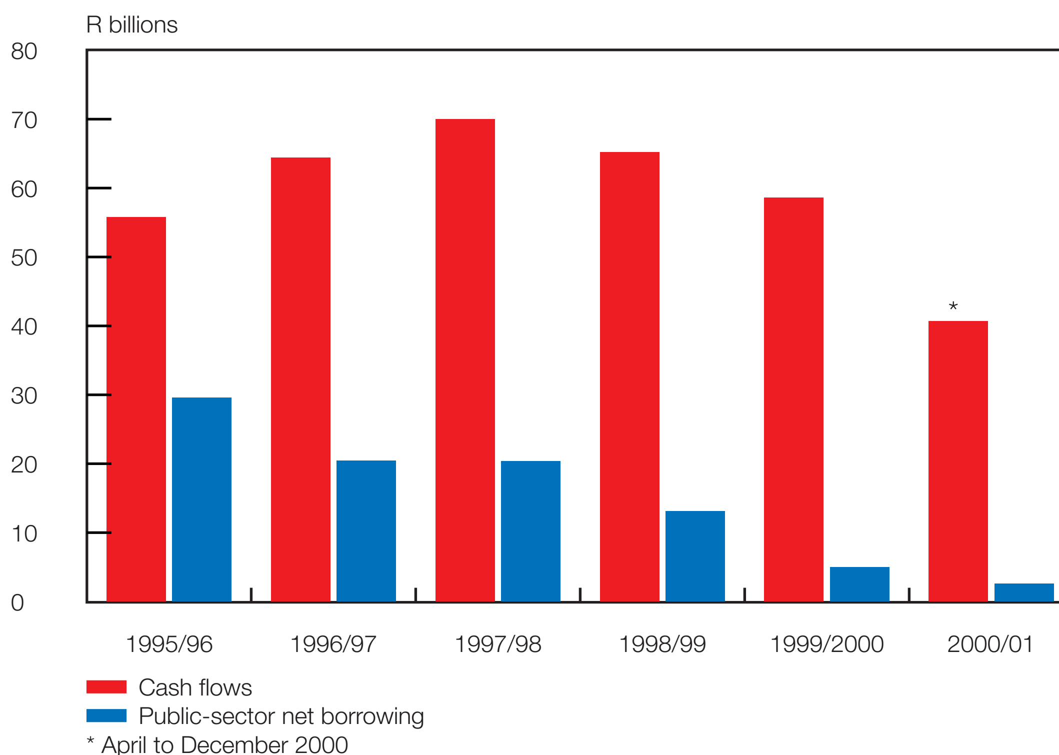


The greater attractiveness of real-estate as an asset class was also reflected in the movement in *share prices* of companies listed in the real-estate sector and building, construction and engineering sector of the JSE Securities Exchange. Since September 1998 to June 2001 the prices of companies in the real-estate sector have increased by 71 per cent, and from February 1999 to June 2001 the prices of building, construction and engineering companies by 104 per cent.

Non-bank financial intermediaries

Institutional cash flows, measured as the current receipts less current expenditure of long-term insurers and pension funds and the net sales of units by unit trusts, have generally declined since 1996.

Institutional cash flows and public-sector net borrowing



This decline reflected the sensitivity of institutional cash flows to changes in interest rates and other factors such as

- the impact of market volatility on asset prices and investment income;
- policy surrenders in response to reinvestment rates offered by other investment products;
- the impact of monetary conditions on households' ability to service policies; and
- the relaxation of exchange controls and increased bias towards investment in foreign markets by domestic investors in an attempt to improve their risk-return profiles.

The domestic current income surplus of *private and official self-administered pension and provident funds* remained fairly constant, largely on account of the contractual nature of member and employer contributions and prior knowledge about the amount and timing of expenses. By contrast, the domestic current income surplus of *long-term insurers* declined from 1996 to 1999, but increased somewhat in 2000. The *net sales of units by unit trusts* mirrored the trend in cash flows of long-term insurers and reflected investors' increased preference for unit trusts as the investment vehicle of choice. The value of the net acquisition of units in unit trusts increased almost fourfold from 1996 to 1999, before falling back sharply in 2000 along with increased volatility in the financial markets and uncertain return prospects.

Public finance

Fiscal policy

The Minister of Finance presented his annual Budget to Parliament on 21 February 2001. He stated that the proposals contained in the Budget bear testimony to the successful and powerful transformation of the South African economy and more specifically of the fiscal policies pursued in the past five years. With the smaller budget deficit and the reining in of growth in government debt, the saving in interest on public debt could now be utilised for government's growth, employment and redistribution objectives. The healthy financial position attained by government has laid the foundation for an investment environment conducive to the development and reform of other macroeconomic variables.

The Public Finance Management Act was implemented on 1 April 2000. The Act lays down a legal and administrative framework for the conduct of fiscal affairs. Broadly following the same principles as those set out in the Public Finance Management Act, a bill governing the financial management of local governments was released for public comment. A new set of Treasury regulations, applicable to all government departments and trading entities in the national and provincial government spheres, was published in terms of the Public Finance Management Act and came into effect on 1 June 2000. These regulations replaced volumes of Treasury instructions in terms of the old Exchequer Act and specify standards comparable with international best practices.

Within such a management framework, government continues with tax reforms which have broadened the tax base, improved the efficiency of tax administration and made way for further tax rate reductions. The main focus of fiscal reform remains improving the living conditions of all South Africans through releasing household spending power as well as through a growth-oriented spending plan. The policy objectives that were considered in formulating government’s spending plans for the medium term included economic growth, job creation, equity, social development and the strengthening of the safety and justice sector.

