# Annual Economic Report

2003

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-third ordinary general meeting to be held on 26 August 2003. 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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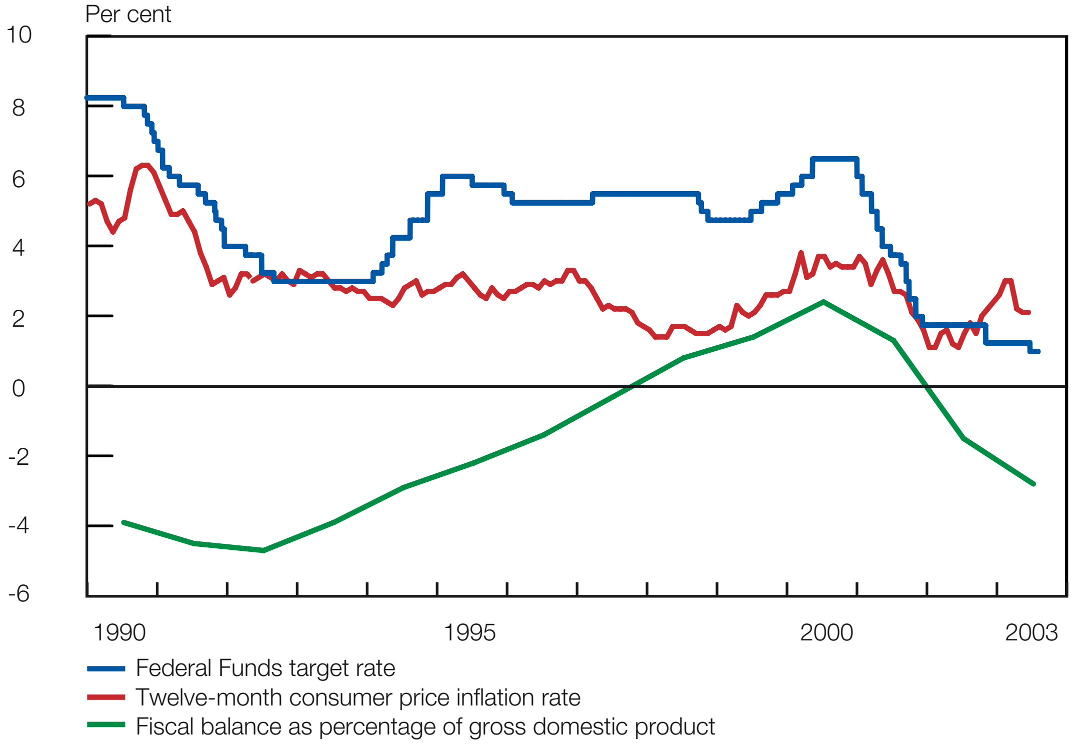
Annual Economic Report 2003

## Introduction

The global economy recovered hesitantly in 2002 after a sluggish growth rate had been recorded in 2001. World output growth is estimated to have accelerated from 2½ per cent in 2001 to 3 per cent in 2002. The outlook for the first half of 2003 was clouded by uncertainties related to the war in Iraq, which eventually broke out in late March 2003. This was aggravated by the outbreak of the Severe Acute Respiratory Syndrome (SARS) epidemic which was concentrated in the Asia Pacific region and parts of North America. The tourism and travel industries in particular were adversely affected by fears of SARS.

While economic activity in most parts of the world remained lacklustre during the past year, inflation was quite low, allowing central banks sufficient leeway to pursue accommodative monetary policies. In the United States, for instance, the Federal Funds target rate was eventually reduced to one per cent per annum, its lowest level in forty-five years. Simultaneously, fiscal policy was loosened quite substantially through a combination of increased government expenditure and reduced taxes. Most developed countries pursued expansionary macroeconomic policies; the combination of monetary and fiscal policy settings adopted in the United States is illustrated in the accompanying graph. Despite these policy measures, however, firm evidence of a resumption of sustained buoyancy in the major developed economies was still being awaited by mid-2003, even though some leading indicators had started to improve.

Indicators of monetary and fiscal policy in the USA



These developments and concerns about the growth prospects of major industrialised countries had a significant impact on South Africa's economic performance during the past year. Weakness in the world economy caused a reduction in the demand for South African exports, which in turn contributed to a slowdown in real gross domestic product growth. The recovery in the exchange value of the rand also reduced the international competitiveness of South African producers.

Growth in South Africa's *real gross domestic product* peaked in the first half of 2002 and slowed down to an annualised 1½ per cent in the first half of 2003 – less than half its recent peak pace of increase in the first half of 2002. The slowdown was most severely felt in manufacturing and in the primary sectors, with real output stagnating or contracting in each of these sectors during the first half of 2003.

Notwithstanding slower growth in real production over the past year, the growth in aggregate gross domestic expenditure remained fairly buoyant, recording annualised half-yearly increases of 4½ per cent in both the second half of 2002 and the first half of 2003. This development indicates strong support for production from domestic demand. Conversely, exports of goods and services have faltered from the second half of 2002, having previously been underpinned by the depreciation of the rand in the second half of 2001.

All the components of final domestic expenditure continued to rise during the past year. Growth in real gross fixed capital formation, in particular, accelerated strongly during 2002 and reached an annualised rate of 9 per cent in the second half of that year. It decelerated to a still solid 8 per cent in the first half of 2003 as capital formation in agriculture receded on account of falling product prices and lower output volumes. Public corporations' investment spending remained buoyant, while that of general government accelerated somewhat from low levels.

Growth in household final consumption expenditure has remained firm despite the tighter monetary policy stance. Households maintained expenditure growth partly by increasing their use of bank credit. Government consumption expenditure growth accelerated slightly, signalling government's greater emphasis on service delivery.

While poor employment prospects continue to hound the South African labour market, comprehensive figures obtained from the 1996 and 2001 Population Censuses indicate an increase in overall employment of 470 000 persons between the two census dates. The less comprehensive enterprise-based data on formal employment in the main non-agricultural sectors indicate a welcome increase in employment in 2002, following a persistently downward trend since 1989.

Whereas 2002 was a year of disquiet and frustration during which inflation worsened appreciably and moved beyond the 10 per cent mark following the strong depreciation of the exchange rate of the rand in 2001, the progress made in arresting inflation during 2003 has been gratifying. Prudent monetary and fiscal policies as well as the recovery in the exchange value of the rand have contributed to the remarkable reduction in inflation. Whereas the twelve-month rate of increase in the overall consumer price index for metropolitan and other urban areas excluding mortgage interest costs (CPIX) reached a peak of 11½ per cent in late 2002, this rate had fallen back to 6½ per cent by June 2003 – close to the psychologically important target range of 3 to 6 per cent.

The prices of services tend to retain their momentum more than the prices of goods, which are more subject to the disciplines of international competition. While services prices helped to stabilise CPIX inflation, the production price index (PPI), covers only goods, displayed significantly more volatility over the past year. Its movements were largely driven by changes in the exchange rate. Led by the prices of imported items, the twelve-month rate of increase in overall production prices reached a maximum of 15,4 per cent in September 2002 before declining abruptly, on account of the recovery in the exchange rate, to a level of 1,2 per cent in May 2003 – its lowest value in the past thirty-five years – and 2,3 per cent in June.

In wage negotiations, past inflation tends to be strongly emphasised while forward-looking projections of inflation are afforded little significance – a phenomenon which an inflation-targeting policy framework tries to turn around. The acceleration in inflation in 2002 fed into both the 2002 and 2003 wage negotiations, and contributed to fairly high settlements. Wage settlements of around 10 per cent have recently been agreed upon; bold advances in productivity would be required to reconcile these wage increases with the inflation target range of 3 to 6 per cent.

In 2002 South Africa recorded its first full-year surplus on the current account of the balance of payments since 1994. However, the surplus on the current account narrowed significantly during the second half of 2002, before reverting to a deficit in the first half of 2003. Weak demand in the world economy contributed to a decline in export volumes in 2002 and a further marginal decrease in the first half of 2003, while import volumes rose somewhat throughout this period, supported by firm growth in real gross fixed capital formation.

A large surplus on the financial account of the balance of payments in the first half of 2002 was followed by a very small surplus in the second half as net inward portfolio investment turned around. In the first half of 2003 a sizeable surplus was again recorded, partly on account of funds mobilised by the national government in the international capital market and foreign direct investment in a South African steel company.

South Africa's net international reserves rose significantly in 2002 and the first half of 2003. As the Reserve Bank purchased the foreign currency proceeds of the government's foreign borrowing or bought small amounts of foreign exchange in the market, it preferred to deliver the bulk of the amounts acquired against its forward book. A milestone was reached on 16 May 2003 when the net open foreign-currency position (NOFP) of the Reserve Bank recorded its first-ever positive balance, having been in an oversold dollar position of more than US$23 billion as recently as 1998. The reversal to a positive balance involved, *inter alia,* the purchasing by the Reserve Bank of the proceeds of a €1,25 billion bond raised by the government, and the application of this amount against the forward book.

Sound and consistent price signals are invaluable in directing resources towards their most efficient uses. The exchange rate, or price of foreign exchange, is probably the price in the economy with the widest impact. Having depreciated by 34½ per cent in 2001, the nominal effective exchange rate of the rand recovered by 24 per cent during 2002 and by a further 12 per cent during the first half of 2003. A preliminary comparison of the volatility of the exchange value of the rand with other currencies reveals that, over the past six years, the rand has been more volatile than the average emerging-market currency, and far more volatile than the average developed-market currency.

Over the past year the rate of increase in the monetary aggregates slowed down significantly, consistent with the slowdown in real income and inflation and the monetary policies pursued by the authorities. For instance, twelve-month growth in

M3 receded from around 20 per cent in the early months of 2002 to less than 10 per cent in most of the first half of 2003.

Banks' credit extension to the domestic private sector rose very rapidly in the early months of 2003, but this was mainly caused by a change in accounting procedures and regulations in terms of which derivatives positions must be reported on the balance sheet on a gross rather than a net basis. When adjusted for this change, growth in credit extension indeed slowed down during 2002, but accelerated again to double-digit levels in the first half of 2003. Mortgage advances to households and loans to companies rose briskly in the first six months of 2003.

In ensuring orderly liquidity conditions in the money market, the Reserve Bank succeeded, through a combination of strategies, to reduce its use of liquidity-draining instruments from R69 billion in August 2002 to approximately half that amount at the end of July 2003. The Bank was assisted by the repayment of liquidity assistance which it had provided to banks in the previous year, and by the appreciation of the external value of the rand. The Bank's repurchase rate remained effective; other short-term interest rates remained well-aligned with it.

The upward cycle in the repurchase rate during the first nine months of 2002 involved a cumulative increase of four percentage points – less than in any other of the past five cycles and also shorter in duration than most of its predecessors. Together with the relatively low level of households' indebtedness, it contributed to the containment of debt problems and insolvencies.

Long-term bonds have enjoyed a bull run from late March 2002, supported by the recovery in the exchange rate, conservative financial policies and therefore favourable market expectations regarding long-term inflation prospects, and the containment of the public-sector borrowing requirement. The yield curve became inverted from April 2002 in response to the tighter monetary conditions, but started to return to its conventional upward-sloping shape after the Bank eased its policy stance in June and again in August 2003.

During the first six months of 2003 the domestic market gained favour among international investors as perceptions of South Africa as an investment destination improved. The recent favourable ratings by international credit ratings agencies contributed to the improved sentiment. The higher ratings confirmed South Africa's solid economic policy and good credit record, the steady improvement in economic indicators, higher and steadier growth and improved resilience of the South African economy to external shocks, despite the volatility in the external value of the rand. Foreign investors increased their holdings of both bonds and shares during the first six months of 2003.

After reaching an all-time high in May 2002 the share market abruptly turned around, primarily due to the recovery of the exchange rate of the rand, while investor concerns regarding future profitability, weak global economic growth and, more recently, the war in Iraq and the SARS virus also contributed to the negative sentiment. The bear trend of 2002 continued into the first part of 2003 as the monthly average price level of all classes of shares lost nearly a third of its value from May 2002 to April 2003, before recovering somewhat in the three months to July 2003.

In contrast to the bearish sentiment in the share market, the rate of increase in residential property prices remained fairly steady during 2002 and accelerated from early in 2003. The buoyancy in the property market is probably explained by its relative attractiveness as an investment alternative, given the poor returns from many other asset classes, both domestically and globally. The growing demand for housing from the emerging black middle class and purchases in anticipation of lower interest rates could also have played a role.

Developments in the regulatory framework of South Africa's financial markets during the past eighteen months aimed to improve the integrity of the financial services industry and focused on improving the quality of financial reporting and enhancing consumer protection. The prevention of criminal conduct and misuse of the financial system, empowerment issues, and further exchange control liberalisation were also addressed.

The Budget delivered in February 2003 provided for further tax reductions and significant increases in government expenditure related to improved service delivery and extension of the safety net. It also provided for an increase in the government deficit in fiscal 2003/04, although it was projected to remain below 3 per cent of gross domestic product.

