Annual Economic Report

2002

South African Reserve Bank

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This review of economic and financial conditions in the Republic of South Africa is presented as background to the chairman's address to shareholders at the eighty-first ordinary general meeting to be held on 28 August 2001. The review also forms part of the Reserve Bank's report to Parliament in terms of Section 31 of the South African Reserve Bank Act No. 90 of 1989.

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Introduction

Domestic demand in the United States economy rose strongly during the second half of the 1990s, and at a faster rate than output. At the same time the United States dollar appreciated substantially in real terms as expectations of increasing returns on dollar assets attracted international capital inflows into the United States economy. These developments were accompanied by a sharp deterioration in that country's current-account deficit.

By late 2000 growth in economic activity in the United States was clearly slowing down. Concerns were raised about the imbalance between aggregate supply and demand, the sustainability of foreign capital inflows and the strength of the United States dollar in foreign-exchange markets. Businesses reduced investment spending – especially their outlays on high-technology equipment – in response to weakening final demand, an oversupply of some types of capital and slower profit growth. Also, economic activity in the euro area and in most other regions of the world was depressed by high oil prices and faltering financial markets. This further reduced the demand for goods produced in the United States.

World economic activity then decelerated noticeably in 2001, resulting in the weakest global growth performance in a decade. The September 2001 attacks on America and continued political tension in the Middle East aggravated uncertainty about the future evolution of global economic activity. Across all countries, average growth in gross domestic production is estimated to have declined from about 4½ per cent in 2000 to just 2½ per cent in 2001.

Early in 2001 it became clear that the impact of high oil prices on inflation in industrial countries would be less severe than in similar previous episodes, because production processes have become less dependent on oil. Moreover, there was little evidence of strong demand for higher wages in response to the rising crude oil prices, essentially because of the growing slackness of labour markets. This effectively contained inflation expectations at low levels and eliminated potentially disruptive wage-price spirals.

In the absence of serious threats to overall price stability, policy makers in most countries and regions could respond promptly to the first indications that a downturn in economic activity was imminent. Fiscal policy became quite expansionary in the United States – helped by increased spending on homeland defence and military interventions elsewhere – and monetary conditions were eased in a series of reductions in the target federal funds rate of the Federal Reserve System. Other major industrial countries followed suit, and the policy environment in most regions of the world became highly conducive to a speedy recovery of economic activity.

Evidence of an improvement in global economic conditions had begun to surface during the fourth quarter of 2001 and since then there were firm signs that a worldwide recovery was under way. Confidence in the United States economy, the traditional locomotive of the world economy, was returning and economic growth of more than 5 per cent was measured in the first quarter of 2002. The United States index of industrial production grew for six months in succession as strong demand prompted producers to expand production in June 2002 to its highest level since May 2001. Overall economic growth continued in the second quarter of 2002, but at a slower pace than in the first quarter.

The South African economy could not benefit in full from the global economic expansion in the second half of the 1990s, largely because the Southeast Asian financial crises of 1997 and 1998 had disrupted economic progress in most emerging-market economies around the world. But the adjustments made to relative prices during those years, most notably the decline in the exchange value of the rand, helped to cushion the effect of the global slowdown on economic activity in South Africa during 2001. The domestic economy weathered the global slowdown well and growth in real output in the non-agricultural sectors merely slowed down from about 3 per cent in 2000 to 2½ per cent in 2001. Economy-wide growth slowed from 3½ per cent in 2000 to 2 per cent in 2001, but recovered to 2½ per cent at an annualised rate in the first half of 2002.

Domestic final demand showed great resilience in 2001. Private and general government consumption expenditure, as well as gross fixed capital formation, increased at a lively pace in 2001 and maintained this momentum in the first half of 2002. Of special significance was the vigorous expansion of fixed capital formation by private-sector businesses. The business sector evidently expects that the lively economic conditions will continue and is prepared to expand production capacity for meeting future growth in domestic and foreign demand.

Inventory investment fell back in 2001 as the global economic slowdown raised concern that a drawn-out recession might be imminent. But even before the end of the year, prospects brightened and inventory accumulation picked up again. Voluntary inventory build-ups continued in the first half of 2002 as producers and traders apparently positioned themselves ahead of the expected expansion in demand.

Operating surpluses generally benefited from the depreciation in the exchange value of the rand, especially in the export-oriented sectors of the economy. The continued paring of labour resources, together with some moderation in nominal wage growth, lifted the share of operating surpluses in the overall value of output. Moreover, companies generally preferred to retain an increased portion of operating surpluses than to distribute higher dividends to shareholders. This bolstered aggregate gross saving, but not to the extent needed for an enduringly strong economic growth rate and steady growth in employment.

The mild slowdown in the growth in overall economic activity had a negative influence on the level of formal-sector employment, and the average level of employment declined further in 2001. This declining trend in the economy's capacity to create employment opportunities persisted into the first quarter of 2002. Of significance is, however, that the pace of decline in formal-sector employment has been gradually tapering off since 1998.

Growth in the nominal compensation of employees in the formal non-agricultural sectors of the economy slowed down in the recent past, strengthening the operating surpluses of businesses, increasing the rates of return on invested capital and contributing to the pick-up in private-sector capital formation. At the same time, productivity growth remained robust, curbing the growth in nominal unit labour cost to modest levels. This has contributed in large measure to the waning of inflationary pressures in the economy in recent years. It would nevertheless require careful macroeconomic management to ensure that this positive development in the South African economy is not reversed.

Helped by the strong growth in productivity which compressed the growth in nominal unit labour cost, price inflation slowed down in 2001 to its lowest level since the early 1970s. This decline in inflation has, however, been reversed by factors causing sharp rises in prices since the fourth quarter of 2001. The sharp decline in the international exchange value of the rand, and rising food prices – also partly related to the depreciation of the rand – were prominent factors that pushed prices higher at the producer and consumer levels.

As inflationary pressures worked their way through the price-formation processes after the rand depreciated during the closing months of 2001, signs emerged in the second quarter of 2002 that month-to-month price inflation could be abating. Among the factors pointing to a continuation of the longer-term slowdown in inflation are the relative strength of the rand since January 2002, greater stability in international petroleum prices, a slowdown in food price increases at the production level, and the absence of excess aggregate demand pressures. All of these contributed to a somewhat improved inflationary environment by the middle of 2002. The deciding factor for the future evolution of inflation is likely to be the outcome of the current round of wage negotiations.

Notwithstanding the slowdown in international economic activity in 2001, the export sector rallied and provided impetus for continued growth in the South African economy. Export volumes, underpinned by the greater price competitiveness of domestic producers in international markets, held up well in the face of weakening global economic conditions. This, together with a somewhat better terms of trade, contributed to a healthy improvement in the trade surplus in 2001 which spilled over into the first half of 2002.

During 2001 the improvement in the trade surplus was counteracted by a widening of the deficit in net services and income payments, essentially due to substantial dividend distributions to non-resident shareholders. This led to a deficit on the current account of the balance of payments, albeit considerably smaller in 2001 than in 2000. In the first half of 2002, these dividend distributions declined appreciably as companies preferred to strengthen their investable resources by retaining an increased portion of their earnings. Alongside the healthier trade surplus, the smaller dividend payments helped to turn the current account of the balance of payments into a surplus roughly equal to 0,3 per cent of gross domestic product in the first half of 2002.

The deficit on the current account of the balance of payments in 2001 posed no serious financing problems for the economy as the net inward movement of capital was more than adequate. Surpluses on the international financial account in 2001 exceeded the absolute size of the deficit on the current account, adding to the country's international reserves. At one stage, i.e. at the end of 2001, the gross international reserves of the country reached a level equivalent to about 24 weeks' worth of imports of goods and services, but this ratio fell back somewhat in the first half of 2002 when import values picked up strongly and the stronger rand left its mark on the rand value of international reserves.

Direct investment inflows dominated in 2001, unlike previous years when portfolio capital flows were the prime determinant of capital movements into or out of South Africa. The restructuring of the corporate relationship between the Anglo American

Corporation and the De Beers mining company contributed substantially to the 2001 inflow of foreign direct investment capital. Portfolio purchases of shares and bonds further strengthened the international financial account, which remained in a surplus in the first half of 2002.

The exchange rate of the rand declined against almost all foreign currencies during 2001, but recovered quite strongly in the first half of 2002 when the surpluses on the overall balance of payments added to the supply of foreign currency in the domestic foreign-exchange market. In the last quarter of 2001 the opposite situation had prevailed: a deficit on the current account of the balance of payments then had coincided with an outflow of capital from the economy. Under such circumstances where there is a greater demand for than supply of foreign exchange, a depreciation in the exchange rate of the rand could be expected as a normal market reaction, but the extent of the depreciation would be largely unpredictable. Ultimately, the weighted average value of the rand lost more than a third of its value in 2001, an event which contributed to the President's appointing a commission of inquiry to determine the reasons for the sharp decline in the external value of the rand.

The resilience of the South African banking system was severely tested over the past eighteen months by general concerns about the inherent strength of financial institutions in emerging-market economies, the volatile behaviour of the exchange rate of the rand and some unfortunate exposures to microlending activities. Ultimately the banking sector withstood all these shocks successfully, but at the cost of an intensification of asset concentration in the sector.

The deposit liabilities of the banking sector expanded robustly during the past eighteen months or so. There were signs that the growth from quarter to quarter in the money supply was slowing down in 2001, but then M3 increased at its fastest pace ever in the first quarter of 2002 and continued to rise at a solid pace in the second quarter. Growth in the M3 money supply exceeded by a wide margin the growth potential of the economy and was evidently inconsistent with the long-term policy objective of low increases in the general level of prices.

By far the largest share of the build-up in bank deposits over the year to June 2002 – about 85 per cent of the overall increase in M3 – could be attributed to corporate deposits. In the first half of 2001, long-term deposits with banks were in strong demand, but over the twelve months to June 2002 households as well as companies had a definite preference for short-term and medium-term deposits. Although this accumulation of deposits with the banking sector may be interpreted as a precautionary move by investors in a highly uncertain investment climate, there is a danger that these deposits could spill over into increased spending, with potentially ominous consequences for long-run price stability.

Albeit fairly robust, growth in bank credit extension to the private sector never assumed the proportions of the growth in M3 over the past eighteen months. The extension of credit to the corporate sector dominated in the second half of 2001 whereas credit extended to households dominated in the first half of 2002. Credit flows over the past year were prominently influenced by leads and lags in the payments of and the receipts for foreign transactions, and later by a turnaround in such leads and lags. Significantly, however, there was a slowdown in credit extension to the private sector from the fourth quarter of 2001 to the second quarter of 2002.

The most important component in banks' funding strategies (i.e. growth in their deposit liabilities) exceeded the growth in the banks' dominant asset class (i.e. credit extended to the private sector) by a wide margin. This left scope for banking institutions to accumulate other assets and to reduce other liabilities. The banks' preferred action during this period of sharp decline in the external value of the rand was to accumulate a substantial amount of foreign assets on a net basis from June 2001 to June 2002.

The behaviour of short-term money-market interest rates during the past eighteen months can be subdivided into two clearly distinct phases. During most of 2001, expectations of future inflation were on the wane. This, along with the general slowdown in overall economic activity, created conditions for the Monetary Policy Committee of the Reserve Bank to lower the Bank's repurchase rate. But when inflationary pressures began to build up in the early months of 2002, the Monetary Policy Committee reversed course and raised the rate on repurchase transactions by a total of 300 basis points over the first half of the year. Other money-market interest rates generally followed the lead taken by the Reserve Bank.

In the market for long-term fixed-interest securities, the bull phase which had started during the international financial crises of 1997 and 1998 came to an end in the final weeks of 2001. Extreme volatility in the foreign-exchange market and the rapid depreciation of the rand ignited inflationary fears which raised the currency risk premium of rand-denominated bonds. Bond yields rose strongly in December 2001 and the first quarter of 2002, and although market behaviour became far less turbulent in the second quarter, risk premiums remained high. Still, the South African bond market behaved in a more orderly fashion than those of most other emerging-market economies during the past eighteen months.

Share price behaviour was influenced by developments in other markets and especially by the September 11 attacks on the United States of America. The share market recovered quickly after the attacks, helped by expectations of an imminent global economic recovery. In addition, export-oriented companies, notably those in the resources sector of the market, benefited from the decline in the exchange value of the rand. Overall, share prices rose by almost forty per cent from September 2001 to May 2002 but retraced part of these gains in June and July.

Non-resident investors added to their South African equity exposures over the past eighteen months. Like domestic investors, they also participated in the booming market in financial derivatives as they sought protection against capricious price movements in the market for the underlying assets. Trading in the real-estate market remained buoyant even though the rise in financing costs weighed on the prices of residential property in the first half of 2002.

The emphasis in fiscal policy-making over the past eight fiscal years was on consolidating the public finances so as to allay any lingering concern about potentially unsustainable growth in the public debt. Firm control over outlays at all levels of government and an impressive improvement in overall tax administration led to a shrinking of the national government deficit to levels consistent with a declining ratio of public debt to gross domestic product. The overall borrowing requirement of the non-financial public sector fell to about half a per cent of gross domestic product in the latest fiscal year.

Given the overall healthy state of public finances, the Minister of Finance could deviate slightly from the path of fiscal consolidation in the current three-year fiscal planning cycle, without jeopardising the prevailing well-balanced macroeconomic situation in the country. As a measure to encourage economic growth, the Minister was in a comfortable position to announce sizeable tax concessions for the current fiscal year – a measure that is expected to assist the economic recovery and help to put the economy on a faster growth path in the years ahead.

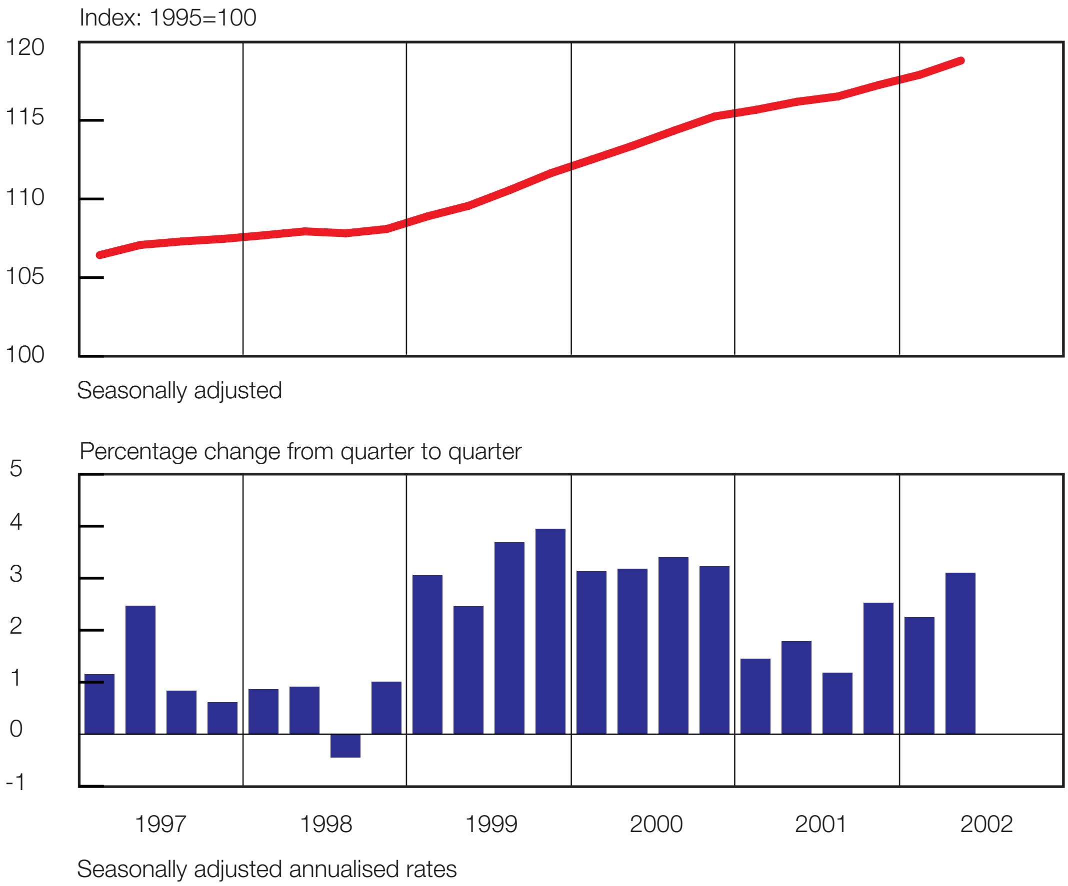
The reduction in the borrowing needs of the national government, along with government's stated intention to give preference to borrowing in the international capital markets over domestic borrowing, had implications for the domestic bond market. Institutional investors with ample investable funds at their disposal faced a dwindling supply of public-sector fixed-interest securities in the domestic market. The National Treasury responded to this development by broadening the range of public-sector securities available in the market and by taking the necessary steps to increase the liquidity and tradeability of government debt instruments. Simultaneously, the supply of private-sector fixed-income securities was allowed to develop rapidly next to the well-established market in national government and other public-sector bonds.

Domestic economic developments

Gross domestic production

Growth in South Africa's real gross domestic product slowed down from 3½ per cent in 2000 to 2 per cent in 2001 before accelerating to an annualised rate of about 2½ per cent in the first half of 2002. The slowdown in 2001 was particularly noticeable in the manufacturing sector, but healthy growth in most of the goods-producing industries contributed to the promising growth recovery in the first half of 2002.

Real gross domestic product



The *agricultural sector* was also a source of weaker growth in 2001. The real value added by this sector fell by 3 per cent in that year, following an expansion of 7½ per cent in 2000. Although the agricultural sector is small in relation to the manufacturing sector, it has important multiplier effects through forward and backward linkages with other sectors. So the recovery in agricultural output at an annualised rate of 3 per cent in the first half of 2002 potentially could inspire cross-sectoral activity, adding value in other sectors such as manufacturing and commerce, and reinforcing the overall pace of economic growth.

The real value added by the *mining sector* declined by 2 per cent in 2000 and then remained at this lower level in 2001. This pause in the medium-term decline in real mining production was short-lived, however, and output levels declined again at an annualised rate of ½ a per cent in the first half of 2002. The gold, coal and platinum sectors recorded lower output volumes in the first half of 2002. The major part of output in these subsectors is destined for the export market, signalling that the current recovery in the international economy might lead to a greater future demand for mining output. In the United States the fitting of catalytic converters to commercial vehicles, which have until recently been exempted from the compulsory installation of these air-cleaning devices, is expected to boost the demand for platinum in the near term.

Real gross domestic product

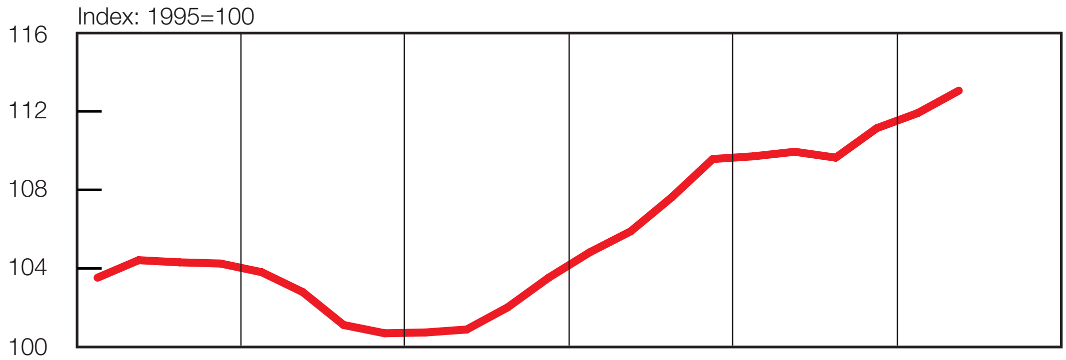
Percentage change at seasonally adjusted annualised rates

	2000	2001			2002
Sectors	Year	1st half	2nd half	Year	1st half
Primary sectors	2	-2	-1½	-1½	1
Agriculture	7½	-6½	-2½	-3	3
Mining	-2	1½	-½	0	-½
Secondary sectors	4	2	1	2½	3
Manufacturing	5	2½	1	3	4
Electricity, gas and water	-2½	-½	1	-½	0
Construction	2½	3½	½	4	1
Tertiary sectors	3½	2½	2½	2½	2½
Commerce	4½	3	3	3½	2½
Transportation and communication	5	4	4½	4	5
Financial and other services	6	3½	3½	4	3½
Non-agricultural sectors	3	2½	2	2½	2½
Total	3½	2	1½	2	2½

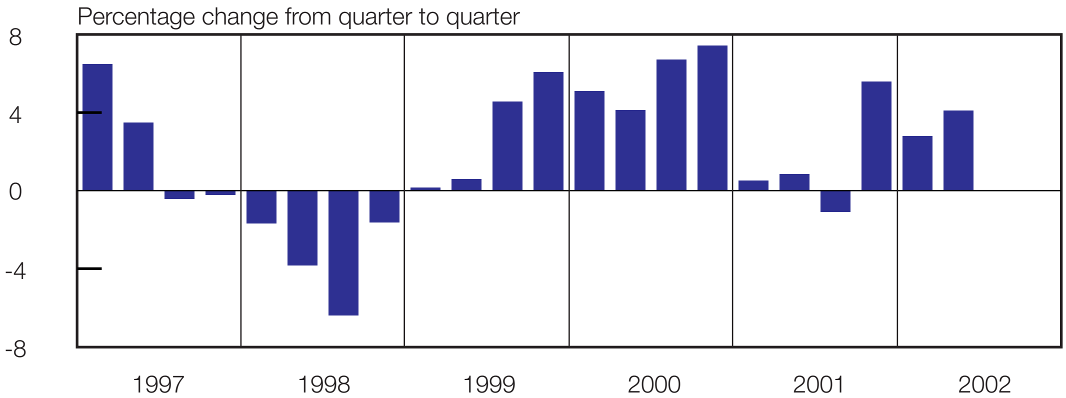
The *manufacturing sector* was directly affected by the worldwide slowdown in economic activity and weaker growth in domestic demand. Growth in this sector fell from 5 per cent in 2000 to 3 per cent in 2001 and was particularly weak in the third quarter of 2001 when output was seriously disrupted by industrial action in industries such as the motor-car and rubber industries. Output growth in the manufacturing sector began to recover towards the end of 2001, spilling over into the first half of 2002 at an annualised rate of 4 per cent.

Fairly solid growth in aggregate domestic final demand, the recovery in the international economy and the greater price competitiveness of domestic producers in export markets, all contributed to the recovery in the manufacturing sector in the first half of 2002. This recovery was reinforced by the need to replenish inventories in order to meet expected increases in final demand and to work down some backlogs in production. New orders increased at an average year-on-year rate of about 14 per cent in the first half of 2002, indicating that there is still adequate demand for sustaining real manufacturing production in the months to come. Furthermore, the utilisation of production capacity which was at 80½ per cent in the first half of 2002 is still well below the percentages usually associated with full utilisation of capacity. This indicates that there is room for manufacturing production to increase before capacity constraints are likely to be reached.

Real value added by manufacturing

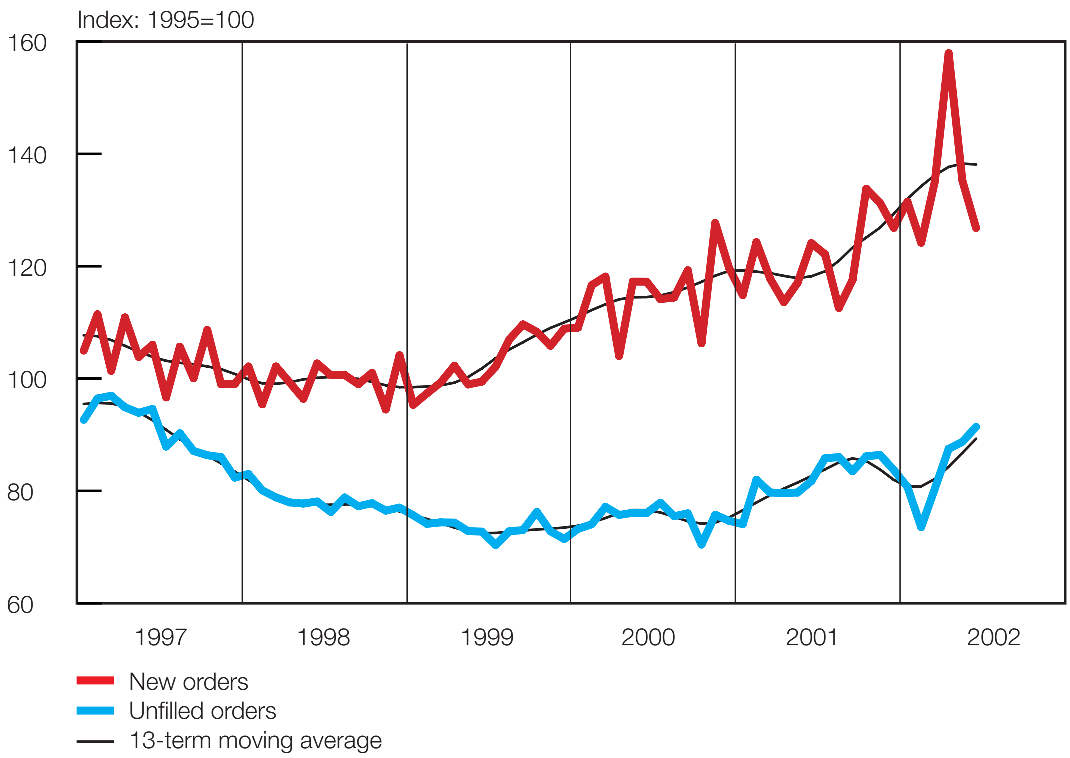


Seasonally adjusted



Seasonally adjusted annualised rates

Manufacturing: New and unfilled orders



Seasonally adjusted

The real value added by the sector supplying *electricity, gas and water* declined by 2½ per cent in 2000 and ½ a per cent in 2001, and then remained roughly unchanged from the second half of 2001 to the first half of 2002. The recent declines and subdued growth in electricity production, which is the dominant sector among the utility industries, could be attributed to mild winters in 2000 and 2001, electricity imports from Mozambique and to the decline in the importance of the goods-producing industries relative to the services sectors. Traditionally, the goods-producing industries consume more electricity per unit of output than the services sectors.

The growth in output originating in the *construction sector* accelerated from 2½ per cent in 2000 to 4 per cent in 2001, mainly due to strong demand for residential buildings. When the demand for residential buildings decelerated in the first half of 2002, growth in the real value added by construction enterprises slowed down to an annualised rate of just 1 per cent.

Growth in the real value added by the *commercial sector,* i.e. essentially the wholesale, retail and motor trade, slowed down from 4½ per cent in 2000 to 3½ per cent in 2001, and to 2½ per cent at an annualised rate in the first half of 2002. The slowdown in 2001 was consistent with the weaker economic conditions around the world, but in 2002 part of the slowdown could be attributed to the bunching of motor-car sales towards the end of 2001 and the return to more normal sales volumes in the first half of 2002.

Apart from the motor trade, the general retail trade sector continued to grow robustly in the first half of 2002. Strong consumer demand, especially for clothing and household textiles, gave momentum to activity in the retail sector. The real value added by the catering and accommodation sector, one of the smaller subsectors of the commercial sector, benefited from an increased number of foreign visitors to the country in the first half of 2002, many of them attending international conferences.

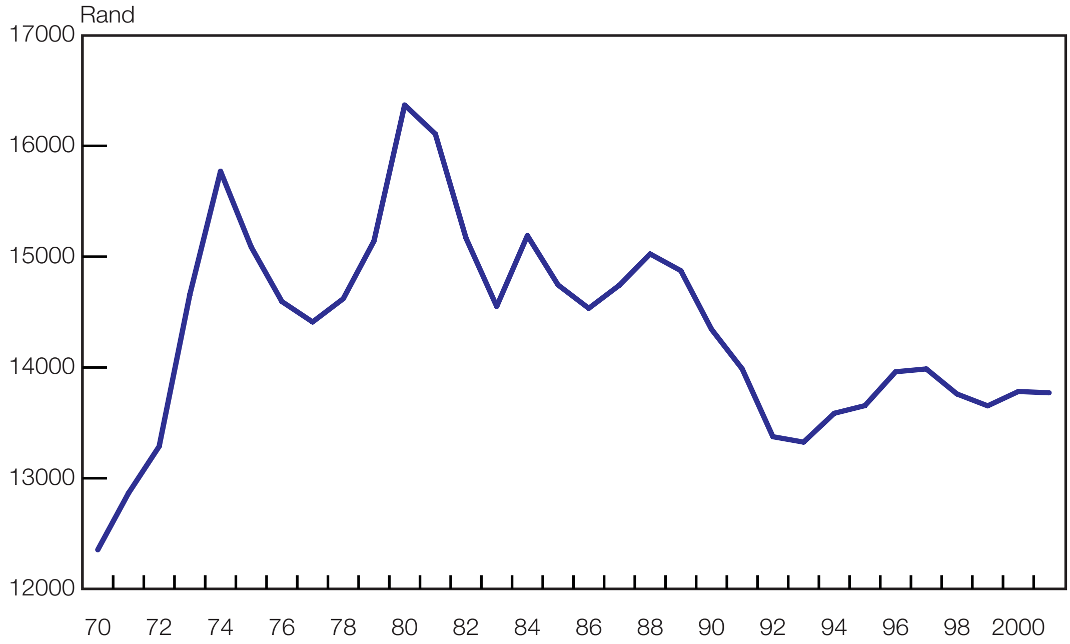
The continued expansion of the country's cellular telecommunications network provided a strong impetus to growth in the real value added by the *transport, storage and communication sector* in 2001 and in the first half of 2002. In addition, high volumes of import and export traffic have created opportunities for the transportation sector to generate extra income during the past eighteen months.

Growth in the real value added by the *financial intermediation, insurance, real-estate and business services sector* slowed down from 6 per cent in 2000 to 4 per cent in 2001 and to a still relatively lively rate of 3½ per cent in the first half of 2002. The latest slight slowdown was mainly confined to the life assurance and pension fund industries, securities traders and to microlending activities, and occurred despite fairly lively conditions in the real-estate industry.

The decline in the real value added by general government persisted into the first half of 2002, albeit at a slower rate than previously. The reason might be that the rate of reduction in the number of government employees has apparently bottomed out recently.

Real gross national income per head of the South African population increased by 1 per cent in 2000 and remained roughly unchanged in 2001. Then there was a strong pick-up at an annualised rate of 3 per cent in the first half of 2002 when dividend payments by resident companies to non-resident parent companies and other shareholders were cut back quite drastically. However, real national income *per capita* in the first half of 2002 was about equal to the level of the early 1990s.

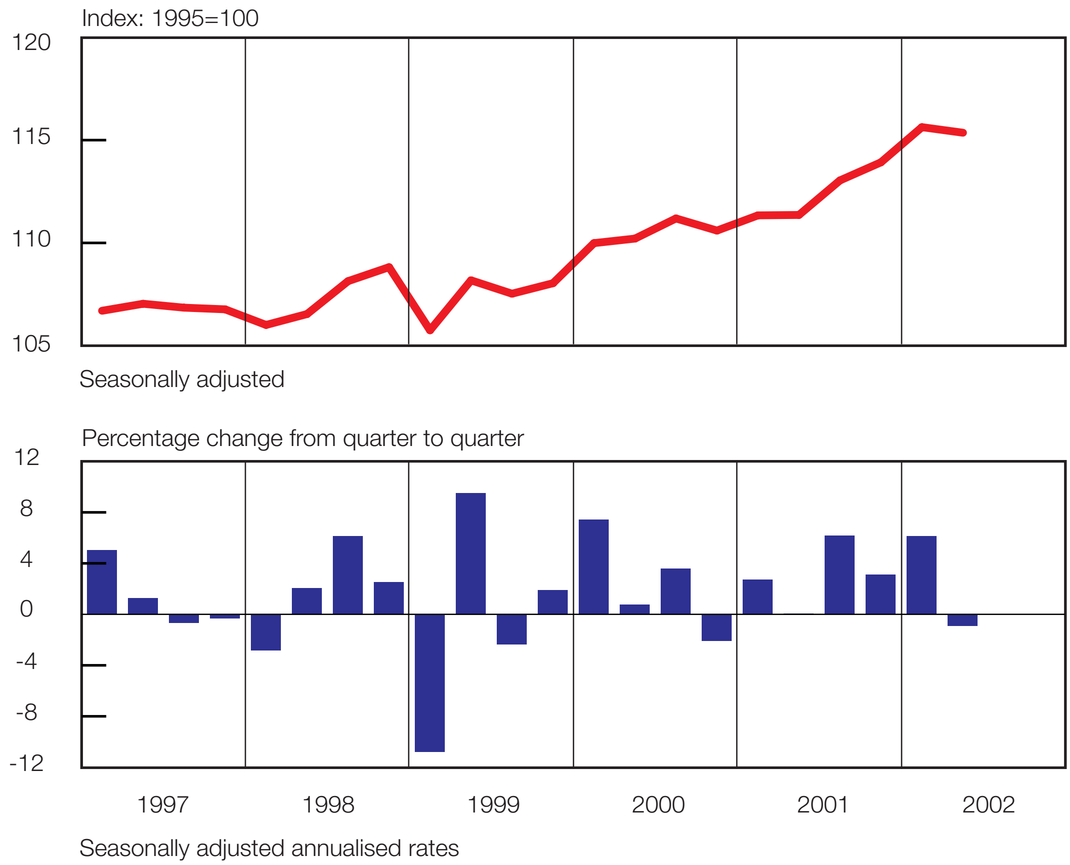
Real gross national income per capita



Gross domestic expenditure

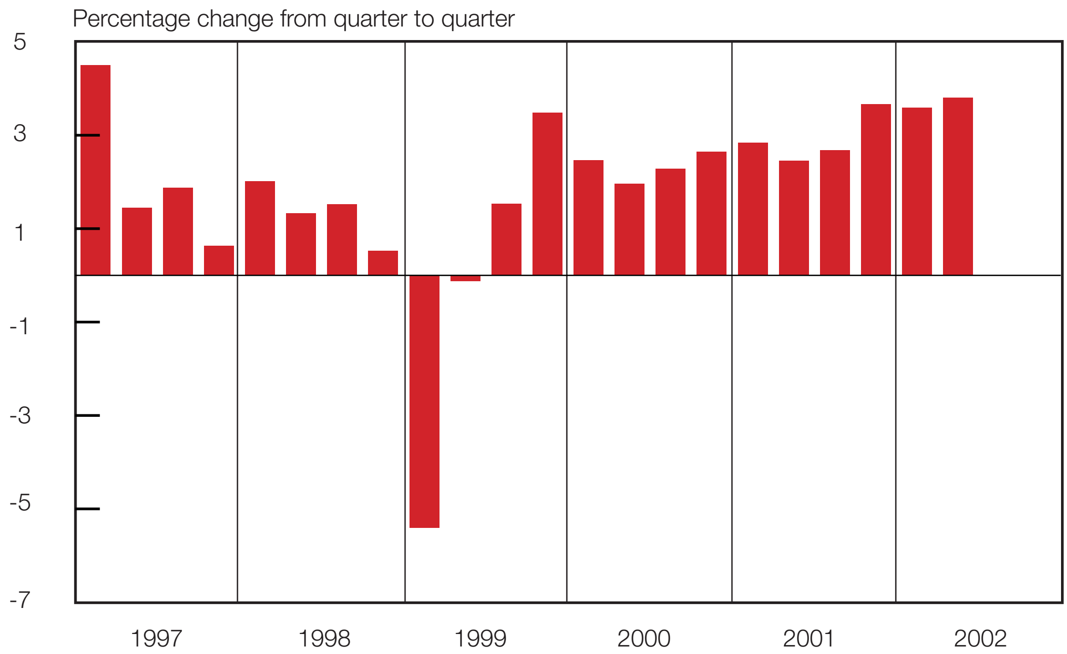
Growth in real gross domestic expenditure decelerated from 3 per cent in 2000 to 2 per cent in 2001, mainly because perceptions of global economic weakness

Real gross domestic expenditure



prompted firms to slow down their inventory accumulation quite substantially. In the first half of 2002 the growth in real aggregate domestic expenditure accelerated at an annualised rate of about 3½ per cent. Spending in the first half of 2002 was boosted by fairly aggressive inventory build-ups and by strong aggregate final demand. Gross fixed capital formation and higher consumption expenditure by households and general government contributed materially to the strong growth in final demand in the first half of 2002.

Real gross domestic final demand



Seasonally adjusted annualised rates

Real gross domestic expenditure

Percentage change

Components	2000	2001	2002*
Final consumption expenditure by households	3½	3	3
Final consumption expenditure by general government	½	1½	3
Gross fixed capital formation	½	3½	6½
Change in inventories (R billions)	7,0	3,0	4,9
Gross domestic expenditure	3	2	3½

* First half at seasonally adjusted annualised rates

Final consumption expenditure by households

Growth in real final consumption expenditure by households, which accounted for more than 60 per cent of real gross domestic product, slowed down from 3½ per cent in 2000 to about 3 per cent in 2001, and maintained this rate of increase in the first half of 2002.

Real final consumption expenditure by households
Percentage change

Components	2000	2001	2002*
Durable goods	9½	3½	2½
Semi-durable goods	5½	6	11
Non-durable goods	½	1½	1½
Services	4	3½	3
Total	3½	3	3

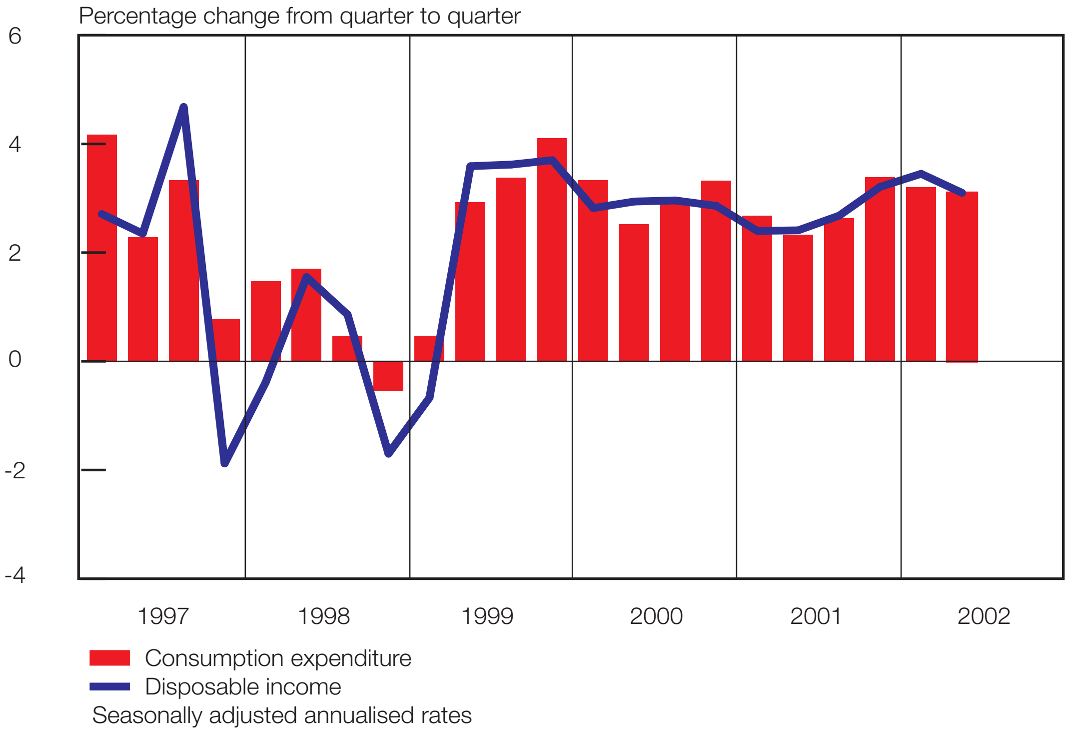
* First half at seasonally adjusted annualised rates

The slowdown in growth over the past eighteen months was particularly evident in household expenditure on durable goods, more specifically in spending on new motor-cars. Real spending on new motor-cars actually declined in the first half of 2002, following exceptionally high spending levels in the last quarter of 2001 when many households bought new cars in order to avoid paying higher prices later. The tightening of monetary policy in the first half of 2002, which raised the financing costs on instalment sale credit, obviously compressed durable goods purchases even further. Unlike household spending on new motor-cars, outlays on furniture and household appliances as well as on recreational and entertainment goods were surprisingly robust in the first half of 2002.

Growth in households' real expenditure on semi-durable goods continued briskly throughout 2001 and gathered further momentum in the first half of 2002 as consumers took advantage of the lower prices of clothes. There were also strong increases in real outlays on the other categories of semi-durable goods, notably household textiles and recreational goods.