With the strict control government has on spending by government agencies, it was possible to shift the emphasis from the level of spending to the composition of spending and the quality and depth of service delivery. Government also acknowledged the importance of capital formation in the public sector in order to attain the desired level of service delivery and to eradicate backlogs. Although government had addressed some of these backlogs through its own spending plans, alternative ways of coping with this challenge were sought, such as public-private partnerships at all levels of government.

There was a marked shift in the allocation of public resources towards provincial and local governments. The increase in the allocation to provincial governments was for the financing of higher social benefit payments, poverty alleviation programmes, health services resulting from HIV/Aids and increased spending on infrastructure. Increased allocations to local governments were related to government's objective to provide basic services, including water, sanitation and municipal services, to all communities.

The Provincial Tax Regulation Bill that provides guidelines on the power of provincial governments to impose taxes, levies, duties and surcharges, was released. The Bill

sets up a legislative framework which promotes co-operative governance among all levels of government while maintaining national economic policies. It was also announced that the local government grant system would be rationalised and extended to a three-year time horizon in order to promote more effective planning at this level of government.

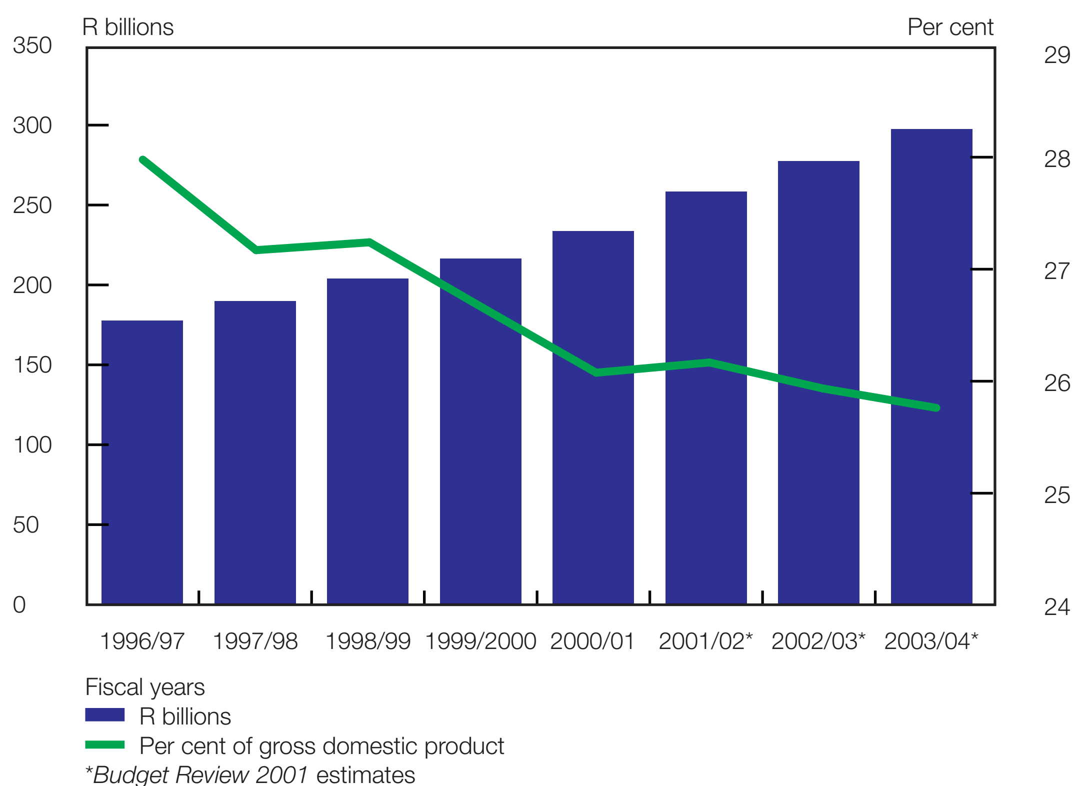
National government finance

The Public Finance Management Act instructs the National Treasury to publish a *Statement of National Revenue, Expenditure and Borrowing* within 30 days after the end of each month. This statement replaces the monthly statement of Exchequer issues and receipts, previously published in the *Government Gazette.* A cash-flow statement is also provided as part of the new information set. Cash-book transactions recorded in the general ledgers of the national government serve as the basis for the new reporting structures, in contrast to the previous structure which relied on bank statement transactions. Although the data reflected in the *Statement of National Revenue, Expenditure and Borrowing* are not strictly comparable with the data reflected in the statements published prior to April 2000, no significant distortion of any established macroeconomic relationship has resulted from this administrative change.

National government expenditure

National government expenditure in fiscal 2000/01 amounted to R233,8 billion, which was R0,3 billion more than originally budgeted for. This outcome for fiscal 2000/01 represents an increase of 8,0 per cent on the actual outcome of the previous year. Although this rate of increase slightly exceeded the growth rate of 7,9 per cent

National government expenditure



envisaged in the original Budget proposals, it was substantially lower than the average rate of increase of 10,0 per cent recorded in the preceding five fiscal years.