In June 2003, at a Growth and Development Summit held under the auspices of the National Economic Development and Labour Council (Nedlac), government, business, labour and organised community agreed to actions for accelerating the growth and development process. The social partners committed themselves to halving unemployment by 2014.

# Domestic economic developments

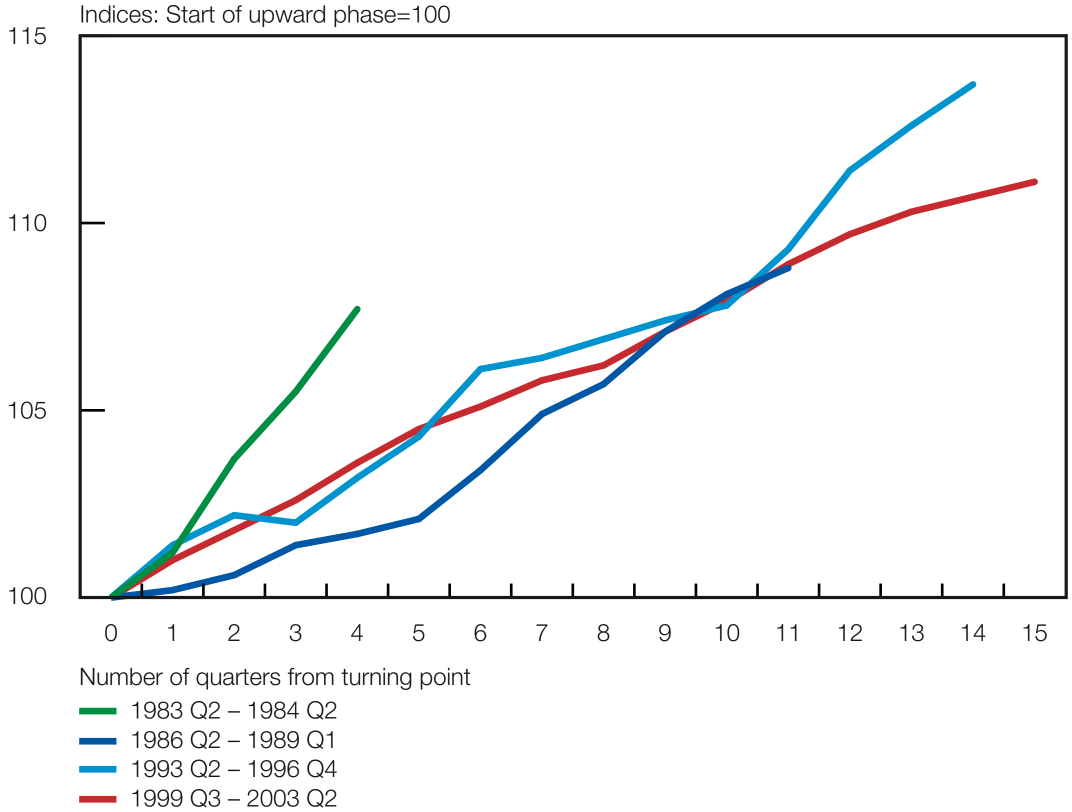
## Gross domestic production[1]

Real economic growth slowed down from an annualised rate of 3 per cent in the second half of 2002 to just 1½ per cent in the first half of 2003. The weaker growth was the result of a contraction in real output in agriculture, and stagnation in the mining and manufacturing sectors which was compounded by slower growth in almost all the other sectors of the economy. Preliminary estimates indicate that, to obtain a growth rate of about 2 per cent for 2003 as a whole, an annualised rate of increase of about 1½ per cent has to be realised in the second half of 2003.

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

An analysis of the current upward phase of the business cycle indicates that over its fifteen-quarter duration, real gross domestic product increased at an average annualised rate of 3 per cent. This is roughly the same as in the upswing between 1986 and 1989, but marginally lower than the annualised growth rate of 3½ per cent recorded in the most recent completed upswing.

Real gross domestic product during economic recoveries




The exchange rate of the rand, which had depreciated significantly towards the end of 2001, appreciated somewhat at the beginning of 2002, but recovered more significantly towards the end of the year and in the first half of 2003. Perversely, the considerable appreciation of the currency had a negative impact on business confidence, particularly the export-oriented mining industry and sections of manufacturing and agriculture. The recovery of the rand eroded part of the competitiveness which these industries had enjoyed in 2002. The volatility of the exchange rate appears to pose more of a problem for business confidence in many industries, as it complicates long-term planning and increases the perceived risk of exchange rate losses. Together, the subdued world economy, the behaviour of the exchange rate and the high level of interest rates resulted in a lower growth performance of the economy during the first half of 2003.

### Real gross domestic product

Percentage change at seasonally adjusted annualised rates

| | 2001 | 2002 | | | 2003 |
|---|---|---|---|---|---|
| Sectors | Year | 1st half | 2nd half | Year | 1st half |
| Primary sectors | -1½ | 2½ | 2½ | 1½ | -1½ |
| Agriculture | -1½ | 6 | 4½ | 4 | -3½ |
| Mining | -1½ | -½ | 1 | -½ | 0 |
| Secondary sectors | 3½ | 4 | 3½ | 3½ | ½ |
| Manufacturing | 3½ | 5 | 3½ | 4 | 0 |
| Electricity, gas and water | 1½ | 1½ | 1½ | 1½ | 2 |
| Construction | 5½ | 2 | 3 | 2 | 3½ |
| Tertiary sectors | 3½ | 3 | 3 | 3 | 2½ |
| Commerce | 3½ | 2½ | 2½ | 2½ | 2 |
| Transportation and communication | 7 | 5½ | 6 | 6 | 5½ |
| Financial and other services | 4½ | 3½ | 3 | 3½ | 2 |
| Non-agricultural sectors | 3 | 3 | 3 | 3 | 2 |
| Total | 3 | 3½ | 3 | 3 | 1½ |

Following an increase at an annualised rate of 4½ per cent in the second half of 2002, real value added by the *agricultural sector* declined at a rate of 3½ per cent in the first half of 2003. The sharp fluctuations in the growth rates of the agricultural sector broadly reflected the changes in field crop production, including maize. The 2002 calendar year was a good one for the maize crop in South Africa. The drought which led to crop failures in large parts of Southern Africa did not affect the domestic crop. As a result, about 10,1 million tonnes of maize were harvested. By contrast, the total maize crop expected for 2003 is about 9,2 million tonnes. The smaller crop was due to poor weather conditions which counterbalanced a comparatively large area planted this season. Simultaneously, the growth in real output by other subsectors of the agricultural sector also slowed down substantially.

Following an increase at an annualised rate of 1 per cent in the second half of 2002, the real output of the *mining sector* moved sideways in the first half of 2003. On an annual basis – with the exception of 1997, when the real value added increased by 1½ per cent – real output in this sector has been in secular decline since 1995. However, the second half of 2002 was marked by an increase in gold-mining output. The increase in gold production may have resulted from the concentration of mining activities on ore deposits with a high gold content. In addition, diamond production increased as world demand picked up somewhat.

The combined effect of a weaker rand and improved global conditions boosted output in the mining sector, of which the bulk is exported, during the second half of

2002. However, this burst in activity was short-lived as real mining output moved sideways in the first half of 2003. This was the net result of a decline in gold output and slower growth in platinum-mining production which more than offset a mild increase in coal and diamond-mining output. Diamond mining benefited from jewellers' endeavours to meet pent-up global demand. The increase in platinum output lost momentum in the first half of 2003 mainly due to industrial action at a major mine in the early part of the year. In addition, the stronger rand also took its toll on the outlook for profits and output in many parts of the mining industry. It would nevertheless appear as if the secular decline in the mining sector might be bottoming out despite weak activity in the gold-mining subsector, as other mining subsectors move ahead.

Real manufacturing output increased at an annualised rate of almost 4 per cent during the current upward phase of the business cycle, which compared favourably with the 3½ per cent attained in the previous completed upward phase of the business cycle. This can partly be attributed to further integration of manufacturers into the global economy, opening up larger markets for domestic manufacturers.

Growth in the real value added by the *manufacturing sector* accelerated from 3½ per cent in 2001 to 4 per cent in 2002. Production was mainly underpinned by robust domestic demand, while global demand remained modest. The depreciation of the rand in late 2001 and its gradual ascent in 2002 benefited the output of manufactured exports. Up to 50 per cent of the real value added by the manufacturing sector is by export-oriented subsectors. These include industries producing chemicals and chemical products, basic metals and transport equipment. Nevertheless, this does not imply that the total output of these sectors is destined for the export market; the strength of domestic demand is equally important in inducing growth in the manufacturing sector.

When the exchange rate of the rand depreciated, the initial benefit was in the support which it rendered to exports as South African goods became internationally more competitive. In addition to that, the weaker rand led to increased production due to import substitution. These benefits started petering out in the second half of 2002. Growth in the real value added by the manufacturing sector amounted to an annualised rate of 5 per cent in the first half of 2002, but slowed down to 3½ per cent in the second half of 2002. Following a solid performance in 2001 and 2002, real manufacturing output stagnated in the first half of 2003. This can be ascribed to faltering world demand and the slower momentum in the growth of domestic demand. Stagnant output was spread throughout the major manufacturing subsectors. It was particularly pronounced in the chemicals and chemical products, basic metals, transport equipment, clothing and textiles, as well as electrical machinery subsectors.

The weak performance of the manufacturing sector in the first half of 2003 can be attributed to, among other things:

- weak demand conditions in the euro area which affected export volumes;
- domestic manufacturers losing international price competitiveness due to the appreciation of the rand and higher unit labour costs, neutralising the benefits derived from existing preferential trade agreements;
- domestic demand increasing at a slower rate as reflected by the reduction in the number of new orders for manufactured products; and
- relatively low business confidence in the first half of the year due to the recovery in the exchange rate of the rand coupled with high interest rates.

The real value added by the sector supplying *electricity, gas and water* increased at a sustained rate of 1½ per cent in 2001 and 2002 before accelerating to 2 per cent in the first half of 2003. Growth in electricity production has been lacklustre, in keeping with recent economic developments and the more efficient use of electricity in various areas of the economy. The mild winter experienced in 2003 further contributed to a subdued demand for electricity. In addition, real value added by the electricity subsector is also influenced by electricity imports from and exports to neighbouring countries. The growth in real electricity output in the first half of 2003 was supported by lower levels of electricity imported from Mozambique, as well as somewhat stronger demand for electricity exports from neighbouring countries.

Growth in the real value added by the *construction sector* accelerated marginally from an annualised rate of about 3 per cent in the second half of 2002 to 3½ per cent in the first half of 2003. This can mainly be attributed to activity in the residential building sector. Demand for residential buildings, particularly in security complexes, held up well throughout 2002 despite the 400-basis-point increase in interest rates. This was probably partly due to the time lag from interest rate changes to a response in demand, and the fact that nominal interest rates did not rise by as much as in previous policy-tightening episodes. There are indications that demand lost some momentum in the second quarter of 2003. On the other hand, general government has raised spending on construction works for infrastructure improvement.

Real value added by the *tertiary sector* increased by 3 per cent in 2002, following a marginally stronger growth rate of 3½ per cent recorded in 2001. The slowdown in growth persisted into the first half of 2003 as real value added increased at an annualised rate of 2½ per cent. The slower growth momentum was evident in the trade, transport, storage and communication, and the finance, insurance, real estate and business services sectors. There has been stable and sustained growth of at least 3 per cent in the tertiary sector almost uninterruptedly for fifteen quarters until the end of 2002, which contributed substantially to growth in total real gross domestic product.

Growth in the real value added by the *commerce sector* slowed down from 3½ per cent in 2001 to 2½ per cent in 2002. The growth rate slowed down further to an annualised 2 per cent in the first half of 2003, corresponding closely with the slowdown in general economic activity. The lower growth can mainly be ascribed to a contraction in the real value added by the wholesale trade sector which neutralised firm growth in the retail trade sector. Marginal growth in real output by the motor trade subsector was primarily due to subdued demand by consumers in the face of higher prices and the higher cost of credit. However, as prices seem to have stabilised and interest rates have started to decrease, the weakness in the real value added by the motor trade subsector might have bottomed out.

The sustained increase in real output by the retail trade sector was a reflection of resilient consumer demand. Demand for semi-durable goods remained fairly high, particularly in ladies' clothing and audio equipment where heightened competition made prices more affordable to consumers. Real value added by the catering and accommodation sector faltered, partly due to the recovery of the rand, the international instability brought about by the war in Iraq as well as fears about SARS. These developments discouraged some foreign tourists from visiting South Africa.