Real final consumption expenditure by households on the less discretionary spending categories such as non-durable goods and services was fairly lively in

Real income and expenditure of households

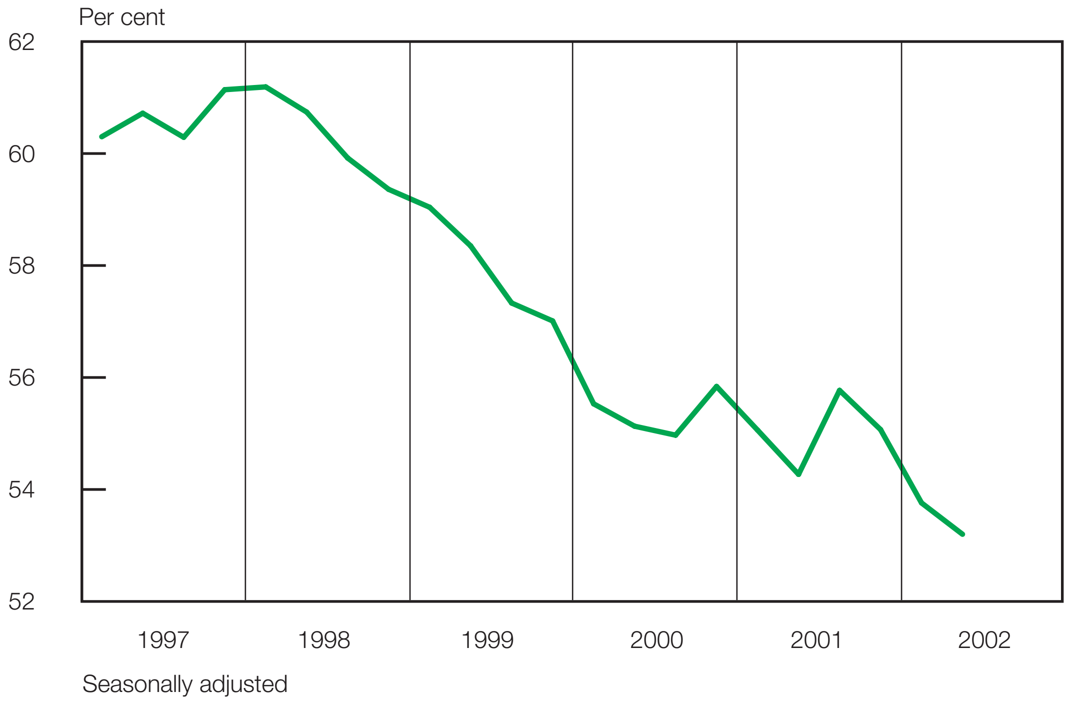


2001 and in the first half of 2002. Real spending on petroleum products and medical services declined, but higher spending was recorded in all the other components of this category.

Real household spending in 2001 and in the first half of 2002 was underpinned by firm growth in the real disposable income of households. Nominal wage growth in excess of the contemporaneous inflation rate ensured that the real purchasing power of household income kept on increasing. This was reinforced by an improvement in farm income and generous cuts in personal income tax in fiscal 2002/03.

With the real income of households expanding quite impressively, consumers generally avoided excessive use of debt financing for their consumption expenditure. As a result, household debt relative to disposable income declined to 54 per cent in the first half of 2002. As recently as 1998 this ratio was still at 60½ per cent. Debt financing costs fell to 8 per cent of disposable income in the first half of 2002, releasing household resources for deployment elsewhere. In 1998 debt financing cost still equalled 12½ per cent of households' disposable income, implying that 6½ weeks' worth of household income had then been required simply for servicing debt. This has now been brought down to about 4 weeks' worth of disposable income.

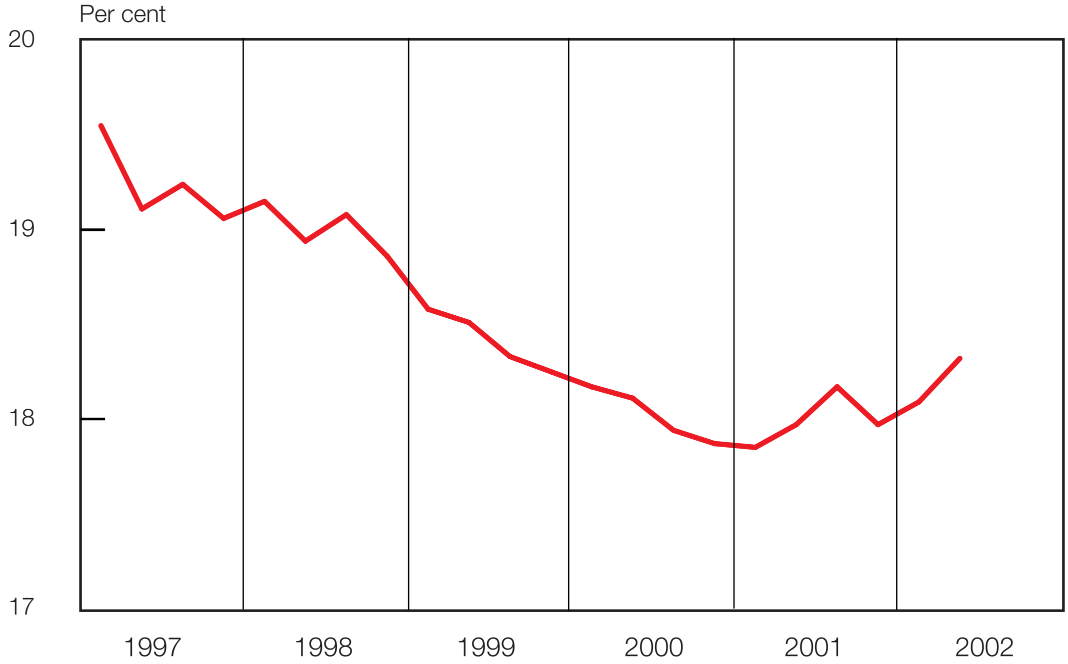
Household debt as ratio of disposable income



Final consumption expenditure by general government

Growth in real final consumption expenditure by general government accelerated from ½ a per cent in 2000 to 1½ per cent in 2001 and to an annualised rate of 3 per cent in the first half of 2002. Spending on intermediate goods and services increased strongly, but the compensation of employees declined in real terms. As a percentage of gross domestic product, consumption expenditure by general government has remained almost unchanged at 18 per cent since 2000.

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



Seasonally adjusted

There are indications that the persistent decline in *real* expenditure on employee compensation by general government is tapering off. It is likely that the employment of temporary workers in education and training and the expansion of the metro police force by several large municipalities and of the national police force may contribute to higher spending in the near term.

During the past eighteen months, government consumption expenditure on individual goods and services, such as health care and education, grew at a faster pace than expenditure on collective goods and services, such as defence, public order and safety. The shift towards increased spending on individual goods and services is consistent with government's overriding policy objective of giving higher priority to social service delivery and to welfare improvements. Almost 90 per cent of overall expenditure targeted at the provision of individual goods and services is spent on employee compensation.

Gross fixed capital formation

Growth in real gross fixed capital formation accelerated from ½ a per cent in 2000 to 3½ per cent in 2001 and at an annualised rate of 6½ per cent in the first half of 2002. Higher investment spending by general government and private business enterprises contributed to this increase, but public corporations as a group have cut back on their real capital outlays over the past eighteen months.

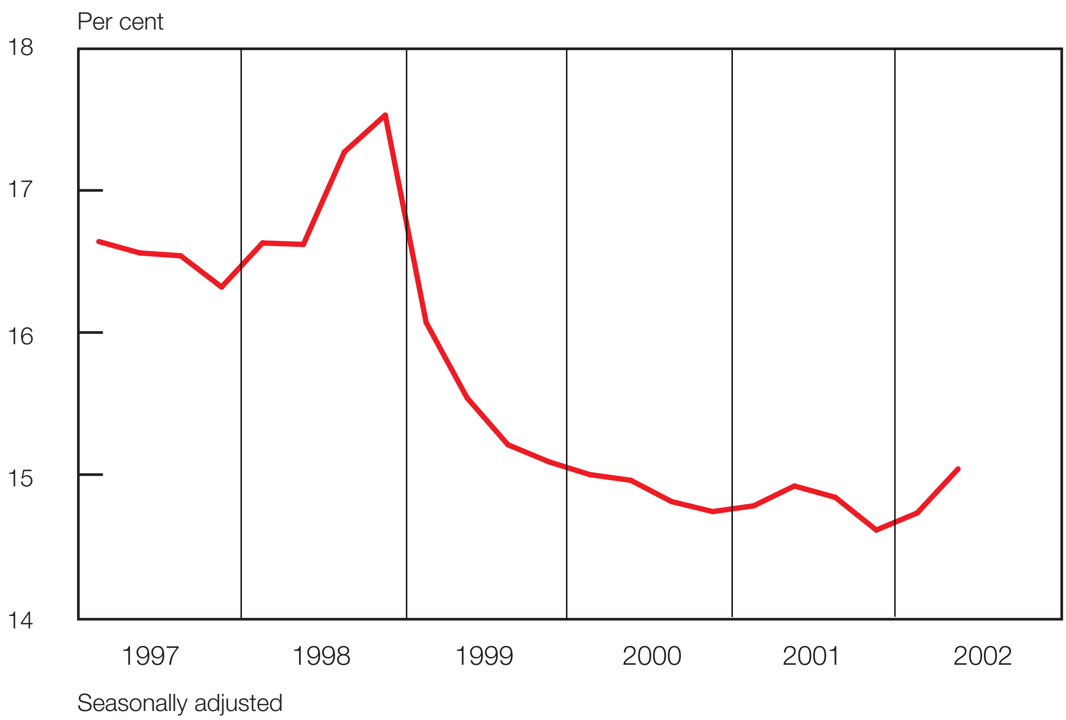
Despite the pick-up in real investment activity over the past year and a half, gross fixed capital formation as a percentage of gross domestic product declined from an average of 17 per cent in 1998 to less than 15 per cent in the first half of 2002. This decline indicates that the pace of capital formation was falling behind the growth in real output. This tendency would, if allowed to continue, reduce the long-run growth potential of the economy and cause capacity constraints and inflationary pressures to arise sooner rather than later during periods of economic expansion.

Real gross fixed capital formation by type of organisation
Percentage change

Components	2000	2001	2002*
Private business enterprises	6½	5½	8
Public corporations	-22½	-6	-4½
General government	-7	0	5½
Total	½	3½	6½

* First half at seasonally adjusted annualised rates

Gross fixed capital formation as ratio of gross domestic product



Reflecting the need to enhance efficiency by replacing obsolete capital stock, investment spending over the past eighteen months or so concentrated on machinery and equipment, which accounted for about half of overall capital outlays. In the first half of 2002, corporate and car rental buying slowed down the pace of spending on transport equipment, as vehicle prices responded to the weakening of the exchange rate of the rand and financing charges rose as part of an overall tightening of monetary conditions.

Growth in real capital outlays on residential buildings accelerated in 2001 at a rate of 12½ per cent, but slowed down to an annualised rate of 4 per cent in the first half of 2002. In 2001 home-building activity had been encouraged by relatively low and declining mortgage interest rates, but during the first half of

2002 it was held back by a 300-basis-point increase in mortgage interest rates. Residential building construction has also been affected by building costs outpacing the rise in the prices of existing homes. Such a change in relative prices usually encourages a greater demand for existing homes than for new homes construction.

Private business enterprises stepped up their real fixed capital formation by 5½ per cent in 2001 and at an annualised rate of 8 per cent in the first half of 2002. This increase has now been continuing for eleven consecutive quarters and been well-dispersed throughout the major productive sectors of the economy. The export-oriented sectors such as mining and manufacturing added capacity to capitalise on the opportunities presented by the more competitive exchange rate of the rand, and the agricultural sector invested in new equipment to accommodate the harvesting of the larger than expected field crops. In addition, new hotels and entertainment areas were developed, retail space was expanded and the communication sector improved its network and added to the existing capacity.

General government's real fixed capital formation in 2001 showed little change from 2000, but increased strongly at an annualised rate of 5½ per cent in the first half of 2002. Provincial governments and local authorities, which are charged with social service delivery in terms of government's over-arching policy framework, were the principal agents in this type of expenditure. Capital outlays were targeted at rural and urban renewal projects, particularly infrastructure such as roads, water supply and sanitation.

Capital expenditure by public corporations declined by 22½ per cent in 2000, 6 per cent in 2001 and again at an annualised rate of 4½ per cent in the first half of 2002. Telkom, in particular, cut back on capital expenditure, probably to present a healthy balance sheet for the organisation at the time of restructuring its ownership.

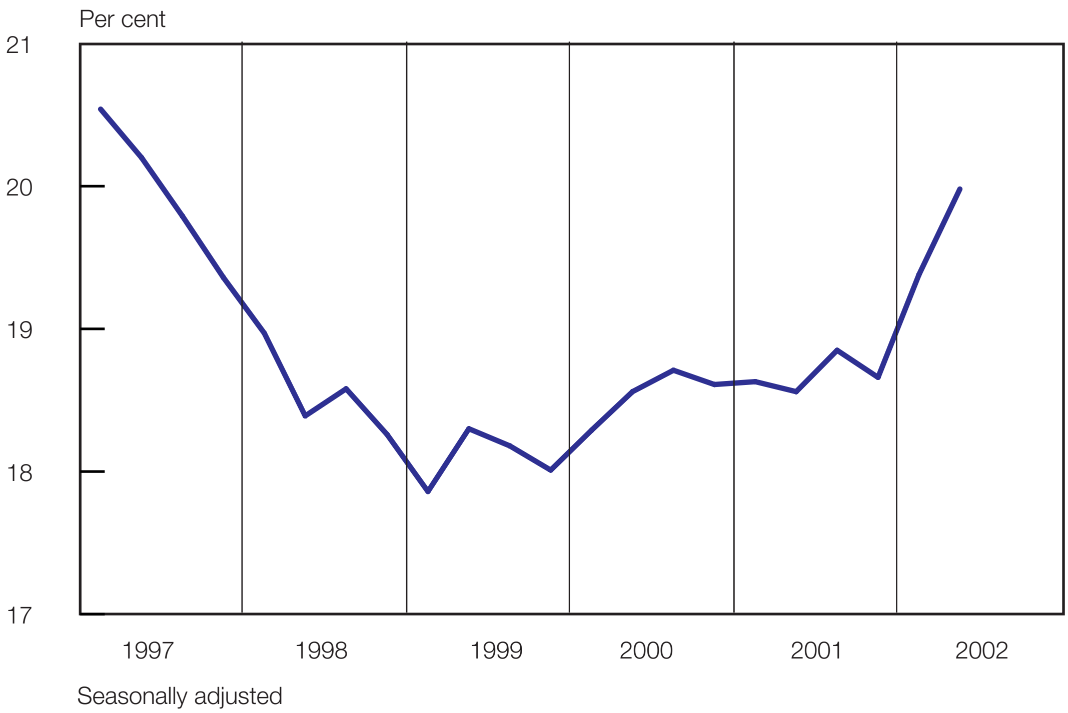
Change in inventories

The rate of inventory accumulation slowed down from 2000 to 2001, but there was a marked increase in inventory investment from the first half of 2001 to the second half. Inventories were further accumulated in the first half of 2002, albeit at a slower pace than in the second half of 2001.

The accumulation of inventories in the first half of 2002 occurred amid expectations of stronger future demand and rising inflation. This inventory accumulation was most pronounced in the manufacturing sector, but inventories were reduced in the wholesale and motor trade sectors.

Inventories have now been accumulated almost uninterruptedly for 13 quarters. This reversed the downward trend in the ratio of inventories to gross domestic product that had started in the early 1980s. At that time inventories were estimated to be equal to approximately 36½ per cent of the non-agricultural gross domestic product, but this ratio fell back to 18 per cent in 1999 as inventory management systems became increasingly sophisticated. Since 1999, businesses have apparently perceived inventory levels as too low to accommodate the changes in aggregate demand during the anticipated economic recovery. The level of inventories relative to non-agricultural gross domestic product was duly raised to some 19½ per cent in the first half of 2002.

Total value of inventories as ratio of non-agricultural gross domestic product



Factor income

The year-on-year growth in nominal factor income slowed down slightly from 10½ per cent in 2000 to 10 per cent in 2001 and in the first half of 2002. Over this period, the growth in employee compensation was fairly steady, but the growth in gross operating surpluses slowed down gradually.

The year-on-year growth in the total compensation of employees of 8 per cent in the second half of 2001 was sustained in the first half of 2002. In most of the various sectors of economic activity, remuneration growth slowed down, except for general government where growth in the aggregate *nominal* remuneration bill accelerated noticeably.

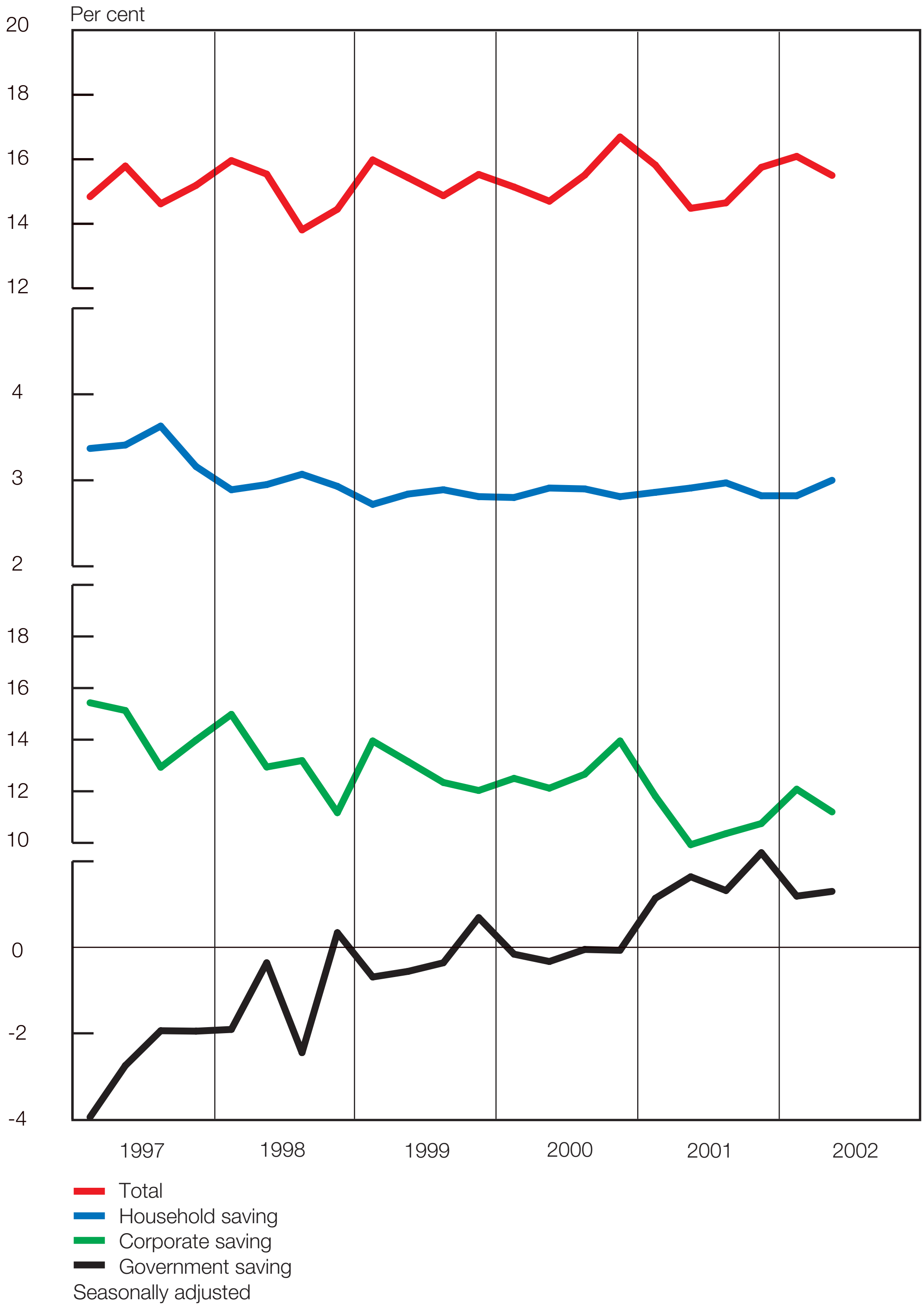
Growth in gross operating surpluses slowed down from a year-on-year rate of 16 per cent in 2000 to 12 per cent in 2001 and in the first half of 2002. Most sectors of the economy recorded growth in operating surpluses during the past year and a half, but it was the mining sector that showed the strongest profit growth, essentially due to the strengthening of international commodity prices and the depreciation in the exchange value of the rand.

As growth in gross operating surpluses exceeded growth in employee remuneration, the contribution of operating surpluses to gross domestic product rose from 46½ per cent in 2000 to 48½ per cent in the first half of 2002. Mirroring these changes, the share of employee compensation in total factor rewards fell back from 53½ per cent in 2000 to 51½ per cent in the first half of 2002. The long-term average share of the compensation of employees to the gross domestic product is estimated at 56½ per cent in the period since the Second World War.

Gross saving

Gross saving as a percentage of gross domestic product declined somewhat from 15½ per cent in 2000 to 15 per cent in 2001, but strengthened to 16 per cent in the first half of 2002. At its latest relatively high level, the gross saving ratio is still slightly below the average saving ratio of 16½ per cent in the 1990s and substantially below the average of 24½ per cent in the 1980s.

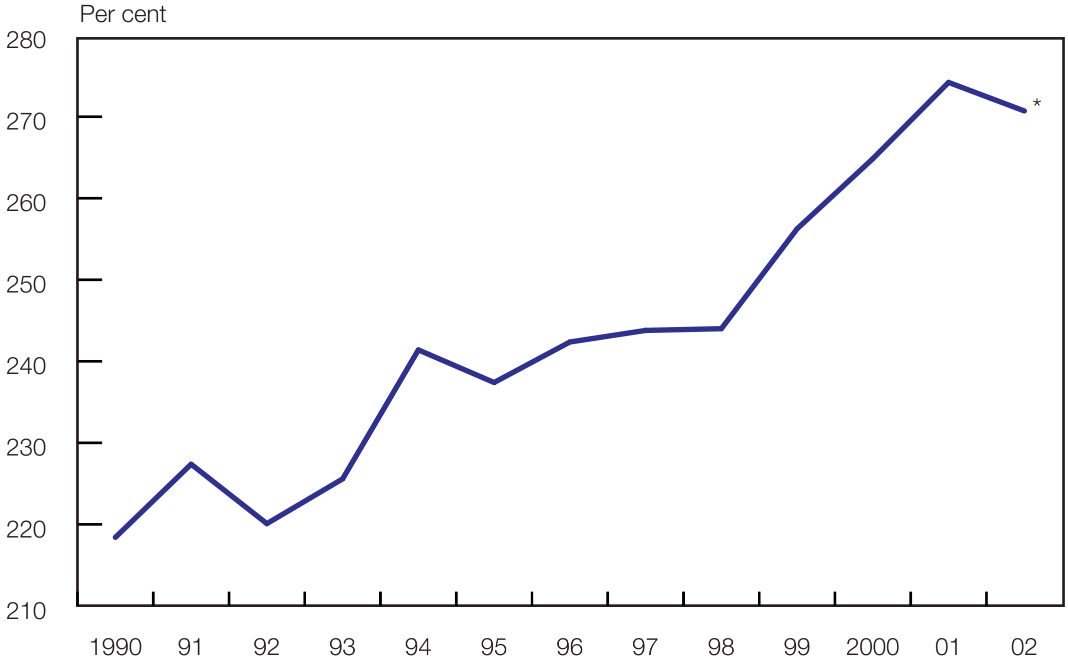
Gross saving as ratio of gross domestic product



The recent variation in the national saving ratio was largely determined by the behaviour of the corporate sector. Companies significantly increased their dividend distributions in 2001, but preferred to retain a greater share of profits in the business during the first half of 2002. The mirror image of these changes in dividend distribution was a weakening in the corporate saving ratio (i.e. gross corporate saving relative to gross domestic product) from 13 per cent in 2000 to 10½ per cent in 2001, and a strengthening to 11½ per cent in the first half of 2002. Companies in mining, manufacturing, transportation and financial services were the main contributors to the improvement in corporate saving in the first half of 2002.

Since 1998 households' saving has been virtually constant at about 3 per cent of gross domestic product. This low saving rate, or high propensity to consume, is in part a reflection of households' perception of increasing wealth. The net wealth of households is estimated to have increased from 237 per cent of disposable income at the end of 1995 to 274 per cent at the end of 2001, before declining to 271 per cent by the middle of 2002 when share prices suddenly lost value. Also, with their debt burden low in relation to their disposable income, households probably experienced a sense of affluence which encouraged them to sustain consumption expenditure at a high level.

Household wealth as ratio of disposable income



* June 2002

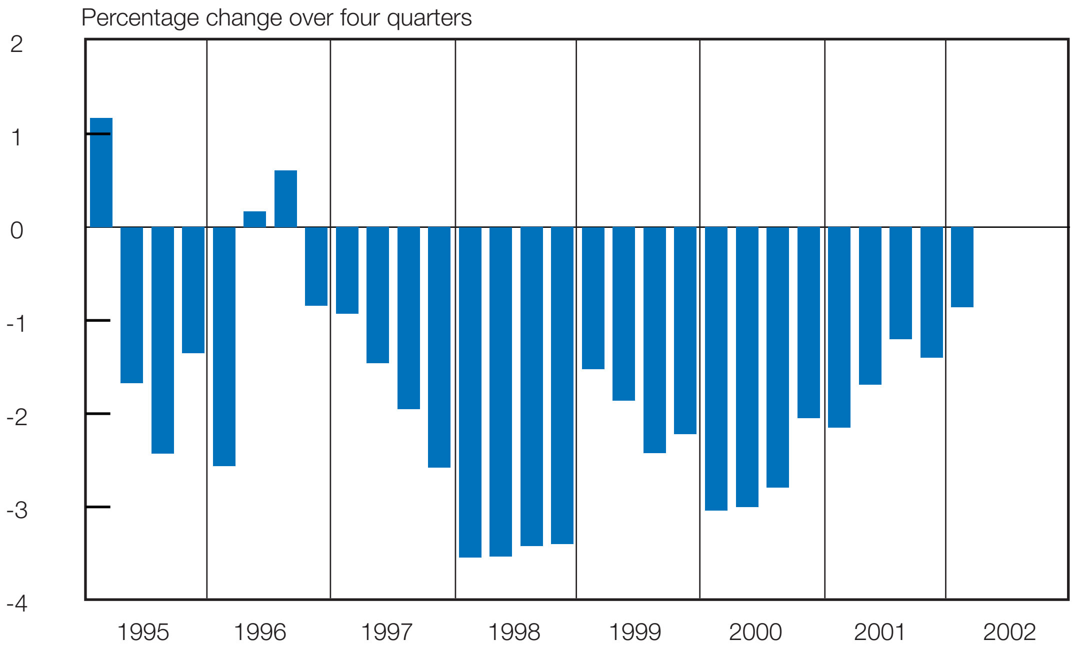
The gross saving of general government, which had been negative since 1991, turned positive in the first quarter of 2001 and averaged about 1½ per cent of gross domestic product in 2001. Government's gross saving rate then weakened marginally to 1 per cent of gross domestic product in the first half of 2002. The turnaround in government saving from dissaving to positive gross saving in 2001 was fully consistent with the national government's long-term commitment to disciplined spending and overall fiscal prudence.

Employment

Broadly consistent with the general slowdown in economic activity, employment creation in the regularly surveyed formal non-agricultural sectors of the South African economy remained sluggish during 2001 and the first quarter of 2002. However, initial signs of a bottoming out in the domestic employment cycle appeared during 2001. For example, the pace of decline from quarter to quarter in overall employment clearly tapered off. When measured over periods of four quarters, regularly surveyed formal non-agricultural employment decreased at a rate of just 0,9 per cent in the first quarter of 2002 – the lowest rate of decline in the past five years.

According to the *Survey of Employment and Earnings in Selected Industries* (SEE) by Statistics South Africa, approximately 4,63 million people were employed in the formal non-agricultural sectors of the economy at the end of March 2002. This reflects an annual decrease of 0,9 per cent or about 40 000 employees since March 2001. Formal employment in these sectors has now effectively shrunk to a level equivalent to that of 1975 or by about 1,1 million people since the employment cycle peaked in 1989.

Non-agricultural employment



In an effort to address the issue of skills shortages, which apparently contributes to the weak employment-creating capacity of the economy, government established *Sector Education and Training Authorities* (Setas) as part of the National Qualifications Framework. These training authorities are encouraging skills training in the economy. Companies participating in the Setas will be rewarded through cash-back bonuses and tax reductions for expenses on skills training and intern placements. It is envisaged that this incentive scheme will improve the short-term employment prospects of the unemployed, provide practical experience to thousands of learners and build the long-term productive capacity of the economy. The Skills Development Fund, which was established in terms of the Skills

Development Act of 1998, may also be approached by the various Setas for financial assistance to encourage the process of skills enhancement.

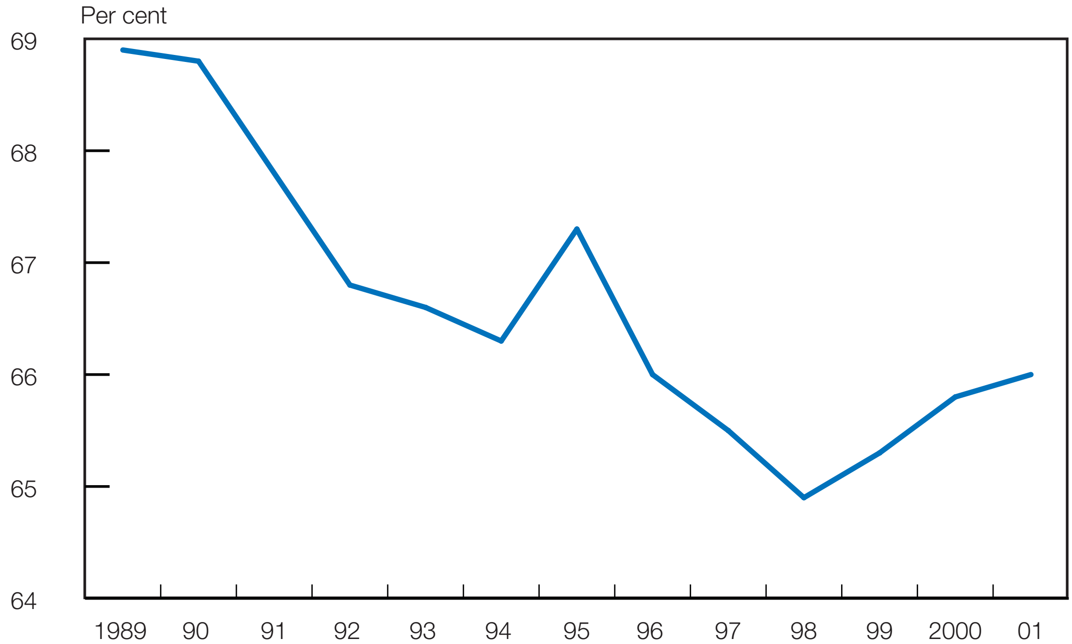
The Department of Trade and Industry has released a policy document on an integrated manufacturing strategy. In practice, this strategy envisages involving the joint efforts of government and industry in developing plans suited for specific areas of the economy. Also, specifically focusing on job creation and on attracting more foreign direct investment into the country, government announced an accelerated depreciation allowance scheme for a broad range of new manufacturing assets acquired within a three-year period from 1 March 2002.

Progress was made during 2001 with legislative amendments aimed at improving the efficiency of the labour market. The tabling in Parliament of the Labour Relations Amendment Bill and Basic Conditions of Employment Amendment Bill was approved in August 2001. In addition to proposed legislative changes to the Labour Relations Act, the Basic Conditions of Employment Act, the Insolvency Act, and the Unemployment Insurance Fund Act, the Minister of Labour has recently also turned his attention to the traditionally vulnerable sectors, recommending the establishment of minimum working conditions and wages for domestic farm workers. The Minister has also continued to assess and emphasise the acceptance and implementation of the existing equity and skills development legislation.

The share of non-agricultural *private-sector* employment in measured total non-agricultural employment reached a low point of 64,9 per cent in 1998. As the process of restructuring and reducing the size of the public sector gained momentum and the pace of decline in private-sector employment abated, the share of private-sector employment to total non-agricultural employment rose to 66 per cent in 2001.

Private-sector employment numbers still contracted in 2001, but the pace of job shedding slowed down from a year-to-year rate of 2,0 per cent in 2000 to 1,3 per cent in 2001. Employment losses continued throughout almost all of the private sector in

Private-sector employment as percentage of total non-agricultural employment



2001, but were most pronounced in the manufacturing, construction and gold-mining sectors. Some sectors nevertheless added to their personnel complements in 2001. For example, employment opportunities in *mining*, apart from gold mining, increased by 2,6 per cent. Employment numbers also rose in the *trade, catering and accommodation services sector* following a significant increase in tourism activity during 2001. Statistics South Africa reported that room and bed occupancy rates rose by 12,9 per cent and 13,7 per cent respectively in the year to March 2002.

The *transport, storage and communication sector* also added to its personnel complement in 2001. In fact, employment in this sector has continuously increased during the three years to 2001, expanding employment by about 8 000 positions.

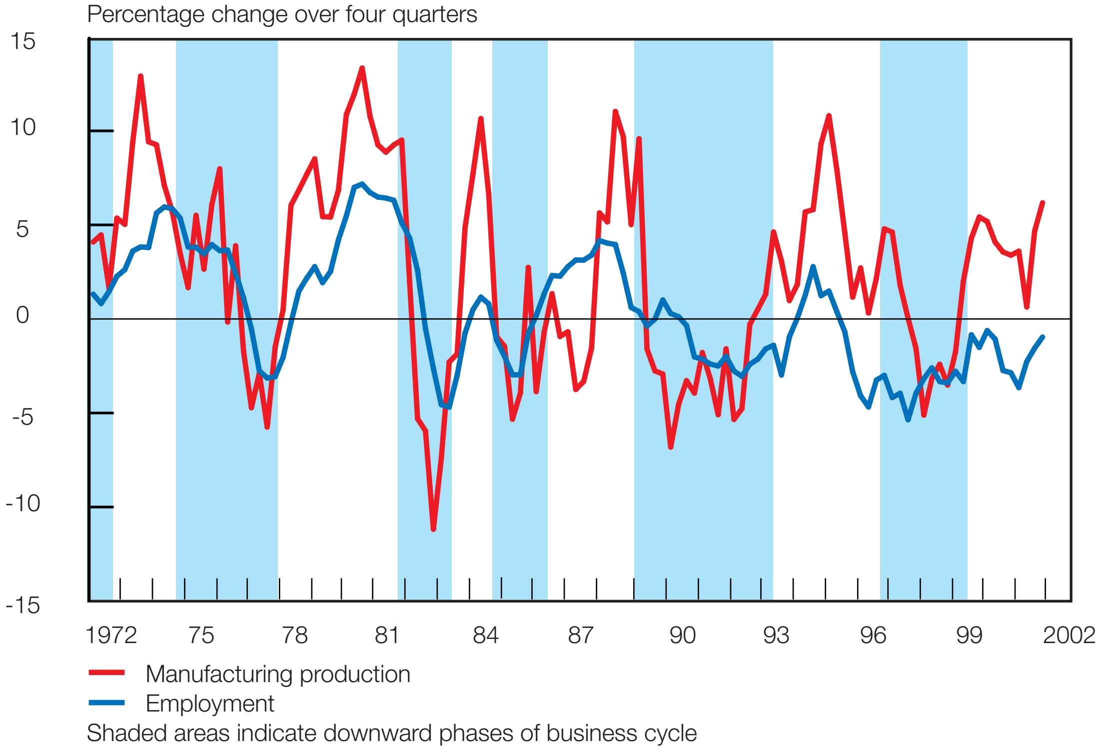
Year-to-year changes in non-agricultural private-sector employment in 2001

Sector	Percentage change
Gold mining	-6,8
Non-gold mining	2,6
Manufacturing	-2,6
Electricity supply	-1,2
Construction	-1,7
Trade, catering and accommodation services	1,2
Transport, storage and communication	0,4
Financial intermediation and insurance	-1,6
Washing and dry-cleaning services	-10,6
Total private sector	-1,3

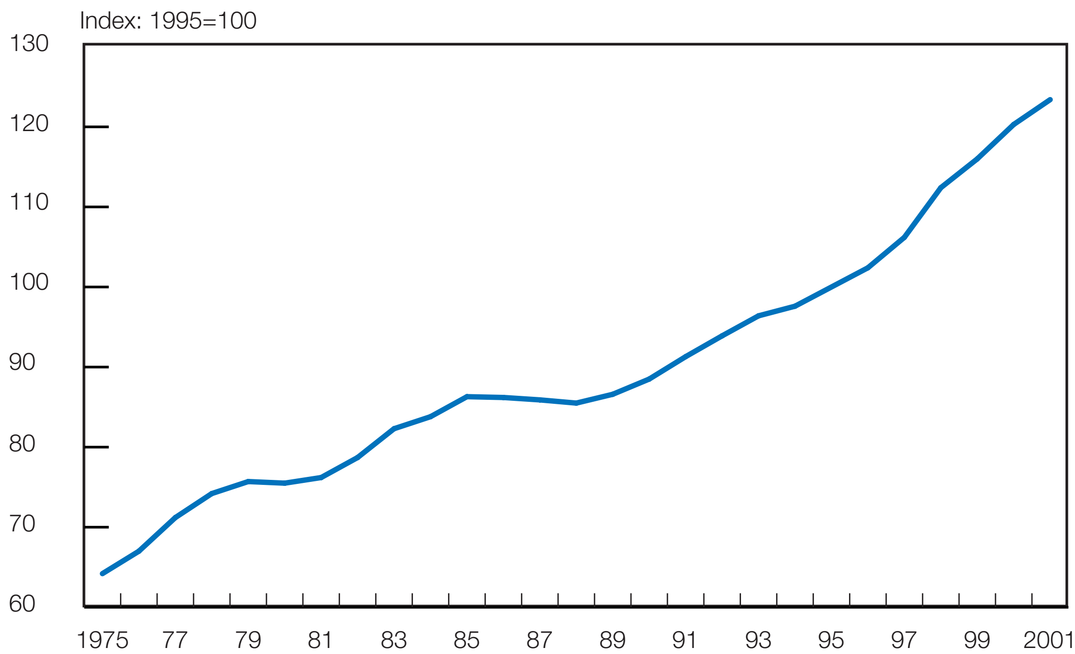
When comparing employment growth in the manufacturing sector with growth in the real value of manufacturing production, a fairly close relationship is discernible (see graph on page 24). Higher rates of increase in both manufacturing production and employment is evident during all of the upward phases of the business cycle since the early 1970s. As economic activity picked up during times of expansion, growth in manufacturing production outpaced employment growth by a fair margin, leading to a sharp rise in labour productivity. Conversely, in periods of contraction, both employment growth and production levels fell back. What is of particular significance is that the slowdown in manufacturing production growth during periods of contraction did not lead to grossly accelerated rates of labour attrition. This indicates that more workers are generally retained during periods of economic slackness than is consistent with prevailing production levels, giving rise to a slowdown in labour productivity growth.

During the current upward phase of the business cycle which started in September 1999, higher rates of output growth were not accompanied – to the same extent as in previous recovery phases – by increases in employment numbers. Although changes in manufacturing employment followed broadly the same pattern as manufacturing output growth, they remained below zero during the current recovery, i.e. employment continued to decline. Growth in manufacturing production during this phase of the business cycle was essentially underpinned by a rise in labour productivity growth – not employment numbers – and a rise in the capital intensity of production processes (see graph indicating aggregate capital-labour ratio on page 24). It is conceivable that declines in the user cost of capital relative to the unit cost of labour helped to intensify capital usage in the manufacturing sector.

Employment and production in manufacturing



Capital-labour ratio*

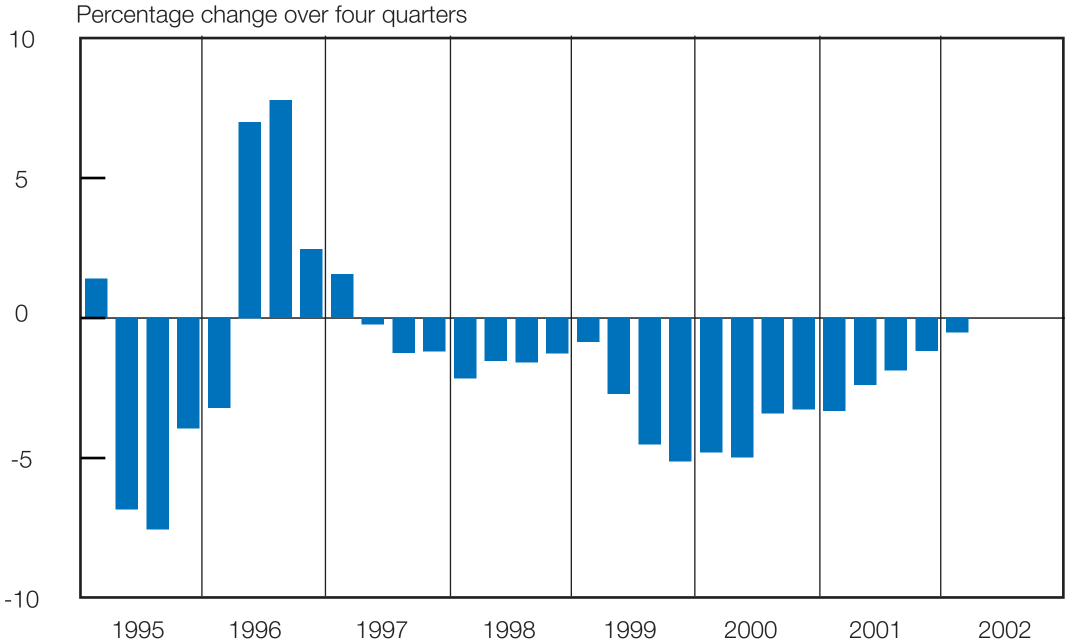


* Capital stock per unit of labour employed in non-agricultural sector

Reflecting the objective of improving efficiency in public-service delivery, *public-sector* employment contracted by about 9 per cent or 161 000 jobs in the three years to 2001, but the pace of job-shedding tapered off from 4,1 per cent in 2000 to 2,2 per cent in 2001. The slowdown in the pace of employment losses in the public sector was apparent in most subsectors of the public service. The only exception was in the *transport, storage and communication sector* where the pace of decline accelerated. Some of these job losses were absorbed by private-sector firms involved in the transportation and communication business, which expanded the size of their workforces.