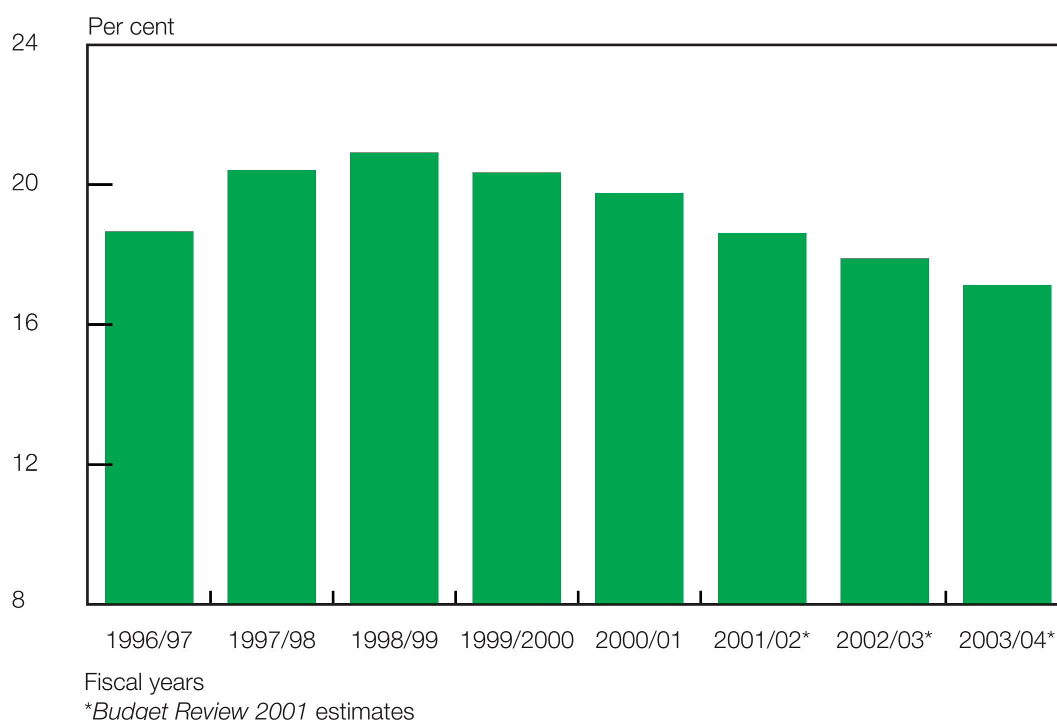
Some 40 per cent of the expenditure of national government can be attributed to the transfers to provincial governments. Expenditure in fiscal 2000/01 included some non-recurrent cost items such as expenses for repairing flood-related damage, the creation of the newly demarcated local government structures and the cost of the local government elections held on 5 December 2000.

Government also incurred some additional personnel costs amounting to approximately R1,0 billion in fiscal 2000/01, owing to the new arrangement for the payment of bonuses to public servants having their birthdays in January, February and March. In the past these bonuses had been paid in April of the ensuing fiscal year. Salary negotiations with public-sector unions settled on an average salary increase of 6,5 per cent compared with the originally projected 5,5 per cent. These wage settlements and a reduction in personnel numbers are set to reduce personnel expenditure as a ratio of non-interest expenditure. Personnel expenditure as a ratio of non-interest expenditure grew from 46,6 per cent in fiscal 1995/96 to 49,6 per cent in fiscal 1999/2000 before declining to 47,5 per cent in fiscal 2000/01. Government plans to reduce personnel expenditure as a ratio of non-interest expenditure to 42,2 per cent in fiscal 2003/04.

Interest payments by national government increased to R46,2 billion or by 4,9 per cent in fiscal 2000/01. Although this rate of increase was somewhat higher than the 3,2 per cent increase recorded in the previous year, it was significantly lower than the average of 13,8 per cent recorded in the preceding five fiscal years.

Appropriate borrowing strategies and the continuous decrease in the borrowing requirement of national government, jointly contributed to a decline in interest

Interest on national government debt as a ratio of national government expenditure



Fiscal years
Budget Review 2001 estimates

payments relative to national government expenditure. In the Budget presentation for fiscal 2001/02, the Minister of Finance projected this ratio to be 17,1 per cent in fiscal 2003/04. This was down from 20,9 per cent in fiscal 1998/99. The slower growth in interest payments allowed some latitude for the allocation of resources to government's social upliftment programmes.

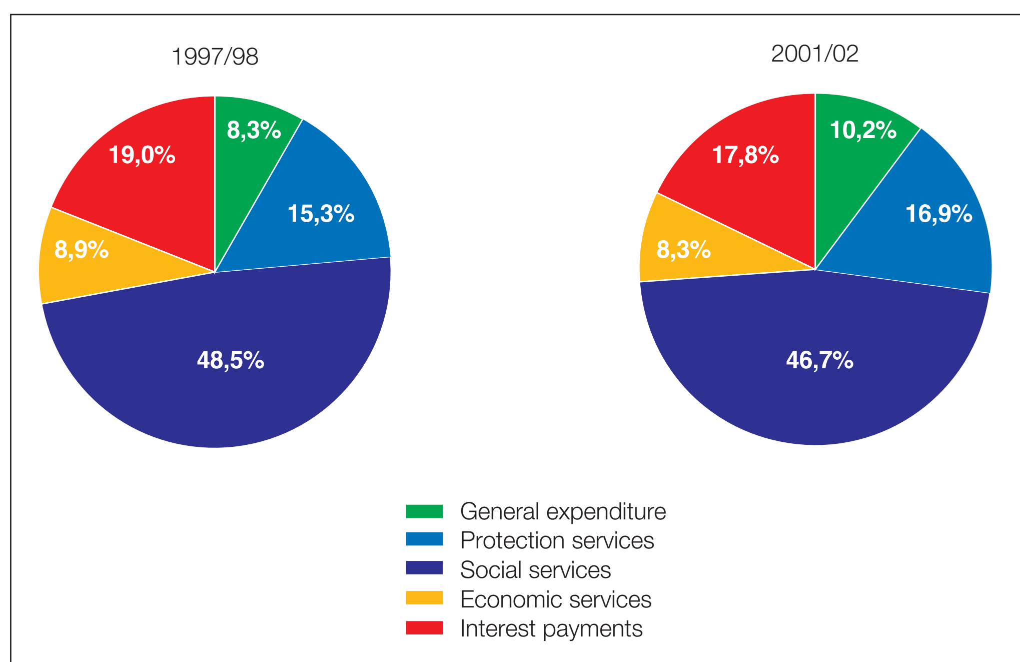
Only R7,0 billion or 3,0 per cent of the total spending of national government was recorded as capital spending in fiscal 2000/01. The original Budget projection allowed for total capital spending of R7,5 billion.