The continued expansion and enhanced competition in the country's cellular communication industry due to the introduction of Cell-C as a third network in 2001, is still providing an impetus for growth in the real value added by the *transport, storage and communication sector*. Notwithstanding that, growth in this sector slowed down from 6 per cent in the second half of 2002 to 5½ per cent in the first half of 2003. This was mainly due to subdued activity in the real value added by the transport subsector. Land transport was adversely affected by lower volumes of goods transported as a result of reduced export and import activity as well as somewhat weaker domestic demand. The brief spurt of higher growth experienced in the air transport subsector around the ICC Cricket World Cup subsequently petered out and was in any event insufficient to lift growth substantially.

Growth in the real value added by the *finance, insurance, real estate and business services sector* decreased steadily from 4½ per cent in 2001 to about 2 per cent in the first half of 2003. This was primarily due to slower growth in the real value added by security traders. The growth performance in this subsector was negatively affected by lower trading volumes on the JSE Securities Exchange South Africa. However, it was partly countered by the real value added by the real-estate subsector which increased robustly from the second half of 2002 to the first half of 2003. This was the result of ongoing activity in the residential market as the demand for existing houses and new units in security complexes remained high.

Following an increase of 4½ per cent in 2002, the growth in *real gross national income* slowed down to an annualised rate of 2½ per cent in the first half of 2003. The growth in real gross national income in 2002 was mainly supported by lower net primary income payments to the rest of the world, particularly dividend payments. Dividend payments to non-resident shareholders returned to more "normal" levels in 2002 following the highs of 2001. This more than neutralised the substantial interest payments made during 2002 on foreign portfolio capital invested in the domestic securities markets. In addition, there was a marked improvement in the international terms of trade. Conversely, net primary income payments to the rest of the world picked up in the first half of 2003, slowing the growth in gross national income. Growth in real gross national income per capita accelerated from an annualised rate of 1 per cent in 2000 to 2½ per cent in 2002, the highest annual growth rate since 1994. Although the level of real gross national income per capita stagnated during the first half of 2003, it was still about 5 per cent above that of 1999 as a whole.

## Gross domestic expenditure [2]

*Aggregate real gross domestic expenditure* increased at an annualised rate of 3½ per cent in the current upward phase of the business cycle. This is the lowest rate of increase recorded in the past four upward phases of the business cycle. However, in keeping with the trend of the previous upward phases, real gross domestic expenditure grew at a faster pace than real gross domestic product.

*2 The growth rates referred to in this section are based on seasonally adjusted data.*

Growth in real gross domestic expenditure retained its momentum, recording an annualised rate of 4½ per cent in both the second half of 2002 and first half of 2003. This can mainly be attributed to marginally weaker growth in domestic final demand. While growth in real final consumption expenditure by households and real gross fixed capital formation remained strong in the first half of 2003, it has nevertheless edged down somewhat compared to the second half of 2002. Real final consumption expenditure by general government maintained the same growth rate attained in the second half of 2002.

Real gross domestic expenditure
Percentage change at seasonally adjusted annualised rates

| | 2001 | 2002 | | | 2003 |
|---|---|---|---|---|---|
| Components | Year | 1st half | 2nd half | Year | 1st half |
| Final consumption expenditure by households | 3 | 3½ | 3 | 3 | 2½ |
| Final consumption expenditure by general government | 3½ | 3½ | 4 | 3½ | 4 |
| Gross fixed capital formation | 3 | 7 | 9 | 6½ | 8 |
| Change in inventories (R billions, 1995 prices) | 1,7 | 3,4 | 5,3 | 4,4 | 5,3 |
| Gross domestic expenditure | 2½ | 3½ | 4½ | 4 | 4½ |

## Final consumption expenditure by households

Growth in *real final consumption expenditure by households*, which accounts for about 63½ per cent of total gross domestic product, slowed down slightly from an annualised rate of 3 per cent in the second half of 2002 to 2½ per cent in the first half of 2003. This slowdown can mainly be attributed to weaker growth in real outlays on durable and semi-durable goods. Expenditure on non-durable goods and services was sustained at the rates attained in the second half of 2002.

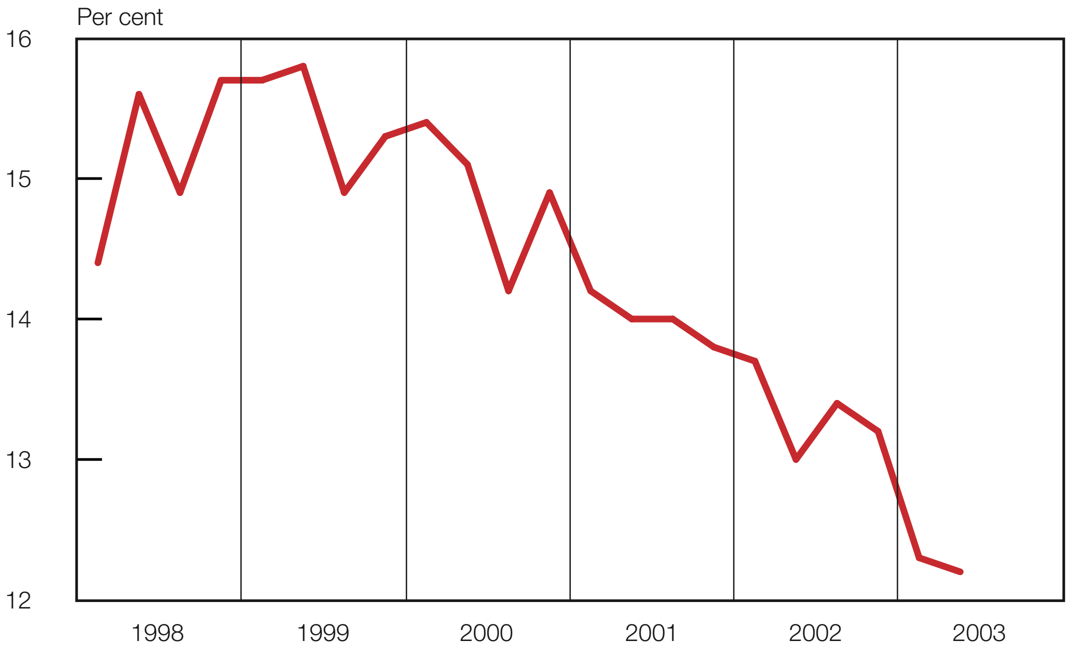
Growth in durable goods expenditure slowed down sharply from 2½ per cent in the second half of 2002 to ½ a per cent in the first half of 2003. This can mainly be attributed to a decline in real outlays on personal transport equipment, which was reinforced by weaker growth in expenditure on furniture and household appliances and other durable goods categories. Real expenditure on personal transport equipment, new motor vehicles in particular, declined at a rate of 2 per cent in the first half of 2003 following an increase at a rate of 1 per cent in the second half of 2002. Although prices of new motor vehicles stabilised from their steep increases in 2002, they remained expensive while interest rates also remained relatively high during most of the first half of the year, dampening demand for new cars. There was some firmness in the used-car market but this was not sufficient to offset the decline in real outlays on new cars.

Real expenditure on semi-durable goods slowed down to a 3 per cent growth rate in the first half of 2003 compared to 6½ per cent in the second half of 2002. This can mostly be ascribed to a contraction in growth in real outlays on car parts and accessories. In addition, growth in expenditure on clothing and footwear, household textiles, and recreational and entertainment goods also slowed down. While households economised on discretionary items like durable and semi-durable goods, expenditure on essential non-durable goods and services remained stable. Real outlays on food increased in response to lower food price inflation.

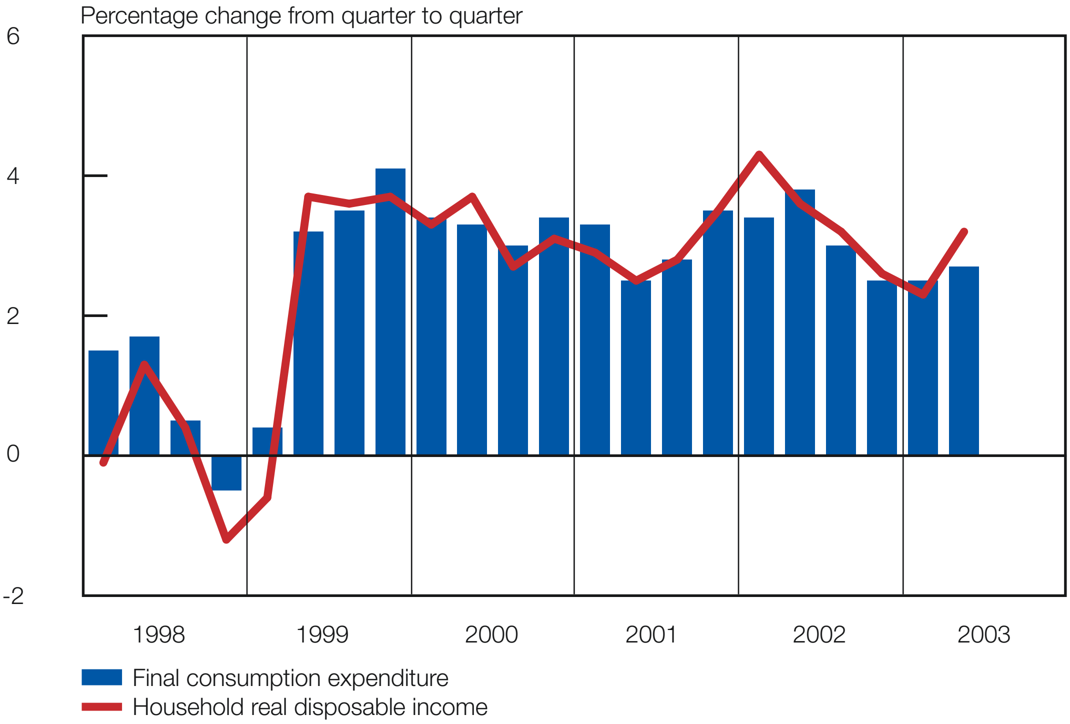
The sustained demand for consumer goods and services can partly be attributed to the increase in the real disposable income of households which benefited from:
- increases in salaries and wages at rates matching or exceeding the current inflation rate;
- the cash injection from tax reductions in the 2003/04 Budget, with tax payments as percentage of current income declining from 15½ per cent in 1999 to an average of 12½ per cent in the first half of 2003;

- the increase in the size of the child grant which was introduced in 2002, and its extension to children in an older age group in the current Budget;
- the lower petrol price in the first half of 2003 compared to the second half of 2002, which further eased conditions for households; and
- the well-contained level of household debt and debt service cost.

Income tax paid as percentage of current household income




Real final consumption expenditure and disposable income of households




Seasonally adjusted annualised rates

Although growth in the demand for durable and semi-durable goods weakened somewhat in the first half of 2003, household debt as a ratio of disposable income increased from 51½ per cent in the second half of 2002 to about 53 per cent in the first half of 2003. A large part of the increase in debt was related to the acquisition of fixed property rather than consumer items.

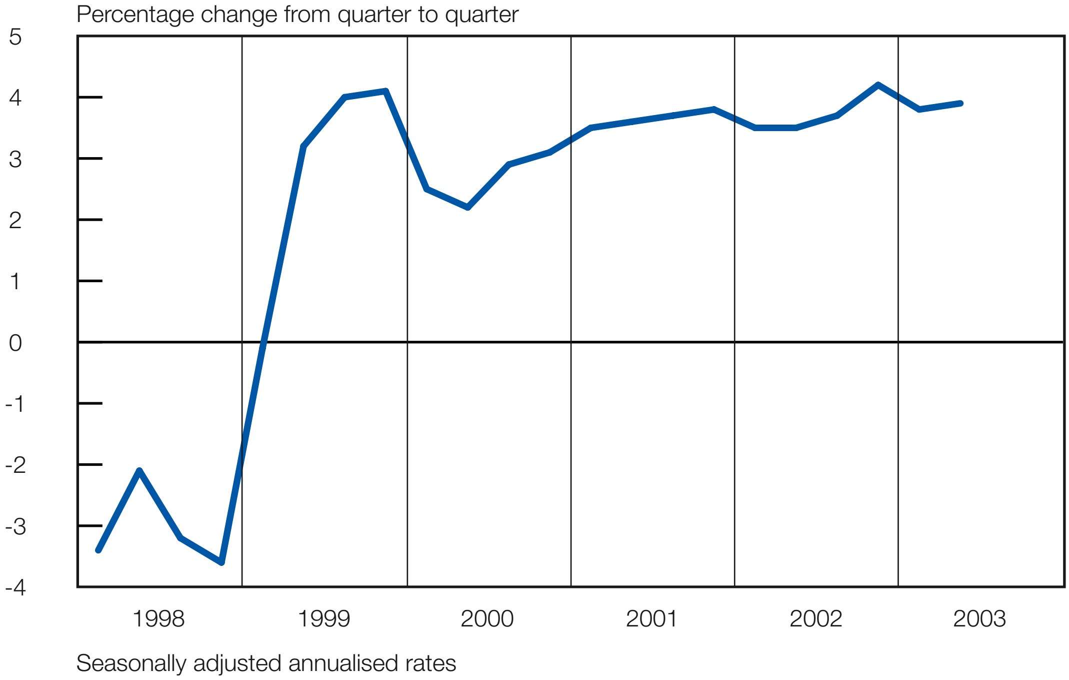
Real final consumption expenditure by households
Percentage change at seasonally adjusted annualised rates

| | 2001 | 2002 | | | 2003 |
|---|---|---|---|---|---|
| Components | Year | 1st half | 2nd half | Year | 1st half |
| Durable goods | 3½ | ½ | 2½ | 1½ | ½ |
| Semi-durable goods | 6 | 13 | 6½ | 9½ | 3 |
| Non-durable goods | 1½ | 2 | 1½ | 2 | 1½ |
| Services | 4 | 3 | 3½ | 3½ | 3½ |
| **Total** | **3** | **3½** | **3** | **3** | **2½** |

## Final consumption expenditure by general government

Growth in *real final consumption expenditure by general government* accelerated from 3½ per cent in 2001 and 2002 to 4 per cent in the first half of 2003. The sustained increase in real government consumption expenditure was mainly evident in real outlays on other goods and services while compensation of employees rose marginally, having declined from 1998 to 2001. As a result of these developments, the ratio of final consumption expenditure to gross domestic product increased from 19 per cent in 2002 to 19½ per cent in the first half of 2003.