A transformation and restructuring agreement was signed by government and recognised trade unions in May 2002 and is expected to add to the process of public-sector restructuring in the months ahead. This agreement will expedite the redeployment of staff throughout the public service and the retraining and re-skilling of others to suit service delivery requirements. The agreement also provides for a co-ordinated search for alternative employment opportunities, which will allow for employment creation in particular sectors where skills shortages are acute. The agreement defines and outlines training needs in line with the service delivery priorities of the public service.

Employment in the public sector



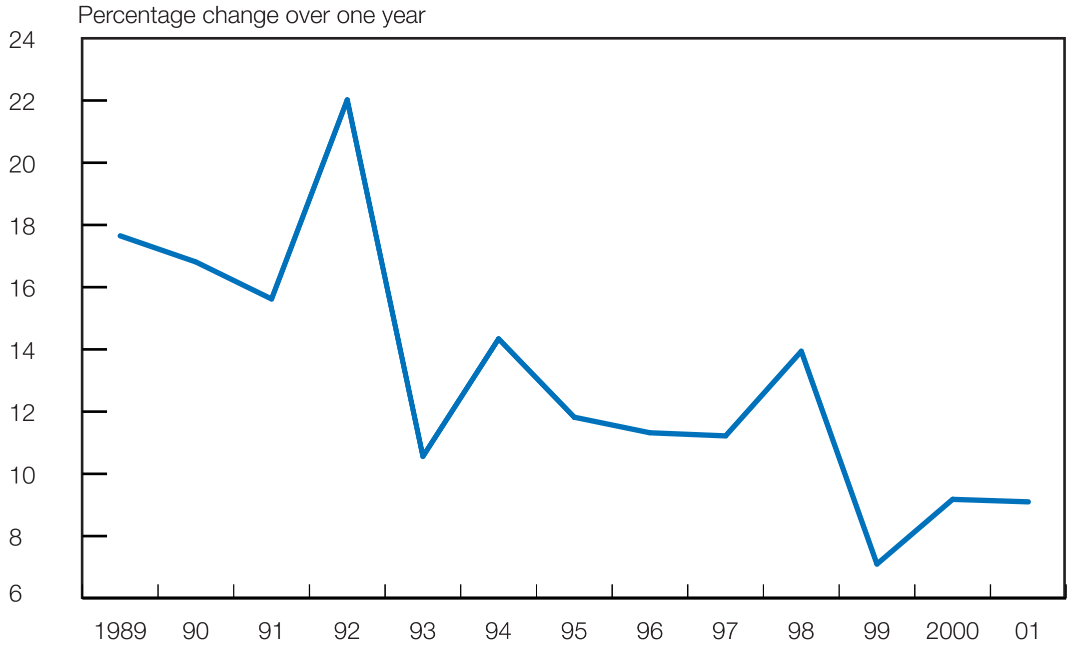
Despite the excess supply of labour and the weak labour-absorbing capacity of the economy, the number of workdays lost due to strikes and other forms of work stoppages rose from 0,5 million in 2000 to 1,25 million in 2001, according to NMG-Levy Consultants and Actuaries. A combination of factors contributed to the sharp rise in industrial action during 2001: for example, a number of multi-year agreements had to be renegotiated during the year; the weaker economic growth in preceding years resulted in employee dissatisfaction with income levels; and many employers' attitudes toughened as they struggled to recover rising production costs in an increasingly competitive business environment.

Labour cost and productivity

Growth in the *nominal compensation per worker* in the formal non-agricultural sectors of the economy has slowed down markedly since about 1992, but there was a slight acceleration in 2000 and 2001. Nominal wage growth, after picking up from

7,1 per cent in 1999 to 9 per cent in 2000, maintained this level in 2001. Growth in nominal remuneration per worker in the public sector outpaced that in the private sector during 2000 and 2001, e.g. average annual remuneration growth in the public sector amounted to 9,6 per cent in 2001, compared with an increase of 8,8 per cent in the private sector.

Nominal wage per worker



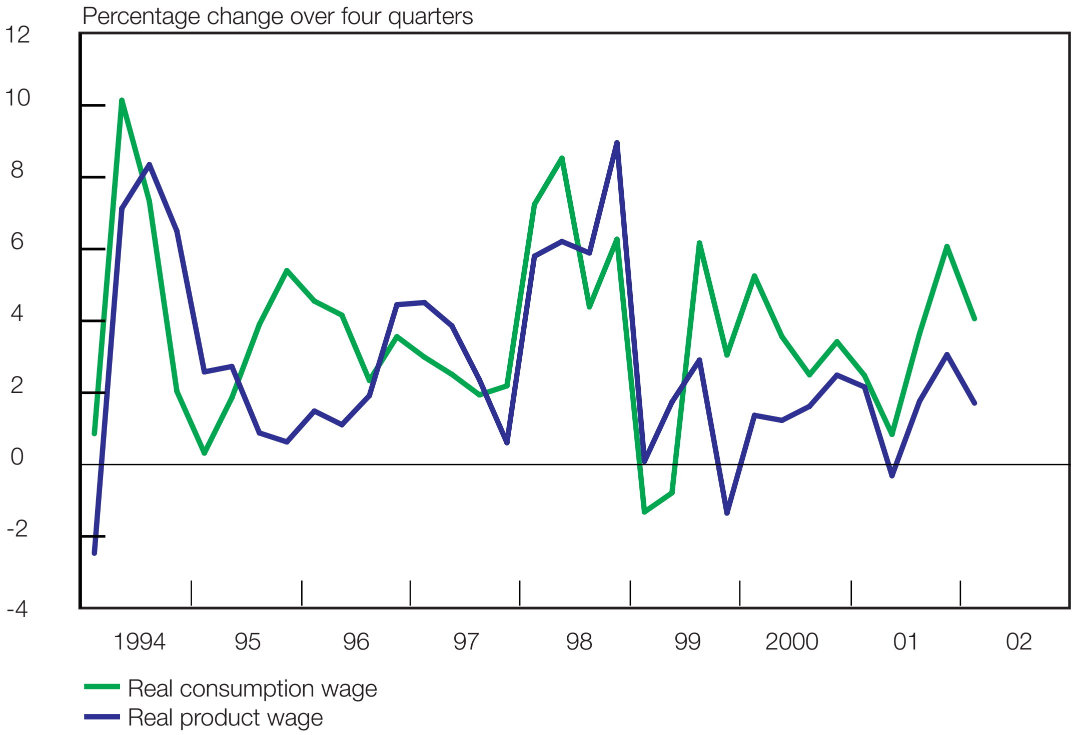
The slowdown in remuneration growth in the *private sector* from a year-to-year rate of 9,2 per cent in 2000 to 8,8 per cent in 2001 has not been sustained in the opening months of 2002. When measured over periods of four quarters, nominal wage growth in the private sector accelerated to 11,8 per cent in the first quarter of 2002 – the highest rate of increase in more than three years.

The skills-intensive financial services sector has been the sector with the highest remuneration growth rate in recent years, but was overtaken by the gold-mining sector in 2001. On average, employees in the gold-mining sector earned some 19 per cent more in 2001 than in 2000. By contrast, nominal wage growth in the financial intermediation and insurance industry fell back from high rates of increase of 18,1 per cent in 1999 and 14,8 per cent in 2000 to 8,2 per cent in 2001.

The growth in nominal compensation per worker in the *public sector* more than doubled from 4,6 per cent in 1999 to 9,6 per cent in both 2000 and 2001. In 2001 the growth in compensation per public-sector worker ranged from 8,7 per cent at the provincial government level to 15,7 per cent at the national government level. Moreover, the annual wage increase in the public sector for the 2002/03 financial year was concluded at 9 per cent.

The accompanying graph shows that the growth in the real product wage of producers (i.e. the ratio of nominal remuneration per worker to output prices) during the past three years or so fell short of the growth in the real consumption wage of employees (i.e. the real purchasing power of employees' nominal wage increases). This indicates that employees were more successful in recovering increases in their cost of living and adding to their real incomes than employers were capable of recovering cost increases through adjustments in output prices. Because of the reduction in their "pricing power", producers had to resort to efficiency-enhancing production technologies and higher productivity growth to protect their operating margins.

Real wages

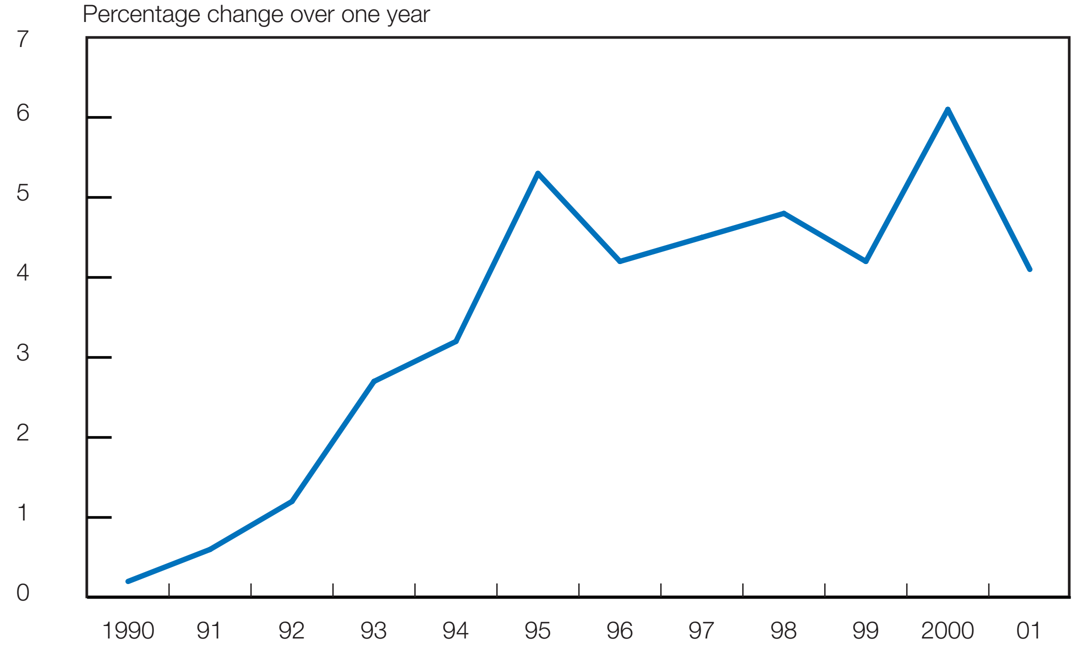


Growth in the real consumption wage exceeded growth in the real product wage by 1,6 percentage points in 2001 and by 2,4 percentage points in the year to March 2002. Such an increase in the real consumption wage relative to the real product wage should assist in reducing short-term wage pressures because the purchasing power of wages will be growing faster, but the operating margins of producers could come under some strain. If there is no abatement in wage pressures, producer strategies to preserve operating margins may lead to more job losses.

The margin between growth in the real consumption wage and the real product wage would be even wider – thus strengthening the case for a reduction in wage pressures – if the latest personal income-tax cuts announced by the Minister of Finance are properly taken into consideration.

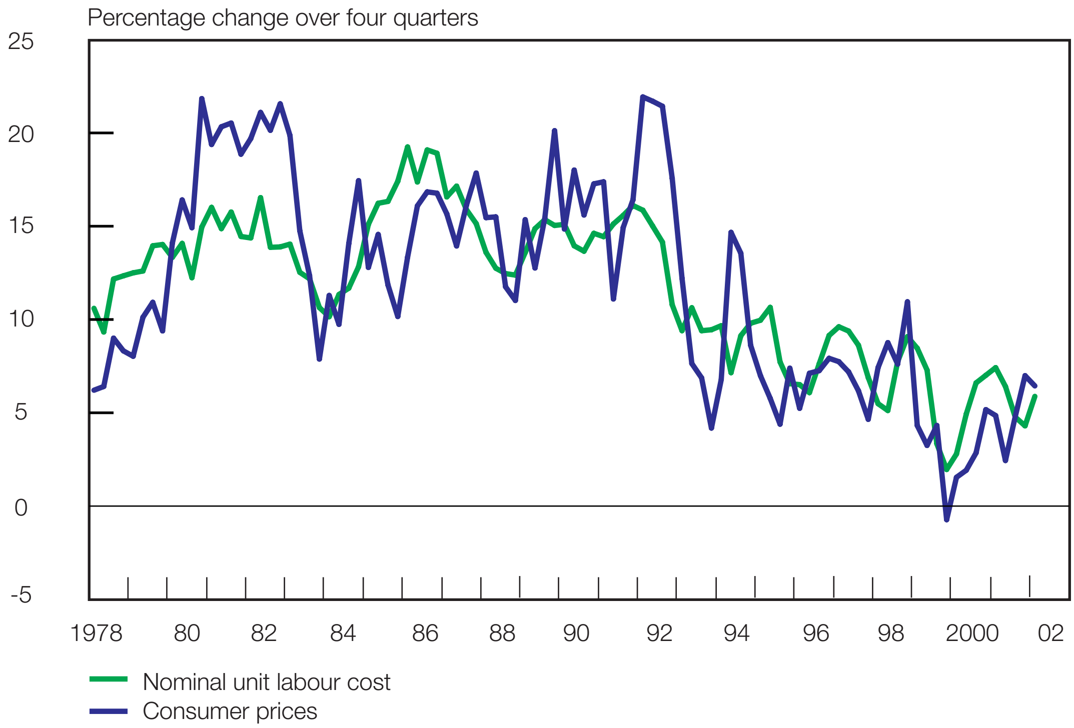
Mainly due to the slowdown in economy-wide output growth, growth in *output per worker* in the formal non-agricultural sectors of the economy receded from 6,1 per cent in 2000 to 4,1 per cent in 2001 and to 3,0 per cent in the year to March 2002. Productivity growth in the manufacturing sector nevertheless remained solid at around the 6 per cent level in 2000 and 2001. As manufacturing production picked up in the opening months of 2002, labour productivity growth strengthened to a brisk year-on-year rate of 7,1 per cent in the first quarter of this year.

Non-agricultural labour productivity



There has been a marked slowdown since 1992 in the rate of growth in *nominal unit labour cost*, i.e. the ratio of nominal compensation per worker to output per worker, and this has contributed largely to the waning of inflationary pressures in the economy in recent years. When nominal remuneration growth in the economy exceeds labour productivity growth, inflationary pressure in the labour market is

Nominal unit labour cost and consumer prices



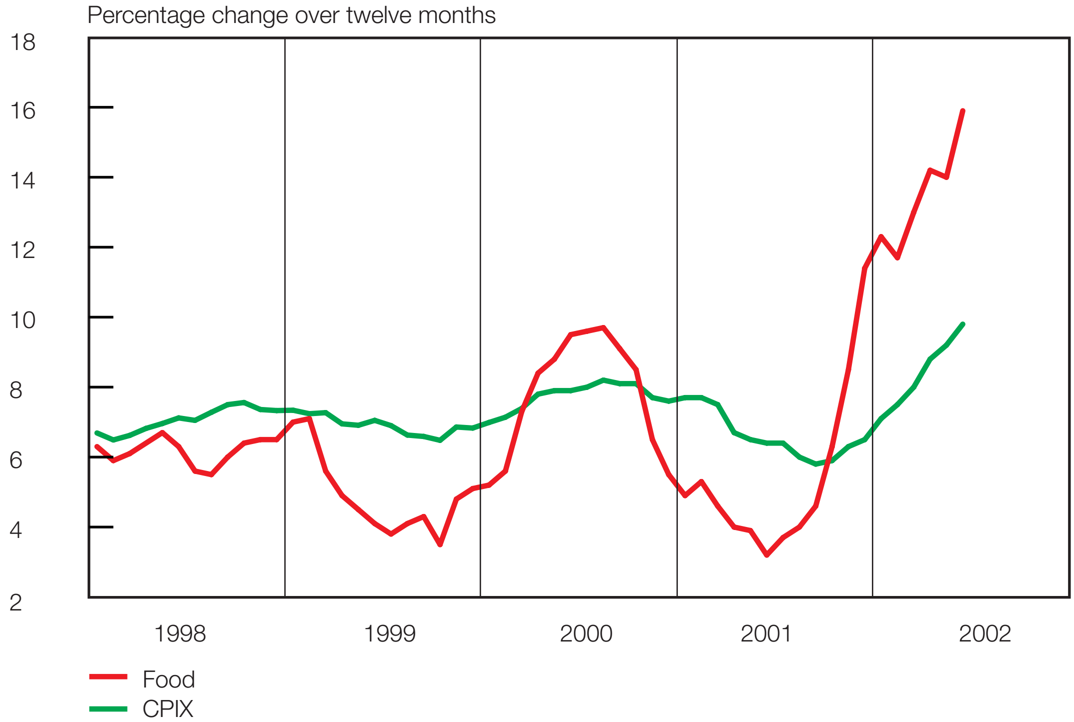
evidenced in a rise in the cost of labour per unit of production. Robust growth in labour productivity compressed the growth in non-agricultural nominal unit labour cost to a low level of around 3 per cent in 1999 and 2000. As labour productivity growth receded, the year-to-year rate of increase in nominal unit labour cost rose to 4,8 per cent in 2001 and to 6,4 per cent in the year to March 2002, contributing to an acceleration in the pace of price increases. In the manufacturing sector, growth in nominal unit labour cost was confined to just 1,5 per cent in 2000. Subsequently, the rate of increase over a year in nominal unit labour cost in the manufacturing sector, albeit still at a relatively low level, was 3,2 per cent in 2001 and remained at that level in the first quarter of 2002.

Higher labour productivity growth and lower rates of increase in unit labour cost not only curb domestically generated inflationary pressures, but also help to improve a country's international competitiveness. An increase in international competitiveness should preferably not be the result of a downward shift in the exchange value of a country's national currency, but should also come from higher efficiency and cost-effectiveness in the processes of production. Strong growth in output per worker reflects the ability of domestic producers to meet or exceed the efficiency standards of other countries.

Prices

In 2001, CPIX inflation slowed down to its lowest level since the early 1970s, amounting to a year-to-year rate of 6,6 per cent, compared with 7,8 per cent in 2000. (CPIX is the overall consumer price index for metropolitan and other urban areas, excluding the influence of mortgage interest costs.) However, when calculated for calendar months, year-on-year CPIX inflation accelerated from 5,8 per cent in September 2001 to 9,8 per cent in June 2002. This acceleration in CPIX inflation towards the end of 2001 and in early 2002 was first and foremost a consequence of rising food prices, which were closely tied to changes in the

CPIX and food prices



international exchange value of the rand. Consumer food price inflation has been consistently higher than 10 per cent since December 2001 and amounted to a year-on-year rate of 15,9 per cent in June 2002.

Rises in food price inflation since about the middle of 2001 have emphasised the important role that food plays in the explanation of short-term price increases. Food prices are recognised as a highly volatile component of the consumer basket. The accompanying table shows the weight of food in the overall consumer price index for the period since 1960 and the CPIX basket from January 1997 – the first officially published observation on CPIX by Statistics South Africa.

The weight of food in the overall consumer price index declined from 27,50 per cent in the 1960s to 18,02 per cent in the period January 1997 – December 2001. Subsequently, food gained importance in the consumer price basket, amounting to 20,99 per cent of overall household expenditure since January 2002. In the case of CPIX, the contribution of food has risen from around 22 per cent in 1997-2001 to almost 26 per cent currently. The outcome of short-term changes in the CPIX therefore depends in large measure on developments in food prices.

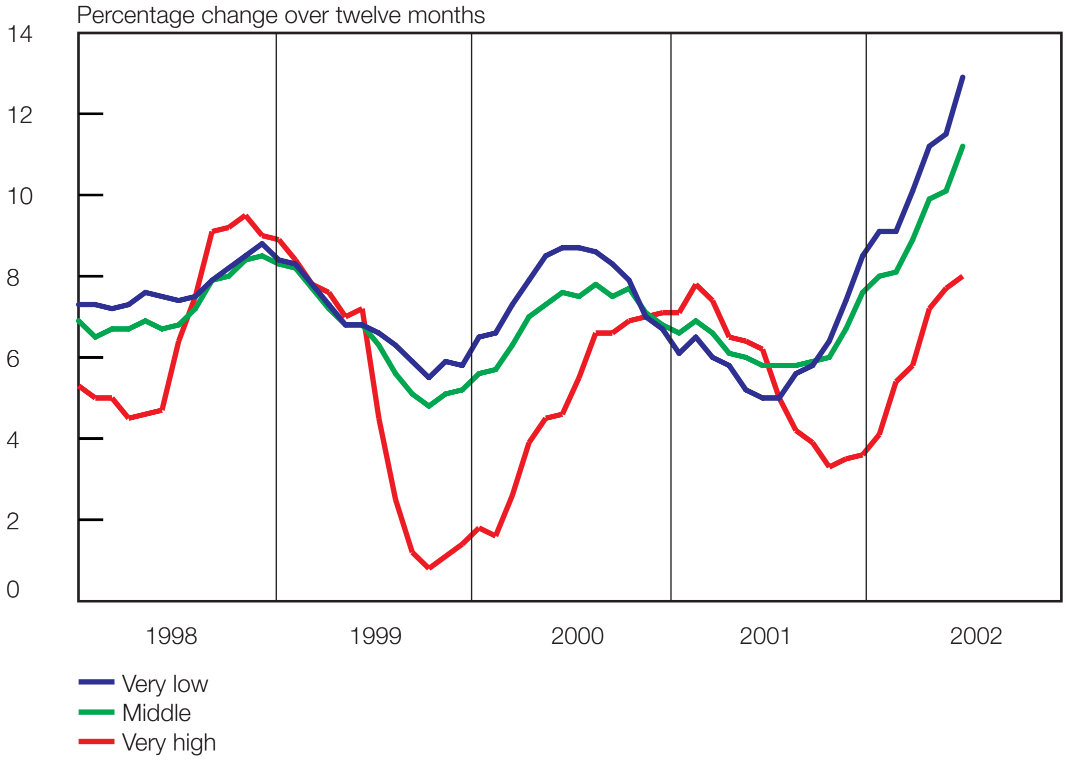
The weight of food in the overall CPI and CPIX
Per cent of overall consumption expenditure

Period	Overall CPI	CPIX
1960/01 – 1970/03	27,50	n.a.
1970/04 – 1977/12	23,90	n.a.
1978/01 – 1987/10	24,98	n.a.
1987/11 – 1991/07	22,72	n.a.
1991/08 – 1996/12	18,64	n.a.
1997/01 – 2001/12	18,02	21,92
2002/01 –	20,99	25,66

Because low-income earners spend a high proportion of their income on food, they are far more vulnerable to changes in food prices than their more affluent counterparts. Food constitutes as much as 51,2 per cent of the total basket of goods and services purchased by those in the very low expenditure group, and only 16,7 per cent for those in the very high expenditure group. Rising food prices accordingly have a greater impact on those in the very low expenditure group than on those in the very high expenditure group. In fact, overall inflation for the very low expenditure group amounted to 12,9 per cent in the year to June 2002, compared with a rate of 8,0 per cent for the very high expenditure group.

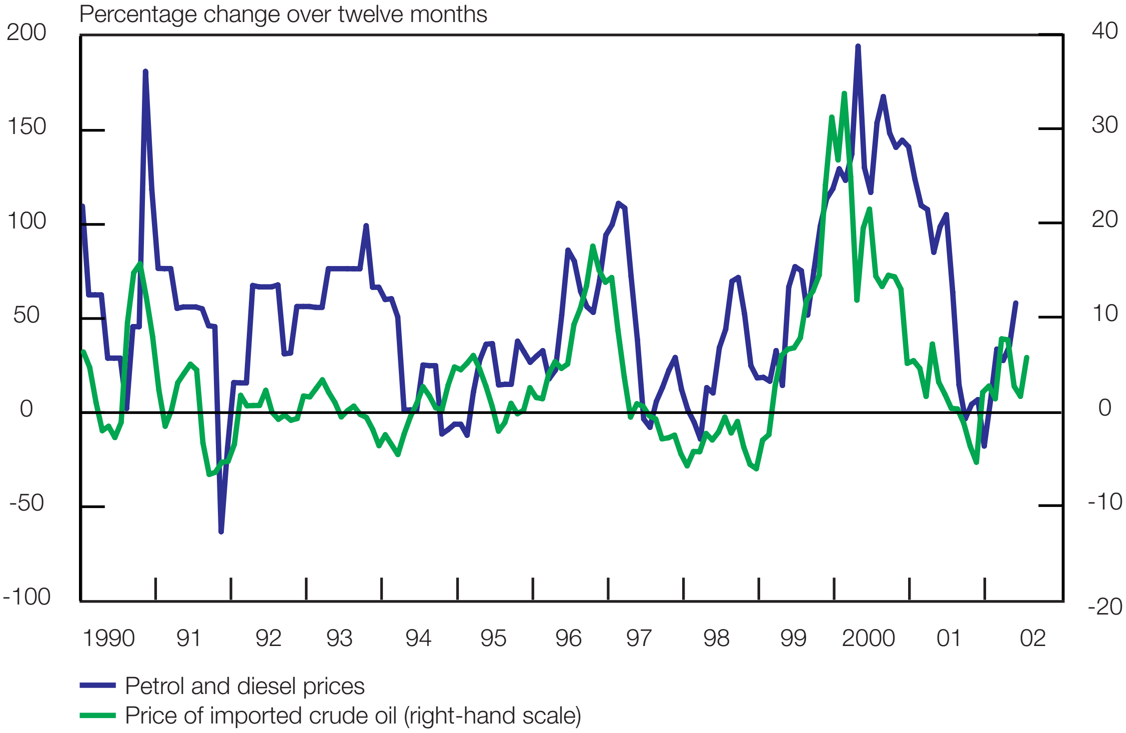
The pick-up in CPIX inflation in recent months was not only a consequence of rising food prices, but was also due to the higher petrol prices resulting from the strong rise in the international price of petroleum from around US$19 per barrel in November 2001 to US$25 per barrel in May 2002. Coupled with the effect of the depreciation of the rand, the increase in the international price of petroleum caused the domestic price of petrol to increase by 42 per cent over this period. Furthermore, as the depreciated exchange value of the rand pushed the input costs of domestic producers higher, stronger price increases occurred in almost all the CPIX subcategories during the first half of 2002. New vehicle prices, due to their high

Consumer prices for different expenditure groups



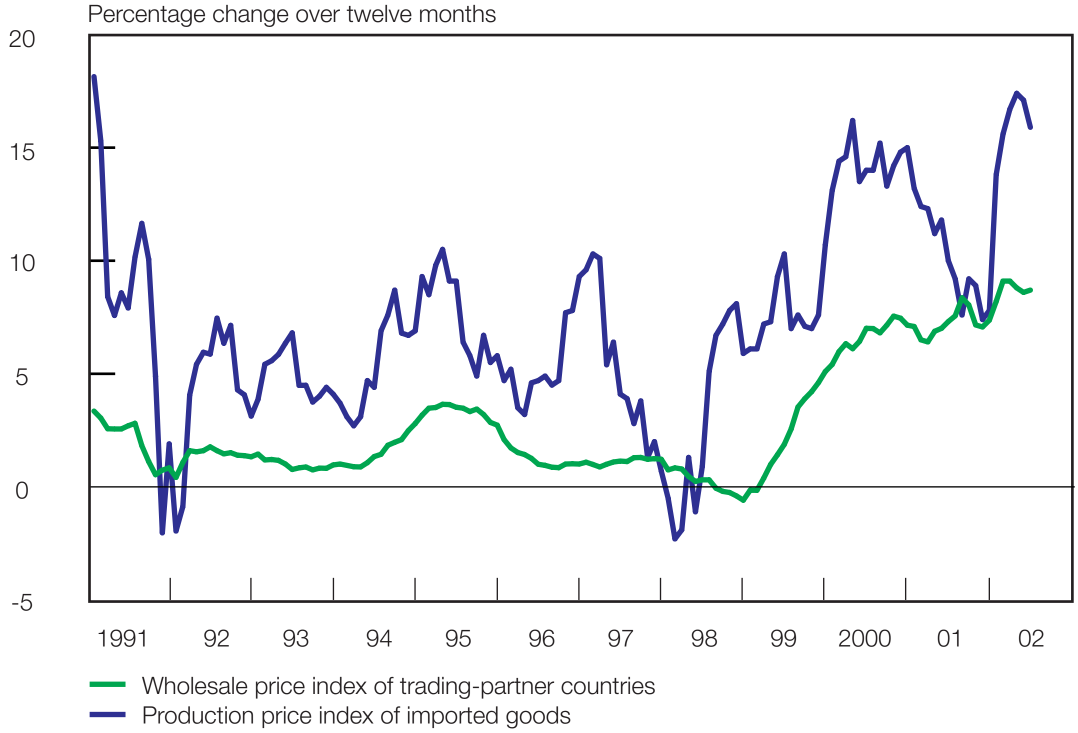
import content, were strongly affected. All these secondary price effects contributed to an acceleration in the increase in CPIX excluding food and petrol from 5,8 per cent in December 2001 to 7,6 per cent in June 2002.

Fuel prices



The pace of *all-goods production price inflation* picked up from 5,8 per cent in 1999 to 9,2 per cent in 2000 but slowed down to 8,4 per cent in 2001. The decline in inflation in the production prices of goods during most of 2001 can be attributed to lower rates of increase in the prices of imported goods, primarily due to the decline in the international price of petroleum. The decline in the international petroleum price during most of 2001 partly offset the inflationary effects of increases in the production prices of South Africa's main trading-partner countries. The year-to-year rate of increase in the composite foreign wholesale price index of South Africa's main trading partner countries rose from 6,7 per cent in 2000 to 7,2 per cent in 2001. Growth in the prices of domestically produced goods during 2001 was also held back somewhat by fairly modest rises in the nominal unit labour cost.

Imported inflation



The monthly measure of production price inflation increased rapidly in the aftermath of the sharp depreciation in the exchange rate of the rand in the closing months of 2001. The year-on-year rate of increase in the *all-goods production price index* accelerated from 7,8 per cent in September 2001 to 14,9 per cent in May 2002 and 14,4 per cent in June. The pick-up was not only confined to the prices of imported goods, but as higher import prices spilled over into the cost structures of goods produced domestically, the prices of these goods were also pushed higher.

The year-to-year rate of increase in the prices of *domestically produced goods* accelerated from 5,2 per cent in 1999 to 7,3 per cent in 2000 and 7,8 per cent in 2001. The increase in domestically generated production price inflation in 2001 was fairly evenly distributed throughout most of the subcategories of the all-goods production price index. The categories that contributed most to the acceleration in price increases of domestically produced goods in 2001 were agricultural and manufactured food, fish products, leather and leather products, machinery and equipment, and wood products and furniture. The acceleration in the growth in unit labour cost in 2000 and 2001 contributed to this pick-up in domestically generated inflation.

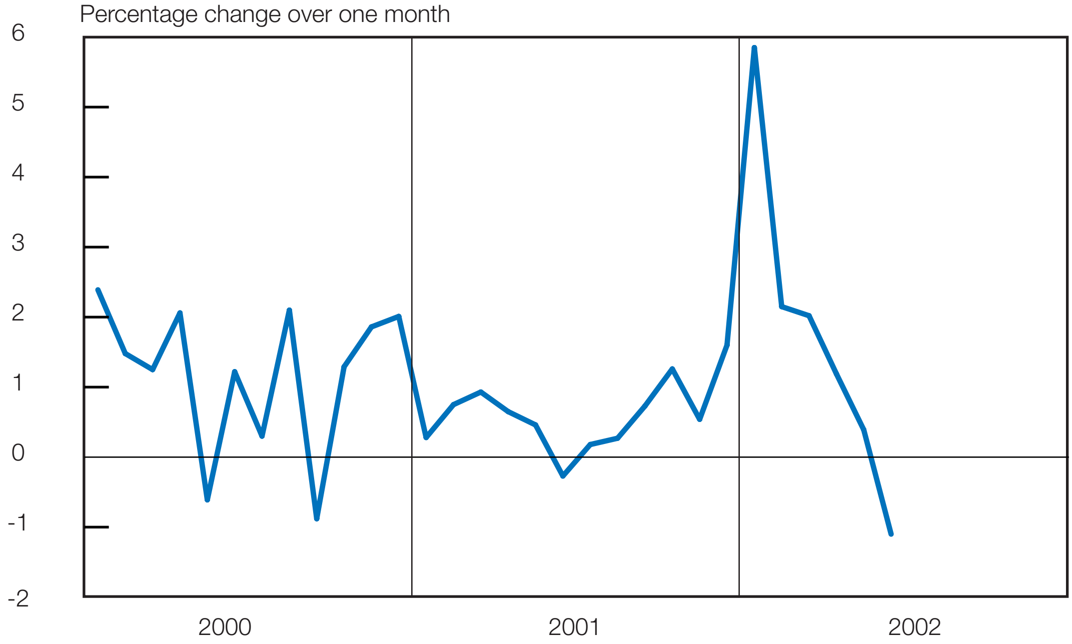
When measured over periods of twelve months, inflation in the prices of domestically produced goods remained consistently below that of imported goods from July 1998, apart from November and December 2001 when imported inflation fell briefly below that of domestically produced goods. As the rising cost of imported inputs in the production process took effect, coupled with increases in nominal unit labour cost, inflation in the prices of domestically produced goods rose from 8,4 per cent in the year to December 2001 to 14,1 per cent in the year to May 2002 and 13,9 per cent in the year to June. In addition, the rapid increase in food prices exacerbated these price increases. The year-on-year increase in the combined index of agricultural and manufactured food prices, contributing about 22 per cent to the all-goods production price index, accelerated from 2,5 per cent in February 2001 to around 26 per cent in June 2002.

Production prices

Growth in the prices of *imported goods* was restrained during the first three quarters of 2001 by the behaviour of the international price of crude oil. Accordingly, year-to-year growth in the prices of imported goods fell from 14,4 per cent in 2000 to 10,0 per cent in 2001. When the effect of rising food prices and the depreciation of the rand started to influence prices, imported price increases accelerated quite abruptly from year-on-year rates of about 8 per cent in the closing months of 2001 to 17,4 per cent in April 2002, 17,1 per cent in May and 15,9 per cent in June.

Growth over one month in the prices of imported goods, which reached rates in excess of 5 per cent in the early months of 2002, slowed down appreciably in the subsequent period as the rand strengthened. These monthly increases petered out so rapidly that the index for imported goods remained unchanged from April to May 2002, even falling back somewhat in June. When calculated on a seasonally adjusted basis, the prices of imported goods declined by 1,1 per cent from May to June 2002 – the first such decline in the index in twelve months.

Prices of imported goods



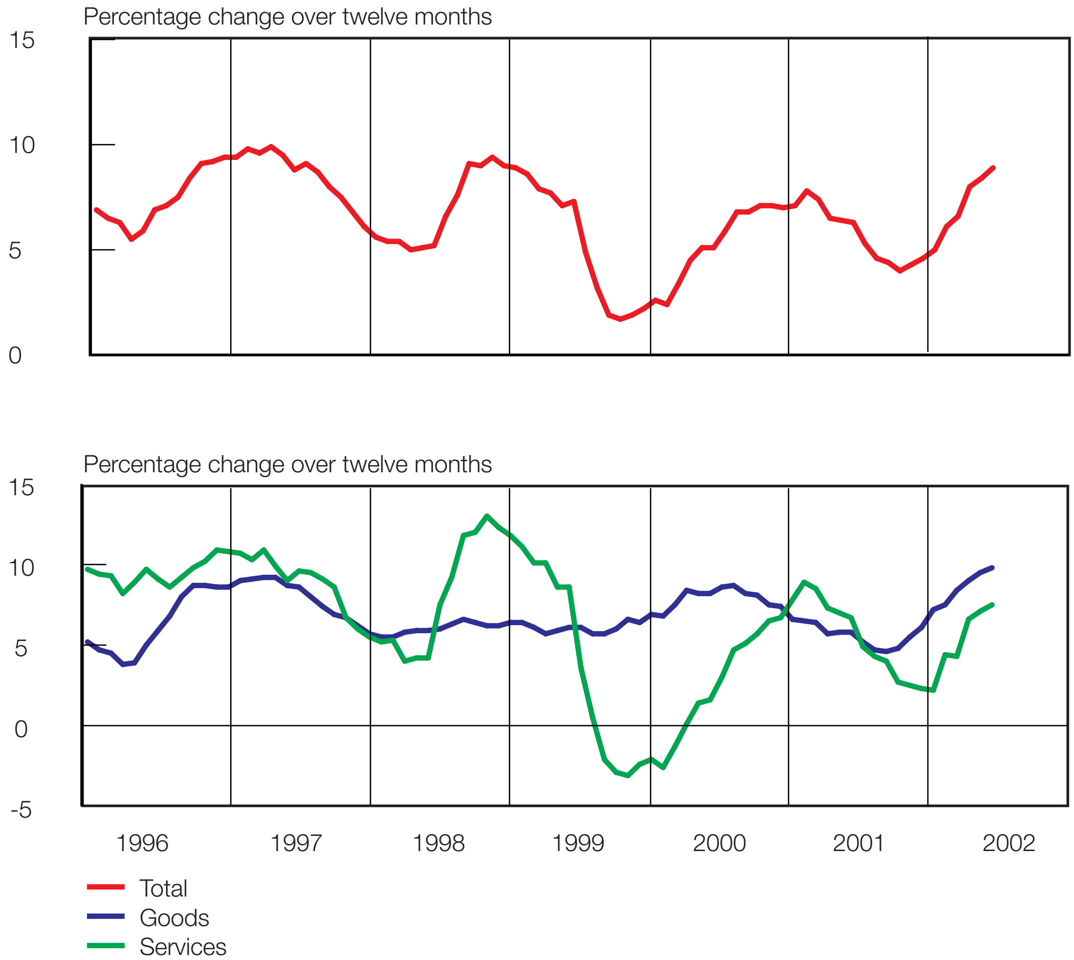
Seasonally adjusted

Following a long downward trajectory from rates in excess of 18 per cent in the mid-1980s, *overall consumer price inflation* fell to a relatively low level in 1999-2001, but nevertheless picked up slightly from 5,4 per cent in 2000 to 5,7 per cent in 2001. But the somewhat faster pace of average inflation in 2001 concealed the disinflationary climate of the first nine months of that year. In fact, the year-on-year increase in the overall consumer price index fell from 7,8 per cent in February 2001 to 4,0 per cent in October. The decline in inflation during the first three quarters of 2001 was essentially brought on by declines in the interest cost of mortgage bonds and low increases in the prices of furniture and equipment, clothing and footwear, and transport running cost, i.e. petrol.

As price pressures arising from the depreciation of the rand were passed on from the production level to end-product prices, year-on-year changes in the overall consumer price index accelerated to 8,9 per cent in June 2002. Higher rates of increase in the prices of consumer goods and of services contributed to this acceleration in overall consumer price inflation.

The year-to-year rate of increase in the *prices of consumer goods* slowed down significantly to a thirty-year low of 5,6 per cent in 2001. When measured over periods of twelve months, the increases in the prices of consumer goods slowed down from 8,7 per cent in August 2000 to 4,6 per cent in September 2001, but picked up in the latter part of 2001 and the first half of 2002 when year-on-year increases in the consumer price index for goods rose steeply to 9,8 per cent in June 2002.