As a ratio of gross domestic product, national government expenditure amounted to 26,1 per cent in fiscal 2000/01 – just below the 26,7 per cent of the previous fiscal year. The decline in national government expenditure relative to gross domestic product is a continuation of the trend that has been established since fiscal 1996/97. 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 expenditure amounted to R234,3 billion in fiscal 2000/01, which was 9,4 per cent higher than in the previous fiscal year.

In the Budget of 2001, it was estimated that national government expenditure would increase to R258,3 billion in fiscal 2001/02 or by 10,5 per cent on the actual expenditure of the previous fiscal year. Further increases to R277,3 billion in fiscal 2002/03 and R297,5 billion in fiscal 2003/04 were indicated in the medium-term projections. This represents an average annual rate of increase of 8,4 per cent in nominal terms over the medium-term budget period.

Spending on social services remains the largest functional category of government spending, amounting to 46,7 per cent of the consolidated national and provincial government expenditure in fiscal 2001/02. Spending on these services is expected

Functional classification of expenditure by consolidated national and provincial governments

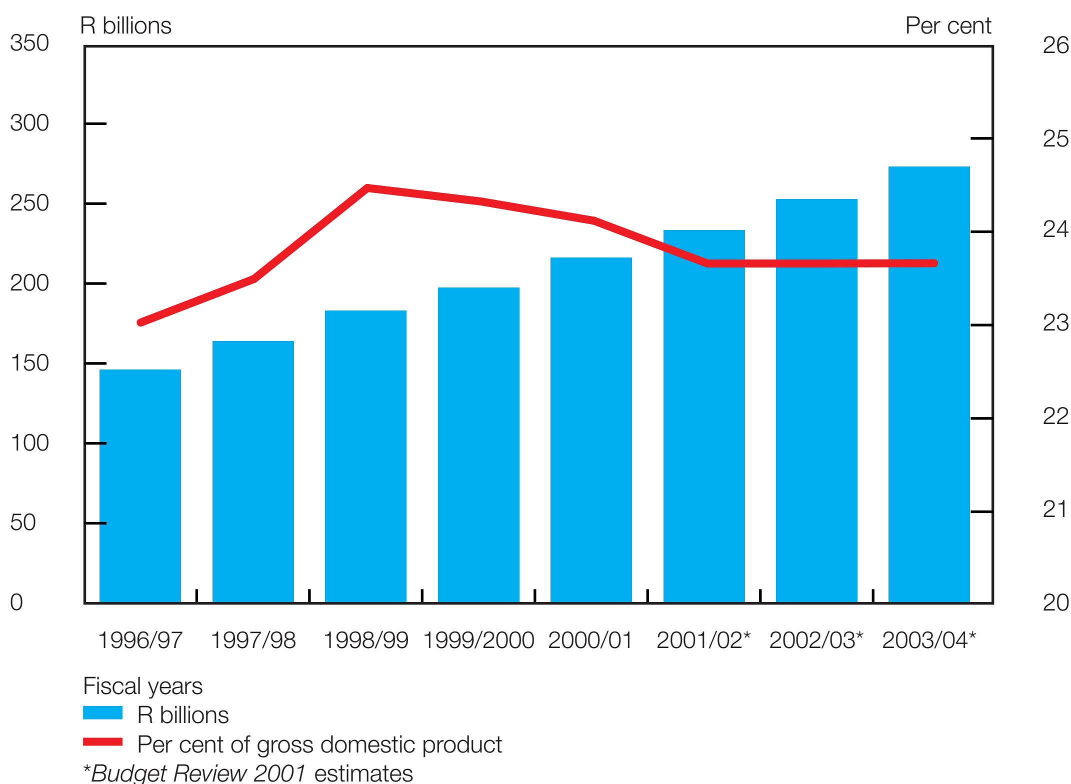


to increase at an average annual rate of 7,3 per cent over the medium-term budget period. A slight shift in the functional classification of expenditure towards expenditure on protection and general government services is planned in the medium term.

National government revenue

The revenue received by national government in fiscal 2000/01 amounted to R216,1 billion, representing a year-on-year rate of increase of 9,5 per cent. This outcome was R5,7 billion more than that projected in the original Budget and the rate of increase was appreciably higher than the growth of 6,6 per cent envisaged at the time of the Budget. The South African Revenue Service (SARS) ascribed the improvement in revenue collections not only to the improvement in economic conditions, but also to better organisation and administrative procedures. The SARS introduced a more effective debt collection strategy, implemented improved risk profiling and enforcement strategies, increased investigative capacities and cleared considerable backlogs in the assessment and auditing of tax returns.

National government revenue



As indicated in the accompanying table, taxes on income and profits remained the principal source of revenue for government. Revenue from this source yielded R4,6 billion more than originally envisaged, mainly as a result of higher-than-estimated collections of taxes on companies. This increase in collections was not only brought about by increased company profits, but also by the secondary tax on companies which usually increases with higher dividend declarations.