Real final consumption expenditure by general government



The modest growth in real expenditure on compensation of employees was in keeping with the government policy of maintaining fiscal discipline to support economic growth and job creation. Total real compensation of employees as a percentage of total consumption expenditure by general government decreased from about 65½ per cent in 2000 to about 59 per cent in the first half of 2003. This indicates that while government is still focused on expenditure on individual goods and services (health, education and other social services), there has been a gradual shift in the input mix required to deliver appropriate services to society, with less spending on the compensation of employees and more on non-wage goods and services. Real growth in the latter aggregate accelerated from 8½ per cent in the second half of 2002 to 9½ per cent in the first half of 2003.

## Gross fixed capital formation

*Real gross fixed capital formation* increased strongly in the first half of 2003, albeit at a slightly slower pace than in the second half of 2002. This aggregate benefited from the need to be competitive in an increasingly globalised environment. After increasing at an annualised rate of 3 per cent in 2001, growth in real gross fixed capital formation accelerated to 6½ per cent in 2002. Activity peaked in the second half of 2002 as fixed capital formation increased at a rate of 9 per cent before slowing down to 8 per cent in the first half of 2003. The growth in real fixed capital formation by both the private sector and public corporations slowed down somewhat in the first half of 2003.

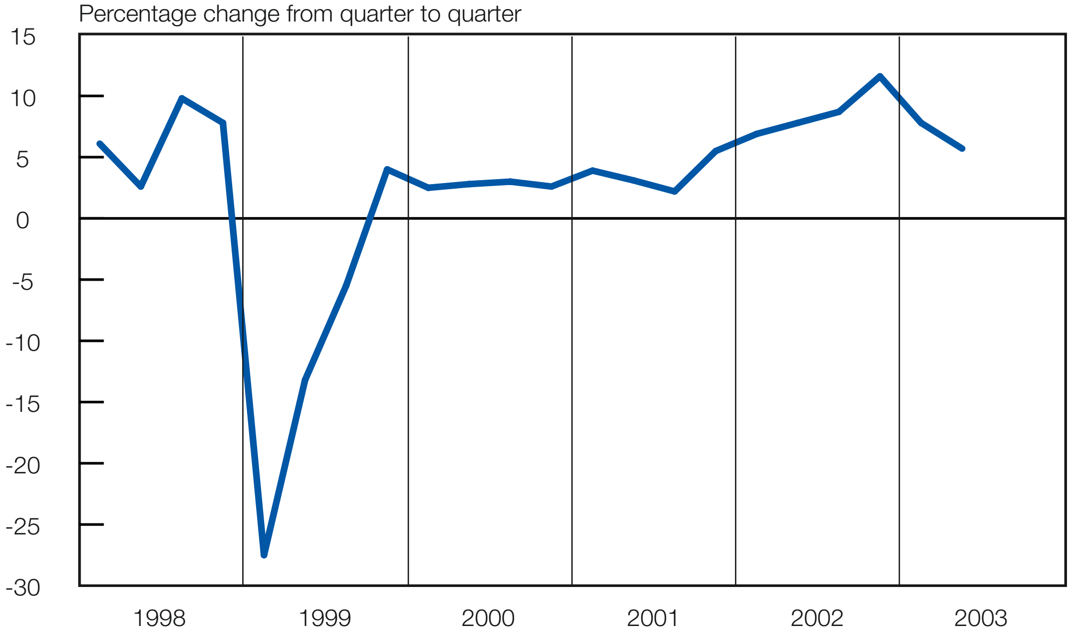
### Real gross fixed capital formation by type of organisation
Percentage change at seasonally adjusted annualised rates

| | 2001 | 2002 | | | 2003 |
|---|---|---|---|---|---|
| Components | Year | 1st half | 2nd half | Year | 1st half |
| Private business enterprises | 5 | 8 | 8 | 7 | 6 |
| Public corporations | -4 | 3½ | 31 | 9 | 29 |
| General government | -½ | 1 | 1½ | 2 | 3½ |
| **Total** | **3** | **7** | **9** | **6½** | **8** |

Despite the relatively high growth rates recorded in real gross fixed capital formation from the calendar year 2001 up to the first half of 2003, the level of fixed capital formation as a percentage of gross domestic product currently amounts to 16 per cent which is significantly lower than the average of 23 per cent recorded in the 1980s. It is also marginally lower than the average of 16½ per cent recorded in the 1990s. For the economy to grow at a rate which can support the absorption of the growth in the labour force, it is estimated that the ratio of fixed capital formation to gross domestic product should increase and be sustained at between 20 and 25 per cent. South Africa's current investment ratio is still below that of most emerging-market economies.

In the *private sector,* growth in real fixed capital expenditure increased from 5 per cent in 2001 to 7 per cent in 2002 before slowing down to an annualised rate of 6 per cent in the first half of 2003. An analysis of capital spending by economic activity indicates that the growth in 2002 was mainly as a result of a surge in real capital outlays by the agricultural, mining, manufacturing, commerce, and transport and communication sectors. The agricultural sector benefited as farmers replaced ageing equipment and acquired harvesters to deal with a relatively good maize crop. They could also afford extensive capital outlays as their income was boosted by grain prices trading at import parity for most of 2002. This trend did not carry through to the first half of 2003.

Real fixed capital formation



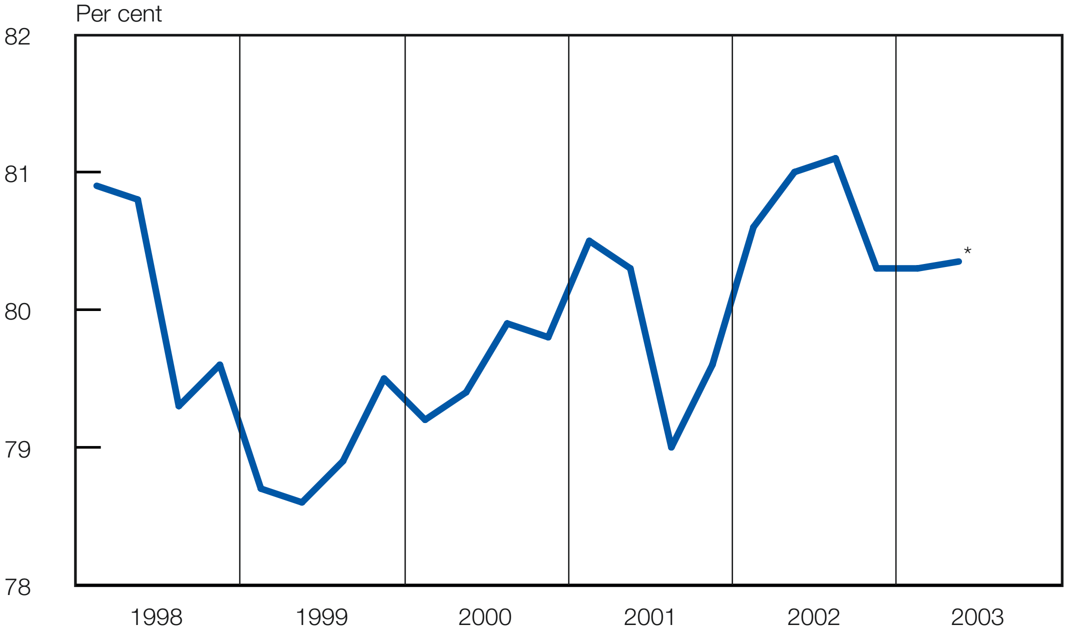

Seasonally adjusted annualised rates

In spite of the fairly high acquisition and interest cost of capital in 2002, the strong domestic demand and the increased competitiveness of South African manufactured goods due to a weaker exchange rate contributed to increased capital expenditure by manufacturers. As a result of the expansion of the production capacity in the manufacturing sector, the utilisation of production capacity declined slightly from an average of 81 per cent in the first half of 2002 to 80½ per cent in the first half of 2003. The mining sector has been investing in infrastructure extensions, particularly at platinum mines. These long-term projects have been carried through from 2002 to the first half of 2003 and investment in this area remains quite strong as these projects are fairly resistant to changes in interest rate and exchange rate fluctuations in the short run.

Real gross fixed capital formation by the *public sector* continued to be buoyant throughout the first half of 2003. Ongoing activity at the Coega harbour project in the Eastern Cape gave impetus to public-sector capital formation. In addition, Transnet is in the process of acquiring several new Airbuses, a process which started in the second half of 2002. This has provided a much-needed fillip to total fixed capital formation at a time when, with lacklustre global and domestic sales, private-sector investment growth was slowing down.

Following a contraction of ½ a per cent in 2001, growth in real gross fixed capital formation by *general government* accelerated to an annualised rate of 2 per cent in 2002 before edging up further to 3½ per cent in the first half of 2003. Solid increases in real fixed capital outlays have been recorded by all three levels of government.

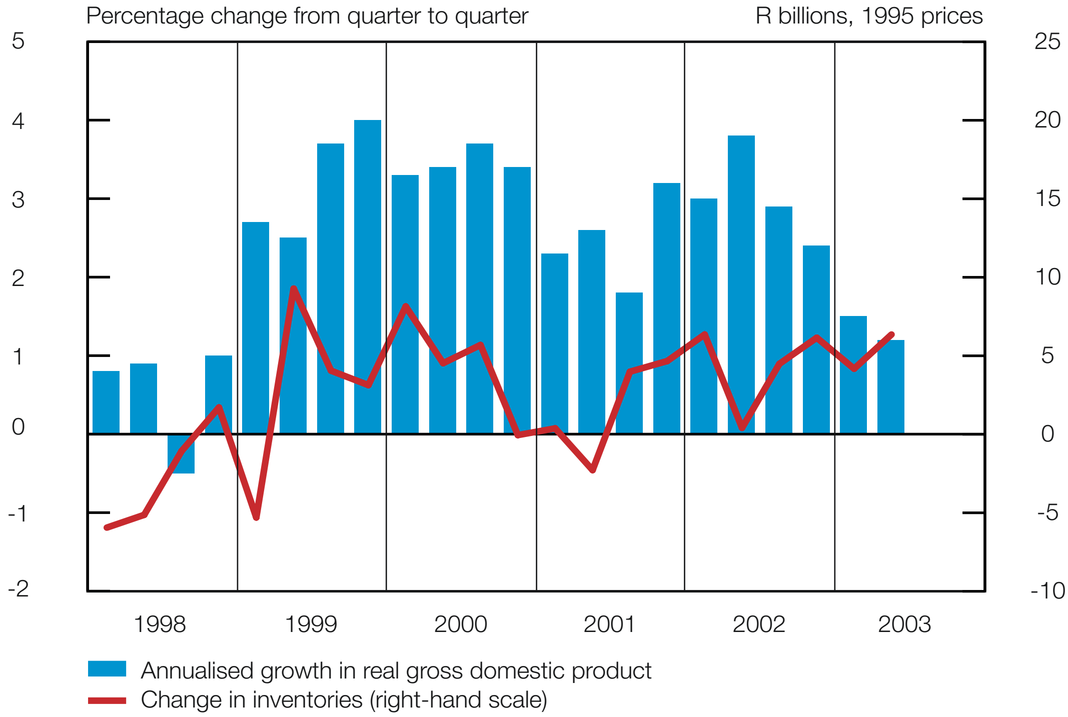
## Manufacturing capacity utilisation




* First half 2003

It is consistent with government policy to spend on infrastructure in order to support economic growth and job creation. National government's real capital expenditure has mainly been geared towards infrastructure that will enhance service delivery such as water supply. Provincial governments concentrated on the development of infrastructure for the main purpose of supporting the provision of health and educational services.