Consumer prices



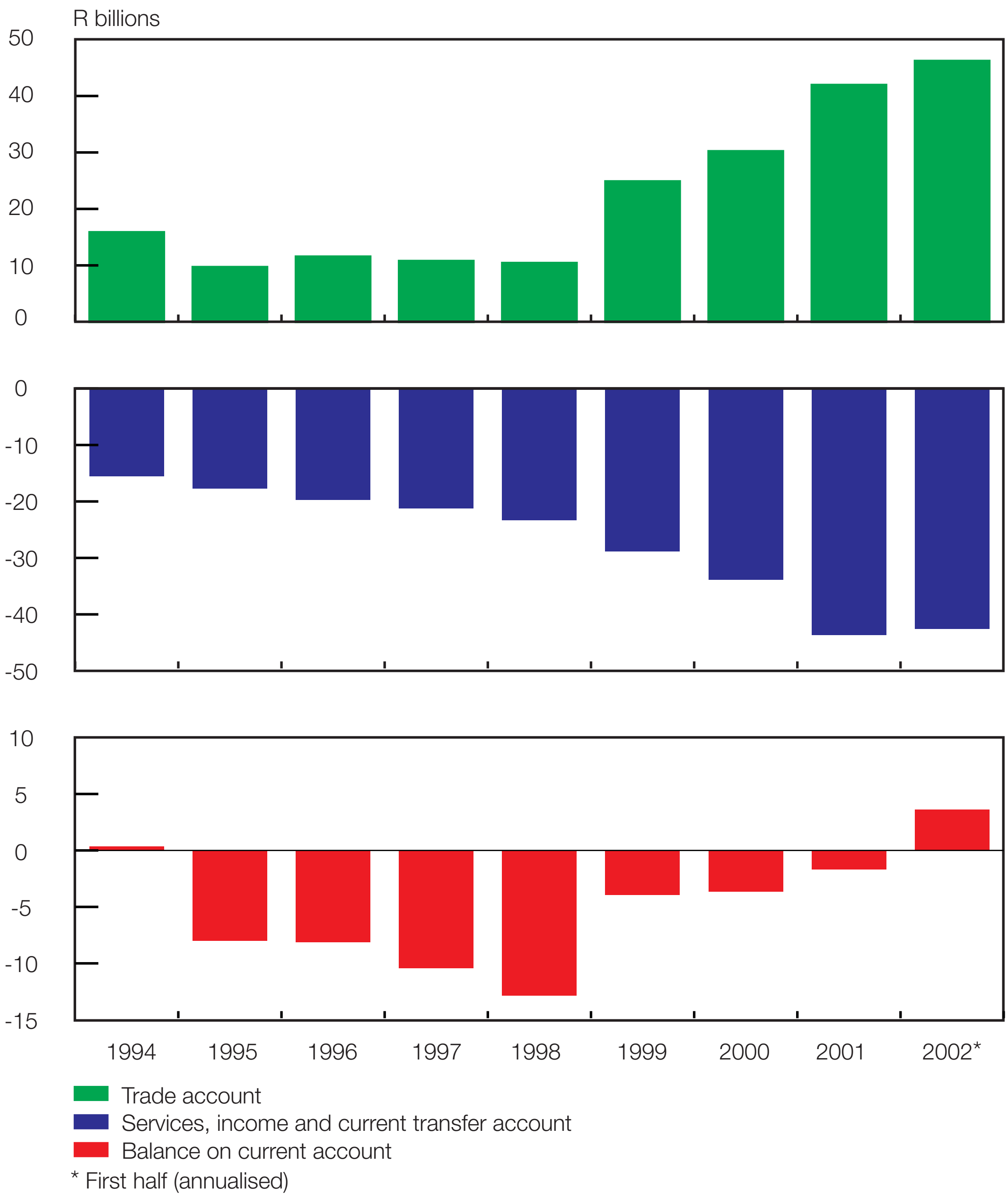
Inflation in the prices of *consumer services* generally restrained overall consumer price inflation during the past three years or so, amounting to year-to-year rates of 4,2 per cent in 1999, 2,4 per cent in 2000 and 5,5 per cent in 2001. When measured over periods of twelve months, inflation in the prices of services declined throughout 2001 and reached a low of 2,2 per cent in January 2002, but then accelerated to 7,5 per cent in June 2002 as higher mortgage interest rates and the cost of transport services started to affect the services component of the representative consumer basket. The prices of services, other than housing and transport services, continued to rise at a rate of around 6 per cent throughout the first half of 2002.

Foreign trade and payments

Balance on current account

The slowdown in global economic activity held back growth in South Africa's export volumes in 2001. At the same time, import growth into South Africa was flat too, because of the slowdown in inventory investment and probably also the sharp rise in the prices of imported goods. These developments were accompanied by an improvement in the country's international terms of trade (i.e. export prices were

Balance of payments: Current account



generally rising faster than import prices), resulting in export earnings rising faster than payments for imports. A healthy surplus accordingly developed on the country's trade account with the rest of the world during 2001. This trade surplus improved further in the first half of 2002.

Balance of payments on current account

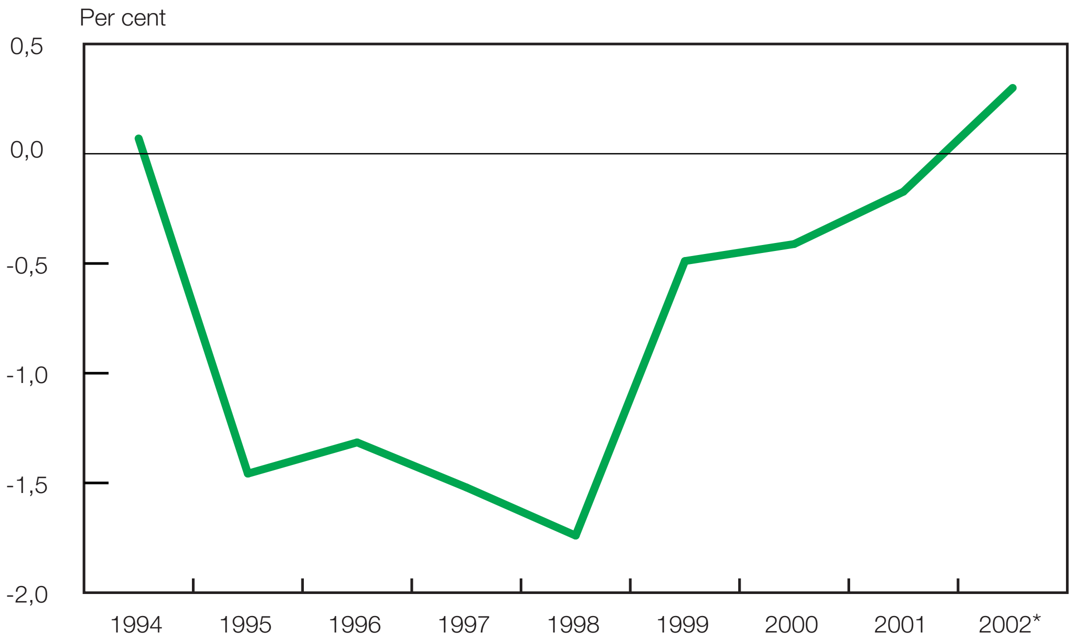
Seasonally adjusted and annualised
R billions

	2000	2001			2002
	Year	1st half	2nd half	Year	1st half
Merchandise exports	193,2	233,7	231,2	232,4	281,6
Net gold exports	26,8	26,4	32,5	29,4	41,9
Merchandise imports	-189,8	-214,5	-225,4	-219,9	-277,3
Net service, income and current transfer payments	-33,9	-42,2	-45,1	-43,6	-42,6
Balance on current account	**-3,7**	**3,4**	**-6,8**	**-1,7**	**3,6**

Traditionally, South African economic agents pay more for services and income to the rest of the world than they receive. This deficit on the "services and income account" of the balance of payments widened considerably in 2001, particularly because of a sharp increase in dividends paid to the non-resident owners of equity in South African firms.

Despite the deterioration in the deficit on the services and income account, the surplus on the trade account was more than adequate to ensure an improvement in the current account of the balance of payments, i.e. the combined balance on the trade account and the services and income account. The current account still showed a deficit, but this deficit shrank from R3,7 billion in 2000 to R1,7 billion in 2001.

Ratio of current-account balance to gross domestic product



* First half (annualised)

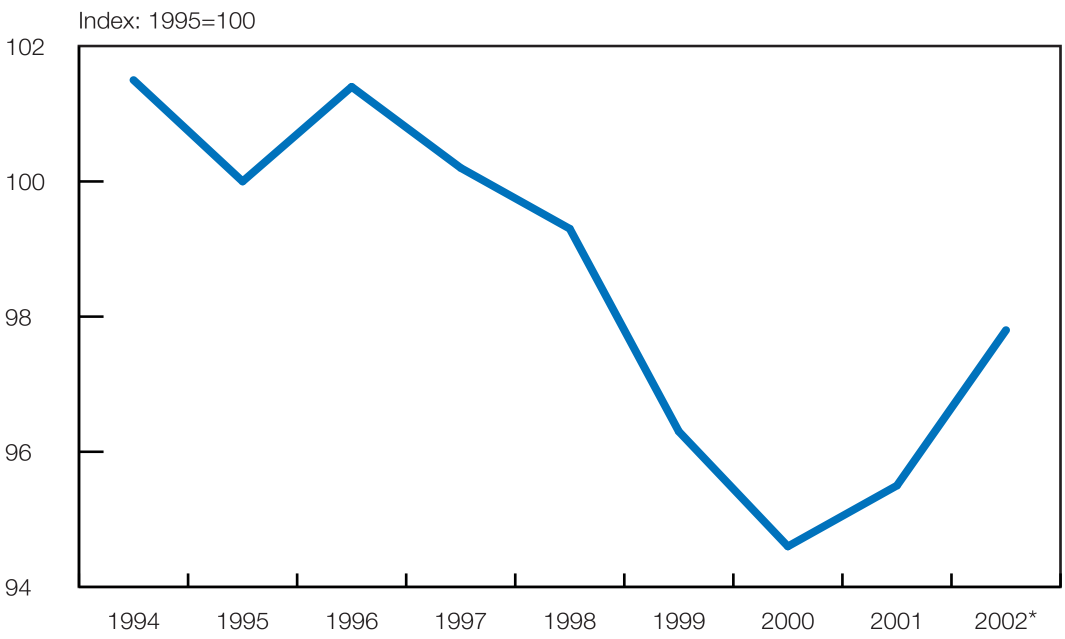
In contrast to the events of 2001, dividend payments to the rest of the world declined in the first half of 2002. This contributed to a sharp reduction in the deficit on the services and income account, and to a turnaround in the current-account balance from a deficit in 2001 to a surplus in the first half of 2002. Relative to gross domestic product, the *surplus* on the current account of the balance of payments was estimated at 0,3 per cent in the first half of 2002, compared with *deficit* ratios of 0,4 per cent in 2000 and 0,2 per cent in 2001.

Exports

Reflecting the slowdown in world economic activity and trade, growth in the volume of merchandise exported from South Africa fell back from 11,6 per cent in 2000 to just 1,6 per cent in 2001. Although the growth rate was well down from the previous year, export volumes from South Africa were still growing in 2001. At the same time world trade volumes declined by 0,7 per cent, implying that South African exporters were successful in raising their share of overall world trade. This probably spilled over into the first half of 2002 when the volume of merchandise exports by South African firms was some 4 per cent higher than in the second half of 2001. Increased efficiency and rising productivity in the domestic production processes, together with a decline of about 7½ per cent per year in the inflation-adjusted exchange rate of the rand from 1998 to 2001, were probably the main factors contributing to the growing market share of South African exporters.

International commodity prices drifted lower as world economic prospects worsened during 2001. On average, international commodity prices expressed in US dollars declined by 6½ per cent in 2001. The depreciation of the rand nevertheless pushed the rand proceeds of commodity exporters so much higher that the average price in rands of exports rose faster during 2001 than the prices of imports. The country's international terms of trade accordingly improved somewhat in 2001 and continued to do so at an even faster pace in the first half of 2002 when world economic prospects brightened and international commodity prices rallied accordingly.

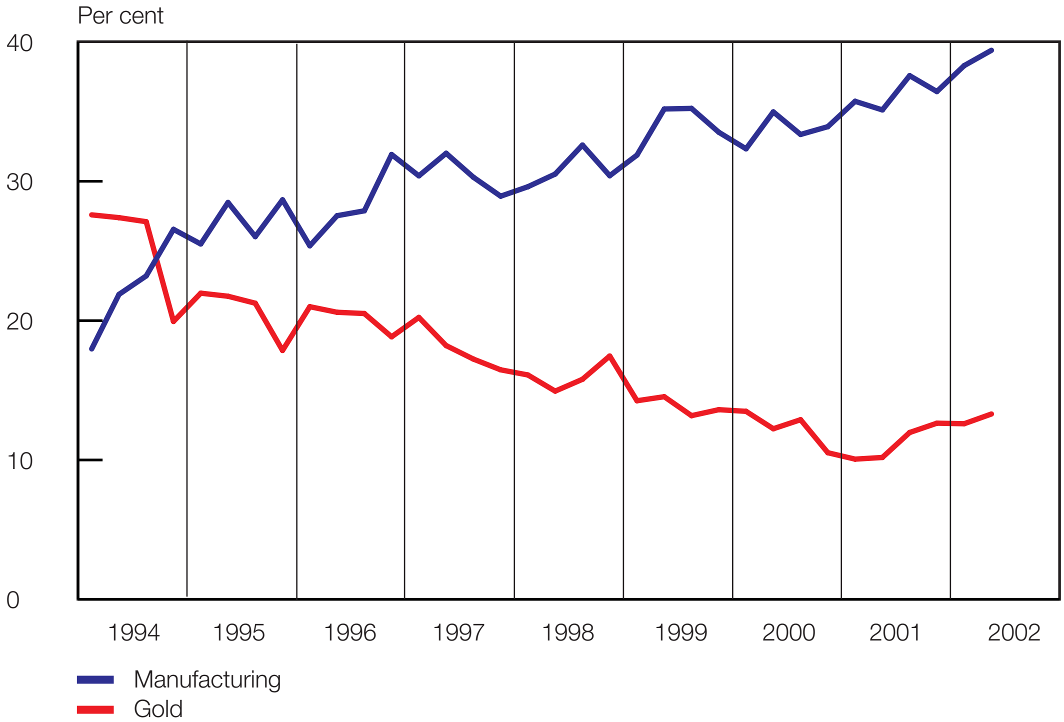
Terms of trade including gold



* First half (annualised)

On the whole, the value of merchandise exports from South Africa (excluding the value of gold exports) rose by 20½ per cent between 2000 and 2001 and at an annualised rate of 22 per cent from the second half of 2001 to the first half of 2002. The share of manufactured goods in the total value of goods exported increased from 35,4 per cent in 2000 to 37,9 per cent in 2001. Great strides were made in stepping up exports of machinery and electrical equipment, and vehicles and other transport equipment. The price competitiveness of these sectors probably benefited most from the lower exchange value of the rand. Mirroring the manufacturing sector's improved contribution to the export effort, the contribution of mining to the total value of exports was reduced from 59,2 per cent in 2000 to 56,6 per cent in 2001.

Contributions by manufacturing and gold to total exports



Gold production fell from 428 tonnes in 2000 to 394 tonnes in 2001, or by 7,9 per cent, but the value of gold exports increased from R26,8 billion to R29,4 billion over the same period. As the average level of the gold price in international markets fell from US$279 per fine ounce in 2000 to US$271 in 2001, the rise in the overall value of gold exports should be attributed entirely to the decline in the exchange value of the rand. In the first half of 2002 the gold price rose to US$327 per fine ounce on 31 May, pushing the rand value of gold exports substantially higher. Political tension in the Middle East, the changing marketing strategies of some dominant gold producers and residual concern about the sustainability of economic recovery in America, created favourable circumstances for the gold price.

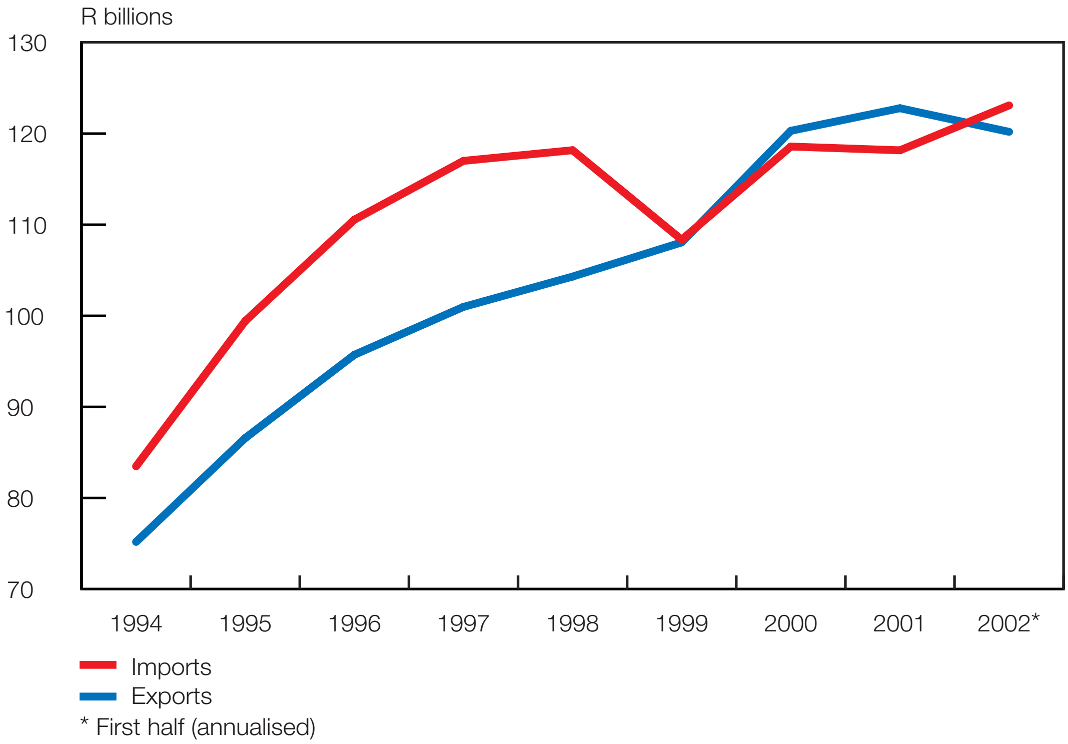
As a percentage of the total value of exports, gold exports have now fallen from 50 per cent in 1980 to 11 per cent in 2001 and 13 per cent in the first half of 2002.

Imports

The physical quantity of merchandise imports into South Africa increased by 9½ per cent in 2000 but declined by about 1 per cent in 2001. The 2001 decline occurred in the face of an expansion in real gross domestic expenditure which usually creates additional demand for imported merchandise. The decline in import volumes should therefore be attributed to a change in the prices of imported goods relative to the prices of domestically produced goods, rather than the change in domestic expenditure.

This rise in relative prices should be seen as the main deterrent to growth in import volumes during 2001, while at the same time encouraging production by import-competing industries. That an increased portion of aggregate domestic demand was satisfied by domestic producers is borne out by a decline in the import penetration ratio (i.e. the ratio of real merchandise imports to real gross domestic expenditure) from 19,8 per cent in 2000 to 19,3 per cent in 2001.

Real merchandise imports and exports



When the exchange rate of the rand strengthened in the first half of 2002, the effect of higher domestic demand took hold again and import volumes rose 6½ per cent above the level of the second half of 2001.

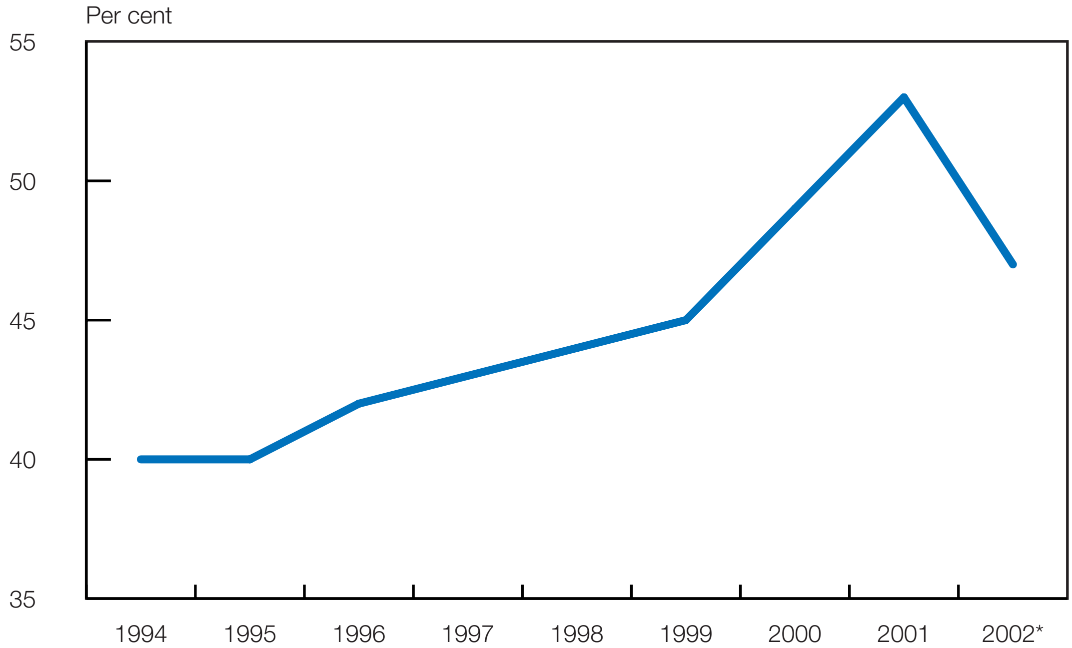
Import prices in rand terms were driven higher by a small increase in wholesale or production prices in South Africa's main trading-partner countries and even more so by the rapid decline in the external value of the rand. The effect of these two price-raising factors on the overall level of import prices was checked somewhat by the fall in the import price of crude oil from US$28,5 per barrel in 2000 to US$24,5 per barrel in 2001. Still, the general level of import prices rose by 17½ per cent in 2001 and 15½ per cent (annualised rate) from the second half of 2001 to the first half of 2002.

Predominantly as a consequence of the sharp increase in the prices of imported goods, the value in rands of merchandise imports rose by about 16 per cent from 2000 to 2001 and by 23 per cent (at an annualised rate) from the second half of 2001 to the first half of 2002. Imports of manufactured goods rose faster than total imports, lifting their contribution to the total from 74 per cent in 2000 to 76 per cent in 2001. The strong showing of imported manufactured goods was related to the higher level of fixed capital formation in the economy which attracted imports of machinery and electrical equipment, as well as imports of vehicles and other transport equipment.

Net service, income and current transfer payments

The deficit on the services and income account widened from R33,9 billion in 2000 to R43,6 billion in 2001. Higher income payments to non-resident owners of shares in South African companies contributed substantially to this deterioration in the country's external account. Because of the increase in dividend distributions, the ratio of interest and dividend payments to total export earnings increased from 13,5 per cent in 2000 to 14,9 per cent in 2001.

Income payments as percentage of total income and service payments to rest of world



* First half (annualised)

Visitor arrivals declined slightly in 2001, but they spent more on travel-related services than in 2000. The decline in the number of visitors to the country was partly related to the disruption in international travel following the attacks on America, whereas the increase in spending was probably encouraged by the low exchange value of the rand against the major currencies of the world. Travel receipts as a percentage of the total of services receipts from foreigners increased from 51½ per cent in 2000 to 54 per cent in 2001. Still, the increase in service receipts was not enough to offset the negative effect of the increase in dividend payments to the rest of the world.

In the first half of 2002 South African companies reduced their dividend payments to non-resident shareholders and parent companies, shrinking the deficit on the services and income account from an annualised amount of R45,1 billion in the second half of 2001 to R42,6 billion in the first half of 2002. This was a major contribution to the turnaround in the current-account balance from a deficit in 2001 to a surplus in the first half of 2002.

Financial account and foreign debt

Problems encountered by other emerging-market economies contributed to the shrinking of the surplus on South Africa's financial account with the rest of the world from R9,1 billion in 2000 to R7,1 billion in 2001. By the beginning of 2002 foreign investor sentiment had improved quite noticeably, and as the prices of domestic assets were at attractive levels following the decline in the exchange value of the rand, healthy capital inflows into the economy were restored in the first half of this year.

Net financial transactions not related to reserves
R billions

	2000	2001			2002
	Year	1st half	2nd half	Year	1st half
Liabilities					
Direct investment	6,2	55,5	1,7	57,2	3,4
Portfolio investment	11,8	-23,7	-0,3	-24,0	19,0
Other investment	10,8	-11,5	-6,6	-18,1	9,1
Assets					
Direct investment	-1,9	34,1	-5,4	28,7	5,5
Portfolio investment	-25,6	-37,8	-5,8	-43,6	-7,3
Other investment	0,9	-16,8	5,6	-11,2	0,1
Total financial transactions*	**9,1**	**4,0**	**3,1**	**7,1**	**33,6**

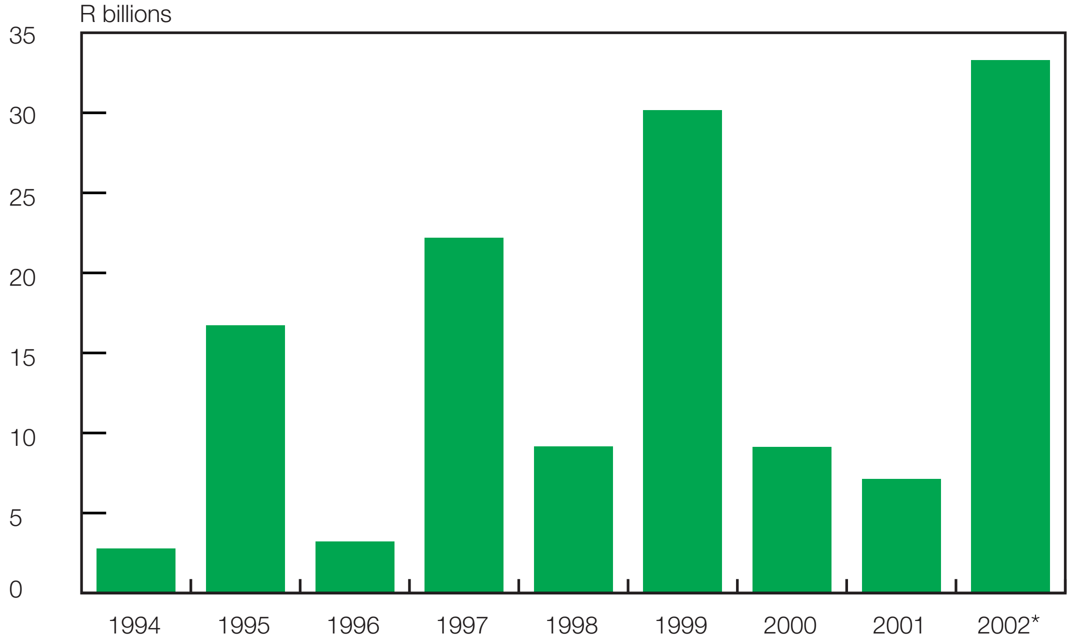
* Including unrecorded transactions

Foreign direct investment flows into South Africa in 2001 were largely dominated by the restructuring of shareholdings in the De Beers mining company. A financial holding company with headquarters in Luxembourg acquired full ownership of the De Beers mining company which was then delisted from the JSE Securities Exchange. In total, South Africa's foreign direct investment liabilities rose by R6,2 billion in 2000 and by R57,2 billion in 2001.

Other increases in South Africa's direct investment liabilities came from
- dividends which were declared during 2001, but scheduled for payment later;
- the acquisition of a dominant interest in the equity capital of several domestic companies by non-resident investors; and
- loans extended by non-resident holding companies to their domestic subsidiaries or affiliates.

Foreign direct investment flows from South Africa turned around from an outflow of R1,9 billion in 2000 to an inflow (a decline in foreign assets) of R28,7 billion in 2001. The bulk of this inflow was related to the restructuring of the corporate relationship between the Anglo American Corporation, a non-resident company, and the De Beers mining company. The decline in foreign direct investment assets resulting from this transaction was partly offset by the actions of South African companies which increased their direct interest in the equity capital of foreign enterprises during 2001. Prominent among these transactions was the acquisition of a foreign chemicals group by a South African petrochemical company.

Balance on financial account



* First half

On a net basis, i.e. after changes in foreign direct investment assets were offset against the changes in foreign direct investment liabilities, foreign direct investment inflows increased from R4,3 billion in 2000 to R85,9 billion in 2001 and amounted to R8,9 billion in the first half of 2002.

The delisting of the De Beers mining company from the JSE Securities Exchange SA caused a sizeable outflow of portfolio investment capital from South Africa in 2001 when investors received shares in the Anglo American Corporation as part compensation for relinquishing their shareholdings in the De Beers mining company. In addition, public corporations repaid foreign-currency denominated securitised debt, and non-resident investors disinvested from the Bond Exchange of South Africa. These outflows were only partly neutralised by an inflow of funds mobilised by the national government on the international capital market and other funds originating from the purchase of listed shares by non-resident investors. In total, portfolio capital to the value of R24,0 billion left the economy in 2001; there had still been a net inflow of R11,8 billion in 2000.

In the first half of 2002, global investors had a more positive attitude towards South African securities. Attractive returns and the expectation of a steady rise in the exchange value of the rand, encouraged an increase in portfolio liabilities to the value of R19,0 billion in the first half of 2002.

Portfolio foreign asset accumulation by South African investors continued unabatedly during 2000, 2001 and the first half of 2002. Foreign assets were accumulated to the value of R25,6 billion in 2000, R43,6 billion in 2001 and R7,3 billion in the first half of 2002. This outward movement of capital occurred despite the discontinuation of the asset-swap mechanism through which institutional investors had been allowed to diversify their portfolios into foreign markets.

South African institutional investors could increase their offshore portfolio assets by means of foreign-currency transfers, based on cash flows in the preceding year and subject to certain limits. In addition, individuals could continue to increase their holdings of foreign assets in terms of the existing exchange controls. However, the major part of the acquisition of foreign portfolio assets in 2001 was in the form of the allocation of shares in the Anglo American Corporation to South African residents in exchange for the shares they had previously held in the De Beers mining company.

On a net basis, i.e. when the accumulation of liabilities is offset against the accumulation of assets, the outflows of portfolio investment capital picked up from R13,8 billion in 2000 to R67,6 billion in 2001, but then changed to an inflow of R8,5 billion in the first half of 2002.

"Other" foreign investment into South Africa (defined as changes in the foreign loan, trade finance and deposit liabilities of South African residents) changed from an inflow of R10,8 billion in 2000 to an outflow of R18,1 billion in 2001 and back to an inflow of R9,1 billion in the first half of 2002. The bulk of the outflow in 2001 was related to the repayment of foreign loans by domestic borrowers and the withdrawal of foreign-currency denominated deposits at domestic banks by non-resident depositors. The inflow in the first half of 2002 was mainly related to the transfer of liability for a syndicated foreign loan of US$1,5 billion from the Reserve Bank to the National Treasury.

"Other" outward investment from South Africa to the rest of the world changed from an inflow (i.e. a decline in foreign assets) of R0,9 billion in 2000 to an outflow (i.e. an increase in foreign assets) of R11,2 billion in 2001. These outflows were mainly related to trade finance extended by South African business enterprises to non-resident clients, and to the delayed repatriation of export proceeds. The repatriation of these funds in terms of exchange control regulations contributed towards a decline of R0,1 billion (i.e. an inflow of capital) in South Africa's other foreign investment assets in the first half of 2002. On a net basis, other investment changed from an inflow of R11,7 billion in 2000 to an outflow of R29,3 billion in 2001 and again into an inflow of R9,2 billion in the first half of 2002.

South Africa's total outstanding foreign debt, a subset of the country's total foreign liabilities, declined sharply from the end of 2000 to the end of 2001. Measured in US dollars, the country's total outstanding rand-denominated and foreign-currency denominated debt declined from US$36,9 billion at the end of 2000 to US$31,4 billion at the end of 2001 – its lowest level since 1994. The disinvestment by non-resident investors from the bonds listed on the Bond Exchange of South Africa, and the revaluation of rand-denominated bonds at a far lower exchange rate of the rand, were the main reasons for the strong decline in the dollar value of the country's external debt.

Measured in rands, the country's foreign debt increased from R279,0 billion at the end of 2000 to R380,6 billion at the end of 2001. The ratio of total external debt to gross domestic product still declined from 28,8 per cent at the end of 2000 to

27,8 per cent at the end of 2001. This ratio had been 41,4 per cent at the end of 1985. The ratio of total foreign debt to total export earnings fell from 94,8 per cent at the end of 2000 to 84,6 per cent at the end of 2001.

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

	1997	1998	1999	2000	2001
Renegotiated debt	2,5	2,3	1,5	0,8	–
Other foreign-currency denominated debt	22,7	22,6	22,4	24,1	24,0
Bearer bonds	4,0	4,3	4,8	5,5	6,0
Converted long-term loans	1,3	0,8	0,4	0,2	0,1
Public sector	4,2	3,6	3,2	3,8	3,0
Monetary sector	7,5	8,8	8,2	8,3	8,9
Non-monetary private sector	5,7	5,1	5,8	6,3	6,0
Total foreign-currency denominated debt	25,2	24,9	23,9	24,9	24,0
Rand-denominated debt	14,0	12,5	15,0	12,0	7,4
Bonds	10,6	8,3	10,7	8,3	4,9
Other	3,4	4,2	4,3	3,7	2,5
Total foreign debt	39,2	37,4	38,9	36,9	31,4

Foreign reserves

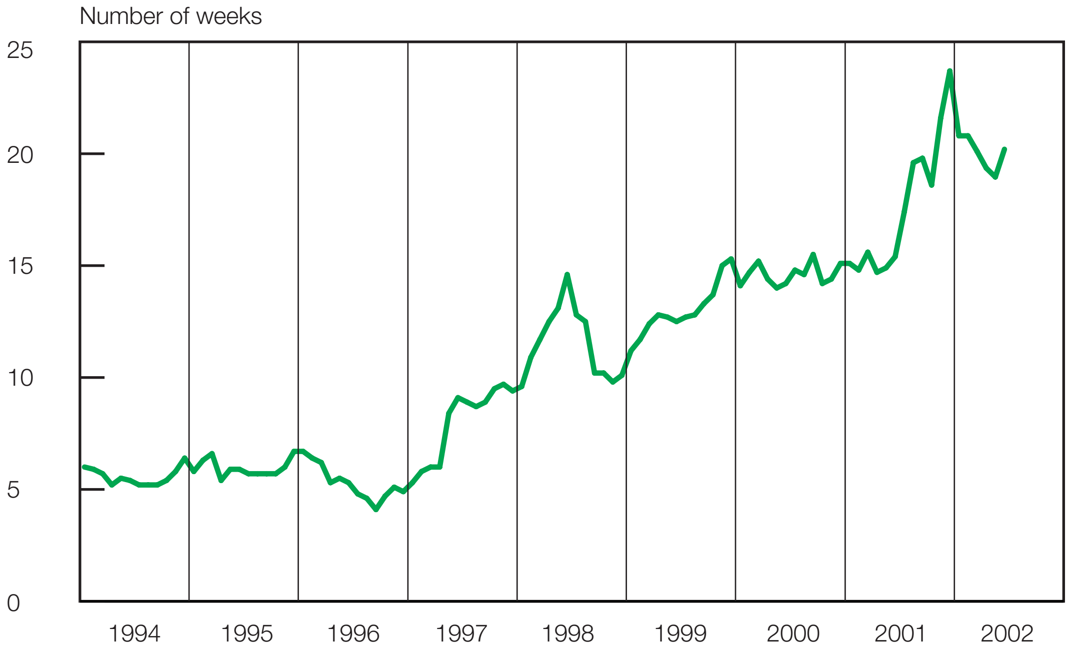
South Africa's net international reserves which had increased by R5,1 billion in 2000, improved further by R5,2 billion from the end of 2000 to the end of 2001. The surplus on the financial account of the balance of payments was only partly offset by a small deficit on the current account in 2001. In the first half of 2002, the sizeable surplus on the financial account together with the surplus on the current account contributed towards another increase of R37,5 billion in the country's net gold and other foreign reserves.

The country's gross gold and other foreign reserves increased from US$11,1 billion at the end of December 2000 to US$12,4 billion at the end of December 2001 and US$14,6 billion at the end of June 2002. Valued at the contemporaneous exchange rate of the rand, the gross gold and other foreign-exchange reserves rose from R84,2 billion at the end of December 2000 to R150,7 billion at the end of December 2001 – an increase of 79 per cent.

Owing to the strengthening in the exchange rate of the rand, the gross gold and other foreign reserves showed limited variation in the first half of 2002 and amounted in rand terms to R151,6 billion at the end of June 2002. Import cover (calculated as gross international reserves relative to the value of imports of goods and services) improved from 15 weeks' worth at the end of 2000 to 24 weeks at the end of 2001, but fell back to 20 weeks at the end of June 2002.

Most of the foreign-currency inflow to the Reserve Bank in 2001 was employed for reducing the Bank's oversold forward position in foreign currency. As a result, the Bank's net open position in foreign currency (NOFP) declined from US$9,5 billion at the end of 2000 to US$4,8 billion at the end of 2001 and US$1,8 billion at the end of June 2002.

Imports covered by reserves



Foreign-currency resources utilised for reducing the NOFP originated mainly from

- a eurobond loan of €500 million by the national government;
- part of the proceeds from the buy-out of minority shareholders in the De Beers Diamond Corporation;
- proceeds of ¥90 billion from government's bond issues in the Samurai market;
- the drawdown of a US$1,5 billion syndicated foreign loan facility by the Reserve Bank which was later transferred to the National Treasury;
- the reopening of an existing dollar bond by the South African government which raised US$274 million; and
- the issuing of a US$1,0 billion bond by the National Treasury in the international capital markets.

On 14 October 2001, the Reserve Bank announced that it would in future reduce the net open position in foreign currency only by utilising the cash proceeds of government's offshore borrowing and the privatisation of parastatal corporations, instead of purchasing foreign exchange in the market.

Exchange rates

Movements in the exchange rate of the rand that were mostly unrelated to macroeconomic conditions in the country characterised the market for foreign currency during 2001. Driven primarily by concern among international investors about developments in emerging-market economies around the world, the nominal effective exchange rate of the rand declined by 34,4 per cent from the end of 2000 to the end of 2001, before recovering quite markedly in the first half of 2002.

The exchange rate of the rand still held up well in the first half of 2001 and on 30 June was just 0,2 per cent down from its effective value on 31 December 2000. The healthy overall state of the balance of payments probably contributed most to the relative stability of the rand in the first half of 2001.

Exchange rates of the rand
Percentage change

	31 Dec 2000 to 30 Jun 2001	30 Jun 2001 to 31 Dec 2001	31 Dec 2001 to 28 Jun 2002
Weighted average*	-0,2	-34,3	8,4
Euro	2,9	-36,1	3,8
US dollar	-6,2	-33,3	16,5
British pound	-0,5	-35,3	10,3
Japanese yen	1,8	-29,5	5,7

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

In the second half of 2001 the rand depreciated unexpectedly and quite dramatically – by 33,3 per cent against the US dollar from 30 June 2001 to 31 December 2001 and by 34,3 per cent on a trade-weighted basis. Initially the weakness of the rand was mainly linked to the contagion effects of a highly volatile political situation in Zimbabwe, fears of debt default and other financial stability problems in emerging-market economies such as Argentina and Turkey, alleged delays with the privatisation of certain parastatal companies in South Africa and a protracted strike in the car manufacturing industry. Later the explanations for the decline in the value of the rand became more closely linked to macroeconomic phenomena and rational market behaviour as expectations of further declines in the exchange rate increasingly became a self-fulfilling prophecy.

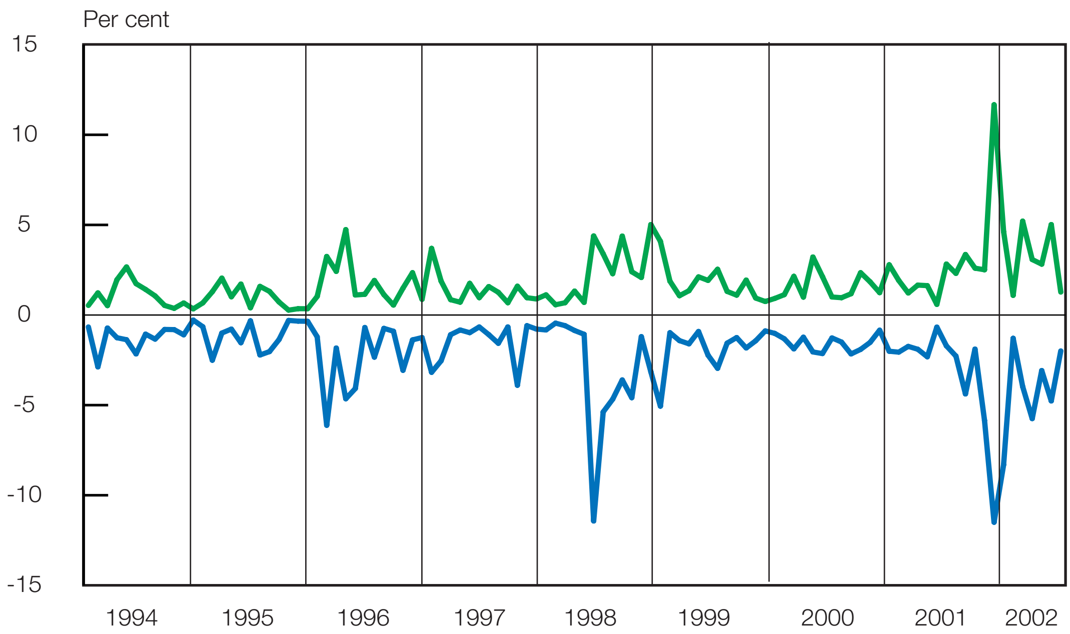
During the fourth quarter of 2001 evidence began to accumulate that the current account of the balance of payments could be heading for a deficit by the end of the year. At the same time the attacks on America in September 2001 caused a steep decline in global equity markets, a heightened risk aversion to emerging markets and a “flight to quality” as asset fund managers withdrew funds from what they regarded as vulnerable economies to safe havens, such as US dollar-denominated assets. This movement of capital increased the demand for dollars in the domestic currency market and, together with the emerging deficit on the current account of the balance of payments, put downward pressure on the exchange value of the rand.