Although domestic taxes on goods and services fell short of the original budgetary expectations, value-added tax collections which form part of this class of taxes

outperformed budgetary expectations. The strong showing of value-added tax collections was occasioned by rising private consumption expenditure, higher product prices and the higher international oil price. The collection of fuel levies fell short of the budget target because there was a decline in the sales volume of fuel in reaction to the higher petrol and diesel prices.

National government revenue in fiscal 2000/01
R billions

Revenue source	Budgeted	Actual
Taxes on income and profits	121,3	125,9
Payroll taxes	1,4	1,2
Taxes on property	3,3	4,0
Domestic taxes on goods and services	79,4	79,0
Taxes on international trade and transactions	6,5	8,3
Other revenue	6,9	6,1*
Less: SACU** payments	8,4	8,4
Total revenue	**210,4**	**216,1**

* Including R0,8 billion received by the National Revenue Fund but not yet classified to a specific tax source
** Southern African Customs Union

The collection of taxes on international trade and transactions outperformed budgetary expectations by far. Revenue from customs duties exceeded expectations owing to stronger-than-expected growth in import values and more efficient tax administration.

South Africa's first payroll tax was introduced on 1 April 2000. The National Revenue Fund received R1,2 billion in respect of the Skills Development Levy. Eighty per cent of the levy collected is intended for funding the sectoral education and training authorities (SETAs) and twenty per cent for the National Skills Fund. An amount of R0,9 billion of these collections was transferred to the SETAs and National Skills Fund during fiscal 2000/01.

National government revenue as a ratio of gross domestic product amounted to 24,1 per cent in fiscal 2000/01 compared with 24,3 per cent in the previous fiscal year. When the Budget for fiscal 2001/02 was presented to Parliament, national government revenue was projected to increase to R233,4 billion – or by 8,0 per cent when compared with the actual outcome for the previous year. It is expected that national government revenue will increase at an average rate of 8,1 per cent over the three-year budget period. The overall tax burden is expected to increase marginally from 24,0 per cent of gross domestic product in fiscal 2001/02 to 24,2 per cent in fiscal 2003/04.

Specific tax adjustments were announced in the 2001 Budget, providing tax relief estimated at R9,1 billion in fiscal 2001/02. However, it is expected that R3,0 billion of this reduction will be recovered through improved tax administration and greater compliance with tax laws. The introduction of capital gains tax, which was originally announced in the Budget for 2000, was deferred to 1 October 2001 after consultation with all interested parties. The implementation was postponed to allow the SARS to put the necessary systems in place and to allow the financial industry and the public sufficient time to obtain the information needed for effective implementation.

National government revenue, adjusted for differences in timing between the recording of transactions and bank clearances, amounted to R216,0 billion in fiscal 2000/01, representing an increase of 9,4 per cent compared with the previous year.

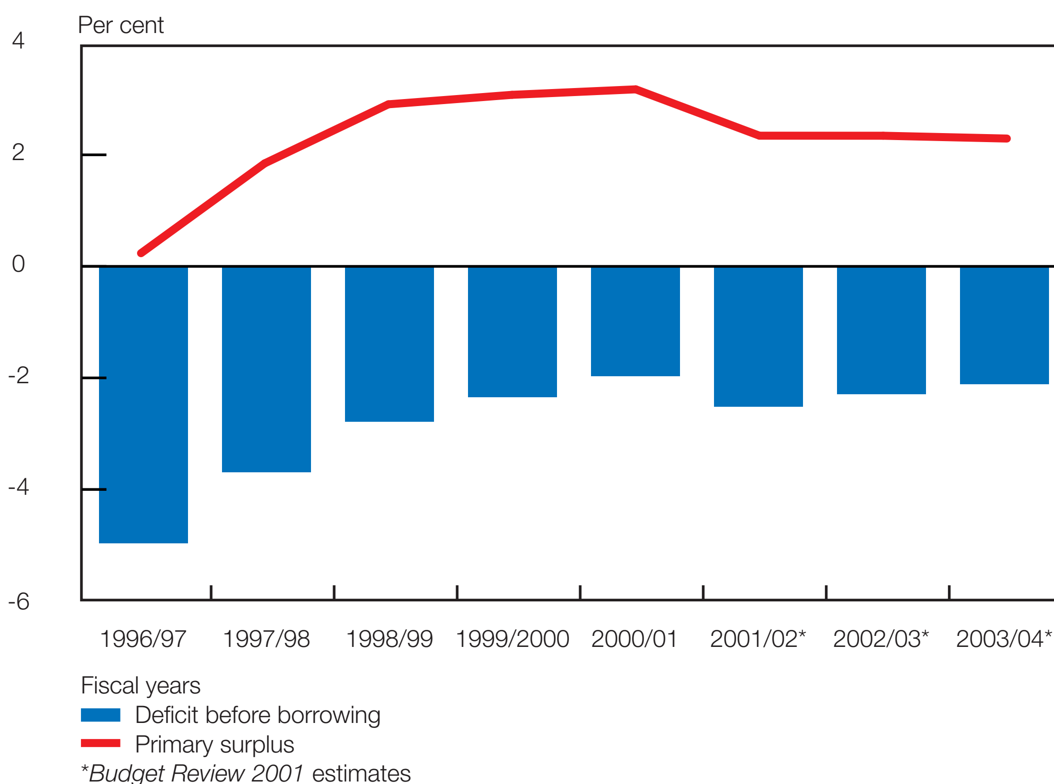
National government deficit

The net result of the higher-than-budgeted revenue and close-to-budgeted expenditure was a *national government deficit before borrowing and debt repayment* of R17,7 billion in fiscal 2000/01 – well below the deficit of R23,1 billion envisaged in the original Budget and the revised estimate of R21,7 billion announced in February 2001. As a ratio of gross domestic product, the national government deficit before borrowing and debt repayment amounted to 2,0 per cent in fiscal 2000/01 compared with 2,3 per cent in the previous fiscal year and the 2,6 per cent originally budgeted for the full fiscal year.