## Real gross domestic product and inventories



An analysis of gross fixed capital formation by type of asset indicates that real fixed capital outlays on construction works and machinery and other equipment increased briskly in 2002 and in the first half of 2003. The ratio of outlays on machinery and other equipment to total fixed capital formation increased to 50½ per cent in 2002 compared to an average of 44½ per cent in the 1990s. This added to the production capacity of the economy, particularly the manufacturing sector.

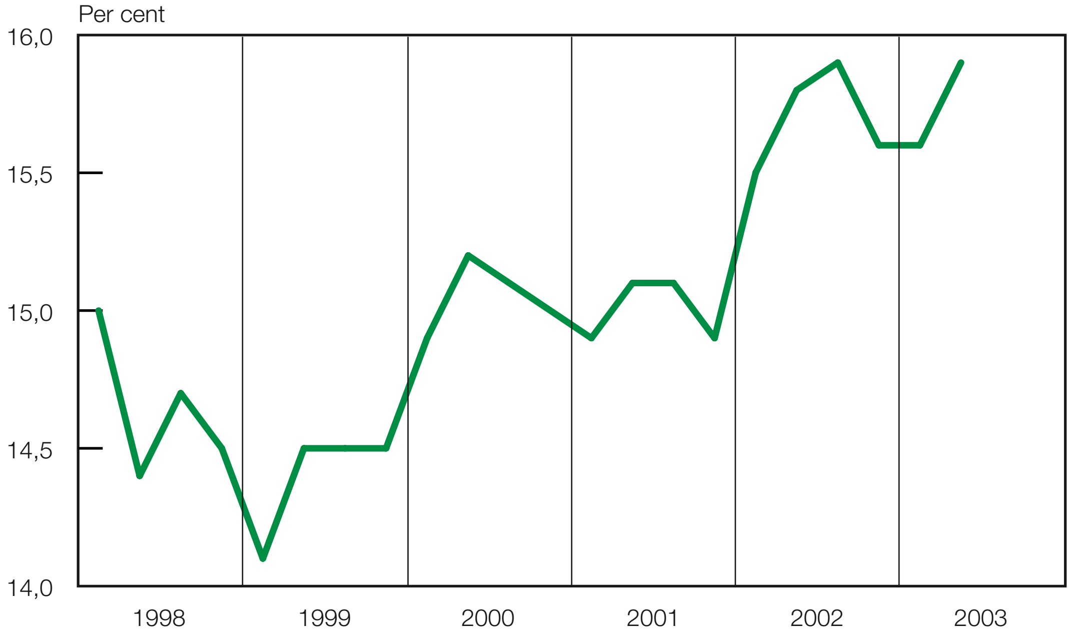
## Change in inventories

Real inventories increased by about R4,4 billion in 2002, measured at 1995 prices. There has been real inventory accumulation on an annual basis since 1999, which broadly coincides with the upward phase of the business cycle and the growth pattern in real gross domestic product. Inventories were accumulated to accommodate anticipated and realised increases in aggregate demand during the recovery in economic activity – a process which continued during the first half of 2003.

An analysis of inventory investment by economic activity in 2002 indicates that inventories were mainly accumulated by the manufacturing sector. This could be attributed to the weaker exchange rate which benefited manufacturers and induced them to accumulate inventories to meet increased domestic demand. All major economic sectors replenished inventories in 2002 against the background of high inflation, attempting to avoid paying higher prices by purchasing earlier rather than later. In addition, agricultural stocks-in-trade increased significantly on account of a fairly large maize crop, resulting in a significant carry-over of maize inventories into the 2003 harvesting season.

The continued real inventory investment in the first half of 2003 was the net result of substantial inventory accumulation by the manufacturing sector which compensated for slower inventory investment by the commerce sector. These changes could have been related to an unplanned build-up of inventories in manufacturing. Inventories continued to rise despite the high cost of carrying them, the slower anticipated

Industrial and commercial inventories as percentage of non-agricultural gross domestic product



growth in domestic demand and the postponement of purchases in anticipation of a further strengthening of the rand. The level of industrial and commercial inventories relative to non-agricultural gross domestic product rose somewhat from 15½ per cent in 2002 to 16 per cent in the first half of 2003.

## Factor income

The year-on-year growth in *total nominal factor income* accelerated from 10½ per cent in 2001 to 11½ per cent in 2002, before slowing down to 9½ per cent during the first half of 2003. Operating surpluses, rather than the compensation of employees, contributed most to the slower growth in factor income.

The growth, measured over one year, in *total compensation of employees*, which constitutes the larger component of total factor income, accelerated from 8 per cent in 2001 to 8½ per cent in 2002 and an average rate of 9½ per cent in the first half of 2003. The need to contain cost in the face of growing competition in an increasingly globalised environment forced most firms to become more cost-conscious and to rationalise their staff complements. This was more than neutralised by an acceleration in compensation of employees in other economic sectors where average wage settlements were relatively high. Consequently, the rate of increase in total nominal compensation of employees accelerated in the first half of 2003.

The growth in *aggregate nominal operating surpluses*, measured over one year, accelerated from 13½ per cent in 2001 to 14½ per cent in 2002. It subsequently slowed down to 9 per cent during the first half of 2003. All the major production sectors contributed to the slower growth in operating surpluses, with the slowdown in the export-oriented sectors being rather more pronounced. This was partly a result of lower export earnings due to the appreciation of the rand.

The share of total remuneration of employees in total factor income declined from an average of 56½ per cent in the 1990s to 54 per cent in 2000. This ratio came down to 50½ per cent in the fourth quarter of 2002 before it edged higher to an average of 52 per cent in the first half of 2003. The decline in the share of the compensation of employees relative to total factor income was the mirror image of marked increases in the gross operating surpluses of business enterprises, mainly reflecting the good performance in nominal value added by the goods-producing industries since 2000. This could, among other things, be attributed to the paring of labour resources, moderate wage growth, impressive productivity growth and the general increase in realised product prices, especially in the export-oriented subsectors, resulting from the depreciation in the value of the rand over the medium to long term.

## Gross saving

*Gross saving as a percentage of gross domestic product*, or the national saving ratio, improved from a level of less than 15 per cent in 2001 to 16 per cent in 2002. This turnaround followed a downward trend in the saving ratio which started in 1998. Most recent estimates show that the ratio subsequently receded slightly to 15½ per cent in the first half of 2003.

The recent improvement in the national saving ratio, which started in the second half of 2001, was largely determined by the behaviour of the corporate sector and the improvement of the saving levels of the general government, with household saving remaining broadly unchanged, albeit at a low level.

Gross saving by the corporate sector increased moderately from 10 per cent of gross domestic product in 2001 to 11 per cent in 2002 and an average of 11½ per cent in the first half of 2003. The improvement in the corporate saving ratio in 2002 was firstly due to a noticeable improvement in companies' operating surpluses, especially those of exporters who generated substantially higher income because of the depreciation of the rand. Secondly, dividend payments slowed down in 2002 after high dividend distributions were made in 2001. The corporate saving ratio remained at 11½ per cent in the first half of 2003, the same as recorded in the fourth quarter of 2002. The recovery in the exchange value of the rand induced lower growth in operating surpluses of export-oriented companies, while tight monetary policy, together with higher dividend payments to non-resident shareholders, weighed on the level of corporate saving in the first half of 2003.

Gross saving by general government as a percentage of gross domestic product rose from less than ½ a per cent in both 1999 and 2000 to 2 per cent in both 2001 and 2002, before receding somewhat to 1 per cent in the first half of 2003. The steady levels of government saving in 2001 and 2002 were due to tight fiscal policy and strong growth in income. However, in the first half of 2003 the growth in the general government's disposable income slowed down to 8½ per cent compared to a year-on-year growth rate of 14 per cent recorded in 2002. This was due to slower growth in tax revenues, whereas general government's current expenditure did not record a corresponding slowdown.

From 1999 to 2002 households maintained their gross saving at a level that was about equal to 3 per cent of gross domestic product. This ratio was broadly unchanged in the first half of 2003, despite a decline in household net wealth as a percentage of annualised disposable income from 275 per cent in 2002 to 264 per cent in the first half of 2003.

The national saving ratio declined from an average of 25 per cent and 24½ per cent in the 1970s and 1980s, respectively, to 16½ per cent in the 1990s and only 15½ per cent in the first three years of the present decade. Nevertheless, gross private saving, which is the mainstay of gross saving in the economy, consistently exceeded private capital formation. The private sector was therefore still generating saving in excess of its own capital needs.

Even allowing for general government, whose investment exceeded its own saving, the recent improvements in the overall saving performance was sufficient to fully finance the investment needs of South Africa in 2002 and to export R3,2 billion of excess funds generated in the economy. This was the first time since 1994 that, on a net basis, South Africa did not need foreign funds to finance its investments needs; by definition this was also reflected in a surplus on the current account of the balance of payments. However, the surplus has again turned into a deficit in the first half of 2003, with a total saving shortfall of some R11,7 billion.

## Employment

Poor employment prospects characterised the South African labour market during the past decade. However, indications are that the employment environment has started to improve. Steadier economic growth around a stronger medium-term trend is beginning to benefit employment creation. Comprehensive figures obtained from the 1996 and 2001 Population Censuses indicate that overall employment in South Africa rose by 470 000 between 1996 and 2001, with the strongest increase recorded in financial intermediation, real estate and business services, and wholesale and retail trade sectors. At the other extreme, employment shrank by nearly a third in the mining sector and more than a third in the sector supplying electricity, gas and water.

Concerning shorter-term developments, less comprehensive indicators have to be relied on. Labour market statistics suggest that formal employment in the main non-agricultural sectors expanded somewhat in 2002. This is the first increase in quarterly surveyed employment since 1989, when the employment cycle reached its peak. Employment creation in 2002 was assisted by the increased international competitiveness of local producers, following the sharp depreciation of the rand towards the end of 2001.

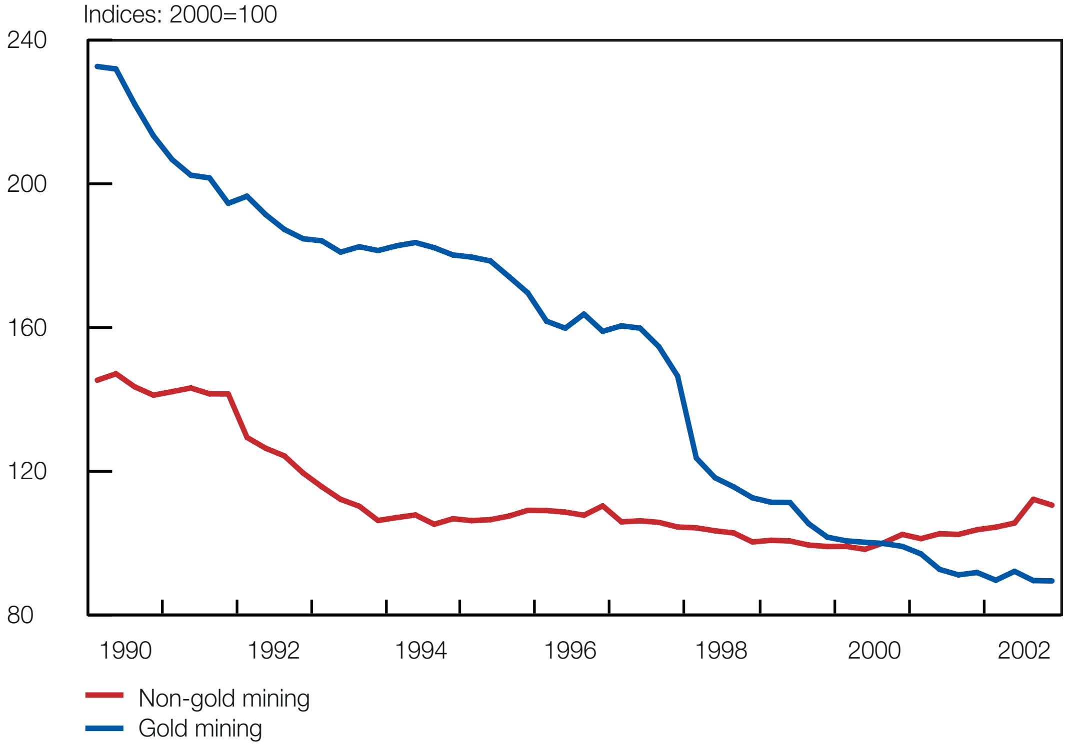
Employment according to National Population Census
Millions

| Sector | 1996 | 2001 | Percentage change |
|---|---|---|---|
| Agriculture, hunting, forestry and fishing | 0,81 | 0,96 | 17,9 |
| Mining and quarrying | 0,54 | 0,38 | -29,2 |
| Manufacturing | 1,12 | 1,21 | 7,8 |
| Electricity, gas and water supply | 0,11 | 0,07 | -34,5 |
| Construction | 0,56 | 0,52 | -6,2 |
| Wholesale and retail trade | 1,10 | 1,45 | 32,5 |
| Transport, storage and communication | 0,48 | 0,44 | -8,5 |
| Financial, insurance, real-estate and business services | 0,68 | 0,90 | 33,0 |
| Community, social and personal services | 1,58 | 1,84 | 16,5 |
| Private households | 1,05 | 0,94 | -10,7 |
| Unspecified | 1,08 | 0,86 | -20,5 |
| Total | 9,11 | 9,58 | 5,2 |

In 2002, the depreciation of the exchange value of the rand benefited the *manufacturing sector* in particular. The sector's enhanced international competitiveness was reflected in successful import substitution and export growth in some areas, despite a relatively weak world economy. The African Growth and Opportunity Act has also added impetus to South African exports to the United States of America (US). According to official US trade statistics, imports from South Africa in terms of this Act increased by 40 per cent in 2002. With an increase in manufacturing production of 5,3 per cent in 2002, employment numbers in the manufacturing sector picked up meaningfully.