These downward pressures were probably aggravated by exporters who delayed the repatriation of their foreign-currency export earnings for as long as they possibly could. They did this in anticipation of further declines in the value of the rand so that they would benefit from increases in the rand value of export proceeds. At the same time, advance payments were made for imports to avoid paying more in rand terms for imported goods which are mostly priced in US dollars.

The volatile behaviour of the rand in the domestic market for foreign exchange was reflected in increases in the deviation of the daily exchange rates from their monthly averages, especially in December 2001 (see accompanying graph). Also, the net average daily turnover in the domestic market for foreign exchange declined from US$10,1 billion in the first half of 2001 to US$9,2 billion in the second half. In November 2001 the average daily turnover for the month fell to US$7,6 billion.

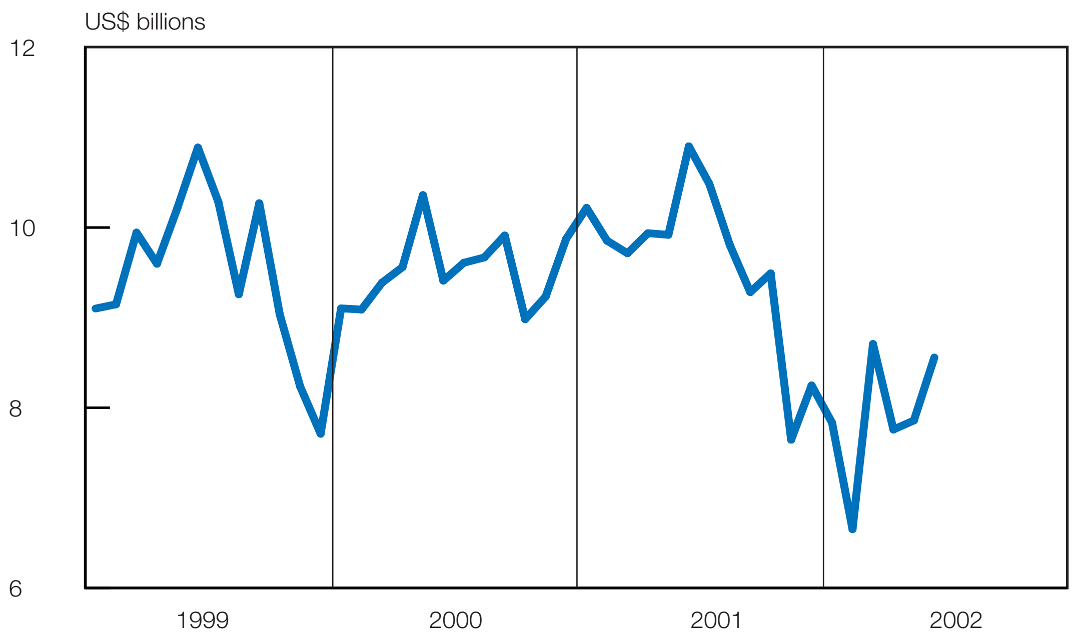
Some commentators allege that the decline in turnover in the market contributed to the weakness of the rand and that the lower turnover could be traced back to a statement issued by the Reserve Bank on 14 October 2001. Prior to 14 October 2001, the Bank had become concerned about comments from certain institutions

Exchange rate volatility



Minimum and maximum deviation of nominal effective exchange rate from monthly average

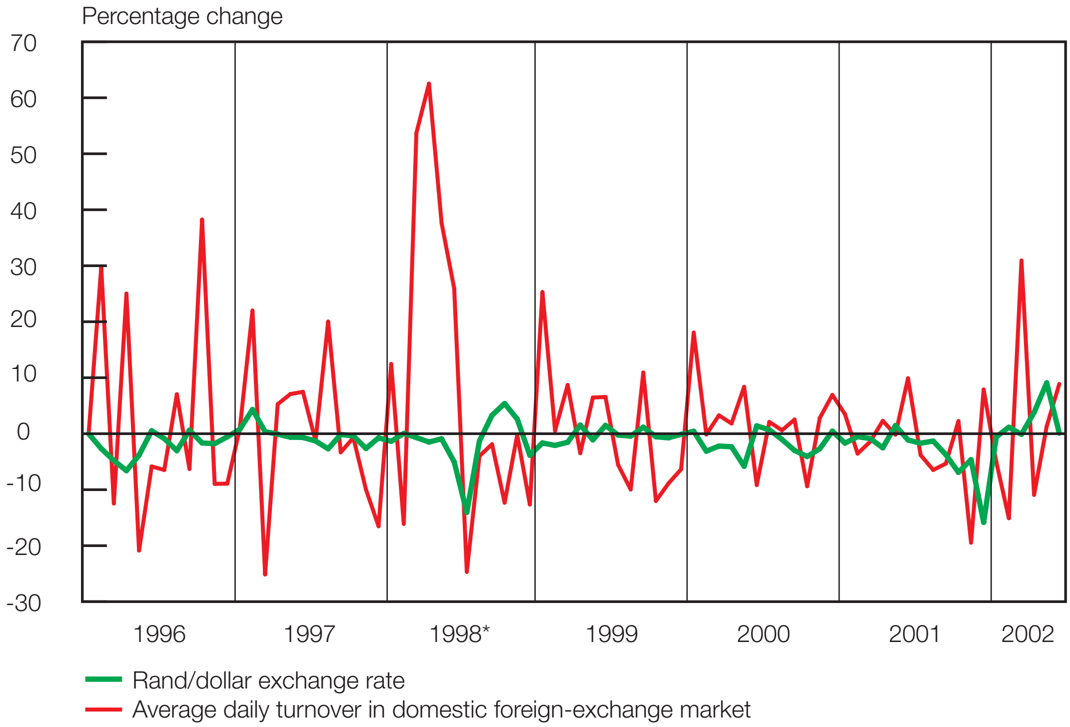
Average net turnover in the South African foreign-exchange market



that specific transactions by non-residents were adding to volatility and rand weakness. The decision was then taken and conveyed to authorised dealers in foreign exchange on 14 October 2001 that the Bank would take appropriate steps against trading activities that were not compatible with exchange controls. Some confusion arose as market participants interpreted the intentions of the Bank differently. This could have contributed to a decline in turnover in the market, but it is hard to contend that there is a systematic causal relationship between changes in turnover in the market for foreign exchange and the movements in the exchange rate of the rand (see accompanying graph).

The steep depreciation in the exchange value of the rand in the fourth quarter of 2001 received extensive media coverage. This, together with allegations of improper conduct by some participants in the market and the conclusion that certain transactions were of a dubious nature, led to the appointment of the presidential "*Commission of Inquiry into the rapid depreciation of the exchange rate of the rand and related matters*". The commission, chaired by Advocate J Myburgh, submitted an interim report to the President on 30 April 2002. The interim report merely summarised the evidence presented to the commission, but did not make any findings or recommendations. A final report and a minority report were publicly released on 1 August 2002. The commission could find no evidence of specific transactions which might have contributed to the rapid depreciation of the rand in 2001.

Exchange rate and turnover in the foreign-exchange market



* Inconsistency in turnover data series due to change in survey methodology in March 1998

On 21 December 2001 the Governor of the Reserve Bank and the Minister of Finance issued a joint statement to allay the anxieties of market participants and to re-emphasise the positive economic fundamentals of the country. This, together with the announcement of the appointment of the commission of inquiry to investigate the reasons for the fall in the value of the rand, helped to stabilise the currency in the final days of December 2001 and throughout the first half of 2002. In fact, the effective exchange value of the rand strengthened by 8,4 per cent from the end of December 2001 to 30 June 2002.

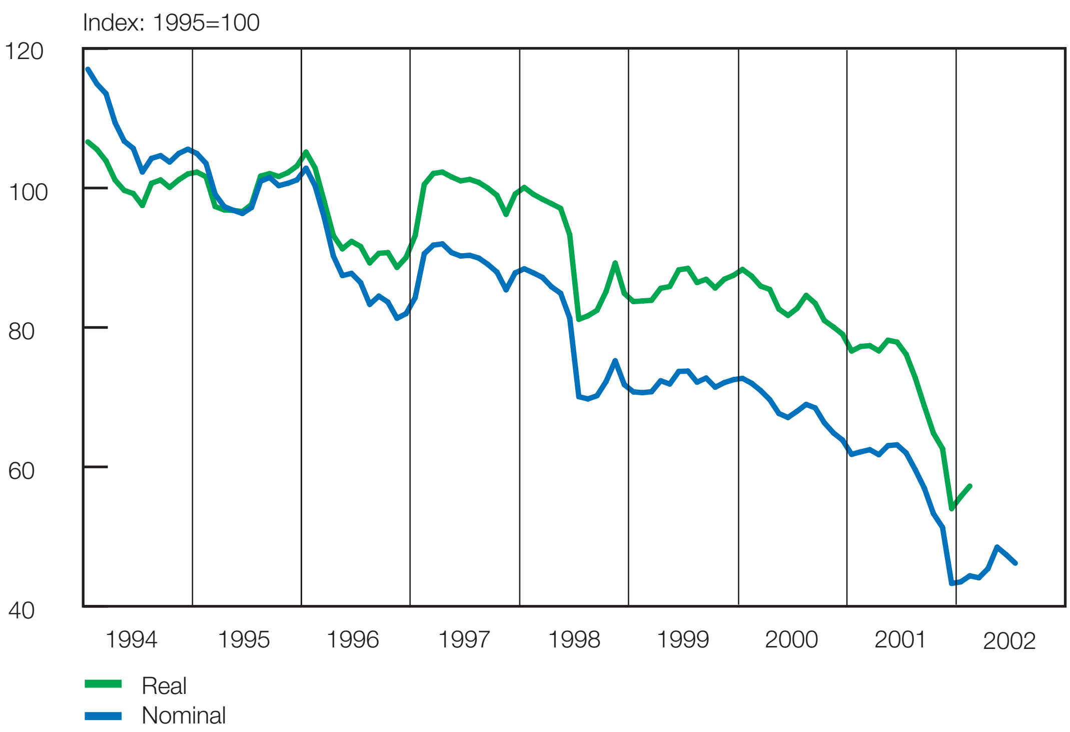
Other factors of a more fundamental nature probably assisted the recovery in the exchange rate of the rand. They were

- the surplus on the current account of the balance of payments in the first half of 2002;

- the inflow of capital into the country in the first half of 2002;
- a rise in international commodity prices since the beginning of 2002;
- the recovery in the global economy and the prospects for continued export growth from South Africa;
- the attractive yields offered by domestic fixed interest securities; and
- the belief that the current rise in inflation is only temporary and would be brought under control speedily by highly credible macroeconomic policies.

The resulting strength in the external value of the rand was reinforced by the speedier repatriation of export proceeds as more and more market participants came to expect a further appreciation in the value of the rand. Simultaneously, rational behaviour on the part of importers seemed to have been to delay payment on their import commitments for as long as they possibly could.

Effective exchange rates of the rand



The decline in the external value of the rand was not without its benefits. Of particular significance is that exporters become more price competitive in global markets. The gain in price competitiveness during 2001 was approximated by a decline of 13,9 per cent in the average inflation-adjusted effective exchange rate of the rand from 2000 to 2001. During 2000 producers for the export market had already gained some 3 per cent in competitiveness. It remains a major policy challenge to prevent these gains from being eroded by persistent increases in the aggregate price level in South Africa.

Monetary developments and interest rates

Structural and regulatory issues

The slowdown in global economic activity, uncertainty about the strength of the economic recovery after the September 11 attacks on America, and volatility in financial asset prices and the exchange rate of the rand proved a severe test for the resilience of South Africa's financial system over the past eighteen months. During this time, the ability of banks to withstand external shocks was formally strengthened when the minimum required capital ratio of banks was raised from 8 per cent of risk-weighted assets to 10 per cent in October 2001. Of a total of 52 banks, 46 currently comply with the new requirements, and the rest are phasing in their programmes with the consent of the Registrar of Banks.

A number of banks encountered setbacks such as large withdrawals of deposits during the past year. In some instances these problems were seen as insurmountable, with the result that two banks were placed under curatorship. Contagion effects, or the contamination of apparently healthy banks by the problems of others, were experienced by some of the remaining smaller banks. This contagion called for special provision of liquidity assistance, and in the case of BoE Bank the issuance of an explicit guarantee by the authorities to allay the anxieties of deposit holders. Two banking institutions (Saambou Bank and BoE Bank) were eventually acquired by other banks and some smaller banks decided to deregister. This stabilised the banking system but simultaneously increased the degree of asset concentration. Prior to the acquisitions, 75 per cent of the total assets of the banking sector were held by the five major banks. After the acquisitions this percentage is likely to rise to about 82 per cent.

The South African banking system was to some degree insulated from the effects of the volatile movements of the exchange rate of the rand during the past year. This was essentially a result of the requirement that a bank's net open position in foreign currency should be limited to less than 10 per cent of its net qualifying capital and reserves. This measure effectively limits the potential losses that a bank may suffer on account of fluctuations in the exchange rate of the rand.

Some banks were disappointed by the poor quality of the assets acquired through their microlending activities, and a number of institutions linked to banks and active in this area were forced to exit the market. But the banks still continued to expand and modernise their range of services to clients. Internet banking, for example, helped many bank clients to economise on their use of cheques and to transfer funds between various accounts far more efficiently than before.

The aggregate scale of the banking system's operations is shown in the accompanying table.

Selected statistics on bank activities*

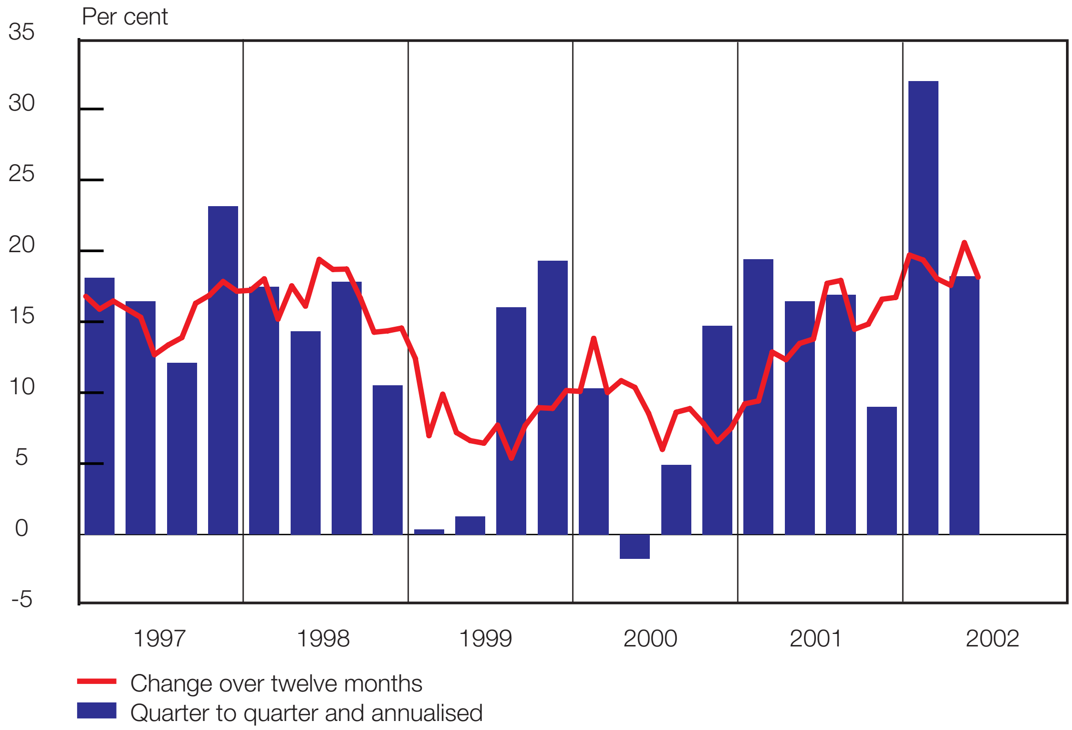
	Number
Employees	123 000
Branches and agencies	10 900
Cash-dispensing automated teller machines	7 900
Card swipe machines at points of sale	157 000
	Number (millions)
Deposit accounts, current accounts excluded	16,4
Current accounts with credit balances	3,4
Overdrawn current accounts	1,0
Mortgage advances	1,9
Instalment sale advances	1,1
Leasing advances	0,3
Credit cards	5,3

* Based partly on surveys conducted at the beginning of 2002
Source: Registrar of Banks and South African Reserve Bank

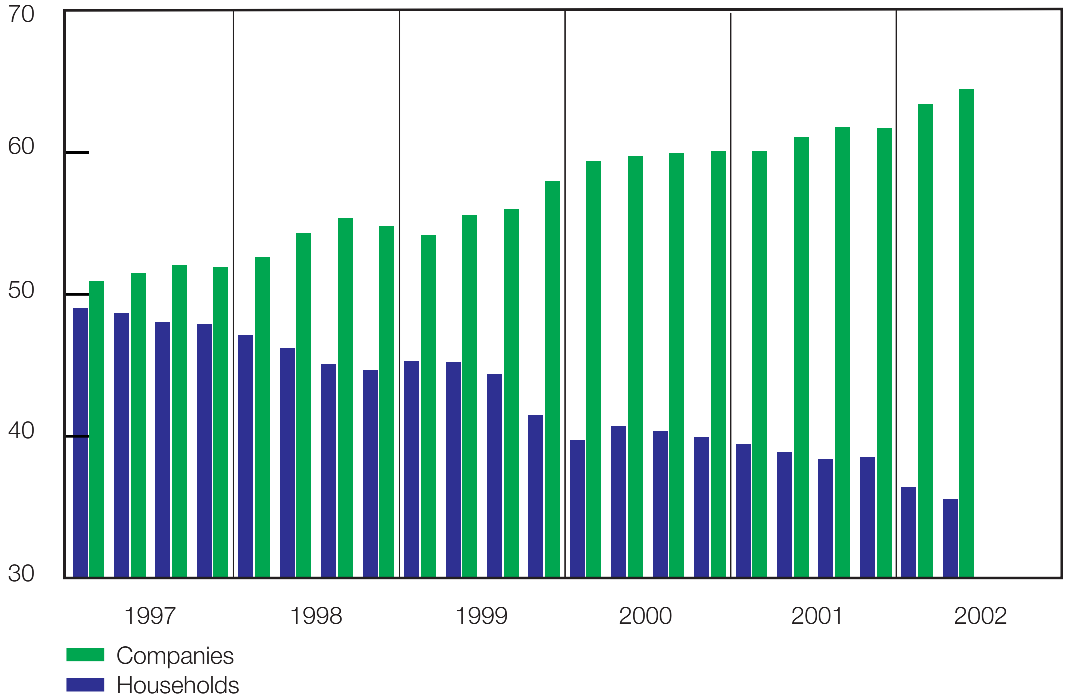
Money supply

The growth in the *broadly defined money supply* (M3) accelerated considerably over the past eighteen months. The effects of the decline in the value of the rand in the second half of 2001 fuelled the growth in M3 to year-on-year rates that exceeded 20 per cent at times. This strong growth in the broad monetary aggregate over the past six quarters was concentrated in the bank deposits of the private corporate sector as opposed to the household sector.

M3 money supply



Deposits as percentage of M3



As the money supply in South Africa is largely determined by aggregate demand in the economy, the relative buoyancy of nominal gross domestic income and expenditure contributed to the strong growth in M3 during the past six quarters. The influence of generally rising prices has also played a prominent role since the fourth quarter of 2001. Other factors contributing to the high growth rate in M3 were

- the withdrawal of the foreign asset-swap mechanism in the first quarter of 2001, which limited the opportunities for offshore portfolio diversification;

- the large inflow of funds from the rest of the world in the third quarter of 2001, resulting from the restructuring of the corporate relationship between the Anglo American Corporation and the De Beers mining company;

- the volatility of share-price movements and the associated risk of losses on equity investments, leading to an increased demand for depository-type assets;

- the heightened precautionary and speculative demand for money that was prompted by uncertainty arising from the worldwide recessionary economic conditions, the September 11 attacks on America, concerns about the credibility of corporate financial statements, and reservations about global financial stability following the problems of Argentina, Brazil and Turkey;

- uncertainty about the future changes in the exchange rate of the rand during the last quarter of 2001 and the first quarter of 2002, adding momentum to an already strong preference for liquid assets; and

- the relatively more attractive yields on bank deposits following increases in short-term interest rates in the first half of 2002.

In the first half of 2001 the growth in M3 occurred mainly in long-term deposits, which are more akin to a vehicle for saving funds. This changed quite abruptly in July 2001 when the inflow of foreign funds into the economy, following the restructuring of the corporate relationship between the Anglo American Corporation and the De Beers mining company, was mainly diverted towards short-term and medium-term deposits. In the ensuing months to March 2002, the preference for short-term and medium-term deposits continued to predominate, with the accumulation of long-term deposits languishing somewhat. However, in the three months to June 2002, long-term deposits rebounded strongly as investors tied in higher interest rates on their deposits.

In the year to June 2002 the deposits held by the corporate sector accounted for 85 per cent of the overall increase in M3 deposits. This could have reflected a lingering uncertainty, especially among financial companies, about the strength and sustainability of the economic recovery and the prospects for continued growth in asset values. The corporate sector could also no longer diversify portfolios through the application of the foreign-asset swap mechanism. By contrast, households could still increase their foreign-asset holdings in terms of the exchange control dispensation which allows taxpayers in good standing to transfer capital of up to R750 000 offshore. This negatively affected their deposits with the domestic banks. Households' increased access to interbank facilities and more flexible loan arrangements also enabled them to offset debit against credit balances, substantially compressing their holdings of bank credit balances.

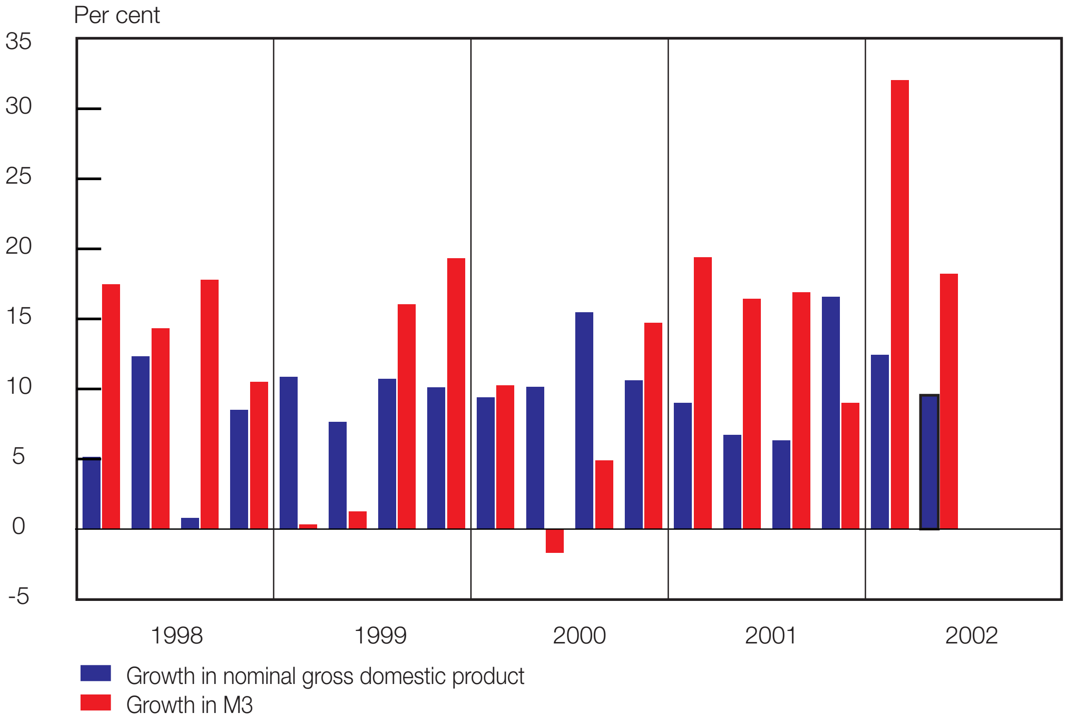
The seasonally adjusted annualised growth in M3 (see accompanying table) slowed down from rates of 19,4 per cent in the first quarter of 2001 to 8,9 per cent in the fourth quarter, but accelerated rapidly to 32,0 per cent in the first quarter of 2002 – the highest quarterly growth rate on record – and 18,2 per cent in the second quarter. Measured over periods of twelve months, the growth in M3 accelerated from 9,2 per cent in January 2001 to a peak for the year of 17,9 per cent in August before slowing down to around 15 per cent in September and October. From November 2001 the year-on-year growth in M3 accelerated sharply, jumping to 20,6 per cent in May 2002 when the relative strength of the rand encouraged exporters to speed up the repatriation of export proceeds to the economy, whereas importers preferred to delay payment for as long as possible. These leads and lags in foreign payments and receipts bolstered growth in the deposit liabilities of domestic banking institutions. Growth over one year in M3 later declined slightly to 18,1 per cent in June 2002.

Change in monetary aggregates
Per cent at seasonally adjusted annualised rates

Period		M1A	M1	M2	M3
2001:	1st qr	9,5	18,8	21,0	19,4
	2nd qr	7,9	18,7	11,3	16,5
	3rd qr	27,3	10,5	9,8	16,9
	4th qr	27,0	8,2	9,0	8,9
2002:	1st qr	14,4	54,2	40,2	32,0
	2nd qr	16,2	21,8	15,4	18,2

The quarter-to-quarter annualised growth in M3 exceeded growth in the nominal gross domestic product by margins ranging from 9,7 per cent to 10,5 percentage points in the first three quarters of 2001. These relative growth rates were reversed

Growth in M3 and nominal gross domestic product

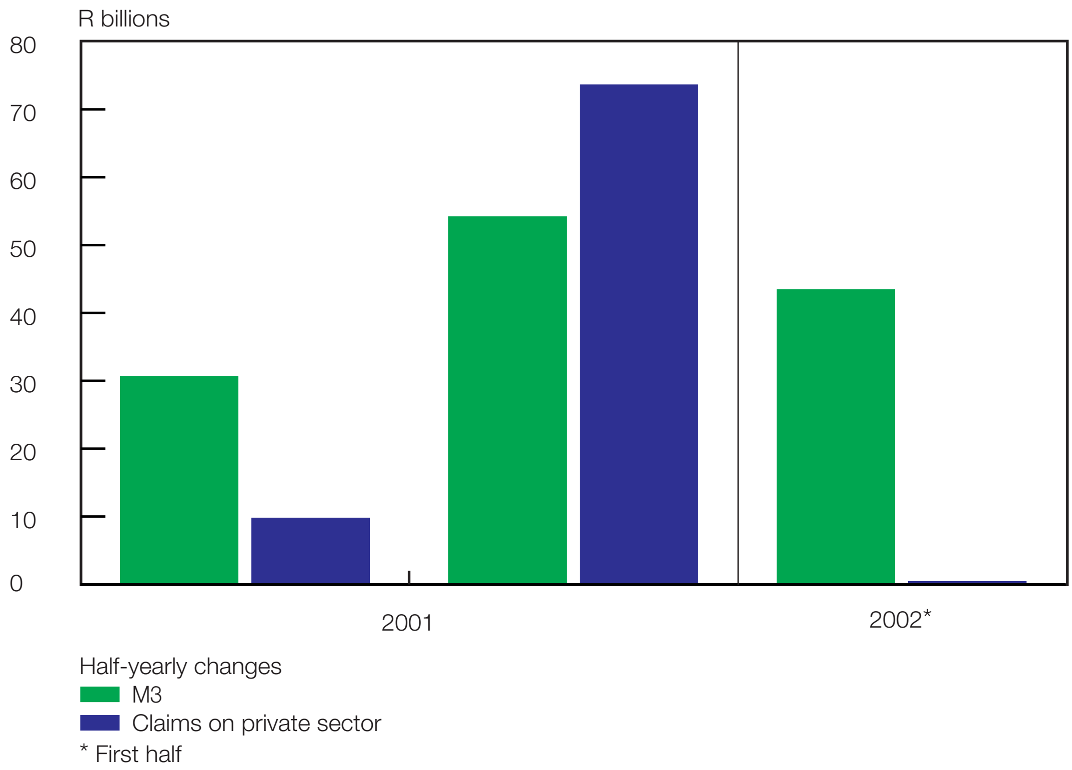


in the fourth quarter of 2001 when growth in the nominal gross domestic product exceeded growth in M3 by 7,6 percentage points. This reversal of growth rates was only temporary and in the first quarter of 2002, growth in M3 once again outpaced growth in the nominal gross domestic product by 19,6 percentage points and by 9,6 percentage points in the second quarter.

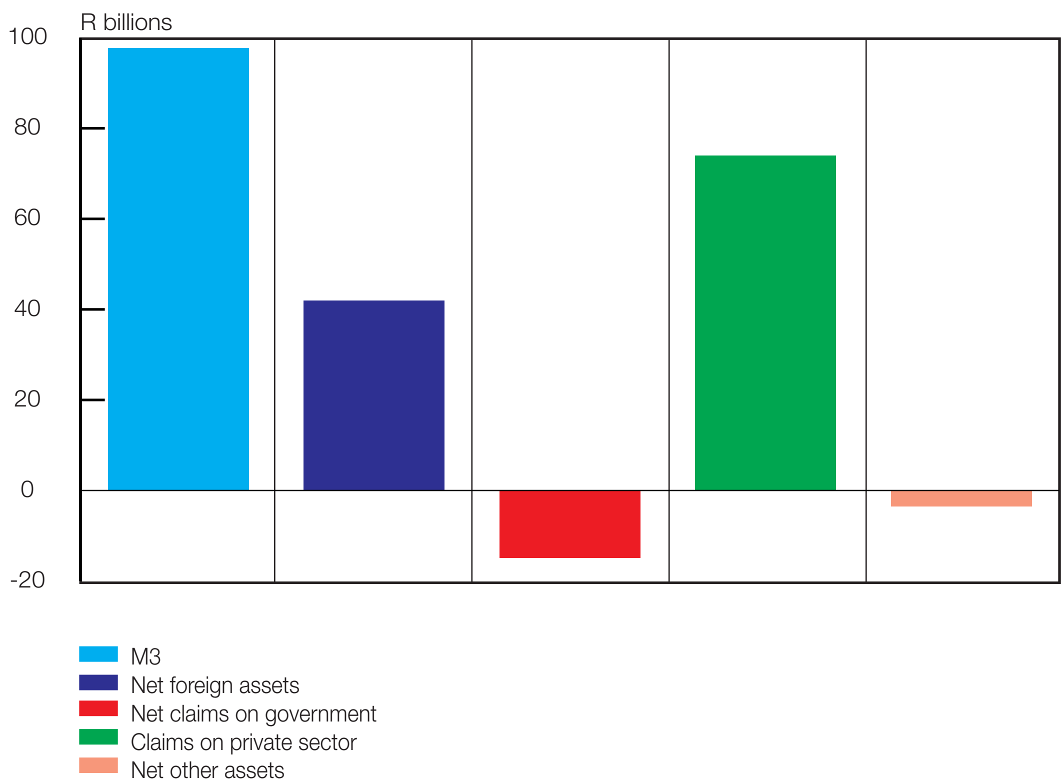
The income velocity of M3 fell from 1,84 in the first quarter of 2001 to 1,72 in the first quarter of 2002 and 1,68 in the second quarter – the lowest level recorded since 1971. The high value of the stock of money relative to the size of the economy is sometimes interpreted as an excess quantity of spending power that can easily spill over into actual spending, with serious consequences for inflation. An alternative view holds that M3 balances could be kept over protracted periods for income, precautionary or investment purposes without fuelling aggregate expenditure. The more or less continuous decline in velocity since 1994, unaccompanied by rising inflation, could be seen as evidence that M3 balances were employed more as an investment vehicle than as a temporary cache for spending power.

From the end of June 2001 to the end of June 2002 the M3 money supply increased by R97,7 billion. The main counterpart, in a statistical or accounting sense, of this increase was the claims of banks on the domestic private sector which increased by R73,9 billion over the same period. With such a wide disparity between growth in bank funding – as portrayed by the rise in banks' deposit liabilities – and growth in banks' dominant asset class – as portrayed by banks' extension of credit to the private sector – banks had ample resources available to step up their holdings of other assets. Their preferred action was to accumulate net foreign assets to the amount of R42 billion over the past four quarters. Net claims on the government sector and "net other assets" were not accumulated to any significant extent over this period – in fact, they declined by a total of R14,8 billion.

M3 and claims on private sector



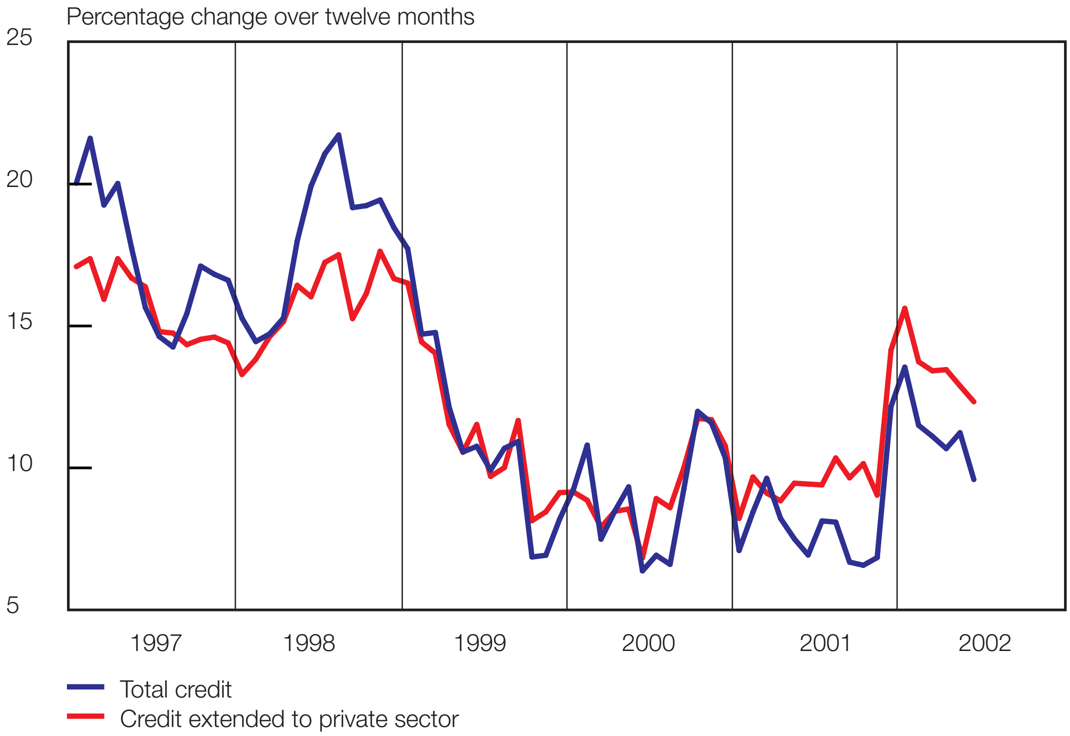
Changes in M3 and accounting counterparts: June 2001 to June 2002



Credit extension

Total domestic credit extension (i.e. credit extended to the non-bank private sector and net claims on the government sector) increased by R59,1 billion in the twelve months to June 2002, following an increase of R40,0 billion in the twelve months to June 2001. Credit to the private sector expanded by R73,9 billion in the twelve months to June 2002, significantly more than the increase of R51,7 billion in the year to June 2001.

Total credit extended and credit extended to private sector by monetary institutions



Net credit extended by banks to the government sector declined by R11,7 billion in the twelve months to June 2001 and by R14,8 billion in the twelve months to June 2002. The decline in banks' extension of credit to the government sector over the past twelve months reflects two aspects of public finances. One was government's preference for foreign borrowing than for funding in the domestic market, which effectively reduced the supply of investable instruments in the domestic market for fixed-interest securities. There was also a strong accumulation of government deposits at private-sector banks as government prepared for major interest payments on public debt and the redemption of debt falling due later in the fiscal year.

Measured as a percentage change over one year, growth in bank credit extension to the domestic private sector accelerated from a low of 8,2 per cent in January 2001 to 10,4 per cent in August and 14,2 per cent in December. The stronger demand for credit by private-sector entities towards the end of 2001 was, among other things, explained by the decline in the value of the rand, which encouraged both exporters and importers to borrow in the domestic credit market.

In January 2002, growth over one year in credit extended to the private sector accelerated even further to a three-year high of 15,6 per cent. This was partly a consequence of the very low base value for year-on-year growth calculations in January 2001 when a new reporting format for banks was implemented. In the months following January 2002, credit extension to the private sector moderated noticeably and the year-on-year growth tapered off to 13,5 per cent in March and 12,3 per cent in June. Measured from quarter to quarter, the annualised growth in bank credit extension to the private sector fell back from 19,3 per cent in the fourth quarter of 2001 to 1,9 per cent in the second quarter of 2002. The reversal of the leads and lags in foreign payments and receipts from the last quarter of 2001 to the second quarter of 2002 contributed significantly to this slowdown in domestic credit extension to the private sector.

Increase in credit extension to the private sector by type of credit

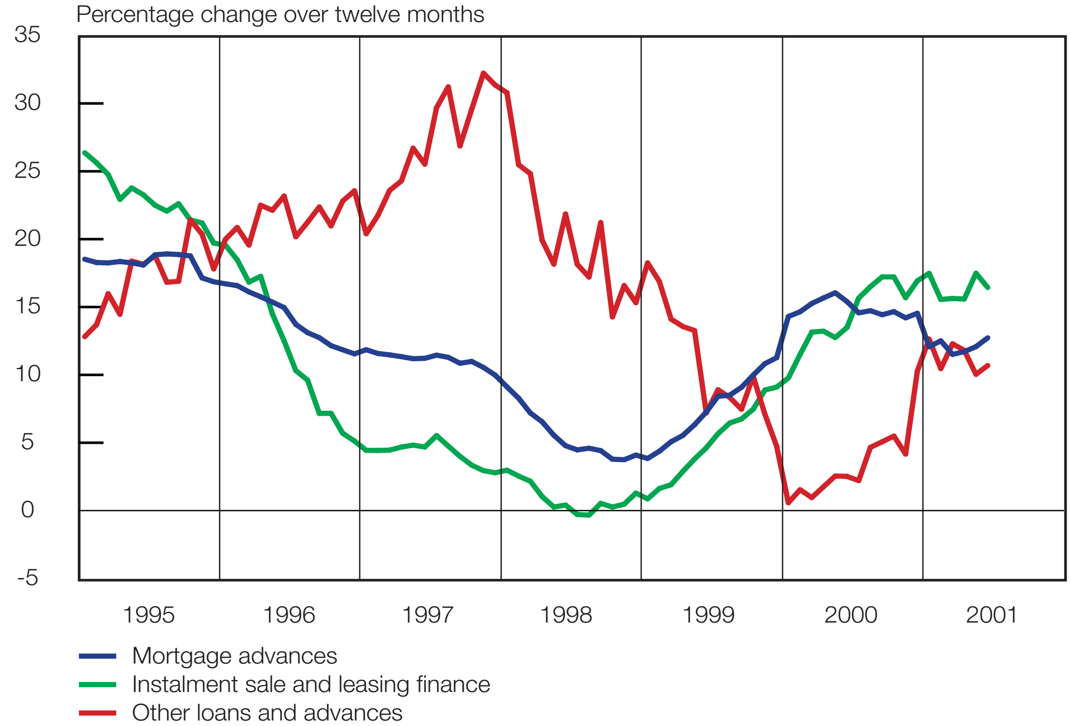
Year-on-year percentage changes

Period		Investments and bills discounted	Instalment sale and leasing finance	Mortgages	Other loans and advances	Total
2001:	Jun	9,1	13,5	15,4	2,5	9,4
	Jul	10,9	15,7	14,6	2,2	9,4
	Aug	7,1	16,5	14,7	4,7	10,3
	Sep	-4,1	17,2	14,4	5,1	9,7
	Oct	-0,8	17,2	14,7	5,5	10,2
	Nov	-2,7	15,7	14,2	4,2	9,0
	Dec	27,2	16,9	14,5	10,3	14,2
2002:	Jan	55,0	17,5	12,1	12,6	15,6
	Feb	37,5	15,6	12,5	10,5	13,7
	Mar	28,7	15,6	11,5	12,3	13,5
	Apr	32,5	15,6	11,7	11,8	13,5
	May	26,3	17,5	12,1	10,0	12,9
	Jun	10,2	16,4	12,7	10,7	12,3

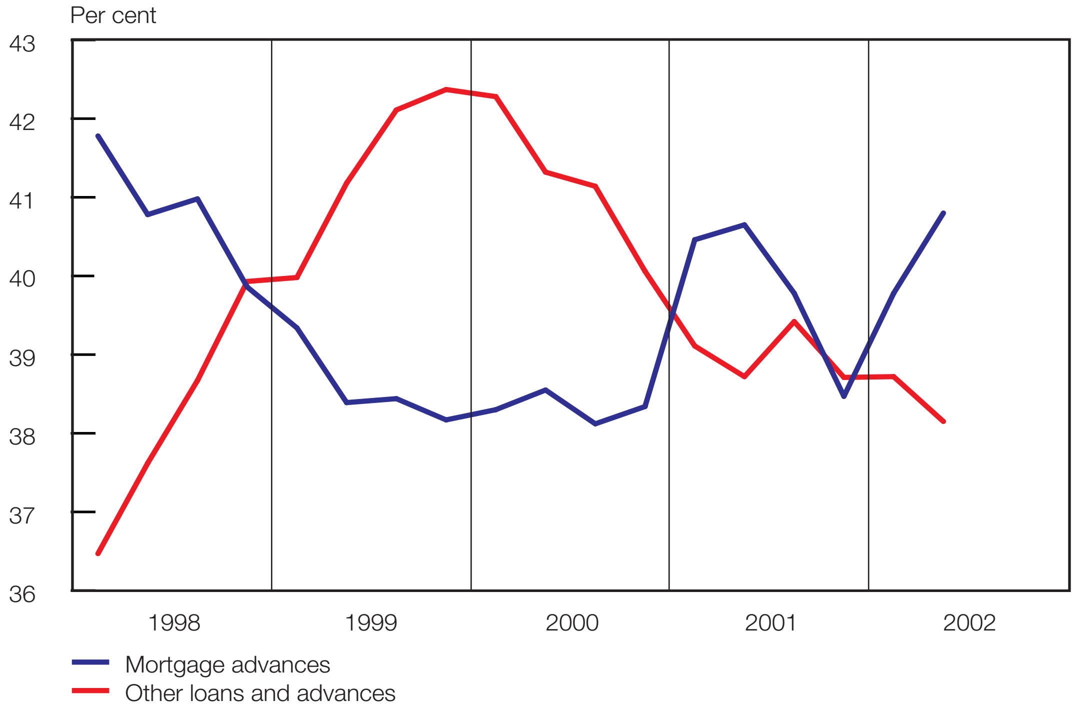
An analysis of banks' claims on the private sector shows that the *mortgage advances* of banks grew at high year-on-year rates varying from 14,2 per cent to 16,1 per cent throughout 2001. It was only from the beginning of 2002 that the rise in home mortgage interest rates caused the year-on-year growth in mortgage advances to start petering out – initially falling to 11,5 per cent in March before edging upwards again to 12,7 per cent in June. The solid growth in mortgage advances in recent years reflected the more affordable cost of mortgage financing and the higher level of activity in the real-estate market. Despite the recent slower growth in mortgage advances by banks, this type of credit still contributed 42 per cent to the overall increase in banks' claims on the private sector in the year to June 2002.