The budgeted expenditure and revenue for fiscal 2001/02 left a deficit of R24,9 billion to be financed through borrowing. It was projected that the nominal deficit would be maintained at approximately that level up to fiscal 2003/04. However, the projected deficit as a ratio of gross domestic product was expected to decline from 2,5 per cent of gross domestic product in fiscal 2001/02 to 2,1 per cent in fiscal 2003/04.

Government's primary balance (i.e. the deficit recalculated by excluding interest payments from total expenditure) steadily improved from a deficit of 3,0 per cent of gross domestic product recorded in fiscal 1992/93 to a surplus of 3,2 per cent in fiscal 2000/01, slightly higher than the 3,1 per cent recorded in the previous fiscal year. A slight decrease to 2,4 per cent is envisaged for fiscal 2001/02. This ratio is expected to remain broadly unchanged at the level of 2,4 per cent over the three-year planning horizon.

National government balances as a ratio of gross domestic product



National government financing and debt

The deficit before borrowing when *adjusted for the cash flows* associated with late departmental transfers, the surrendering of funds by spending departments and funds requested by spending departments but not yet spent, amounted to R18,3 billion in fiscal 2000/01. Apart from financing this deficit, national government had to fund the cost of revaluing maturing foreign loans and also accepted responsibility for the repayment of some debt of the South African Rail Commuter Corporation.

Although the proceeds from the restructuring of state assets were less than anticipated in the Budget, they nevertheless contributed significantly to financing the national government deficit in fiscal 2000/01. Receipts from this source included R0,4 billion from the restructuring of the South African Special Risks Insurance Association (Sasria), R1,8 billion from a special restructuring dividend paid by the transport utility Transnet and R0,6 billion received from the telecommunications corporation, Telkom.

After taking the extraordinary transactions into consideration, the net borrowing requirement of national government amounted to R18,6 billion in fiscal 2000/01. The greater part of this requirement was financed by means of new issues of Treasury bills in the first eleven months of fiscal 2000/01. However, Treasury bills to the amount of R5,6 billion were redeemed in March 2001, making bond issues the preferred financing instrument for the full fiscal year. During fiscal 2000/01, an amount of R2,0 billion was drawn on the export credit facility that had been arranged specifically to finance the costs associated with the Special Defence Procurement Programme.

National government financing in fiscal 2000/01
R billions

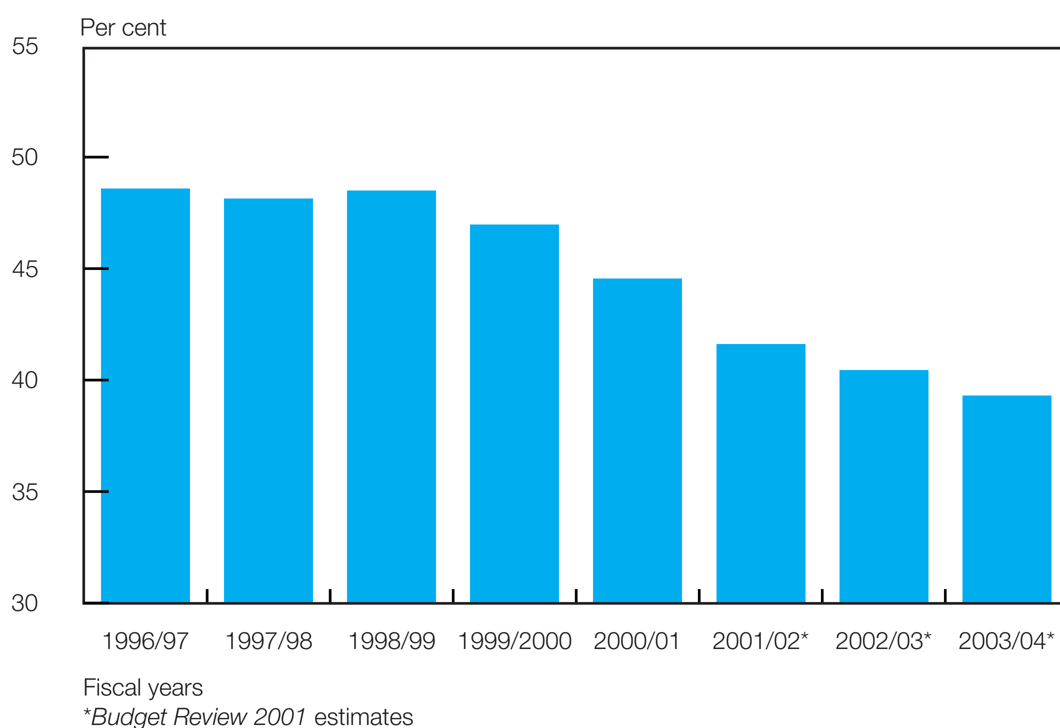
	Originally budgeted	Actual
Deficit	**23,1**	**18,3**
Plus: Extraordinary payments	2,2	2,3
Revaluation of maturing foreign loans	0,5	0,7
Less: Extraordinary receipts	5,0	2,7
Net borrowing requirement	**20,8**	**18,6**
Domestic primary capital market		
Government bonds	...	6,9
Less: Discount on government bonds	...	0,5
Net receipts from domestic government bonds issued	**10,1**	**6,4**
Treasury bills	3,5	5,0
Foreign loans	5,2	2,6
Change in available cash balances*	2,0	4,6
Total net financing	**20,8**	**18,6**

* Increase -, decrease +

Long-term funding in fiscal 2000/01 was obtained at an average rate of 11,8 per cent per annum and short-term instruments were sold at an average rate of 9,9 per cent per annum. These rates were appreciably below the Budget assumptions of 13,6 per cent and 11,0 per cent respectively.