During the past year or so, prospects for employment in the *mining sector* were boosted by increases in commodity prices. Employment in the non-gold mining sector increased by 5,5 per cent during 2002 as a whole. However, further employment opportunities that may arise from high gold and platinum prices during recent months are likely to be offset to some extent by the recovery of the rand.

Employment in mining sector



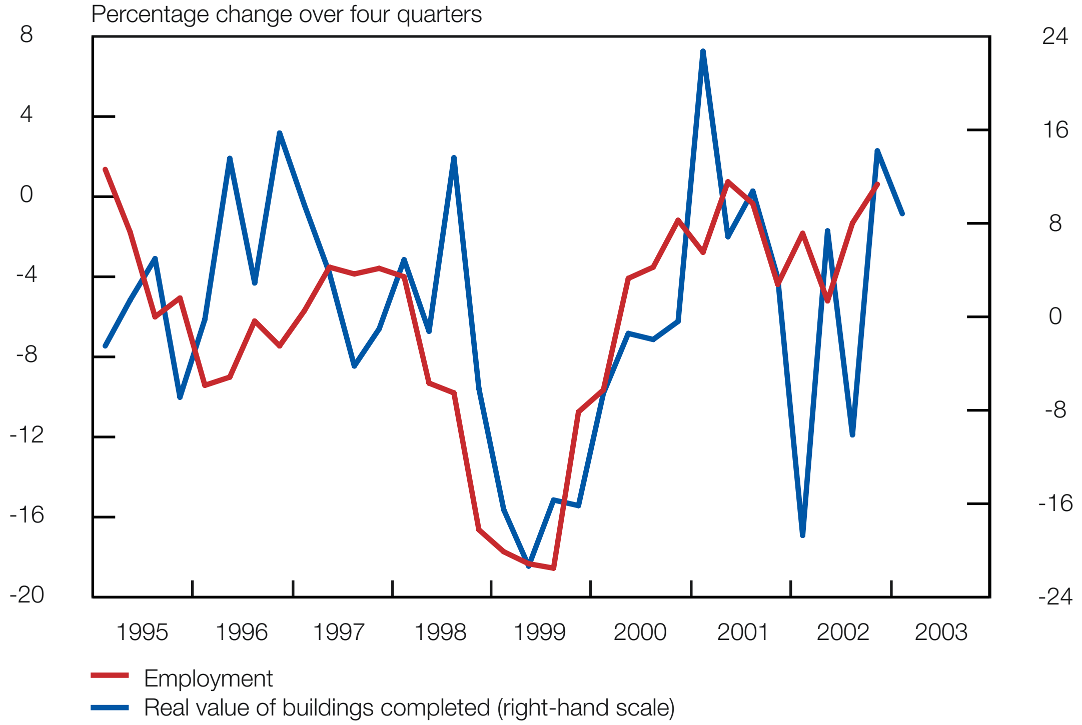

The pace of job shedding in the *construction sector* levelled out considerably during the past year. As indicated in the graph on the following page, higher growth in the real value of buildings completed moderated the pace of labour paring in the construction sector during 2002. In fact, employment in the construction sector rose somewhat from the fourth quarter of 2001 to the fourth quarter of 2002.

Employment in the *trade, catering and accommodation services sector* also benefited from the depreciation of the rand. The improvement in affordability of South Africa as a tourist destination and its distance from international conflict areas resulted in an increase of 10,9 per cent in the number of foreign tourists during 2002. The hosting of the African Union conference in July 2002, the World Summit on Sustainable Development in August 2002 and the ICC Cricket World Cup early in 2003, also contributed meaningfully towards the dramatic improvement in foreign tourism. The appreciation of the rand, an outbreak of SARS and sluggish world growth have, however, contributed to slower growth in tourism in recent months.

Employment losses occurred in the *financial intermediation and insurance services sector* during 2002. Bank takeover and rationalisation activities caused the banking sector to shed nearly 9 000 jobs over the past year. According to a Price-waterhouseCoopers survey, major banks anticipate further cuts of up to 10 per cent in their personnel complements by 2006, implying that employment in the banking sector is likely to fall from the current level of around 112 000 jobs to just more than 100 000 over the next three years.

Employment increased in the *national and provincial governments* and other state institutions, but not in the large public corporations such as Transnet and Eskom. In an effort to disperse skilled public servants more evenly across the country, government has embarked on a large public-service restructuring programme. It is not envisaged that the overall level of employment in general government of around 1,5 million jobs will be reduced because of this initiative.

Employment in construction sector and real value of buildings completed




Changes in the volume of job advertisements in the printed media and in the level of formal non-agricultural employment have historically been fairly well correlated. As indicated in the graph on the following page, changes in the volume of job advertisements usually precede those in the level of employment. Drawing on this relationship, it can be expected that the rate of recovery in formal non-agricultural employment during 2002 will peter out in the early months of 2003, as job advertisements have fallen back steeply since the latter part of 2002.

Notwithstanding evidence of formal-sector employment growth during 2002, the *Labour Force Survey* by Statistics South Africa indicates that approximately 30 per cent of the economically active population was still unemployed in September 2002. This compares poorly with a worldwide average of about 9 per cent. The Government, organised labour and representatives of the business community met for a Growth and Development Summit in June 2003. Key agreements that were reached at the summit include:

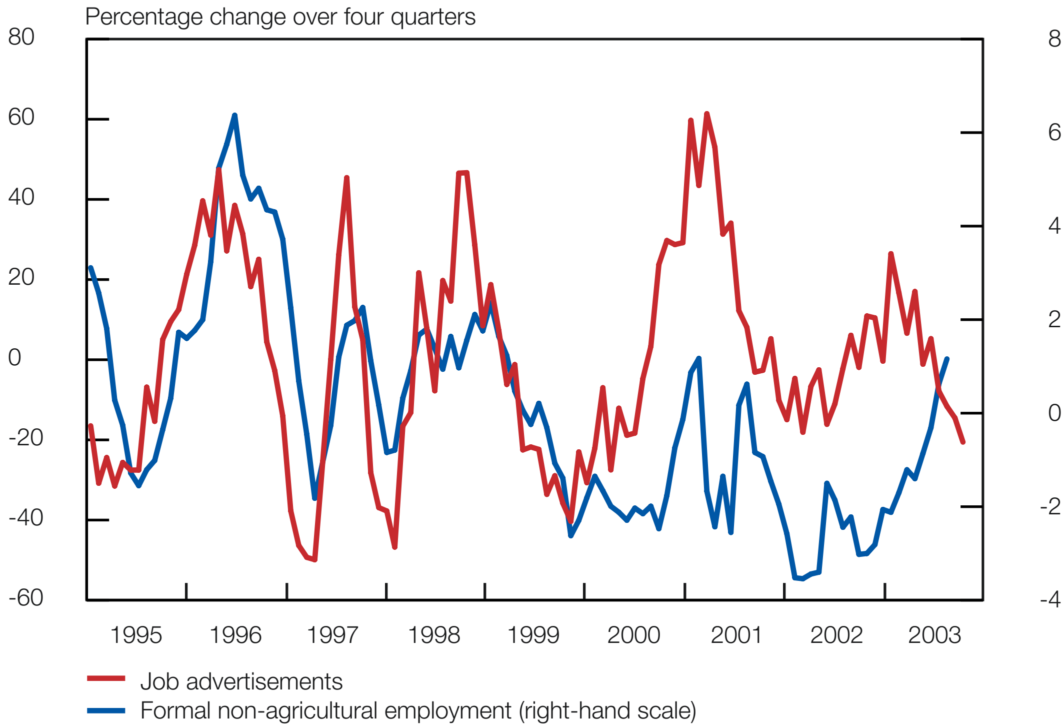
- institutional investors, in particular retirement funds, the life insurance industry and administrators of other contractual savings, such as unit trusts, are expected to voluntarily allocate 5 per cent of their investible income to job-creating investments;

- public works programmes will be expanded through providing short-term jobs, such as the cleaning and renovation of public buildings, road construction and animal dipping services in rural areas;

- business enterprises will provide 72 000 learnership positions or trainee jobs for the unemployed, and will be partly reimbursed through receipt of a grant and tax reductions from government; and

- public-private partnerships at local government level will be encouraged as a way of boosting government capacity to deliver by involving private-sector expertise and finance.

Job advertisements in printed media and formal non-agricultural employment




Over and above the agreements reached at the summit, progress was made in achieving a social consensus on pressing national issues. The decline in the number of workdays lost due to strikes and other forms of work stoppages from 1,25 million in 2001 to 945 000 in 2002 corroborates the progress made in harmonising labour relations. In the first half of 2003, workdays lost numbered 240 000, mainly on account of strikes that were not related to wage negotiations but to funeral benefits at a platinum mine, retroactive compensation for skills training at a steel manufacturer, and changes in shifts at a municipal bus service.

Amendments and additions to labour legislation and regulations during the past year included:
- a restructuring of the Unemployment Insurance Act, effective from 1 April 2002, and the extension of unemployment insurance to domestic and agricultural workers from May 2003;
- amendments to the Labour Relations Act and Basic Conditions of Employment Act, effective from 1 August 2002;
- the Code of Good Practice on the Employment of People with Disabilities, effective from 19 August 2002;

- a minimum wage for domestic workers that came into effect on 1 November 2002;
- the sectoral determination for the agricultural sector that was promulgated on 2 December 2002; and
- the sectoral determination for wholesale and retail trade that was promulgated on 19 December 2002.

Notwithstanding an improvement in labour market conditions, the prevalence of the HIV/Aids pandemic continued to cost lives and absorb resources. The Joint United National Programme on HIV/Aids (UNAIDS) estimates that about 11 per cent of the South African population was living with this disease during 2002, of which some 4,7 million cases were between 15 and 49 years of age. The age profile of those affected by the disease is such that it impacts mostly on the economically active segment of the labour force, thereby impacting negatively on potential economic growth.

## Labour cost and productivity

Following an increase in inflationary pressures in 2002, the average level of wage settlements picked up to compensate for the decline in the purchasing power of employees' salaries and wages. According to the *Wage Settlement Survey* by Andrew Levy Employment Publications, average wage settlements rose from 7,4 per cent in 2001 to 8,0 per cent in 2002. Average wage settlement rates were as high as 8,9 per cent in the first half of 2003, and a 10 per cent increase for a large part of the mining industry was agreed to in late July.

During 2002, high remuneration increases per worker – in excess of 15 per cent – were recorded in the financial intermediation and insurance industry. Settlements in the trade, catering and accommodation services industries were also around that level. Wage increases in the automobile industry as a whole were lower at about 10 per cent, while motor retailers increased wages by between 9 and 18 per cent. In the mining sector, wage settlements varied between 7 and 18 per cent. The government has recently also endorsed the public services bargaining chamber's decision to award an effective salary increase of 9,5 per cent as of 1 July 2003.