Fully consistent with the stronger demand for durable consumer goods, the growth in *instalment sale credit and leasing finance* gained momentum throughout 2001, accelerating from a year-on-year rate of 9,8 per cent in January to 17,2 per cent in September and 16,9 per cent in December. This type of credit extension grew even faster at a year-on-year rate of 17,5 per cent in January 2002 but in the ensuing months, growth in the supply of instalment sale credit and leasing finance slowed down somewhat to a year-on-year rate of 15,6 per cent in the three months from February to April and 16,4 per cent in the year to June 2002.

Credit extended to private sector by type of credit



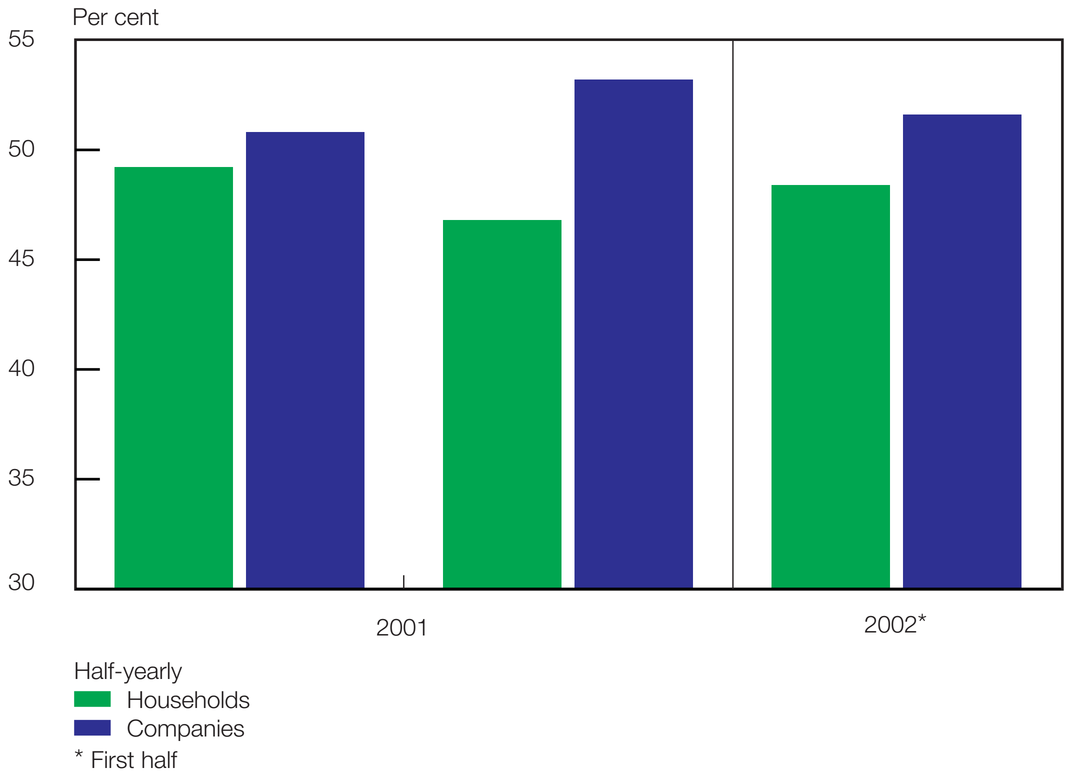
Contribution of mortgages and other loans and advances to claims on private sector



The percentage change over twelve months in banks' *"other loans and advances"* – i.e. bank credit extension which is not linked to the acquisition of an asset by the debtor – fluctuated between 0,6 per cent and 5,5 per cent for most of 2001, but accelerated rapidly to 10,3 per cent in December when leads and lags in the receipts and payments of external trade transactions overwhelmingly influenced the demand for this type of bank credit. Strong demand for credit by companies generally underpinned the brisk pace of growth in “other loans and advances” made by banks during 2001. This continued in the first half of 2002 when growth in “other loans and advances” granted by banks grew at a year-on-year rate of 12,3 per cent in March and 10,7 per cent in June, and the share of “other loans and advances” in the overall stock of outstanding bank claims on the private sector settled down at an average level of 38,2 per cent.

The corporate sector accounted for the greater part of the demand for private-sector credit in the second half of 2001 when credit extension was strongly influenced by the decline in the external value of the rand. These developments were largely reversed in the first half of 2002 when the household sector absorbed the bulk of the increase in bank credit extension to private-sector entities. This turnaround was probably related to the increase in the exchange value of the rand and the switching of the leads and lags in foreign payments and receipts. As a consequence, the accumulated value of credit extended to the household sector relative to total credit extended to the private sector picked up from 46,8 per cent at the end of 2001 to 48,4 per cent at the end of the second quarter of 2002.

Composition of banks' claims on private sector



Interest rates and yields

Observed inflation generally slowed down and inflation expectations improved appreciably during the first three quarters of 2001. Under such positive circumstances the Monetary Policy Committee of the Reserve Bank decided to lower the Bank's repurchase rate by 100 basis points on 15 June 2001 and by 50 basis points on 21 September.

Between these two reductions in the repurchase rate, there was also a once-only administrative reduction of 100 basis points on 5 September 2001. This was intended as a step to narrow the differential between the Bank's repurchase rate and other borrowing rates prevailing in the interbank market for overnight cash. In total, the repurchase rate of the Bank came down by 250 basis points during 2001 and was fixed at a level of 9,50 per cent at the end of the year.

Mounting inflationary pressures in the last quarter of 2001 and in the first half of 2002 convinced the Monetary Policy Committee to reverse the downward movement in the repurchase rate. The committee increased the repurchase rate on three occasions during the first half of 2002: on 16 January from 9,50 per cent to 10,50 per cent; on 15 March from 10,50 per cent to 11,50 per cent; and on 14 June from 11,50 per cent to 12,50 per cent. In motivating these decisions the committee emphasised that the sharp decline in the exchange value of the rand in the last quarter of 2001 and higher international petroleum prices had negatively influenced inflation expectations, and that the attainment of the inflation target in 2002 and 2003 could be at risk.

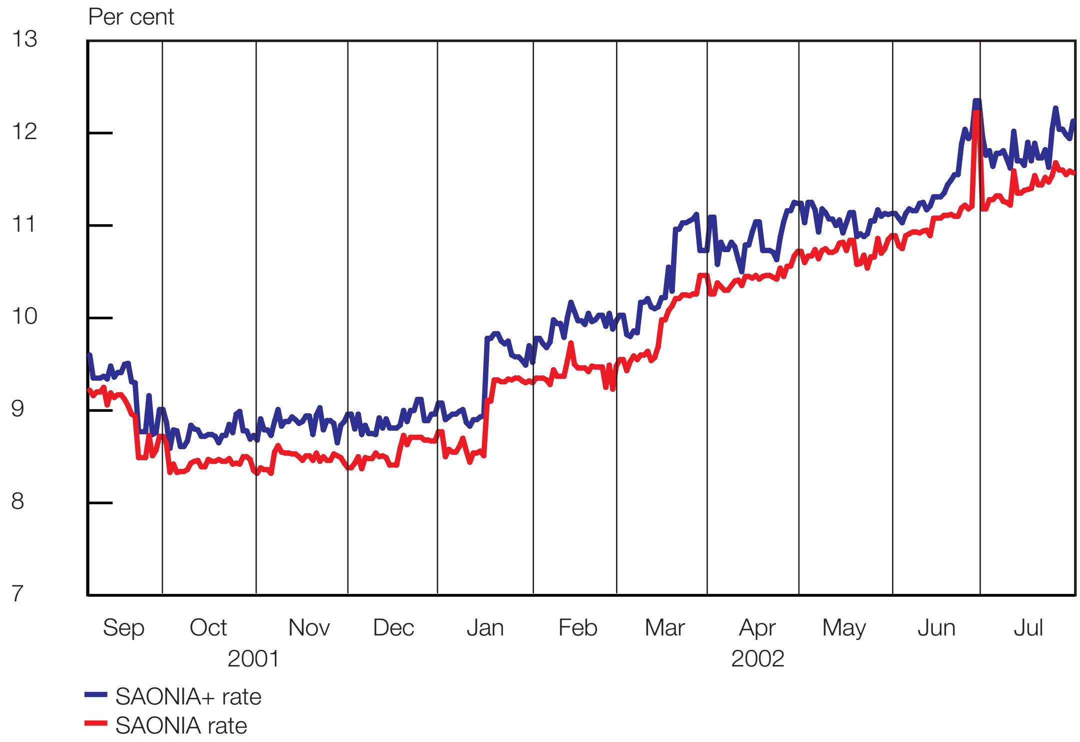
Consistent with the objective of making money-market interest rates more responsive to changes in liquidity conditions, the Reserve Bank started calculating from 5 September 2001 a South African Overnight Interbank Average (SAONIA) rate which serves as a benchmark for money-market interest rates. Later, on 2 April 2002, some changes were made to improve the usefulness of the SAONIA rate as an indicator of money-market conditions, and an amended weighted average rate was calculated.

The revised SAONIA rate now comprises the average rate on unsecured interbank funding at market rates only, i.e. interbank overnight funding obtained in terms of special arrangements among banks at the prevailing Reserve Bank repurchase rate is no longer taken into account. The overnight SAONIA rate was renamed the SAONIA+ rate and it still represents a weighted average of funding at both the repurchase rate and the other overnight rates that private-sector banks agreed to.

Since their inception, the SAONIA and the SAONIA+ rate have moved in close proximity to each other and both displayed limited volatility. Relatively minor fluctuations in the rates usually occur shortly before the start of a new maintenance period when the minimum reserve requirements of the banking system are under review, and occasionally on or close to the last trading day of the month.

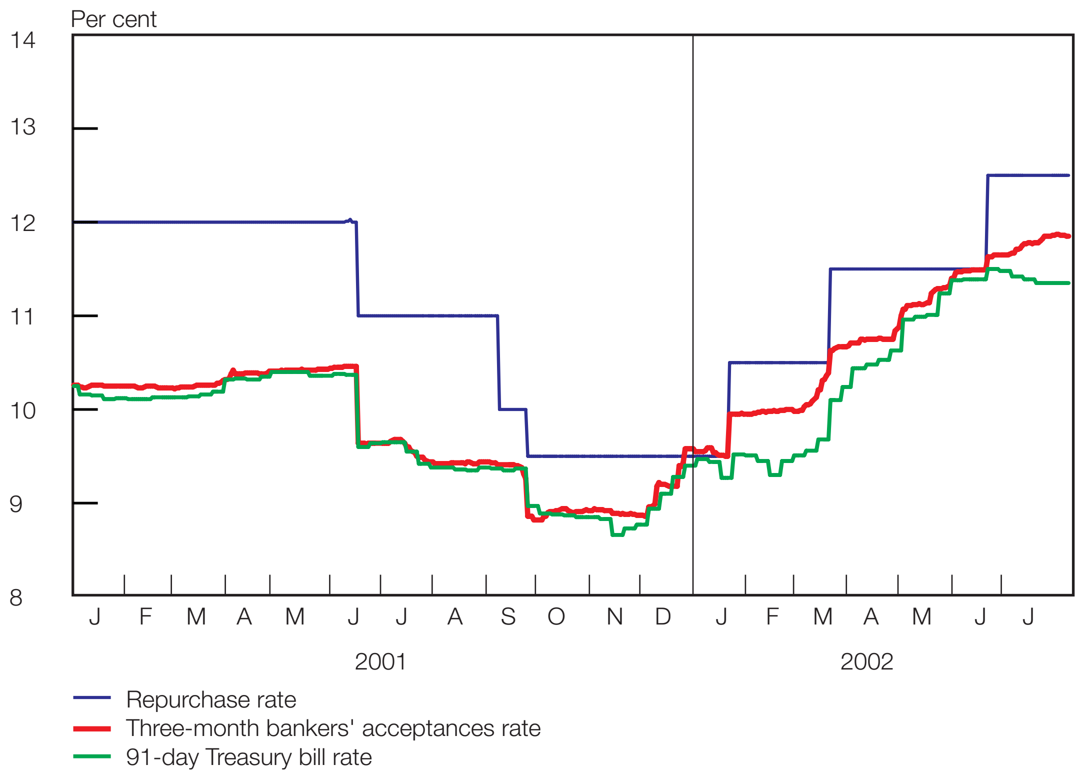
On 5 September 2001 the SAONIA rate stood at 9,22 per cent and then drifted downwards to a low of 8,32 per cent on 31 October. As liquidity conditions tightened in the ensuing months, and expectations of an imminent tightening in monetary policy emerged, the SAONIA rate gradually shifted higher. After the Reserve Bank had increased the repurchase rate in March 2002, the SAONIA rate rose through the 10 per cent mark, and after the increase in June, it rose beyond 11 per cent. The SAONIA rate briefly breached 12 per cent on 28 June 2002 when some private-sector banks had to access the accommodation facilities of the Reserve Bank through the final clearing mechanism, but during July 2002 this rate had fallen back to within a range from 11,18 per cent to 11,68 per cent.

SAONIA and SAONIA+ rates



Broadly following the changes in the Reserve Bank's repurchase rate, other money-market rates declined during the first nine months of 2001. For example, the rate on three-month bankers' acceptances declined by 144 basis points from 10,26 per cent on 2 January 2001 to 8,82 per cent on 29 September. In November 2001, money-

Money-market interest rates



market rates changed direction and began to rise, pre-empting a tightening in monetary conditions, which was expected to follow on the heels of worsening inflation expectations. The rate on three-month bankers' acceptances eventually increased to a level of 11,87 per cent late in July 2002. The rate on 91-day Treasury bills roughly emulated the behaviour of the three-month bankers' acceptances rate: generally declining from 10,25 per cent on 4 January 2001 to a lower turning point of 8,66 per cent on 15 November, but increasing again to 11,50 per cent on 14 June 2002.

Forward rate agreements (FRAs) also generally moved in sympathy with the Reserve Bank's repurchase rate and declined during most of 2001, even though the general downward movement was interrupted from time to time by short-lived increases. But the general movement in the 9x12-month FRAs made a decisive turnabout in November 2001 when the exchange rate of the rand was under severe downward pressure and expectations were rife that monetary policy would be tightened.

The 9x12-month FRA rate increased to 12,70 per cent on 20 December 2001, having been at 8,42 per cent on 13 November. Since then the 9x12-month FRA rate has been highly volatile, falling back to 9,85 per cent on 8 January 2002 but peaking again at 12,97 per cent on 27 March. During the second quarter of 2002 the 9x12-month FRA rate steadily drifted down, signalling market expectations of potentially lower money-market interest rates later. The increase in the Reserve Bank's repurchase rate in June 2002 was seemingly fully discounted by the market and the FRA rate consequently showed little variation in the aftermath of this tightening of monetary conditions.

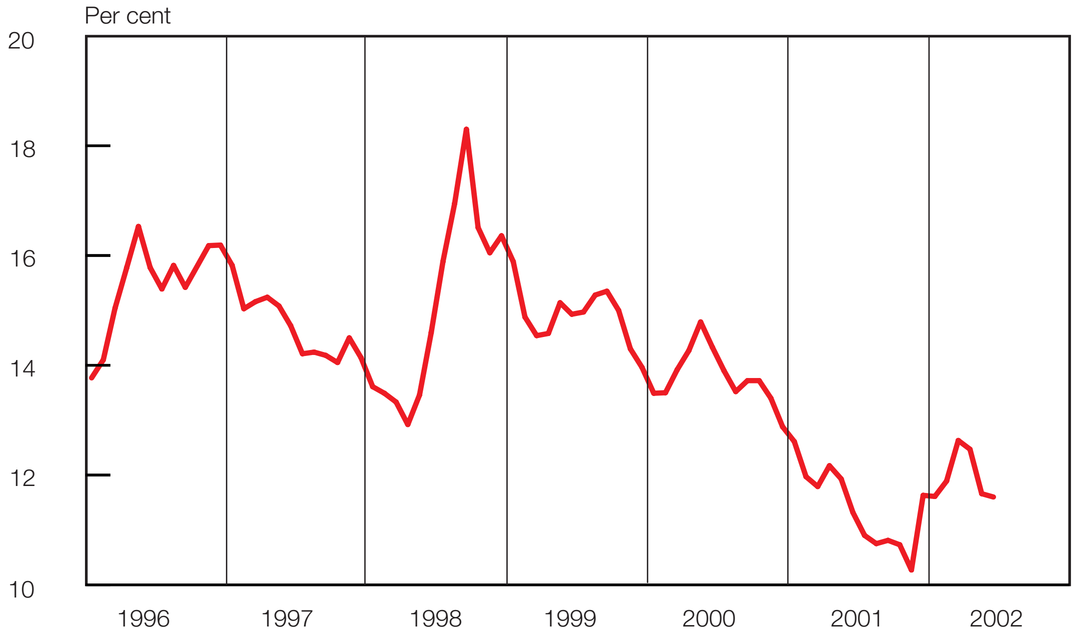
Forward rate agreements: 9x12 months

In the market for long-term fixed-interest securities, the bull run following in the wake of the international financial crises of 1997 and 1998 was unexpectedly interrupted towards the end of 2001. The monthly average *yield on long-term government bonds* declined by 800 basis points from 18,3 per cent in September 1998 to 10,3 per cent in November 2001 when it reached its lowest level since August 1980.

During this phase of declining yields the market was strongly influenced by declining inflation and by a growing awareness of the strong commitment of the South African authorities to low and stable inflation. Lower inflation was widely expected by the investor community and by the general public. The sudden depreciation of the rand in December 2001 completely changed the outlook for inflation. From then on, bond yield movements became more sensitive to changes in the exchange rate of the rand and the implications these changes held for future inflation in the South African economy.

When the exchange rate of the rand declined so rapidly in December 2001, bond yields reacted almost instantaneously and the monthly average yield on long-term government bonds rose to 12,6 per cent in March 2002 – a rise of 230 basis points from November 2001. More tranquil trading conditions returned to the market during the second quarter of 2002 as the exchange value of the rand stabilised and even strengthened somewhat. Non-resident investors returned to the market as net buyers of bonds and this, together with a relative shortage of investable securities, pushed bond yields lower. The average level of yields was 11,2 per cent in July 2002 – still substantially higher than the average level in November 2001.

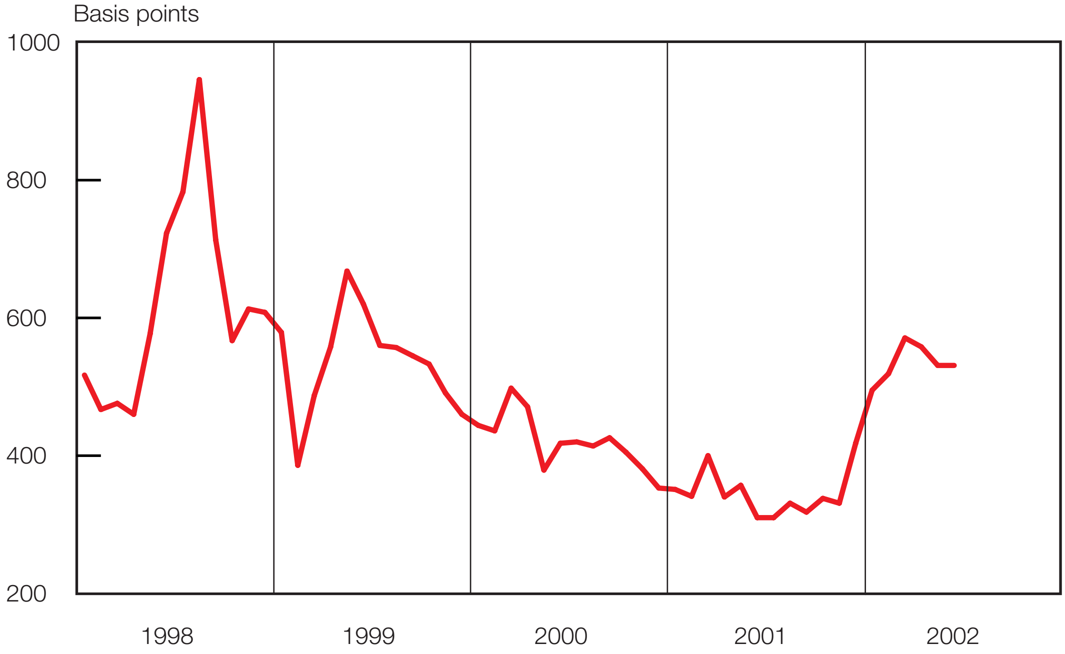
Nominal yield on long-term government bonds



Because of the sharp fall in bond prices in the domestic market, the *currency risk premium* embedded in South African government bond yields (measured as the spread between the nominal yield in the domestic market and the United States market) increased by some 240 basis points from November 2001 to March 2002. This currency risk premium shrank somewhat in the second quarter of 2002, but still exceeded the average risk premium of 2000 and 2001 by a sizeable margin.

There was a serious deterioration in the outlook for inflation of most bond-market participants in the first few months of 2002. Inflation expectations in the bond market are reflected by changes in the *break-even inflation rate* which is calculated as the difference between the nominal yield on conventional bonds and the real yield

Currency risk premium on South African government bonds



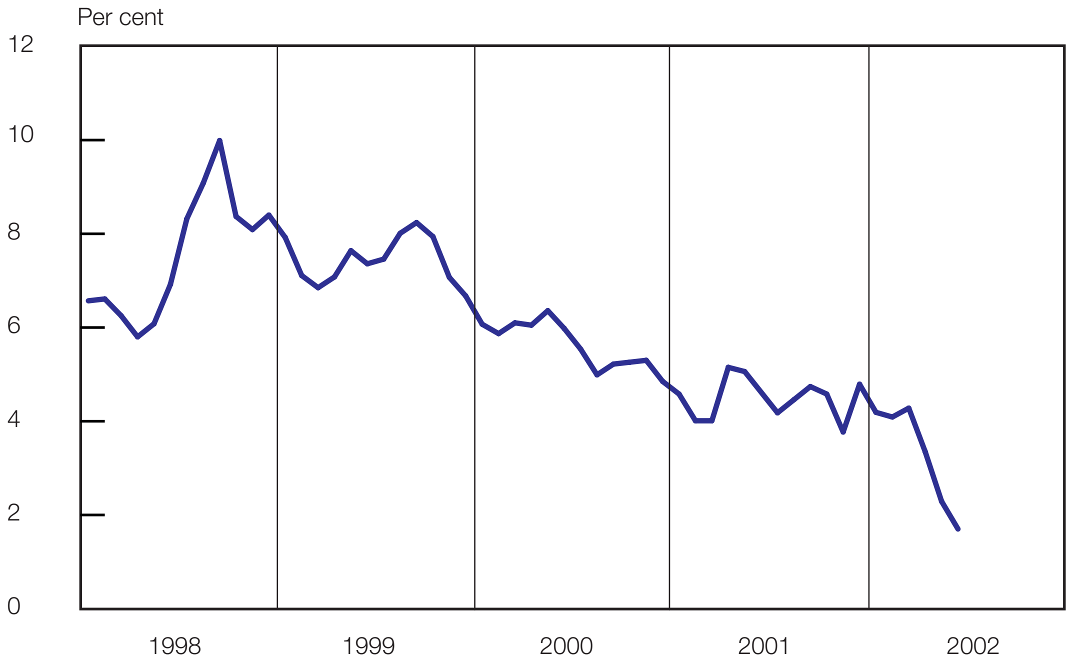
on inflation-linked bonds. According to this measure, expected inflation declined by 3,06 percentage points from May 2000 to November 2001, but picked up by 3,20 percentage points from November 2001 to April 2002. As market participants became convinced of the authorities' resolve to contain inflation, the break-even inflation rate declined noticeably in May and June 2002.

Inflation expectations in the bond market

Difference between nominal yield on conventional and real yield on inflation-linked bonds

The monthly average *inflation-adjusted* or *real yield* on long-term government bonds declined sharply in the second quarter of 2002, probably signalling the market's view that the current acceleration in year-on-year inflation was a temporary phenomenon and that it might dissipate in the near term. Real yields, using historical price increases as an indicator of expected inflation, declined steadily from 10,0 per cent in September 1998 to 3,8 per cent in November 2001 and 4,8 per cent in December, but then plunged to 1,7 per cent in June 2002 as actually measured inflation accelerated. If market participants had been convinced that inflation had permanently moved to a higher plane, nominal yields probably would have risen higher in order to reflect the higher level of expected inflation.

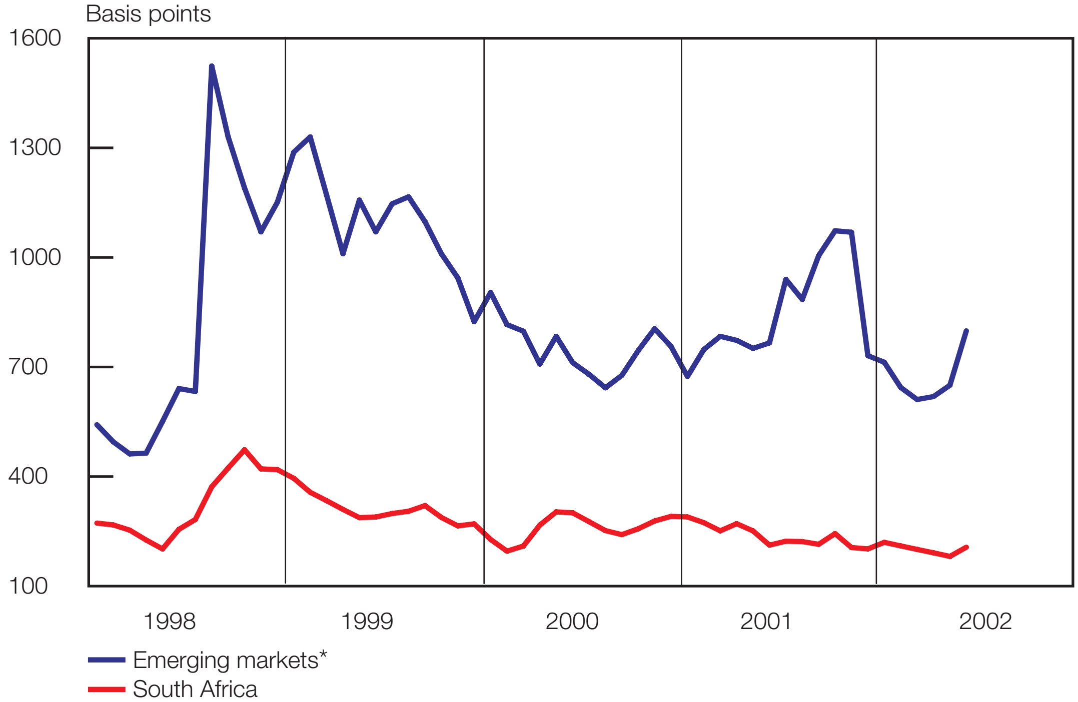
Inflation-adjusted yield on long-term government bonds



South Africa's foreign-currency denominated bonds that trade in international bond markets are currently rated considerably higher than those issued by governments of other emerging-market economies. The *sovereign risk premium* on the 10-year bond issued by the South African government in the North American capital market was 207 basis points at the end of June 2002, i.e. the South African bonds were trading at yields that were 207 basis points higher than the yields on bonds of similar outstanding maturity issued by the United States Federal Government. The sovereign risk premium of emerging markets in general (measured by the JP Morgan Emerging Markets Bond Index or EMBI+) was indicated at 799 basis points at the end of June 2002. South Africa's risk premium was also markedly less volatile during 2001 and the first half of 2002 than that of the other emerging-market economies.

The level and shape of the *yield curve* changed quite drastically during the past year. The yield curve was at its lowest level on 28 November 2001 and was also mildly upward sloping over the full maturity spectrum. The events in the foreign-exchange market in December 2001 pushed the curve higher, but with the yields on longer-term bonds responding far more aggressively than the yields on shorter-term bonds, the gradient of the curve steepened noticeably. When the Reserve Bank embarked

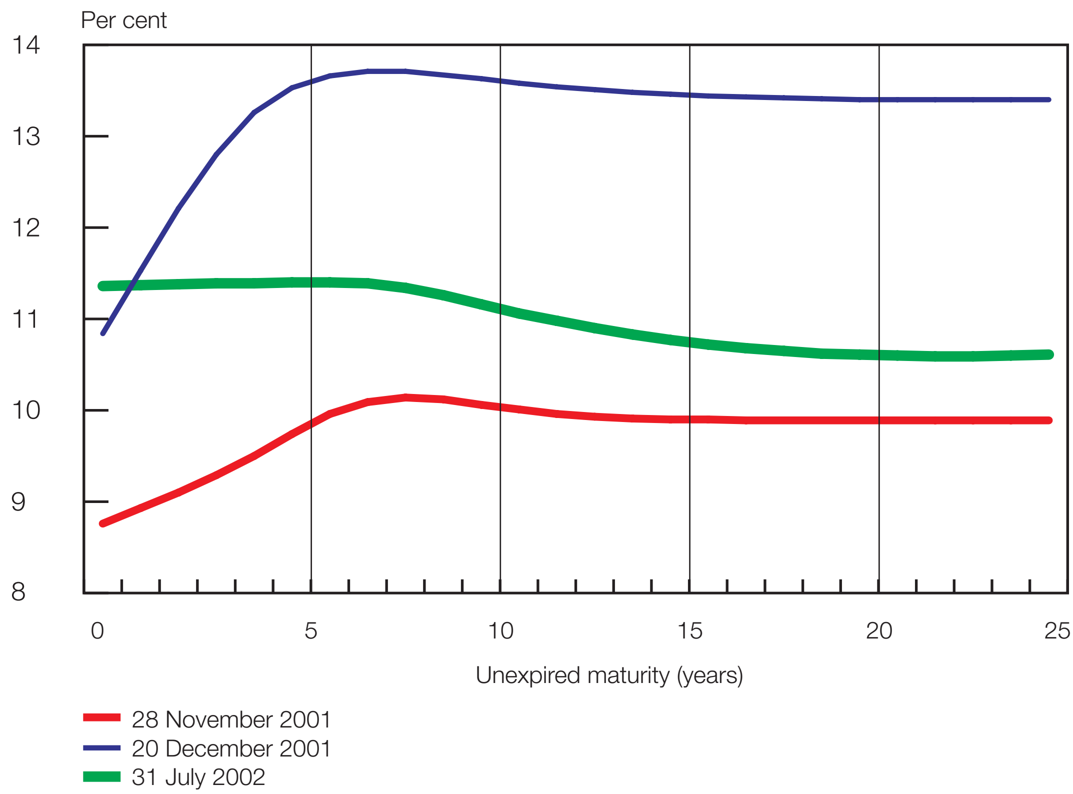
Sovereign risk premiums



* Source: JP Morgan EMBI+

on its policy of monetary tightening, long-term yields declined against the backdrop of more sanguine inflationary expectations whereas yields at the short end of the curve moved higher. Towards the end of July 2002 the yield curve had a rather flat shape with a slightly inverted inclination, probably reflecting the conviction among

Yield curves

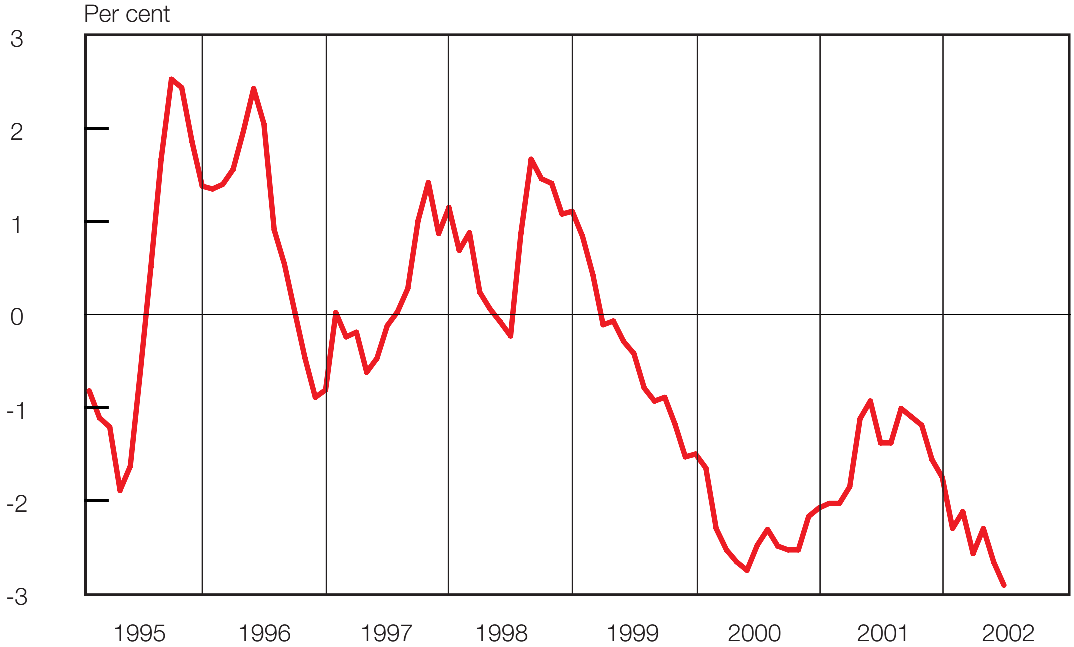


market participants that the current monetary policy stance would be adequate to keep general price increases in check.

The retail *lending and deposit rates* of private-sector banks broadly followed the changes in the repurchase rate of the Reserve Bank over the past year. The private-sector banks lowered the *predominant rate on mortgage loans* and the *prime overdraft rate* in three steps from 14,5 per cent in May 2001 to 13,0 per cent in September. This was the lowest level since 1988. Later these rates were raised in three steps to 16 per cent in June 2002, following the lead signalled by the Reserve Bank through upward adjustments in the repurchase rate.

The *predominant rate on twelve-month fixed deposits* was lowered from 9,5 per cent in May 2001 to 8,0 per cent in September, but was increased again from January 2002 to 11,0 per cent in June. The marginal after-tax real return on twelve-month fixed deposits for savers in the highest income bracket has been negative since March 1999. This return improved from a negative value of 2,8 per cent in May 2000 to a negative value of 0,9 per cent in May 2001, but deteriorated to a negative value of 2,9 per cent in June 2002 as the acceleration in inflation outpaced the rise in nominal returns. At this level, savers in the high income brackets had a substantial negative real after-tax return – i.e. savers were actually penalised for postponing spending.

Real after-tax return on 12-month fixed deposits



Financial markets

Globalisation, and structural and regulatory changes in financial markets

Globalisation, driven by the abolition of capital controls in many countries and technological and communications developments, continues to transform financial markets around the world. During the past year much progress has been made with promoting the international profile of the domestic financial markets by moving closer to international best practice. In the interest of capital accumulation, developments in the South African financial markets were aligned to global trends and directed at integration into the international financial markets.

Structural and regulatory changes aimed at enhancing efficiency and competitiveness, included
- broadening the range of tradable financial instruments;
- improving the financial market infrastructure;
- abolishing some taxes on financial transactions; and
- strengthening of regulatory and supervisory practices.

Securities and financial market regulation and *institutional arrangements* are continuously updated and modernised in line with international standards and trends. The *legislative programme* of the Financial Services Board for 2002, with the objective of strengthening regulation and supervision in the financial services sector, includes the following:

- The Collective Investment Schemes Control Bill, 2002, which regulates all types of collective investment schemes where assets are pooled on behalf of investors. (This Act will replace the Unit Trust Control Act, 1981, and the Participation Bond Act, 1981.)

- The Financial Advisory and Intermediary Services Bill, 2001, which provides for the authorisation of providers of advice and intermediary services, codes of conduct and other enforcement measures.

- The Securities Services Bill, 2001, 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, 2002, which provides for the recognition of voluntary ombudschemes and regulates situations where consumer complaints fall outside an ombud arrangement.

- The Financial Reporting Bill, 2002, which provides for the legal backing of financial reporting standards.

In the *share and derivatives markets*, the Johannesburg Securities Exchange South Africa (JSE) extended its *range of tradable financial instruments* and introduced internationally recognised *index products*. By combining equity, commodity and derivative products, an integrated multi-product exchange was established, after the JSE's acquisition of the South African Futures Exchange (SAFEX) in August 2001. In January 2002, the global index provider FTSE commenced the calculation and management of the FTSE/JSE Africa Index Series. This resulted in the official introduction of a market-related free-float index range on 24 June 2002. In February 2002, the JSE extended its range of exchange-traded funds with the introduction of tradable industrial and financial indices.

The diversity of *derivative instruments* traded on the JSE was broadened. In the warrants market the number of listed warrants increased from 380 in June 2001 to 653 in June 2002, while in the JSE Financial Derivatives Division the range of individual equity futures increased from 30 to 59 and the variety of futures and options on government bonds was extended to include the R186 and R194 bonds. The JSE Agricultural Products Division introduced soybean contracts in April 2002 and contracts for white and yellow maize of optional origin in July 2002.

The JSE progressed significantly in the area of *financial market infrastructure*. In August 2001, the implementation of the electronic settlement system called STRATE (Share Transactions Totally Electronic) evolved further with the introduction of automated corporate action processing which, among other things, facilitates the payment of dividends and eliminates market claims. Since October 2001, all new warrants have been issued electronically and settlement takes place through STRATE. By February 2002, the electronic settlement process was successfully implemented when all the JSE counters were migrated to STRATE. All JSE-listed share transactions are now settled and registered electronically. On 13 May 2002, the JSE, as part of its technology agreement with the London Stock Exchange (LSE), converted from the JET (Johannesburg Equity Trading System) to the JSE SETS (Securities Electronic Trading System) and introduced a new electronic system for information dissemination.

The increased sophistication and efficiency of the *bond market* were facilitated by the involvement of the Bond Exchange of South Africa (BESA), the National Treasury and corporate issuers. The Restructuring Project 2002 will give effect to the decision taken at the Annual General Meeting of BESA in October 2001 to

- unbundle and demutualise BESA so as to create a new corporate structure;
- provide a range of new products; and
- offer a wider range of services to a broader customer base.

The Bond Exchange of South Africa upgraded its Bond Automated Trading System (BATS) in December 2001 to facilitate the development of the strip bond market and to introduce new types of bonds. In January 2002, BESA reviewed its members' minimum capital-adequacy ratios in response to concerns about stability in the financial sector.