Apart from the need to finance the deficit of national government, government debt also increased as a consequence of the discount on new government bonds issued and the higher rand value of outstanding foreign-currency denominated debt. All of these factors led to an increase in the total loan debt of national government from R381,2 billion at the end of March 2000 to R399,3 billion at the end of March 2001. Total foreign loan debt amounted to R31,9 billion or 8,0 per cent of total loan debt at the end of March 2001, up from 6,8 per cent at the end of March 2000. The outstanding balance on the Gold and Foreign Exchange Contingency Reserve Account increased from R9,2 billion at the end of March 2000 to an unaudited amount of R18,2 billion at the end of March 2001. This brought the total outstanding debt of national government at the end of March 2001 to R417,5 billion or 46,6 per cent of gross domestic product, compared with R390,4 billion or 48,1 per cent of gross domestic product at the end of March 2000.

Total loan debt of national government as a ratio of gross domestic product



**Budget Review 2001* estimates

The average maturity of national government's domestic marketable bonds decreased from 110 months at the end of March 2000 to 103 months at the end of March 2001. By contrast, the average maturity of the foreign marketable debt of national government increased from 92 months at the end of March 2000 to 98 months at the end of March 2001.

The Budget for fiscal 2001/02 projects that the restructuring of state assets will contribute R18,0 billion to the financing of national government in fiscal 2001/02 and R5,0 billion in each of the following two fiscal years. The initial public offering of the South African telecommunications utility, Telkom, and the proposed partial listing of the South African Airways are expected to make significant contributions to government funding in fiscal 2001/02. The Eskom Conversion Bill was tabled in

Parliament. Once approved, this legislation will transform the electricity-generating corporation into a public company governed by the Companies Act, with government as the sole shareholder. Other restructuring initiatives in progress are the separation of Portnet (a division of Transnet responsible for managing South African ports) into two divisions, namely a ports authority and port operations division, and the selling of some of the interests of the South African Forestry Corporation (SAFCOL).

Further financing would be obtained through the issuance of foreign loans, which will become the principal means of financing government over the medium term. A net redemption of domestic government bonds was projected for fiscal 2001/02 and limited amounts of these bonds would be issued in the ensuing years. Moderate increases in short-term funding, providing for the needs of the money market, were projected. The Budget of 2001 assumes that long-term funding in fiscal 2001/02 would be obtained at an average rate of 11,6 per cent per annum and short-term instruments would be sold at an average rate of 10,0 per cent per annum.

The medium-term funding strategy of national government resulted in an estimated increase in the nominal value of outstanding loan debt from R410,8 billion at the end of March 2002 to R453,9 billion at the end of March 2004. However, debt (excluding the outstanding balance on the Gold and Foreign Exchange Contingency Reserve Account) as a ratio of gross domestic product is projected to decrease to below 40 per cent at the end of March 2004.

Latest indications are that the financial guarantees issued by national government amounted to R79,0 billion at the end of March 2000, compared with R81,3 billion at the end of March 1999. The decrease in outstanding guarantees was mainly due to a decrease in the outstanding guarantee of a loan entered into by the South African National Roads Agency, and the repayment of outstanding foreign obligations in terms of the debt standstill agreement. The 2001 Budget provides for the winding down of the South African Housing Trust which could result in a further decrease of approximately R0,6 billion in government-guaranteed debt in fiscal 2001/02.

General government finance

The borrowing requirement of general government (i.e. the borrowing requirement of the consolidated central government, provincial governments and local authorities) increased from R14,0 billion in fiscal 1999/2000 to R17,9 billion in fiscal 2000/01. As a ratio of gross domestic product, the borrowing requirement of general government amounted to 2,0 per cent in fiscal 2000/01, only slightly higher than the ratio of the previous fiscal year. Total revenue and grants received by general government increased at a rate of 5,8 per cent in fiscal 2000/01. Tax revenue increased by 8,8 per cent. By contrast, non-tax revenue collections decreased by 14,8 per cent, owing mainly to the decline in the restructuring dividends paid by Sasria from R6,3 billion in fiscal 1999/2000 to R2,1 billion in fiscal 2000/01.