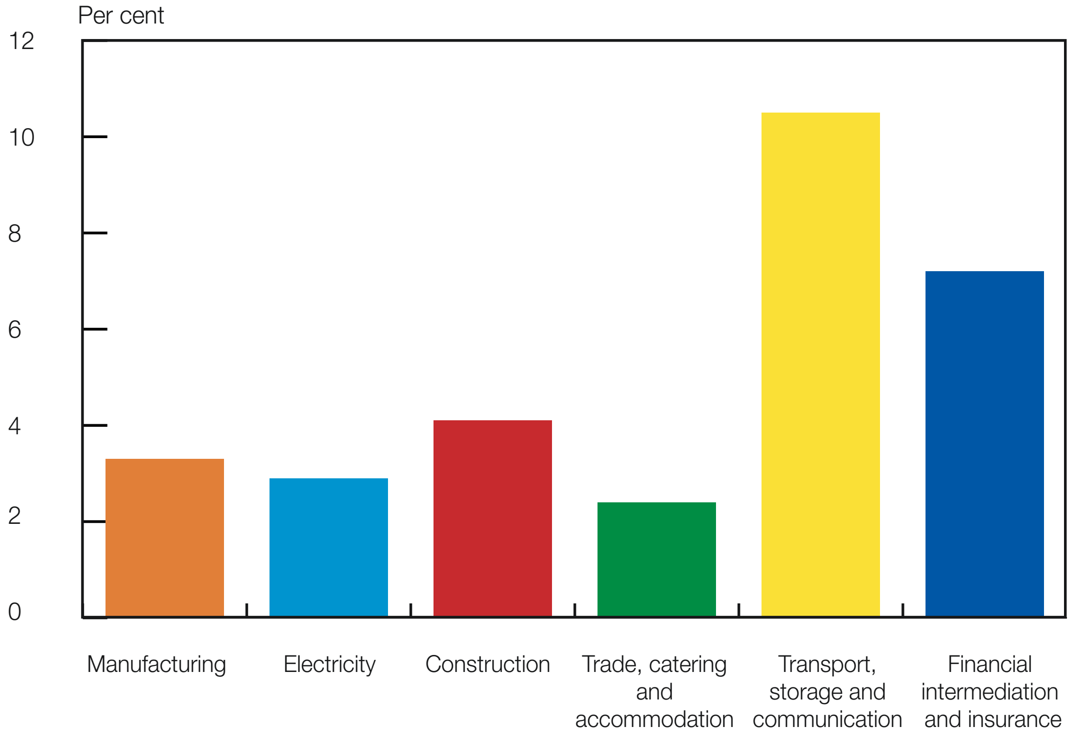
The pick-up in nominal wage growth during 2002 is corroborated by information from the Automated Clearing Bureau on the average salaries, wages and pensions deposited into the bank accounts of almost 5 million salaried and retired workers. According to these statistics, the average payment rose by 10,1 per cent in 2002 and by 10,3 per cent in the year to the first quarter of 2003. Subsequently, the rate of increase moderated to 7,3 per cent in the year to the second quarter of 2003. According to the *Survey of Average Monthly Earnings* by Statistics South Africa, nominal remuneration per worker increased by 10,6 per cent in 2002 and by 10,0 per cent in the year to February 2003.

The *Survey of Employment and Earnings in Selected Industries* by Statistics South Africa reports increases of a similar magnitude, and furthermore suggests that nominal wage growth in the private sector outpaced that of the public sector during 2002. Whereas nominal wage growth in the public sector remained at around the 9,5 per cent level during the past three years, wage growth in the private sector accelerated to a four-year high of 10,3 per cent in 2002.

Labour productivity growth in manufacturing was about 5 per cent in 2002 and exceeded that in the economy as a whole during the past two years. As a result of the contraction in manufacturing production towards the end of 2002, alongside increased employment numbers, labour productivity growth fell back sharply in this sector. Economy-wide labour productivity growth also receded substantially during 2002 from a year-on-year rate of 3,7 per cent in the first quarter to 1,8 per cent in the fourth quarter. Labour productivity growth remained positive in all the main sectors of the economy during 2002. In the transport, storage and communication sector and in the financial intermediation and insurance industry, labour productivity growth remained robust. This was largely related to the capital intensive nature of the expansion in production capacity in these sectors.

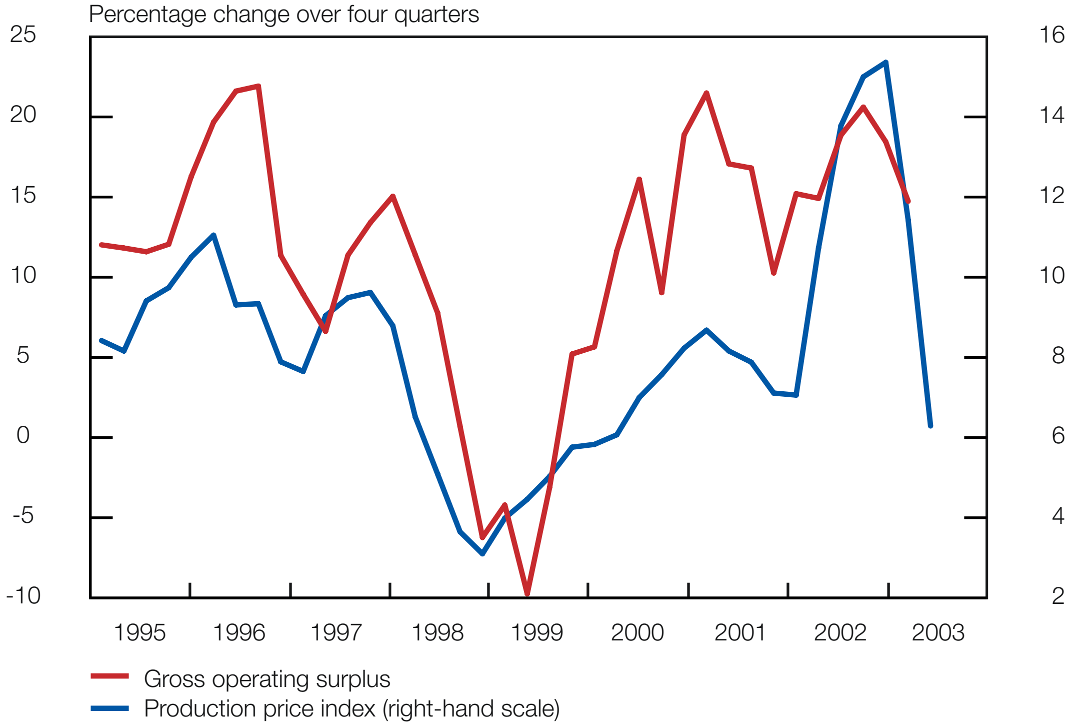
Low rates of growth in *nominal unit labour cost* contributed meaningfully to the waning of price inflation in recent years. However, following the rise in nominal wage growth and a moderation in labour productivity growth, growth in nominal unit labour cost in the formal non-agricultural sectors of the economy accelerated from 4,1 per cent in 2001 to 7,0 per cent in 2002. This rate of increase is the highest in the past four years and contributed to domestic price pressures during 2002. Increases in nominal unit labour cost in the manufacturing sector for 2002 were lower than in the broader formal non-agricultural sector, but nonetheless accelerated from an annual increase of around 2 per cent in 2000 to double that in 2002.

Growth in real gross domestic product per worker in 2002




Growth in nominal unit labour cost in the manufacturing sector was brisk towards the end of 2002 as manufacturing production fell while employment expanded. Within an environment of rising unit labour cost faced by producers, together with little, if any, increases in their selling prices, profit margins of manufacturers have come under pressure since the second half of 2002.

Manufacturing sector




## Prices

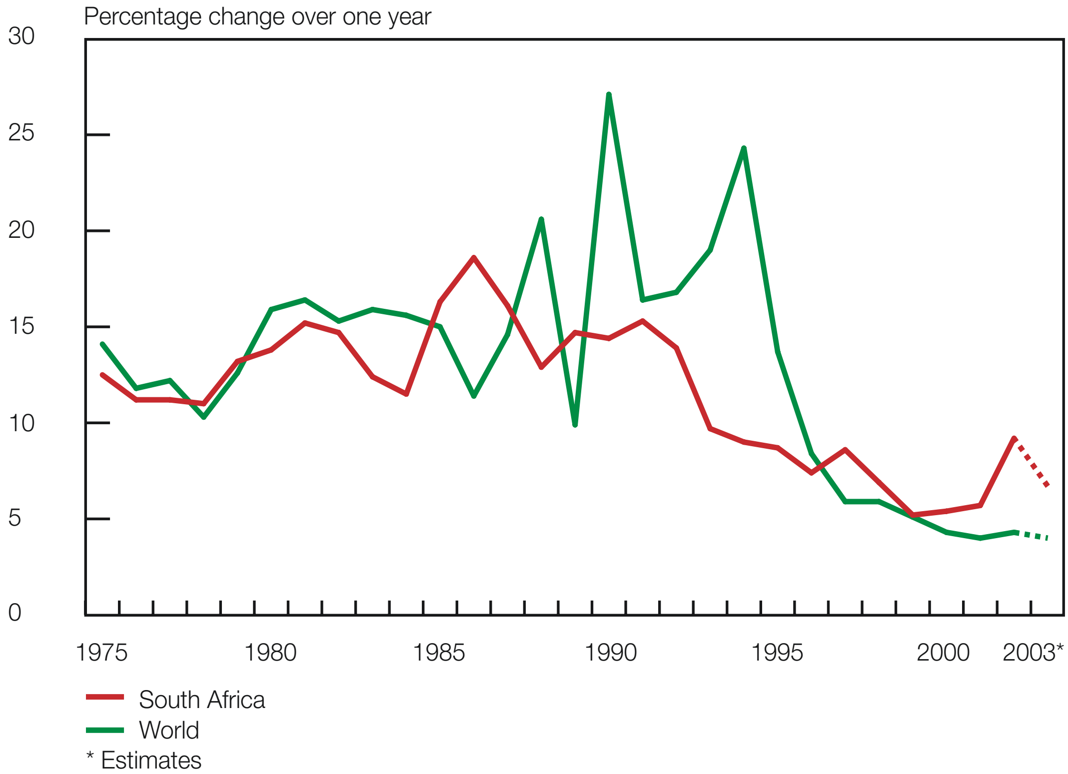
Over the shorter run, exogenous shocks to the macroeconomy can easily steer inflation off course. If the authorities accommodate the new course, it may become entrenched; if it is resisted through countervailing policy measures, inflation will eventually return to its original course. This is essentially what has happened since late 2001, with the sharp fall in the exchange rate at first pushing inflation to very high levels, but restrictive monetary policies, along with a substantial recovery in the exchange rate of the rand, later braking the inflationary momentum.

Against the background of declining world inflation since the beginning of the 1990s, consumer price inflation in South Africa has moderated from 15,3 per cent in 1991 to 5,7 per cent in 2001. The continued moderation of price inflation over this period resulted from consistent, conservative monetary and fiscal policies and conformed with the world trend towards price stability. World inflation, as calculated by the International Monetary Fund, remained at around 4 per cent in the three-year period to 2002. In 2002, however, price inflation in South Africa accelerated rapidly.

The most important factor responsible for the acceleration in price inflation in South Africa during 2002 was the sharp depreciation in the external value of the rand in the second half of 2001; the nominal value of the rand on a trade-weighted basis declined by 34,3 per cent from the end of June 2001 to the end of December 2001.

Simultaneously, added forces were at work, fuelling inflation. These included:
- the increase in the international prices of food products, which together with the depreciation of the rand and drought conditions in the Southern African region, caused the domestic prices of food to rise considerably;
- the increases in international crude oil prices; and
- the double-digit rates of increase in some administered prices, in particular in the prices of medical and education services, and water and assessment rates.

## Consumer prices

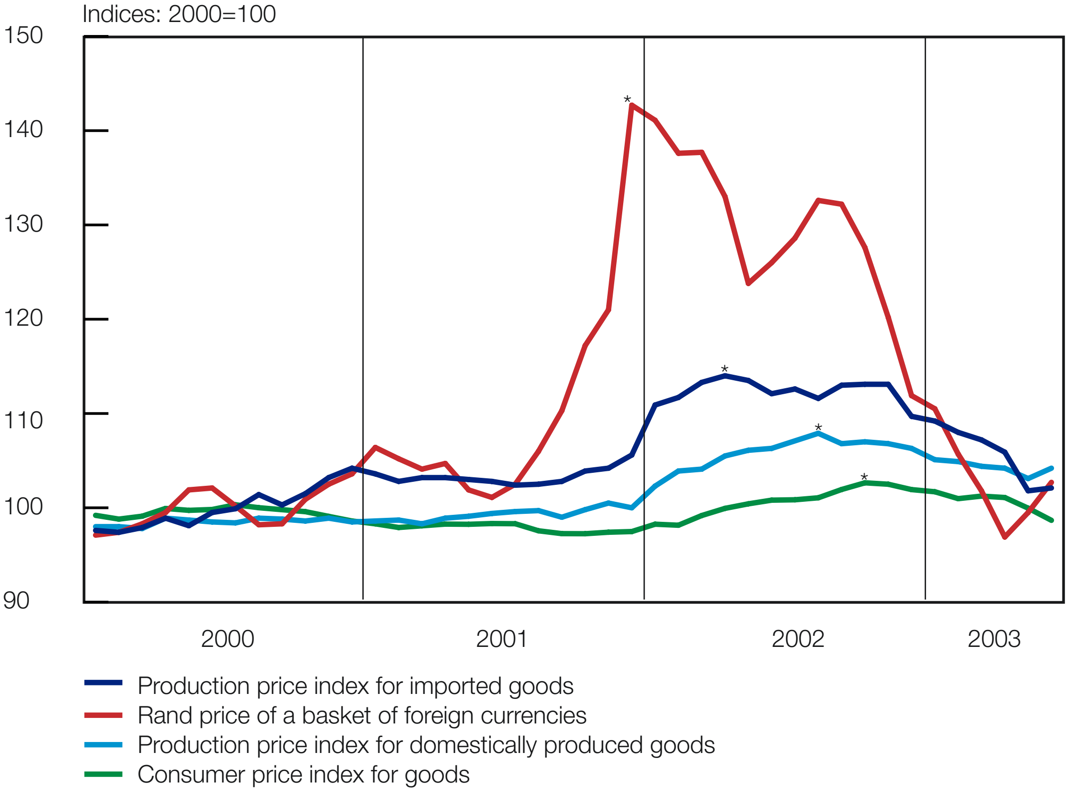



Early in 2002 it became apparent that the inflation target, set at an average rate of increase of between 3 and 6 per cent in CPIX for 2002, was unlikely to be achieved. The Minister of Finance announced that the inflation target range would remain at between 3 and 6 per cent in 2003 and 2004 and that the upper limit of this range for 2004 would not be lowered to 5 per cent as announced previously.