The increased sophistication of the bond market was reflected in the growing number and variety of securities and issuers. New *financial instrument listings* by the *corporate and public sector* include

- a corporate bond issued by a local company in the domestic market and guaranteed by a foreign parent company;
- an index-linked bond listed by a bank;
- an inflation-linked bond issued by a public corporation and secured by a guarantee given by the national government;
- a credit-linked note programme;

- mortgage-backed securities; and
- synthetic collateralised loan obligations.

The *National Treasury* introduced a STRIP (Separate Trading of Registered Interest and Principal of Securities) programme in January 2002 with the listing of national government strip bonds – i.e. separating a standard coupon-bearing bond into its constituent interest and principal components. These components may be held or traded separately as zero coupon instruments. In April 2002, government changed the weekly government bond auction system from a multi-price auction to a Dutch auction where all bidders receive the cut-off price. Government also issued their third inflation-linked bond, and commenced its programme to split the separate tranches of RSA bonds with different maturity intervals into new single-maturity bonds.

South Africa's investor base was enlarged in November 2001 when Moody's upgraded the local currency bond rating from Baa1 to an A2 investment grade.

The 2002 *Budget* contributed to the competitiveness and development of the financial sector by abolishing the following *financial transaction taxes*, with effect from 1 April 2002:
- Repurchase of warrants by their issuers.
- Issuance of listed debt instruments.
- Transfer of a mortgage bond from one institution to another.
- Various insurance policies or contracts and the cession of insurance policies.

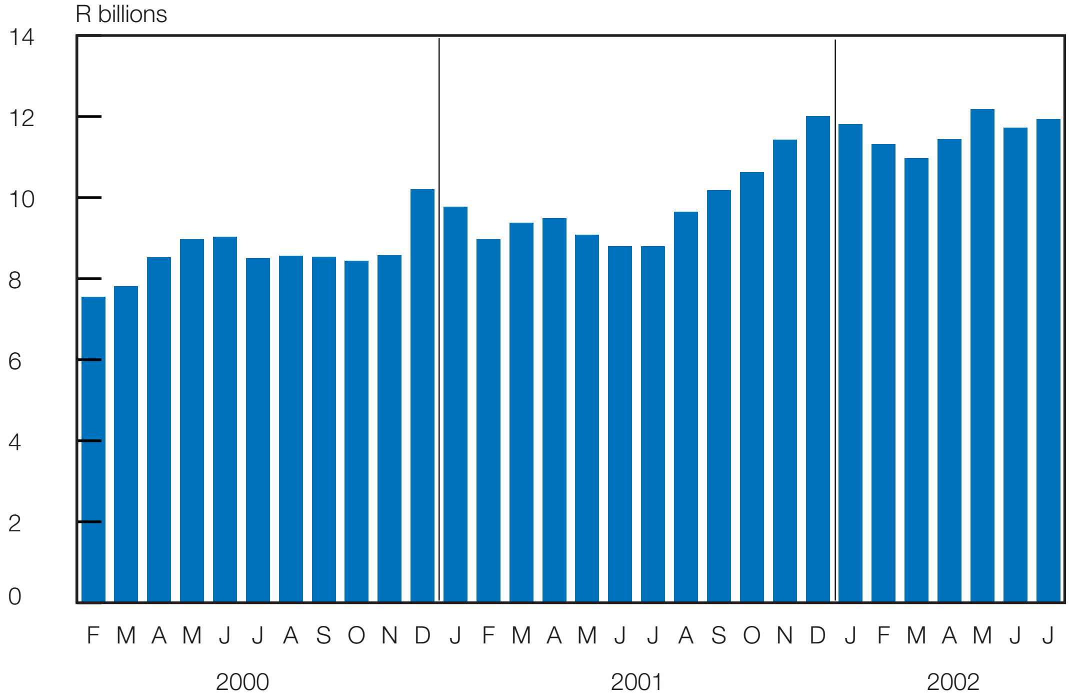
The Uncertificated Securities Tax (UST) and the Marketable Securities Tax (MST) were repealed to ensure that similar specifications apply to foreign and domestic issuers of warrants. This allowed for continued foreign participation and higher levels of liquidity in the domestic warrants market. The removal of stamp duty and UST on the issuing of listed debt instruments are expected to encourage the development of the corporate bond market by lowering the cost of raising finance in the primary bond market relative to the cost of finance arranged through other financial intermediaries.

Money market

Money-market conditions were relatively stable and fairly easy during the first eight months of 2001 but tightened considerably in subsequent months. The average daily liquidity requirement of private-sector banks varied between R8,7 billion and R9,8 billion in the months from January to August but then increased sharply to R12,0 billion in December. During the first quarter of 2002, conditions in the money market again eased somewhat, in part because of the liquidity assistance the Reserve Bank provided to certain banks when they encountered large-scale deposit withdrawals. This easing was reflected in a decline of the average daily liquidity requirement to R11,0 billion in March 2002. In the ensuing months liquidity conditions became less accommodative again and the average daily liquidity requirement of private-sector banks increased to R12,2 billion in May and R11,9 billion in July.

The Reserve Bank ensured the existence of an adequate daily liquidity requirement in 2001 and the first seven months of 2002 by actively implementing various intervention techniques. These were aimed at offsetting liquidity injections arising from the deficits sustained on forward foreign-exchange transactions by the Reserve Bank and, at times, flows arising from changes in the Bank's net foreign assets, and liquidity assistance provided to certain banks.

Total liquidity requirement



On 5 September 2001, a number of important changes were made to the Reserve Bank's refinancing system. The main refinancing operations which were previously conducted at a daily frequency are now conducted at a *weekly frequency at fixed-rate tenders* with a seven-day maturity. Banks with short or long liquidity positions are accommodated by way of final clearing repurchase or reverse repurchase auctions at rates which are 1,50 percentage points above or below the fixed repurchase rate.

In cases where the Reserve Bank has unintentionally under- or over-estimated the market's liquidity requirement, supplementary repurchase or reverse tenders are conducted at the fixed repurchase rate. These tenders are mainly aimed at enabling banks to square off their short positions. They are conducted at the Reserve Bank's discretion and occur far more frequently than the final clearing repurchase auctions and the regular weekly auctions.

The amount of vault cash that qualifies as a deduction for purposes of calculating the minimum reserve balances to be held without interest remuneration in an account with the Reserve Bank, was reduced to 75 per cent of the total amount of vault cash held as from September 2001 – increasing the structural liquidity deficit of the banking system by almost R2 billion at that time. The currently prevailing deductible proportion will be reduced by a further 25 percentage points per year over a three-year period.

Actions by the Reserve Bank to mop up excess liquidity in the money market in 2001 and the first months of 2002 included foreign-currency swap transactions with parties in the private sector. The outstanding amount of these swap transactions rose sharply in January 2002 after the government had replaced the Reserve Bank as debtor in respect of a foreign loan of US$1,5 billion. This transaction swelled liquidity in the money market by R17,5 billion.

On 25 April 2002, the proceeds of government's foreign loan of US$1 billion expanded liquidity by R10,7 billion but this amount was immediately neutralised through foreign-exchange swap transactions. These swaps were gradually reversed when the foreign exchange was repurchased by the Bank in the second leg of the transaction, and delivered against maturing forward foreign-exchange contracts.

As part of its liquidity management operations, the Reserve Bank increased the amount of outstanding reverse repurchase transactions in government securities with private-sector parties from R5,0 billion at the end of January 2001 to R6,6 billion at the end of October. The Reserve Bank also allowed the amount of its own outstanding debentures to fluctuate between R3,5 billion and R5,0 billion from January 2001 to August. During December 2001, the Bank eased liquidity conditions by reducing the amount of outstanding debentures to R1,3 billion and that of reverse repurchase transactions to R3,5 billion. Part of the resulting liquidity expansion in the money market was counteracted by a rise in the value of notes and coin in circulation outside the Reserve Bank, which peaked at R38,0 billion on 27 December 2001, up from R33,4 billion at the end of November.

When notes and coin in circulation began to flow back to the Reserve Bank in 2002, the Bank once again started draining liquidity from the money market so as to restore an adequate level of dependence on central bank funding. The required tightening in the money market was achieved *inter alia* through an increase in the amount of Reserve Bank debentures; these eventually rose to R6,0 billion at the end of July 2002. The amount of outstanding reverse repurchase transactions in government securities was also increased to R6,7 billion at the end of February 2002 but was subsequently reduced to R6,0 billion at the end of March 2002. At the end of July 2002 the outstanding amount of these transactions came to R7,1 billion. Since June 2002 the Reserve Bank has introduced 3-month reverse repurchase transactions to complement the conventional 28-day reverse repurchase transactions.

During 2001 government initially sold large amounts of up to R2,2 billion in Treasury bills at the weekly auctions, but these amounts were whittled down in the second half of that year and the first half of 2002. The accompanying table shows the

Changes in the weekly amount of Treasury bills issued

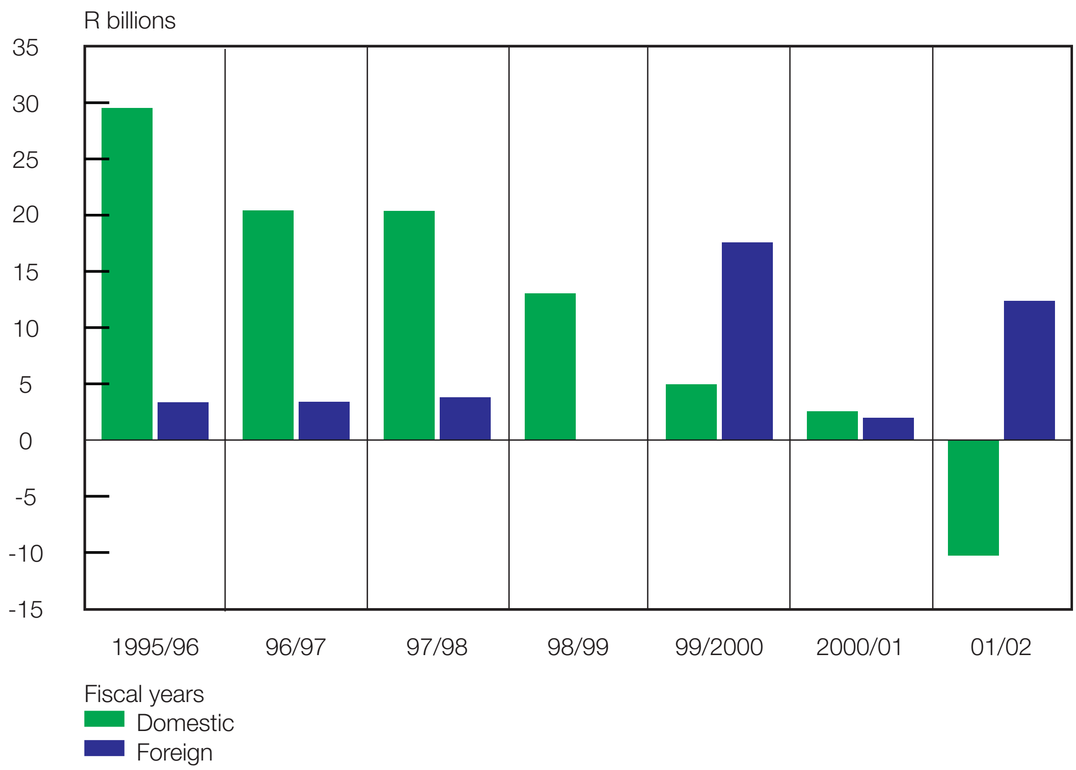
	Amount of bills issued	
Date of change	91-day Treasury bills R million	182-day Treasury bills R million
05 Jan 01	2 000	200
19 Jan 01	1 400	200
09 Mar 01	1 500	200
30 Mar 01	2 000	100
06 Apr 01	2 000	200
04 May 01	1 600	200
07 Sep 01	2 000	200
28 Sep 01	1 300	200
02 Nov 01	1 400	200
14 Dec 01	1 240	110
28 Dec 01	1 000	200
25 Jan 02	1 100	200
01 Feb 02	1 000	200
28 Mar 02	1 400	200
31 May 02	1 000	200

decline in the amounts of Treasury bills issued since late September 2001, mainly in reaction to strong increases in tax collections and because the proceeds of foreign loans became available for financing expenditures.

Bond market

There was a reduction in the supply of fixed-interest securities in the *domestic primary bond market* as the *public sector* focused closely on lowering its overall borrowing requirement and preferred to borrow in the international capital markets. Public-sector borrowers accordingly retired debt on a net basis to the value of R10,2 billion in fiscal 2001/02. In fiscal 2000/01 net issues of fixed-interest securities in the domestic market still amounted to R2,5 billion which was half of the R5,0 billion borrowed in fiscal 1999/2000.

Public-sector borrowing

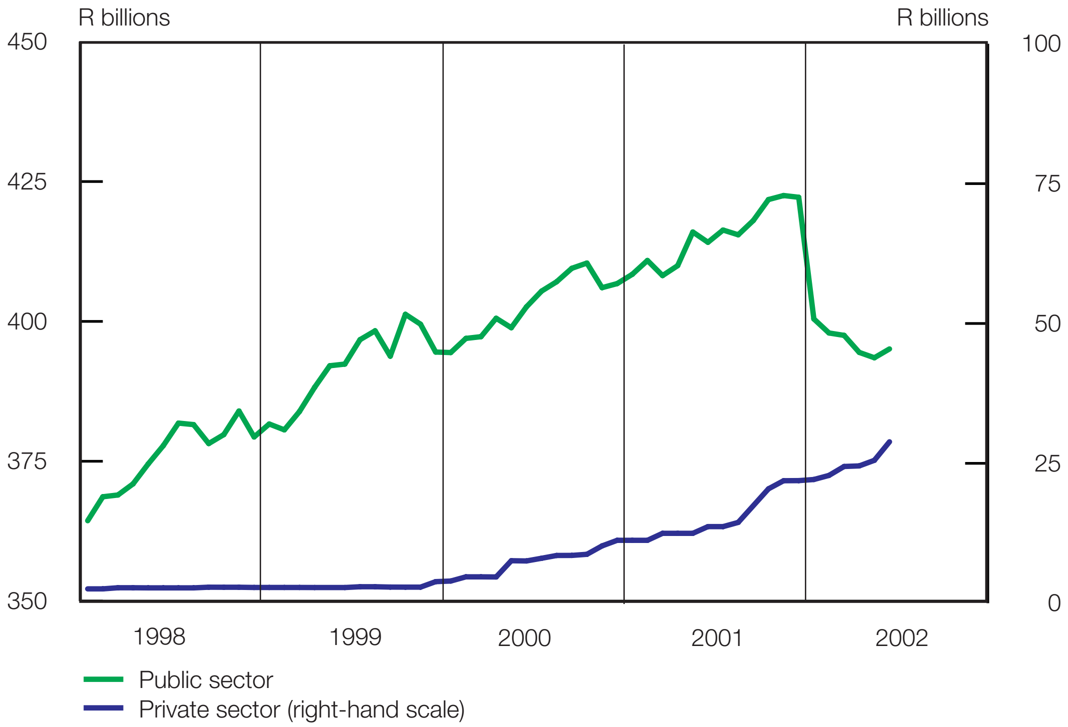


The greater part of the public-sector funding requirement in the past fiscal year was satisfied by borrowing in the *international markets*. The improvement in the country's international credit rating in November 2001 encouraged funding through the issuance of foreign-currency denominated bonds. Several foreign debt issues were successfully concluded and the national government mobilised R12,3 billion in fiscal 2001/02 and R10,7 billion in April 2002. *Other public-sector borrowers* steered clear of the international bond market.

Alongside the growing offshore market for South African sovereign foreign-currency denominated debt, the increase in *rand-denominated bonds* in the *eurobond market* was small, presumably because of uncertainties about future movements in the exchange rate of the rand. The proceeds of eurorand bond issues fell from R21,6 billion in 1997 to R4,8 billion in 2000 and R4,4 billion in 2001. What is more, redemptions exceeded new borrowing by R1,8 billion in 2000 and R0,1 billion in 2001. However, net proceeds of R1,2 billion in the first half of 2002 reflected a somewhat more positive view of the rand.

An outstanding feature of the *domestic primary bond market* in recent years was the livelier market in *corporate debt securities.* This market is steadily filling the void left by public-sector borrowers. The private sector contributed R7 billion in 2000 and R11 billion in 2001 to the increase in the nominal value of bonds listed on the Bond Exchange of South Africa. In the first half of 2002 outstanding private-sector loan stock increased by R7 billion, still considerably less than the R27 billion decline in the nominal value of outstanding public-sector debt issued.

Value of bonds listed on the Bond Exchange of South Africa

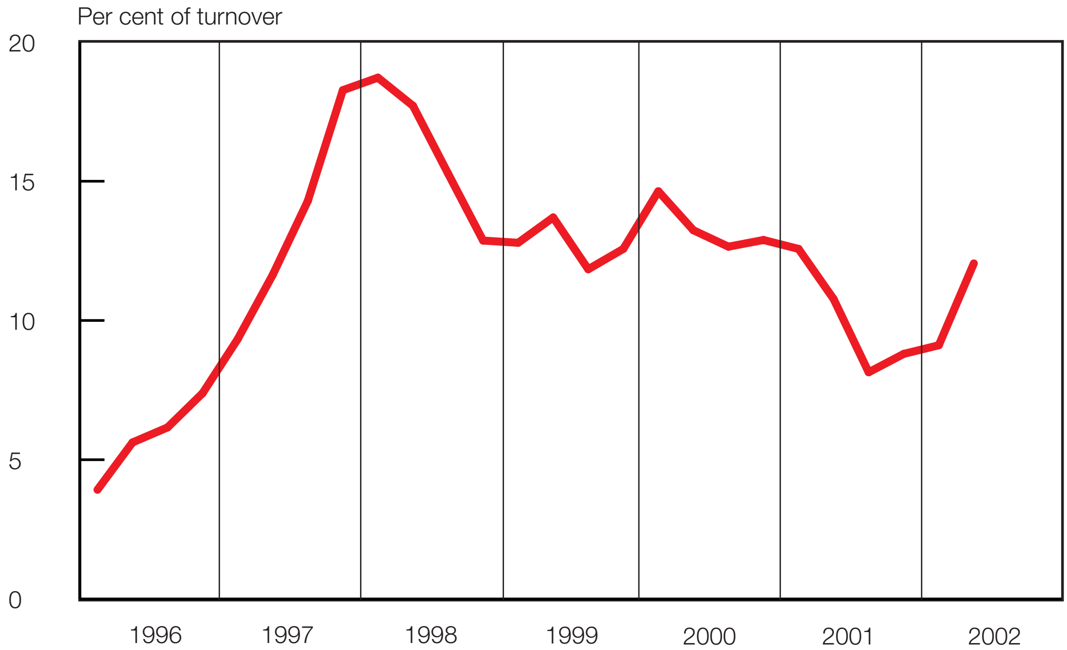


A reduction in *non-resident holdings of bonds* traded on the Bond Exchange of South Africa reflects the perceived risk of investing in *rand-denominated bonds*. The deterioration in foreign investor confidence, which started in 2000, persisted in 2001 as the effect of protracted rand weakness weighed heavily on expected returns and investor sentiment. The decline in long-term bond yields to historically low levels in 2001 further eroded such returns in relation to those offered by other investments.

On a net *outright basis,* non-residents sold bonds to the value of R11,7 billion in 2000 and R29,5 billion in 2001. In 2002, sentiment changed quite noticeably. The potential profit opportunities brought about by the strengthening of the rand vis-à-vis other currencies and the decline in longer-term bond yields from a high level in March 2002, motivated non-resident investors to purchase bonds, on a net outright basis, to the value of R6,3 billion in the first half of 2002. Non-residents also maintained long positions in bonds through repurchase transactions in the first half of 2002.

Non-residents' net purchases of listed South African rand-denominated bonds fell back sharply after the international financial crises of 1998. This reduction in non-resident bond holdings was reflected in the decline in *non-resident participation* in the domestic bond market (measured as purchases and sales of bonds by non-residents as a percentage of total purchases and sales), from almost 19 per cent in the first quarter of 1998 to 11 per cent in the first half of 2002.

Non-resident participation in secondary bond market



The decline in non-resident participation in domestic bond trading was more than offset by the rising turnovers generated by domestic investors. An unprecedentedly high annual turnover of R12,4 trillion was recorded in the *secondary bond market* in 2001, followed by a turnover of R6,7 trillion in the first half of 2002. Rising turnovers were reflected in the *annualised liquidity ratio* (measured as the nominal value of bonds traded relative to the nominal value of bonds listed on the Bond Exchange of South Africa), which increased from 18,7 in the first quarter of 1998 to 30,7 in the second quarter of 2002.

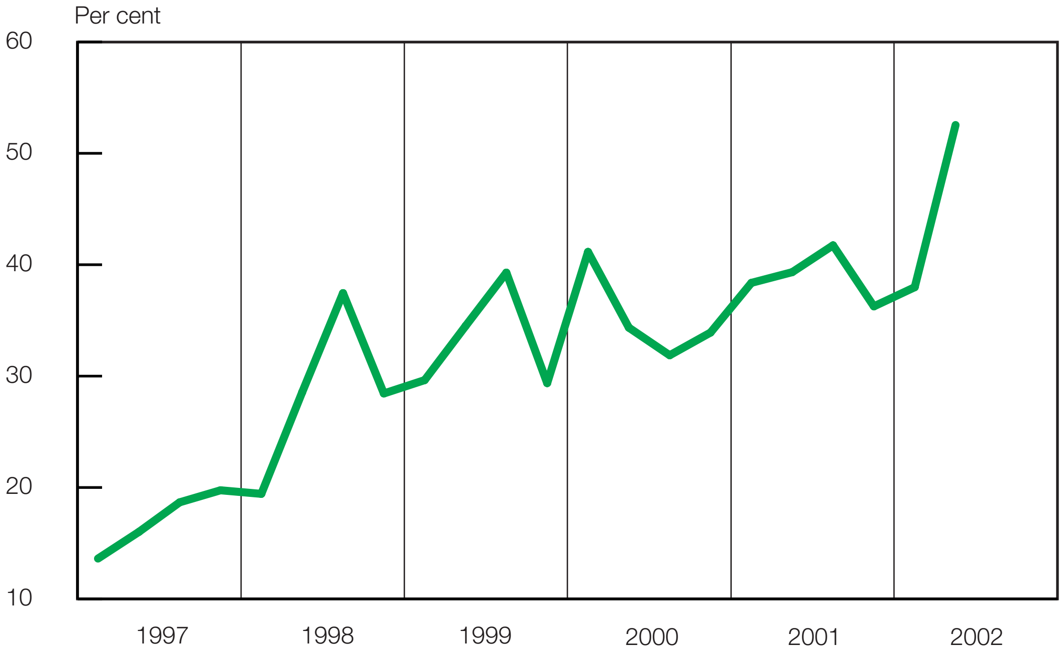
Share market

The *total value of equity capital raised* in the *primary share market* by listed companies fell from R74 billion in 2000 to R24 billion in 2001. This decline in funding was related to the slowing pace of domestic economic activity, uncertain prospects for global economic growth and adverse conditions in the share market. There were signs of an increase in the demand for funding when the amount of capital raised increased from R6 billion in the first half of 2001 to R18 billion in the second half. The continued increase in domestic share prices to new record highs kept funding in the primary equity market at a level of R21 billion in the first half of 2002.

Total capital raised in the share market in the eighteen months to June 2002 amounted to R45 billion, of which 36 per cent was earmarked for the industrial sector, 28 per cent for the resources sectors and 25 per cent for the financial sector. Over the same period a total of 117 companies were delisted. There were only 17 new listings, shrinking the number of listed companies by 100 to 516.

The heightened share price volatility brought about by the attacks on America in September 2001 and volatility in the exchange value of the rand boosted trading activity in the *secondary share market*. Shares worth R606 billion traded on the JSE Securities Exchange in 2001. This was 13 per cent more than the record turnover set in 2000. In the first half of 2002 the value of shares traded was 37 per cent higher than in the first half of 2001. *Market liquidity* (turnover expressed as a percentage of market capitalisation) accordingly increased from 36 per cent in 2000 to 38 per cent in 2001 and 45 per cent in the first half of 2002. Overall, *market capitalisation* rose from R1 551 billion in December 2000 to R1 771 billion in December 2001 and R1 800 billion in June 2002.

Turnover as percentage of market capitalisation in secondary share market

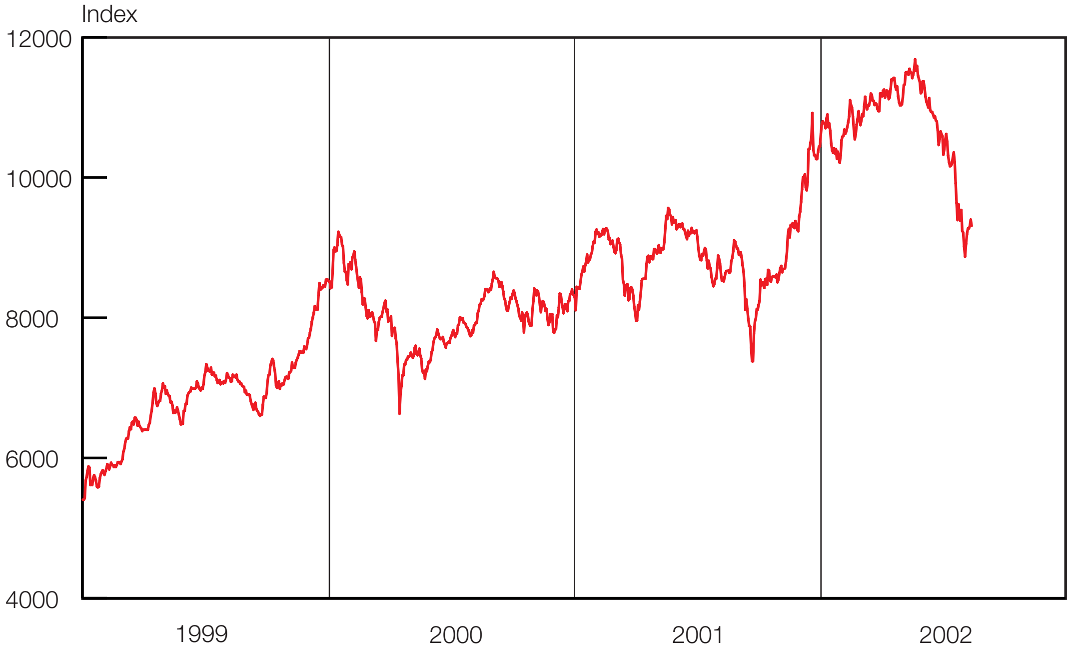


Non-residents traded actively in the *secondary share market* and the value of their purchases and sales of listed shares kept pace more or less with the growth in total purchases and sales on the JSE Securities Exchange. On average, non-resident participation accounted for 28 per cent of the gross value of shares traded in 2000 and 31 per cent in the ensuing eighteen months. At this level, non-resident participation probably had a significant influence on price determination and volatility in the domestic market.

Volatility in share prices on the JSE Securities Exchange SA reflected the shifts in global investor sentiment during the past eighteen months. Investor sentiment in the major financial centres was somewhat gloomy during most of 2001, contributing to a decline of 23 per cent in domestic share prices from 21 May to 21 September. Naturally, this downward slide was aggravated by the events of 11 September.

After 11 September, the South African share market recovered in sympathy with the international markets, but the recovery lasted longer in South Africa. Prices in the United States market peaked in January 2002, those of emerging markets in April 2002 while the prices of shares listed on the JSE Securities Exchange continued to rise until 22 May. The all-share price index subsequently fell back by 20 per cent from 22 May 2002 to 14 August.

All-share price index



Source: JSE and FTSE/JSE

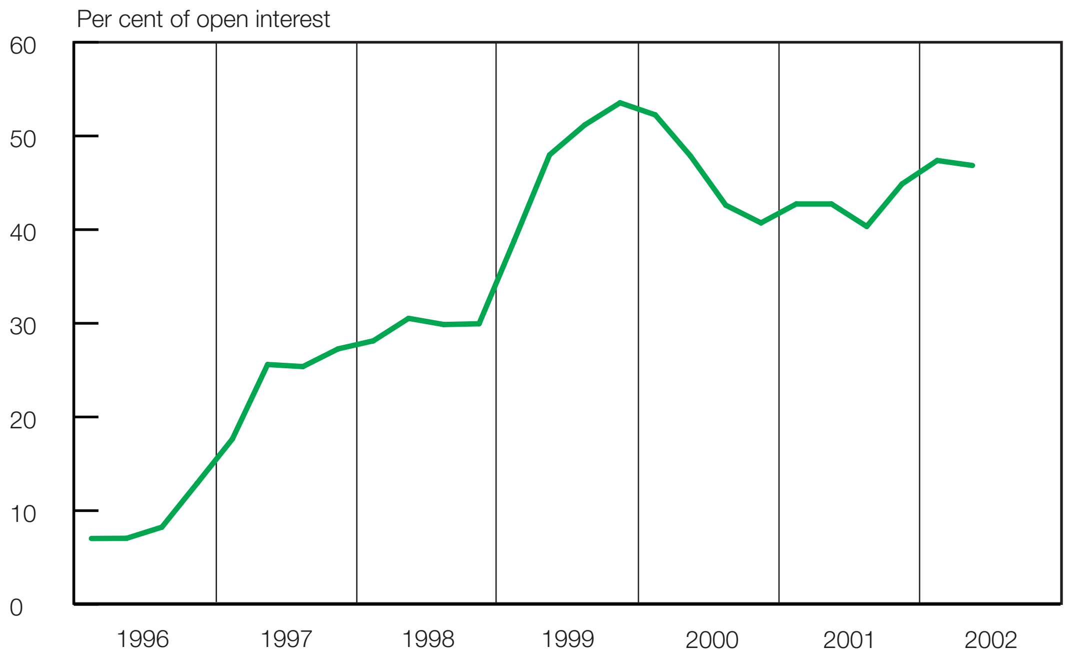
The *monthly average price level of gold-mining shares* recorded an increase of 167 per cent from September 2001 to June 2002 and the *resources index* (representing 48 per cent of overall market capitalisation) increased by 71 per cent. The *industrial sector* gained only 16 per cent whereas the prices of companies in the *financial sector* declined by 2 per cent over the same period. Overall, the average monthly price level of all classes of shares increased by 22 per cent from September 2001 to July 2002.

Strong gains in share prices and weaker growth in earnings took the *price-earnings ratio* of all classes of shares from 10,5 in September 2001 – its lowest level since the international financial crises of 1998 – to 13,2 in June 2002. The monthly average *dividend yield* on all classes of shares declined from a high of 3,4 per cent in September 2001 – when it was at its highest level since December 1998 – to 3,0 per cent in June 2002.

Market for derivatives

Trading in financial derivatives, warrants and commodity contracts in the *formal market for derivative products* was boosted by price volatility in the markets for the underlying assets and increased non-resident participation over the past year and a half. *Participation by non-residents,* measured as a percentage of open interest, fell back from an average of 43 per cent in the first half of 2001 to 38 per cent in July, before increasing to an average level of 47 per cent in the first half of 2002.

Non-resident participation in market for derivatives



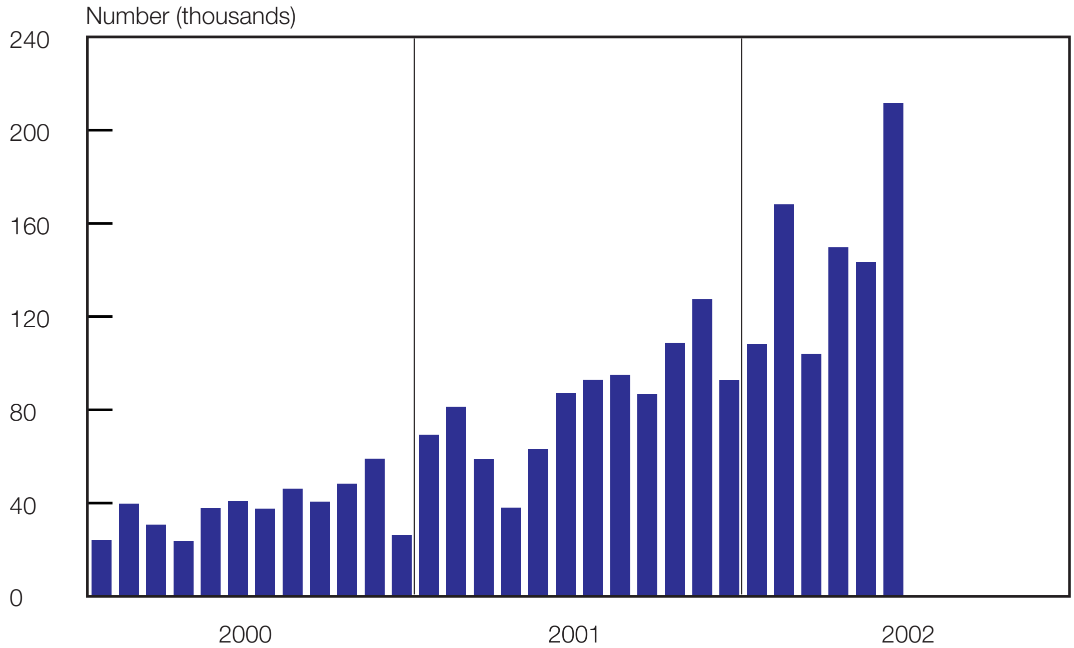
Index derivative products accounted for about 93 per cent of the overall number of trades in financial derivatives, and individual equity derivative products for 6 per cent. The value of these derivative contracts as a *ratio* of turnover on the JSE Securities Exchange increased from an average of 1,5 in the four quarters to June 2001 to almost 2,0 in the fourth quarter of 2001, before falling back to an average of 1,3 in the first half of 2002 as market behaviour became somewhat less volatile.

The combined number of *futures and options on futures contracts* traded in the JSE Financial Derivatives Division increased by 47 per cent to 35,6 million in 2001. In the past eighteen months the number of contracts traded increased by 25 per cent from 15,8 million in the first half of 2001 to 19,8 million in the second half, but fell back to 14,2 million in the first half of 2002 when price changes in the foreign-exchange and other financial markets became less volatile.

Growth in the *warrants market* was spectacular. The number of warrants traded increased by 157 per cent to 25,6 billion in 2001, and by 35 per cent from the first half of 2001 to 14,7 billion in the second half. Subsequently trading activity receded to 11 billion in the first half of 2002.

Commodity futures and options on futures traded in the JSE Agricultural Division mainly consist of *white maize* contracts, which on average account for 78 per cent of all commodity-related trading and 82 per cent of all maize-related contracts. Trading in commodity derivatives was boosted by the sharp increase in the domestic spot price of white maize, which was strongly influenced by the decline in the exchange rate of the rand. The number of commodity futures and options contracts traded more than doubled to a million contracts in 2001, and increased further by 47 per cent from the second half of 2001 to the first half of 2002.

Trading in agricultural derivatives



Futures and options on futures contracts traded

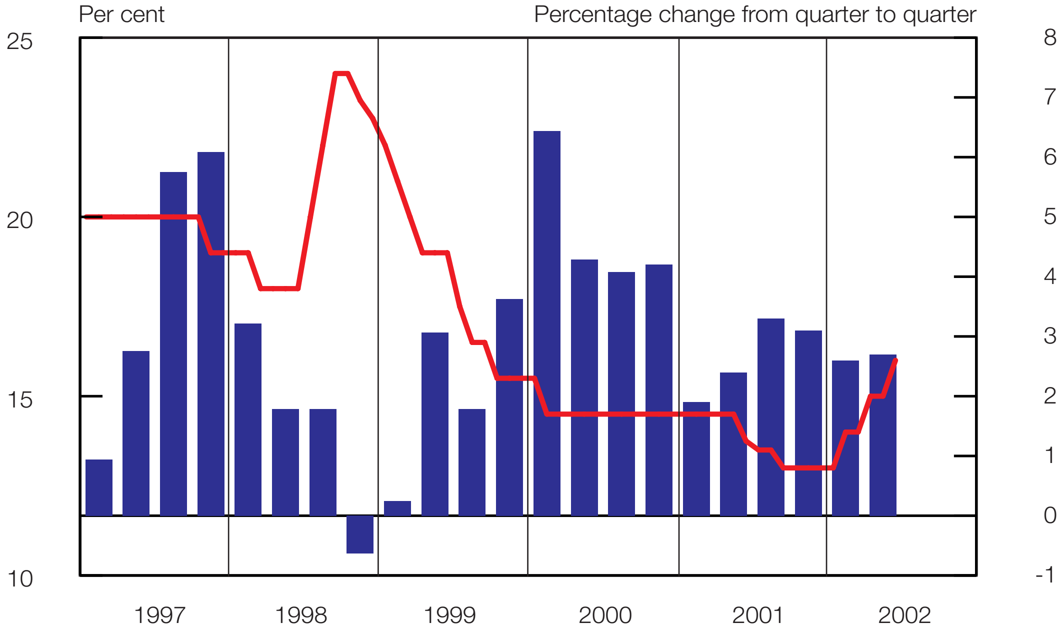
Real-estate market

Trading activity in the *real-estate market* remained buoyant over the past one-and-a-half years. The overall seasonally adjusted value of turnover, measured by *transfer duty paid,* increased by 19 per cent in 2001 and by 17 per cent when comparing the first half of 2002 with the last half of 2001.

Activity in the real-estate market stimulated growth in the *home loan market* and growth over twelve months in outstanding home loan balances granted by banks accelerated from a recent low of 3,8 per cent in November 1999 to 16,1 per cent in May 2001. However, in contrast to the consistent buoyancy of turnover in the real-estate market, growth in the home loans granted by *banks* slowed down from May 2001. This slowdown could have been caused by increased competition from non-bank mortgage lenders and greater capital repayments by mortgage debtors.

The decline in the cost of mortgage finance in 2001 fostered the demand for *residential property* and contributed to a rise in house prices. The rate of change from quarter to quarter in the average *nominal price* of houses measured by Absa Bank increased from 1,9 per cent in the first quarter of 2001 to 3,3 per cent in the third quarter. When mortgage interest rates increased again in the first half of 2002, growth in house prices slowed somewhat to 2,6 per cent in the first quarter and 2,7 per cent in the second quarter. The year-on-year increase in the *inflation-adjusted* or relative prices of houses slowed down from a high of 10,4 per cent in the fourth quarter of 2000 to 6,7 per cent in the fourth quarter of 2001 and 6,5 per cent in the second quarter of 2002.

House prices and cost of mortgage finance

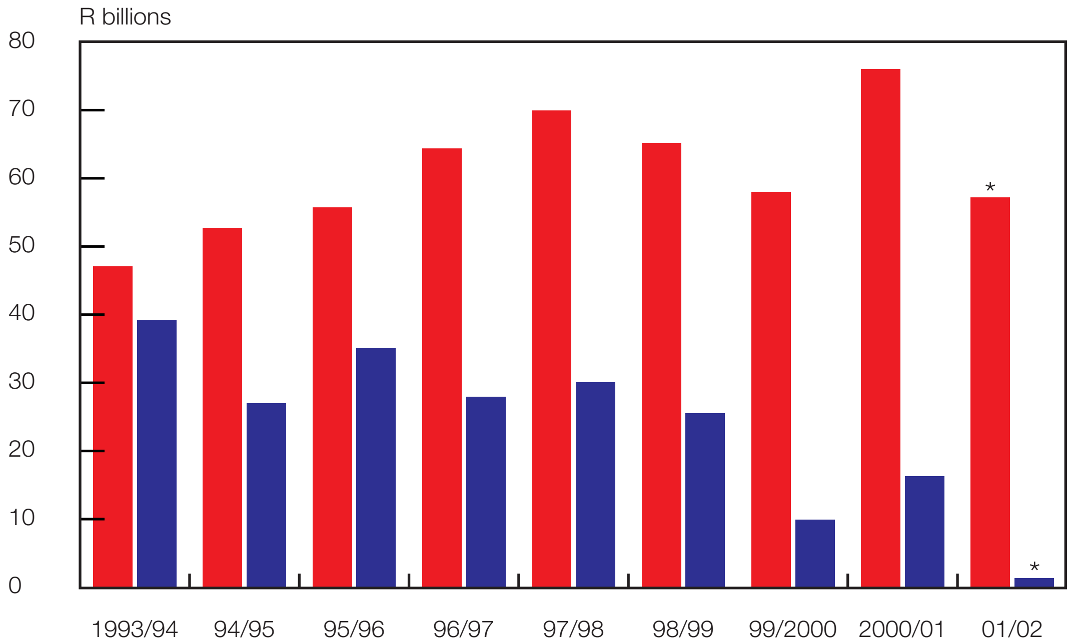


Predominant rate on mortgage loans
Nominal house prices (right-hand scale)*
* Source: Absa

Non-bank financial intermediaries

Public-sector net borrowing in the domestic primary bond market, measured as issues less redemptions of fixed-interest securities, generally declined over the past

Institutional cash flows and demand for non-bank financing



Fiscal years
Cash flow
Private and public-sector demand
* April to December 2001

eight fiscal years and even changed to net debt redemptions in fiscal 2001/02. This decline bears testimony to national government's commitment to limiting its claim on domestic saving through prudent management of both revenue and expenditure, and through increased recourse to borrowing in the international capital markets.