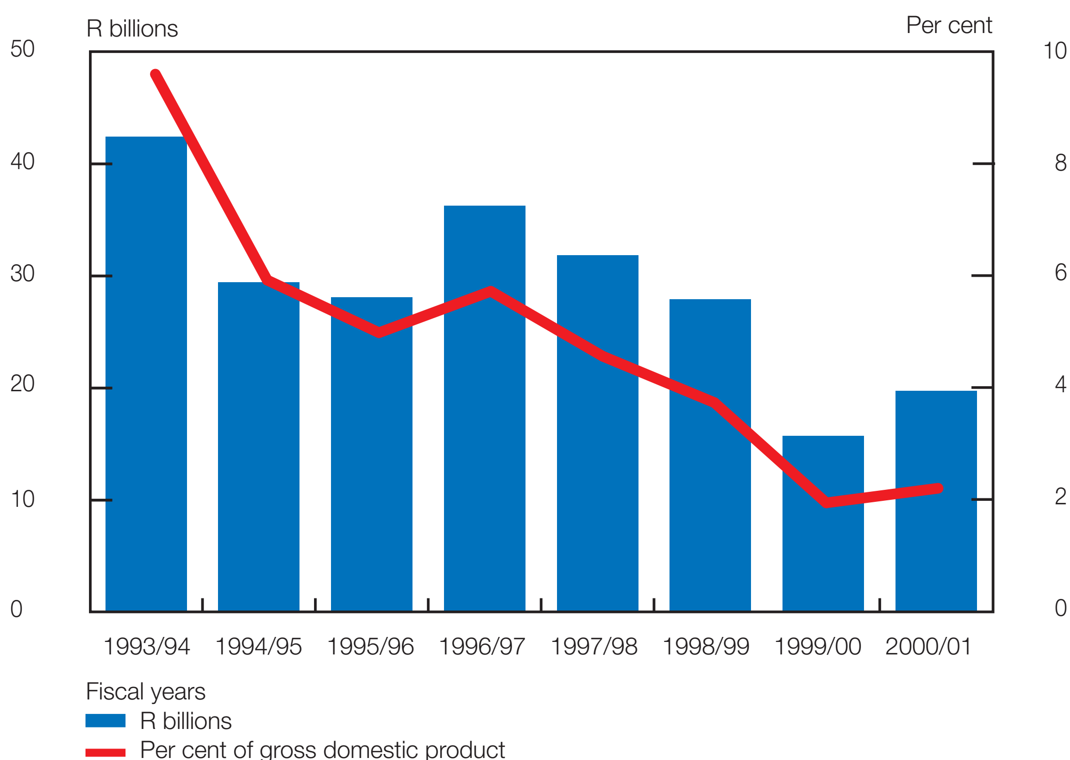
Total expenditure and net lending by general government rose at a rate of 7,0 per cent in fiscal 2000/01 compared with an increase of 8,6 per cent in fiscal 1999/2000. Interest payments increased at a rate of 4,4 per cent, and spending on goods and services increased by 7,9 per cent in fiscal 2000/01. The *Budget Review* for fiscal 2000/01 projected the borrowing requirement of general government would be 1,6 per cent, on average, of gross domestic product over the next three years.

The increase in the borrowing requirement of general government occurred mainly at the level of consolidated central government. Prudent financial management by the provincial governments caused their combined surpluses to increase slightly from R3,4 billion in fiscal 1999/2000 to R3,6 billion in fiscal 2000/01. Preliminary indications are that the borrowing requirement of local authorities in fiscal 2000/01 increased to R1,5 billion, which was slightly more than the R1,3 billion borrowed in the previous year. A broadly similar deterioration occurred in the finances of the social security funds. The finances of the extra-budgetary institutions improved from a deficit of R2,6 billion recorded in fiscal 1999/2000 to a deficit of R1,7 billion in fiscal 2000/01. The South African National Treasury envisages that the social security funds will record surpluses up to 2003/04, though the borrowing needs of the extra-budgetary institutions will decline steadily.

Non-financial public-sector borrowing requirement

The non-financial public-sector borrowing requirement, defined as the borrowing requirement of the consolidated general government and non-financial public-business enterprises, amounted to R19,8 billion in fiscal 2000/01 compared with R15,7 billion in the previous fiscal year. The borrowing requirement as a ratio of gross domestic product increased from 1,9 per cent in fiscal 1999/2000 to 2,2 per cent in the past fiscal year. The latest ratio was nevertheless markedly lower than the average ratio of 4,2 per cent in the preceding five fiscal years. The non-financial public-sector borrowing requirement reached an all-time high in fiscal 1993/94 when it amounted to 9,6 per cent of gross domestic product. Since then, it has declined steadily and is expected to decline further to 1,3 per cent of gross domestic product in fiscal 2001/02. After that, a slight increase to an average of 2,4 per cent of gross domestic product is projected for the ensuing two years.

Non-financial public-sector borrowing requirement



The accounts of public enterprises and corporations reflect a borrowing requirement of R1,8 billion in fiscal 2000/01 compared with a borrowing requirement of R1,7 billion in the previous fiscal year. The borrowing requirement of these public businesses as a proportion of the non-financial public-sector borrowing requirement is much lower than in fiscal 1998/99 when investment spending by public corporations increased strongly. The South African National Treasury envisaged a steady increase in the borrowing needs of non-financial public enterprises over the medium term. It was estimated that their borrowing needs would comprise approximately 20 per cent of the total borrowing needs of the non-financial public sector in fiscal 2003/04, up from close to 10 per cent in fiscal 2000/01.

National government finance in the April to June quarter of fiscal 2001/02

National government expenditure and revenue in the April to June quarter of fiscal 2001/02 resulted in a deficit of R8,5 billion or 3,6 per cent of the estimated gross domestic product. Cash-flow adjustments amounted to R3,7 billion, bringing the deficit to R12,2 billion. Taking into account the special dividend received from Sasria, the net borrowing requirement amounted to R10,0 billion. Foreign loans were the principal means of financing, in accordance with the funding strategy announced in the *Budget Review 2001.*

National government finance
R billions

	Fiscal 2001/02	
	Budgeted	April to June
Revenue	233,4	53,2
Less: Expenditure	258,3	61,7
Deficit before borrowing and debt repayment	**24,9**	**8,5**
Cash-flow adjustment	-	3,7
Plus: Extraordinary payments	0,6	0,0
Revaluation of maturing foreign loans	0,0	0,0
Less: Extraordinary receipts	18,0	2,2
Net borrowing requirement	**7,5**	**10,0**
Domestic government bonds issues (net of discount)	-7,4	3,5
Treasury bills	3,5	4,8
Foreign loans	11,3	8,3
Change in available cash balances*	-	-6,6
Total net financing	**7,5**	**10,0**

* Increase -, decrease +