The public sector's reduced demand for loanable funds limited the potential for *crowding out* and left ample resources available for *private-sector borrowers*. This is evident from the growing excess of *institutional cash flows* (defined as the current receipts less current expenditure of long-term insurers and pension funds, and the net sales of units by unit trusts) over net domestic borrowing by the public sector. These institutional cash flows were sufficient to meet the demand for resources by private-sector organisations in the primary bond and share markets (estimated as the change in the outstanding nominal value of listed private-sector loan stock and rights issues of ordinary listed shares). Ample investable funds were mobilised by the non-bank financial intermediaries, even though their cash flows as a percentage of their total assets declined from 9,4 per cent in fiscal 1993/94 to 4,6 per cent in 1999/2000 and 5,6 per cent in 2000/01.

Public finance

Fiscal policy

The *Medium Term Budget Policy Statement* of the National Treasury enunciates the policy framework within which government formulates its revenue and expenditure strategies and measures the progress made towards meeting its policy objectives. This policy statement also creates the framework for compiling government's budget proposals. The *Medium Term Budget Policy Statement 2001* reiterates government's firm intent to confront South Africa's social and development challenges within a consistent, growth-oriented fiscal and budgetary framework, and with strong emphasis on fiscal discipline.

Intergovernmental fiscal relations were formulated in the context of the overarching policy framework to clearly define the relationships between different levels of government. The *Intergovernmental Fiscal Review 2001* states that the national government's responsibility lies with policy decisions and that provincial and local governments are charged with providing basic and other public services to the various groups of society. The *Budget Review 2002* gives effect to this by introducing a strong shift of resources towards provincial and local governments.

In the Budget Speech presented to Parliament on 20 February 2002, the Minister of Finance signalled a strong orientation to economic growth, for example by providing for a faster increase in real government spending over the medium term. In addition to the continued support for social development, emphasis was placed on increasing the infrastructural investment in urban and rural areas. It was also announced that renewed attention would be focused on the justice and protection services of the country.

The South African tax system has undergone extensive restructuring in recent years, resulting in improvements in tax administration and tax morality. These reforms have also led to strong growth in tax collections, enabling the government to reduce its budget deficit while service delivery continued to expand. The tax proposals announced in the *Budget Review 2002* provide for tax relief to individual taxpayers and enhance the international competitiveness of the business sector by introducing tax incentives for encouraging capital formation. These measures are expected to foster economic growth in the medium term.

Reforms to the public debt management strategy reduced the loan debt of national government to more sustainable levels and changed the composition of government's loan debt. Foreign-currency denominated debt increased as a portion of total government loan debt, the maturity profile of loan debt was restructured and new loan instruments were introduced. Government reaffirmed its intention to actively manage its debt portfolio with the aim of minimising the risk and cost of funding, and to ensure a liquid market for trading in government securities.

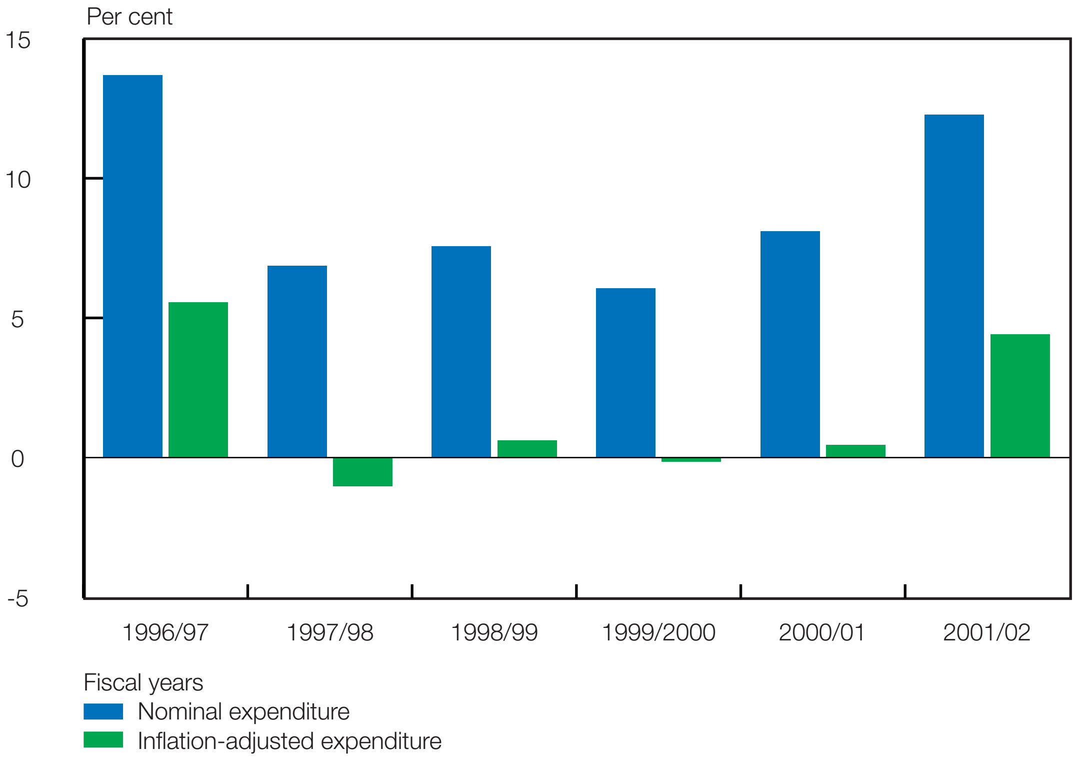
National government expenditure

The April 2002 *Statement of Revenue, Expenditure and Borrowing* of the national government shows the preliminary outcome of national government finances for fiscal 2001/02 and the final outcome for the previous fiscal year. The statement indicates that national government expenditure in fiscal 2001/02 amounted to R262,7 billion. This implies an increase in the ratio of national government expenditure to gross domestic product from 25,7 per cent in fiscal 2000/01 to 26,3 per cent in fiscal 2001/02.

The year-on-year rate of increase in the expenditure of national government amounted to 12,3 per cent in fiscal 2001/02 – well above the original budget projection of 10,4 per cent. The rate of increase in national government expenditure in fiscal 2001/02 also exceeded the average year-on-year rate of increase of 8,5 per cent in the preceding five fiscal years. The relatively strong increase in government expenditure in 2001/02 bears testimony to the shift in the fiscal policy stance from emphasising consolidation to a more growth-oriented approach.

In the *Budget Review 2002* it is estimated that national government expenditure will increase at a rate of 9,6 per cent to R287,9 billion or 26,6 per cent of the projected gross domestic product in fiscal 2002/03. The projections provide for an average annual rate of increase of 8,4 per cent over the three-year planning period, implying that growth in inflation-adjusted expenditure is likely to continue. National government expenditure as a ratio of gross domestic product is projected to be above 26 per cent over the entire three-year planning cycle.

Changes in national government expenditure



Growth in the interest payments of national government was kept in check and increased by only 2,3 per cent to R47,4 billion in fiscal 2001/02. This rate of increase was appreciably lower than the 5,1 per cent increase in the previous year, and was also significantly lower than the average rate of increase of 9,7 per cent in the preceding five fiscal years. This slowdown in the growth in the government's interest bill in recent years can mainly be attributed to a reduction in the borrowing requirement of government, but the restructuring and consolidation of existing debt also made a noteworthy contribution in the past fiscal year. However, the restructuring of debt caused additional extraordinary expenses of R2,1 billion in fiscal 2001/02.

Interest payments as a ratio of gross domestic product amounted to 4,7 per cent in fiscal 2001/02, slightly below the original budget estimate of 4,9 per cent. The *Budget Review 2002* projects that the interest bill of national government will decrease further to 4,4 per cent of the projected gross domestic product in fiscal 2002/03, and 4,2 per cent and 4,1 per cent in the two ensuing fiscal years. Provision is also made for an extraordinary payment of R1,0 billion in respect of debt restructuring costs in fiscal 2002/03.

Provincial governments, being at the centre of service delivery to the public, received substantial transfers from national government as their equitable share of the national revenue pool. In fiscal 2001/02 national government transferred R105,3 billion, or 40,1 per cent of its total expenditure, to provincial governments. It was envisaged that these transfers would grow at an average rate of 9,2 per cent over the next three years.

Although only 5,6 per cent of national government spending was of a capital nature, the capital expenditure recorded in fiscal 2001/02 represented an increase of 87,6 per cent from the previous fiscal year. In the *Budget Review 2002* it is estimated that capital expenditure will continue to grow at an average annual rate of 13,4 per cent during the current three-year planning period.

The *Budget Review 2002* indicates that spending on social services is still the most important functional category of government spending, amounting to 47,5 per cent of the projected national and provincial government expenditure in fiscal 2002/03. Spending on these services is expected to increase at an average annual rate of 8,8 per cent over the three-year budget cycle. In the area of protection services an increased portion of the spending allocated to police services will provide for the appointment of additional police officers. Although the provision for general government services seems to be increasing, this is essentially due to the inclusion of a contingency reserve which is expected to grow to R3,3 billion in fiscal 2002/03 and R9,0 billion in fiscal 2004/05. The contingency reserve provides for unforeseen and unavoidable spending in all functional areas.

Functional classification of expenditure of consolidated national and provincial governments
R billions

Spending category	Percentage of total expenditure				Average growth 2001/02 – 2004/05 Per cent
	2001/02	2002/03	2003/04	2004/05	
General government services and unallocatable expenditure	**7,8**	**9,1**	**10,1**	**11,5**	**23,9**
Protection services	**17,2**	**17,3**	**17,1**	**17,0**	**10,1**
Defence	6,6	6,8	6,6	6,4	9,6
Police	6,8	6,6	6,7	6,8	10,0
Prisons	2,5	2,4	2,4	2,4	10,1
Justice	1,3	1,5	1,4	1,4	13,3
Social services	**47,6**	**47,5**	**47,3**	**46,6**	**8,8**
Education	20,4	19,6	19,6	19,2	7,2
Health	11,7	11,2	11,2	11,1	7,9
Social security and welfare	12,5	13,5	13,1	13,1	11,8
Housing and community development	2,4	2,6	2,7	2,6	10,1
Other	0,6	0,6	0,7	0,6	13,0
Economic services	**9,9**	**10,4**	**10,2**	**9,9**	**11,3**
Water schemes and related services	1,3	1,4	1,4	1,2	6,8
Fuel and energy	0,3	0,5	0,4	0,3	75,2
Agriculture, forestry and fishing	1,9	2,0	1,9	1,9	9,7
Mining, manufacturing and construction	0,5	0,5	0,5	0,5	6,9
Transport and communication	3,7	3,6	3,6	3,6	9,2
Other economic services	2,2	2,4	2,4	2,4	17,3
Interest	**17,5**	**15,7**	**15,3**	**15,0**	**3,2**
Total	**100,0**	**100,0**	**100,0**	**100,0**	**9,6**

National government revenue

The *Statement of Revenue, Expenditure and Borrowing* of national government indicates that unaudited national government revenue increased at a year-on-year rate of 14,8 per cent to R247,6 billion in fiscal 2001/02. This rate of increase was substantially higher than the rate of increase of 8,3 per cent originally envisaged in the Budget for fiscal 2001/02.

The rate of increase in national government revenue in fiscal 2001/02 was higher than the rate of increase of 8,6 per cent recorded in the previous fiscal year and also well above the average year-on-year rate of increase of 11,2 per cent in the preceding five fiscal years. The contribution made by broadening the tax base and greater efficiency in tax collections is evident from the pick-up in the inflation-adjusted rate of increase in government revenue from an average of 3,6 per cent in the years from 1996/97 to 2000/01 to 6,9 per cent in fiscal 2001/02.

As indicated in the accompanying table, the increase in national government revenue was primarily due to stronger than envisaged growth in taxes on income and profits. This can partly be attributed to the steady elimination of backlogs in the

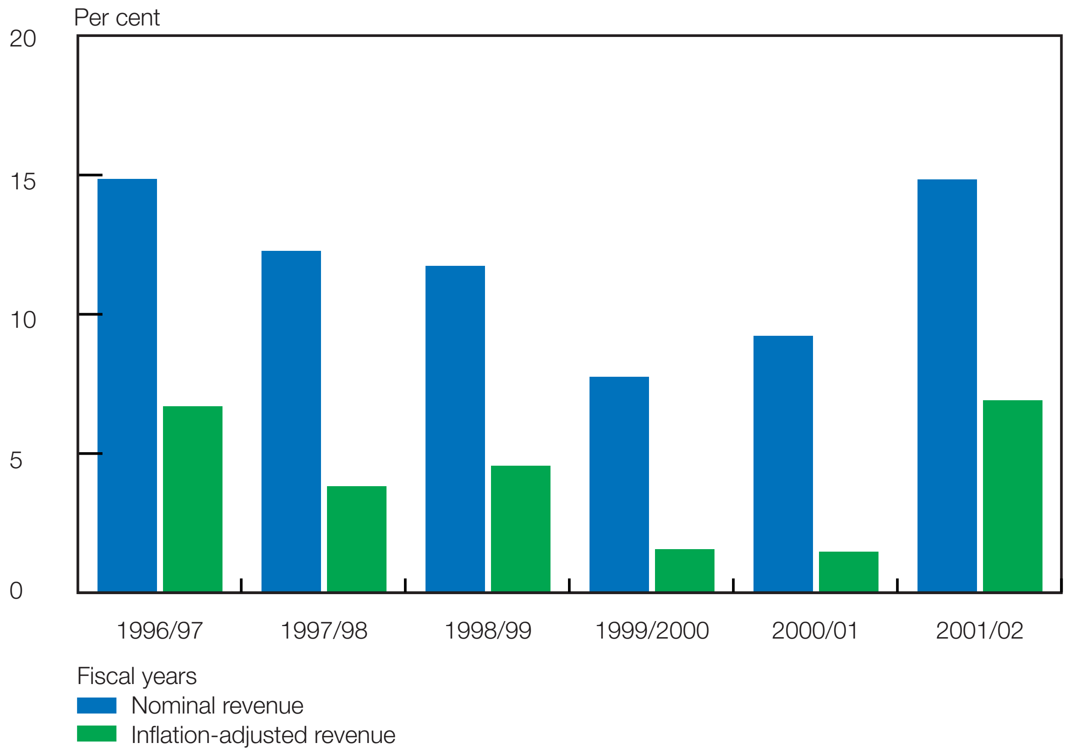
National government revenue in fiscal 2001/02
R billions

Revenue source	Originally budgeted	Actual
Taxes on income and profits	131,6	147,3
Payroll taxes	2,8	2,7
Taxes on property	4,7	4,6
Domestic taxes on goods and services	86,7	86,7
Taxes on international trade and transactions	9,4	9,0
Other revenue	6,4	5,5
Less: SACU* payments	8,2	8,2
Total revenue	233,4	247,6

* Southern African Customs Union

processing of tax assessments and to a reduction in the time spent on the processing of tax returns. Strong growth in the taxes paid by companies, including mining companies, was a major contributor to the buoyancy of tax collections. An increase in the distribution of dividends by companies caused revenue collected through the secondary tax on companies to increase from R4,0 billion in fiscal 2000/01 to R7,2 billion in fiscal 2001/02.

Changes in national government revenue



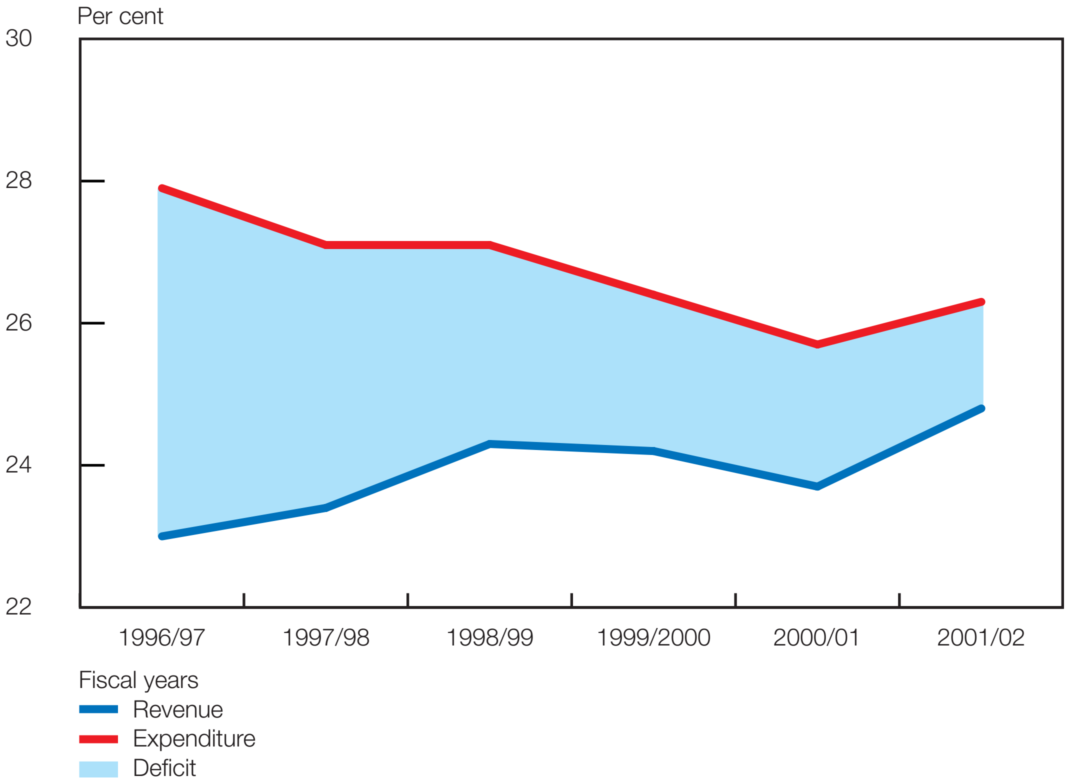
The total revenue of national government is estimated to amount to R265,2 billion in fiscal 2002/03, representing a year-on-year increase of 7,1 per cent. It is estimated that national government revenue would increase at an average annual rate of 8,2 per cent over the current three-year planning horizon. The strong growth in revenue created room for some tax relief which will amount to an estimated R15,2 billion in fiscal 2002/03. The tax relief was primarily targeted at reducing personal income tax rates and providing some tax incentives for the corporate sector, as such incentives are believed will strengthen the potential for longer-term economic growth.

National government revenue as a ratio of gross domestic product amounted to 24,8 per cent in fiscal 2001/02, compared with 23,7 per cent in the previous fiscal year. It is estimated that national government revenue will average 24,5 per cent of gross domestic product over the three-year budget cycle.

National government deficit

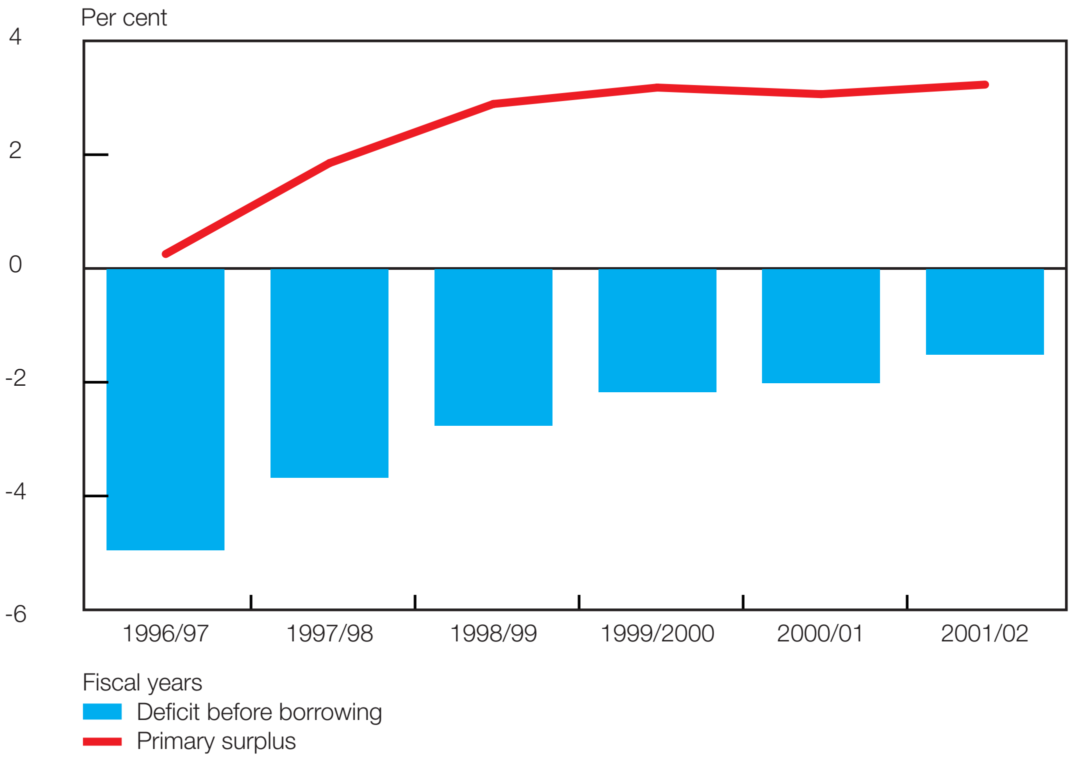
The net result of the higher-than-budgeted revenue and expenditure was a national government deficit before borrowing and debt repayment of R15,1 billion in fiscal 2001/02. The actual deficit was far less than the originally budgeted deficit of R24,9 billion. The national government deficit before borrowing and debt repayment as a ratio of gross domestic product amounted to 1,5 per cent in fiscal 2001/02 compared with the ratio of 2,0 per cent recorded in the previous fiscal year. The ratio of 1,5 per cent is the lowest deficit ratio recorded since fiscal 1989/90. The deficit is expected to rise temporarily to 2,1 per cent in fiscal 2002/03, but to decline thereafter to 1,7 per cent in fiscal 2004/05.

National government finances as percentage of gross domestic product



The primary balance (i.e. the deficit recalculated by excluding interest payments from total expenditure) reached a surplus of 3,2 per cent of gross domestic product in fiscal 2001/02, slightly higher than the 3,1 per cent recorded in the previous fiscal year. A decrease to 2,3 per cent is envisaged for fiscal 2002/03, a level expected to be maintained during the remainder of the current three-year budget cycle.

National government balances as percentage of gross domestic product



Financing of national government debt

Apart from financing the shortfall of revenue relative to expenditure, the national government also had to fund the cost of revaluing maturing foreign loans in the amount of R47 million and the cost of debt portfolio restructuring in the amount of R2,1 billion. Albeit less than originally anticipated, extraordinary revenue from the restructuring of state assets made a significant contribution towards reducing the net borrowing requirement of national government. Receipts from the restructuring of government assets consisted of a special dividend of R2,2 billion received from the South African Special Risks Insurance Association (Sasria) and a dividend of R1,4 billion declared by the transport utility Transnet. This dividend emanated from the monetisation of Transnet's interest of 20 per cent in M-Cell, an information and telecommunications company.

The greater part of national government's net borrowing requirement in fiscal 2001/02 was financed through the issuance of bonds in the international capital market. Total foreign loans arranged during fiscal 2001/02 amounted to R33,2 billion compared with the R11,4 billion originally envisaged in the budget proposals for 2001/02. Amounts drawn on the export credit facility arranged specifically for the Special Defence Procurement Programme amounted to R3,4 billion in fiscal 2001/02. National government also assumed liability for a syndicated loan denominated in US dollars, initially concluded with the Reserve Bank as debtor. The proceeds of this loan amounted to R17,5 billion. In addition, the reopening of an existing US dollar loan contributed R2,8 billion to the Exchequer account.

National government financing in fiscal 2001/02
R billions

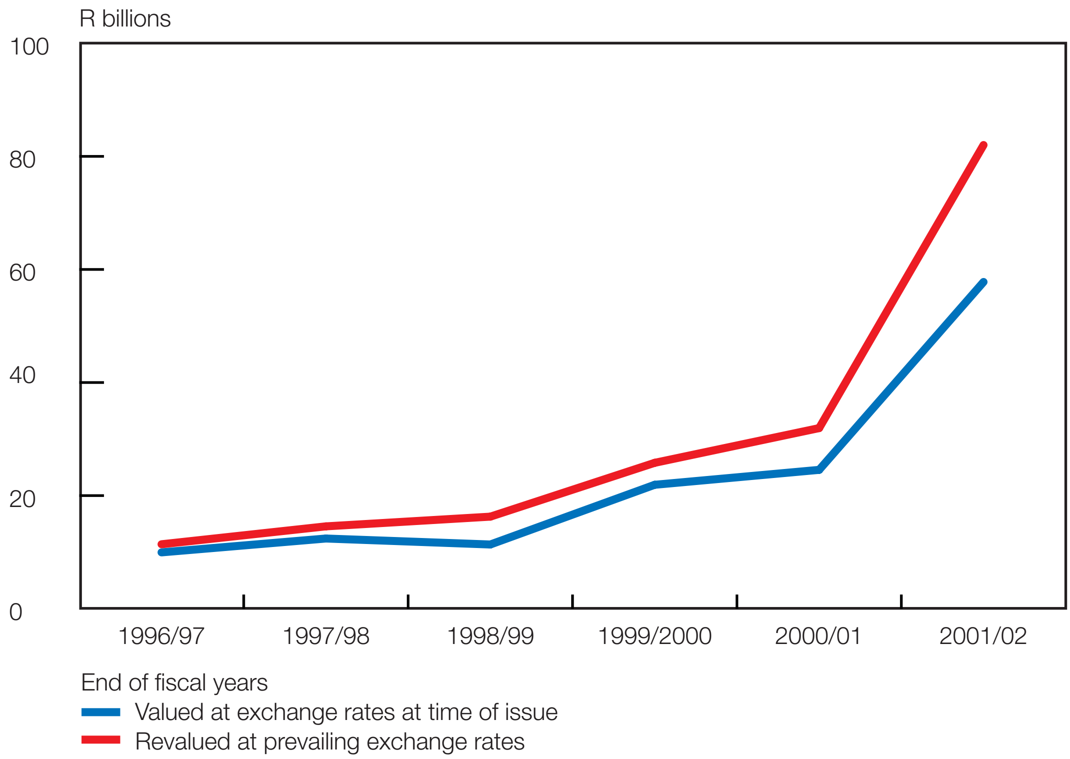
	Originally budgeted	Actual
Deficit	**24,9**	**15,1**
Plus: Extraordinary payments	0,6	2,1
Revaluation of maturing foreign loans	0,0	0,1
Less: Extraordinary receipts	18,0	4,0
Net borrowing requirement	**7,5**	**13,3**
Domestic primary capital market		
Government bonds	...	-9,1
Less: Discount on government bonds	...	3,2
Net receipts from government bonds issued	**-7,4**	**-12,3**
Treasury bills	3,5	-8,0
Foreign loans	11,4	33,2
Change in available cash balances*	-	0,4
Total net financing	**7,5**	**13,3**

* Including changes in the Exchequer and Paymaster-General Account balances with the South African Reserve Bank and private-sector banks, as well as changes in other balances stemming from timing differences in the recording of transactions and bank clearances (Increase -, decrease +)

The marketable foreign loans concluded in fiscal 2001/02 shortened the average outstanding maturity of foreign government debt from 98 months at the end of March 2001 to 89 months at the end of March 2002.

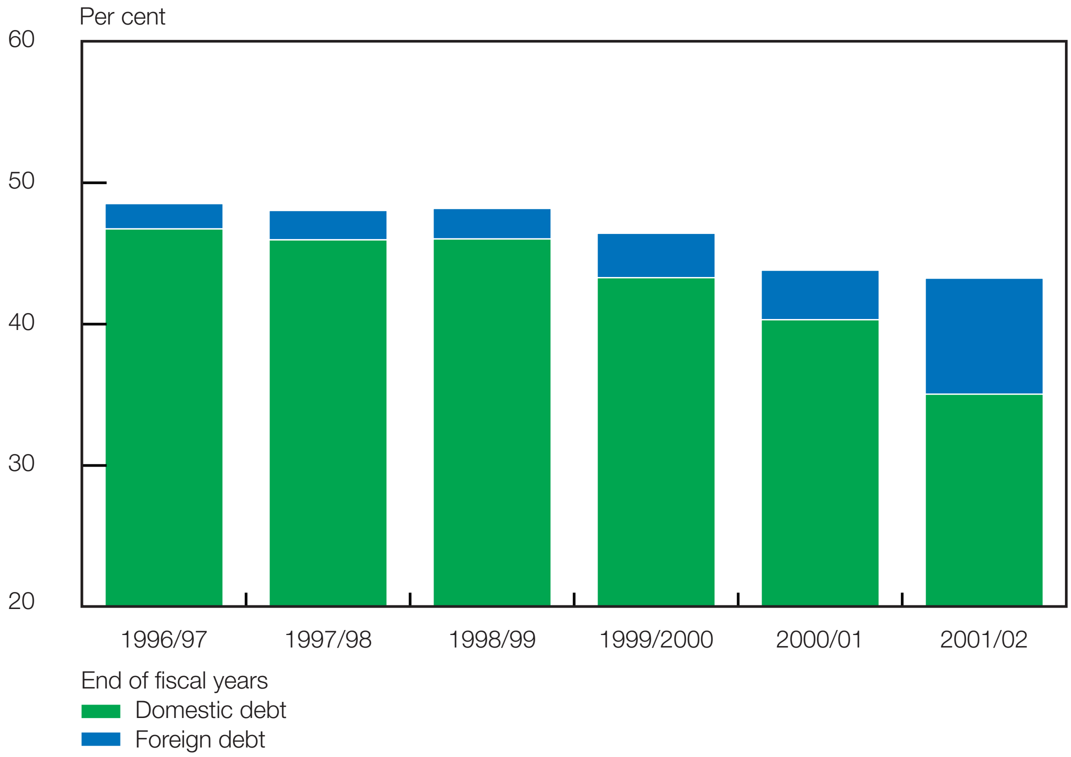
The heavy emphasis on foreign funding enabled the National Treasury to redeem net amounts of Treasury bills and domestic government bonds in fiscal 2001/02.

Total foreign debt of national government



Domestic long-term funding was obtained at an average rate of 8,5 per cent per annum in fiscal 2001/02, compared with a budget assumption of 11,6 per cent. However, the indicated cost of the past fiscal year excludes the cost of revaluing the inflation-linked bonds. Short-term instruments were sold at an average rate of 9,4 per cent per annum, compared with a budget assumption of 10,0 per cent.

National government loan debt as percentage of gross domestic product



Funding estimates for the medium term indicate that the restructuring of state assets will contribute R12,0 billion to the financing of national government in fiscal 2002/03, with R5,0 billion provided for each of the subsequent two years. An extraordinary payment of R1,0 billion provided for in fiscal 2002/03 was meant to defray the costs associated with the restructuring of government's domestic debt portfolio. Provision has also been made for the payment of R0,6 billion in fiscal 2002/03 in respect of the termination of the South African Housing Trust, originally anticipated in the *Budget Review 2001.*

The issuance of debt instruments, the discount on new government bond issues and the revaluation of foreign debt at a depreciated exchange value of the rand, led to an increase in the loan debt of national government from R399,3 billion at the end of March 2001 to R432,3 billion at the end of March 2002. As a ratio of gross domestic product, national government loan debt still decreased from 43,8 per cent at the end of March 2001 to 43,3 per cent at the end of March 2002. Foreign loans equalled 8,2 per cent of gross domestic product, compared with just 3,5 per cent at the end of March 2001. However, as indicated in the accompanying graph, this increase is partly due to the revaluing of outstanding foreign loans at a weaker exchange rate of the rand. In government's current modified cash accounting system, the cost of the revaluation of foreign loans is not recognised as expenditure but is defined as part of overall financing needs when this debt has to be retired on reaching maturity.

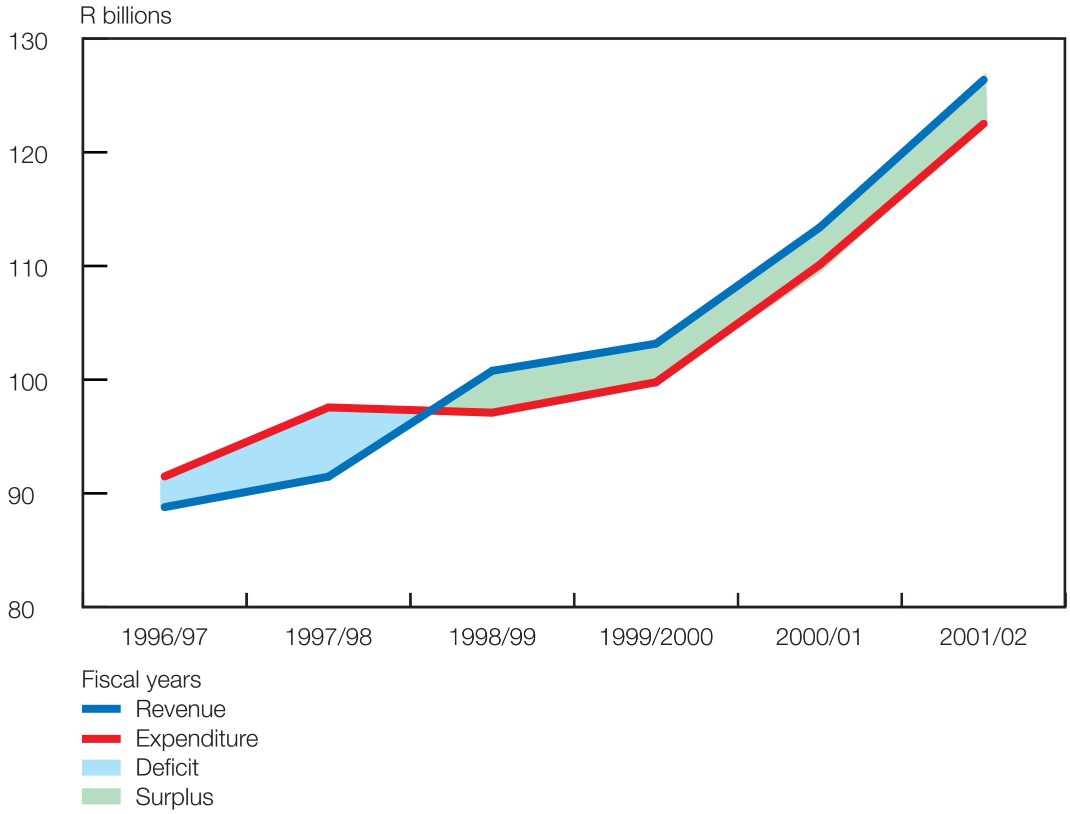
Although it was estimated that the nominal value of national government's loan debt would increase to R481,9 billion at the end of March 2005, this would be equal to only 37,7 per cent of the projected gross domestic product – well down from the currently prevailing ratio.

General government finance

The borrowing requirement of the consolidated general government shrank from R17,6 billion in fiscal 2000/01 to R11,0 billion in fiscal 2001/02. The financial position of the national government and of the provincial governments improved impressively during the fiscal year, but the position of local governments deteriorated overall.

An analysis of the *Statement of Revenue, Expenditure and Borrowing* of the provincial governments indicates that these administrations recorded a revenue surplus of R3,9 billion in fiscal 2001/02. Capital spending by provincial governments amounted to R11,1 billion during the 2001/02 fiscal year. The overall bank indebtedness of the provincial governments decreased from R1,6 billion at the end of March 2001 to R0,5 billion at the end of March 2002, whereas their deposits with the banking sector increased from R7,9 billion to R9,6 billion over the same period.

Revenue and expenditure of provincial governments



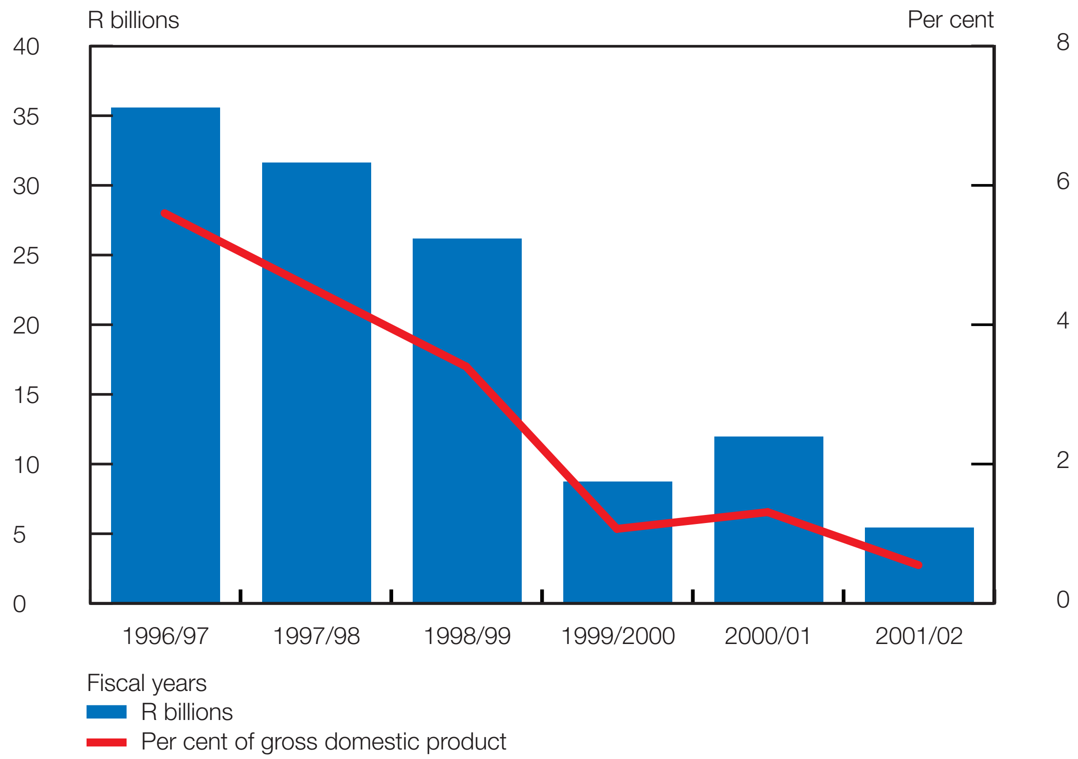
The first budget year of the newly demarcated local government structures came into effect on 1 July 2001. Preliminary financial statistics indicate a deterioration from a deficit of R1,5 billion in fiscal 2000/01 to a deficit of R4,4 billion in fiscal 2001/02, partly because the financial position of some local governments was adversely affected by non-payment for services provided.

The borrowing requirement of the extra-budgetary and social security funds improved in fiscal 2001/02. The small financial surplus of the social security funds was due to an additional transfer to the Unemployment Insurance Fund (UIF) for the repayment of outstanding debt to the Department of Labour and for financing the restructuring of the fund. The restructuring was necessitated by the introduction of the new Unemployment Insurance Act which came into effect on 1 April 2002.

Non-financial public-sector borrowing requirement

The non-financial public-sector enterprises and corporations produced a financial *surplus* during fiscal 2001/02, helping to improve the financial results of the non-financial public sector (i.e. the consolidated central government, provincial governments, local governments and non-financial public enterprises and corporations) from a borrowing requirement of R12,0 billion in fiscal 2000/01 to R5,4 billion in 2001/02. As a ratio of gross domestic product, this borrowing requirement amounted to 0,6 per cent in fiscal 2001/02 compared with 1,3 per cent in the previous fiscal year. Medium-term estimates contained in the *Budget Review 2002* indicate that the borrowing requirement of the public sector is expected to increase to 1,4 per cent of gross domestic product in fiscal 2002/03 and to 1,7 per cent in the ensuing two years, giving credence to government's resolve to attain financial discipline at all levels of the public sector.

Non-financial public-sector borrowing requirement



National government finance in the April-June quarter of fiscal 2002/03

National government expenditure and revenue in the first quarter of fiscal 2002/03 resulted in a deficit of R1,6 billion. After allowing for extraordinary payments of

R0,3 billion, the net borrowing requirement amounted to R1,9 billion. In April 2002 the National Treasury announced the launch of a new 10-year US dollar bond, maturing in April 2012 with a coupon rate of 7,375 per cent. This transaction mobilised R11,0 billion for the National Revenue Fund and concluded government's budgeted funding programme in the international market for fiscal 2002/03, envisaged in the *Budget Review 2002.*

National government financing in fiscal 2002/03
R billions

	Budgeted	April-June 2002
Deficit	22,7	1,6
Plus: Extraordinary payments	1,6	0,3
Less: Extraordinary receipts	12,0	0,0
Net borrowing requirement	12,3	1,9
Domestic primary capital market		
Government bonds	...	5,0
Less: Discount on government bonds	...	0,6
Net receipts from government bonds issued	-11,0	4,4
Treasury bills	4,0	4,1
Foreign loans	16,3	12,7
Change in available cash balances*	3,0	-19,3
Total net financing	12,3	1,9

* Including changes in the Exchequer and Paymaster-General Account balances with the South African Reserve Bank and private-sector banks, as well as changes in other balances stemming from timing differences in the recording of transactions and bank clearances (Increase -, decrease +)