To prevent the inflationary momentum from being perpetuated, monetary policy was tightened on four occasions from January to September 2002. By the end of 2002, there were signs that inflation pressures were abating. The marked recovery of the exchange value of the rand (the nominal effective exchange rate of the rand appreciated by 24 per cent in 2002 and by a further 12 per cent in the first half of 2003) and related to it, lower rates of increase in food prices, contributed meaningfully to the waning of price inflation in the final months of 2002 and the early part of 2003.

With inflation forces initially triggered by exchange rate developments, the sequence of price increases since the closing months of 2001 is illustrated in the graph on the following page. Changes in the rand price of a basket of foreign currencies (i.e. the inverse of the nominal effective exchange rate of the rand) consistently preceded those in the various production and consumer goods price indices. For instance, the upper turning point in the rand price of foreign currency in December 2001 was followed four months later by an upper turning point in the PPI for imported goods. The PPI for domestically produced goods then reached its peak within the next four months. The peak in consumer goods prices followed two months later. Exchange rate changes were transmitted through the price formation process within a period of 10 months, although some secondary effects had not run their course and are not accounted for in this chronology.

Pass-through of exchange rate changes **




* Peak values

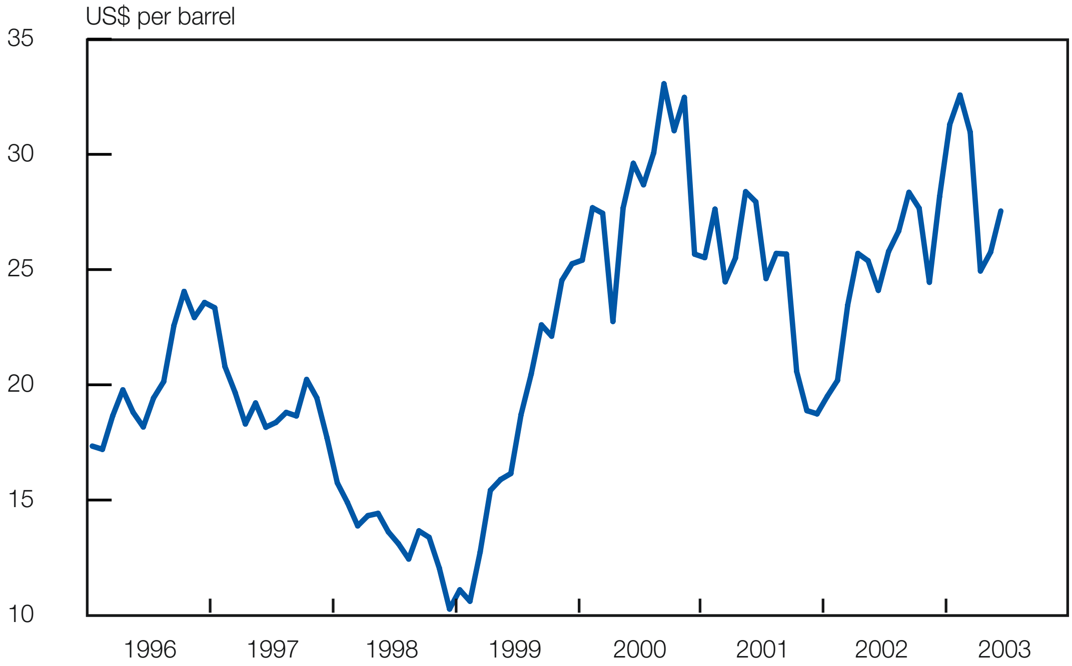
** All observations indicated as deviations from long-term trend

The year-on-year rate of increase in the prices of imported goods rose steeply from 7,4 per cent in November 2001 to 17,4 per cent in April 2002, and remained at around the 15 to 16 per cent level for the remaining part of that year. The recovery of the exchange rate of the rand eventually started to reduce the rand price of imported goods to reach year-on-year rates of decline of 4,8 per cent in May 2003 and 3,4 per cent in July. Even more impressively, the quarter-to-quarter annualised rate of change in the prices of imported goods reverted from an increase of 37,5 per cent in the first quarter of 2002 to a decrease of 9,6 per cent in the first quarter of 2003 and 10,2 per cent in the second quarter. This fallback in imported goods inflation occurred despite a fairly steep rise in international crude oil prices in early 2003.

Higher import prices influenced the cost of domestic production, and year-on-year inflation in the prices of *domestically produced goods* accelerated from around the 8 per cent level in the closing months of 2001 to a peak value of 15,3 per cent in August 2002. Prices of domestically produced goods were pushed higher by a rise in energy costs following the higher international crude oil prices. Domestic petrol and diesel prices increased by 14,5 per cent in the year to December 2002. Steep increases in the prices of processed and unprocessed food products also added to inflationary pressures. The production prices of food increased by no less than 30,4 per cent in the year to September 2002.

The combined effect of rising energy and food prices alone lifted the year-on-year rate of inflation in the prices of domestically produced goods by as much as 4,6 percentage points in September 2002. In subsequent months, as price inflation in these two categories subsided, year-on-year inflation in the production prices of domestically produced goods fell back to 4,4 per cent in June 2003. By the end of June 2003, the rand price of maize, a key staple food, had fallen by 36 per cent since the beginning of 2003 and inflation in the prices of other food products also moderated. An acceleration in nominal unit labour cost during 2002 prevented an even more substantial moderation in domestically produced goods inflation.

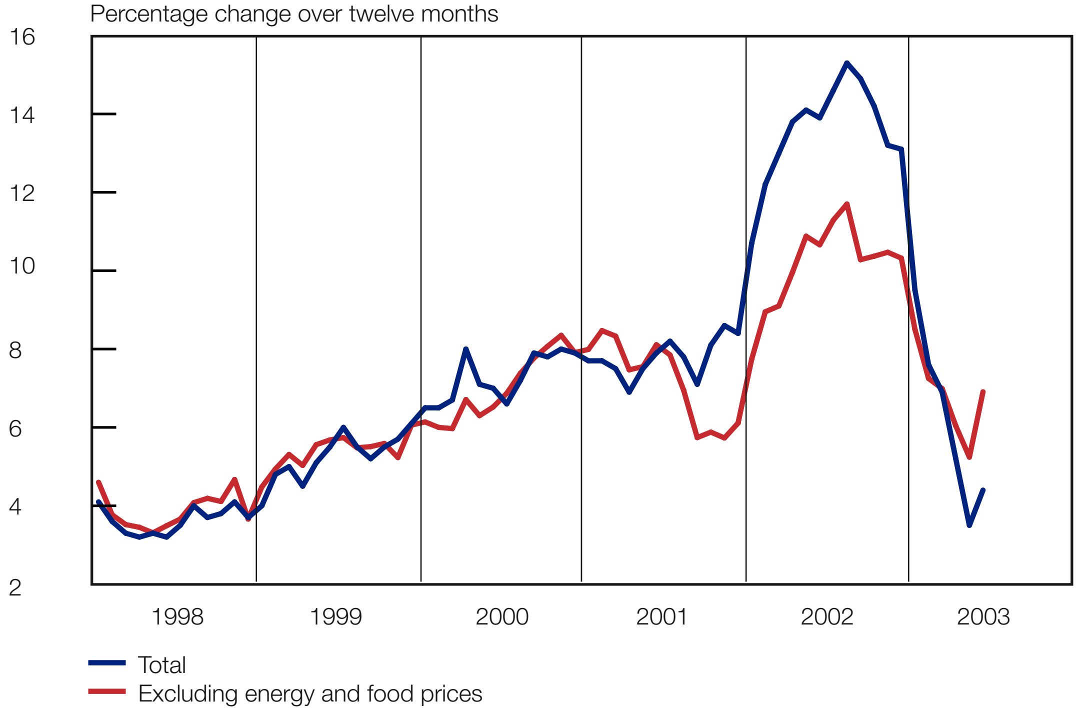
International Brent crude oil prices



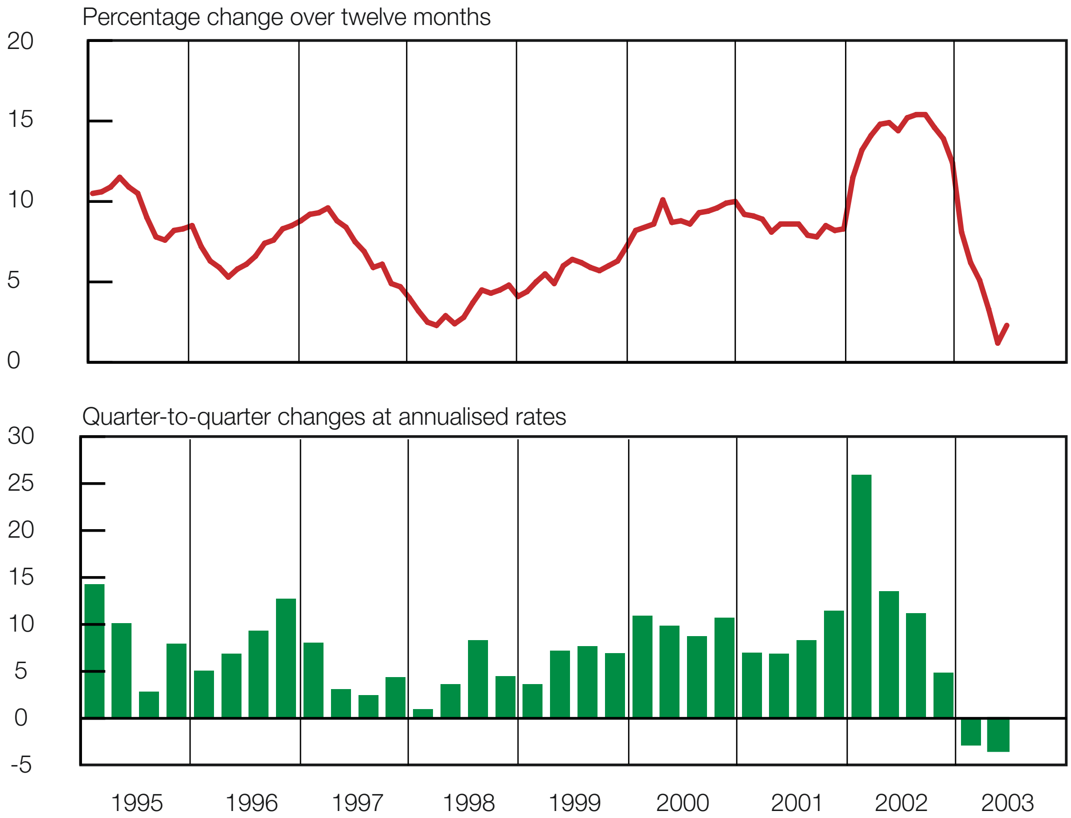

The combined effect of sharp increases in the prices of imported and later also in domestically produced goods resulted in an acceleration in *all-goods production price inflation* from 8,4 per cent in 2001 to 14,2 per cent in 2002 – the highest rate in the past thirteen years. The incremental short-term growth in production prices began to wane as early as the second quarter of 2002. The quarter-to-quarter pace of change in the all-goods production price index slowed down from an increase of 26,0 per cent in the first quarter of 2002 to an actual decrease in the first and second quarter of 2003. Year-on-year increases in overall production prices also proceeded at a more sedate pace, falling back markedly from 15,4 per cent in September 2002 to 1,2 per cent in May 2003 – the lowest rate in the past thirty-five years. This rate of increase rose somewhat to 2,3 per cent in June 2003, as winter electricity tariffs were implemented and the price of imported crude oil increased.

Given the increase in production price inflation in the initial months of 2002, prices of consumer *goods* also accelerated from early in 2002. Consumer *services* price inflation started accelerating later in 2002, reflecting the more indirect linkages from goods to services prices. Consequently, year-on-year inflation in *overall consumer prices* picked up from around 4 per cent at the end of 2001 to a peak value of 13,0 per cent in October 2002. For 2002 as a whole, consumer price inflation amounted to 9,2 per cent – the highest rate of increase in the past nine years and more than double that of world inflation in 2002.

## Production prices of domestically produced goods

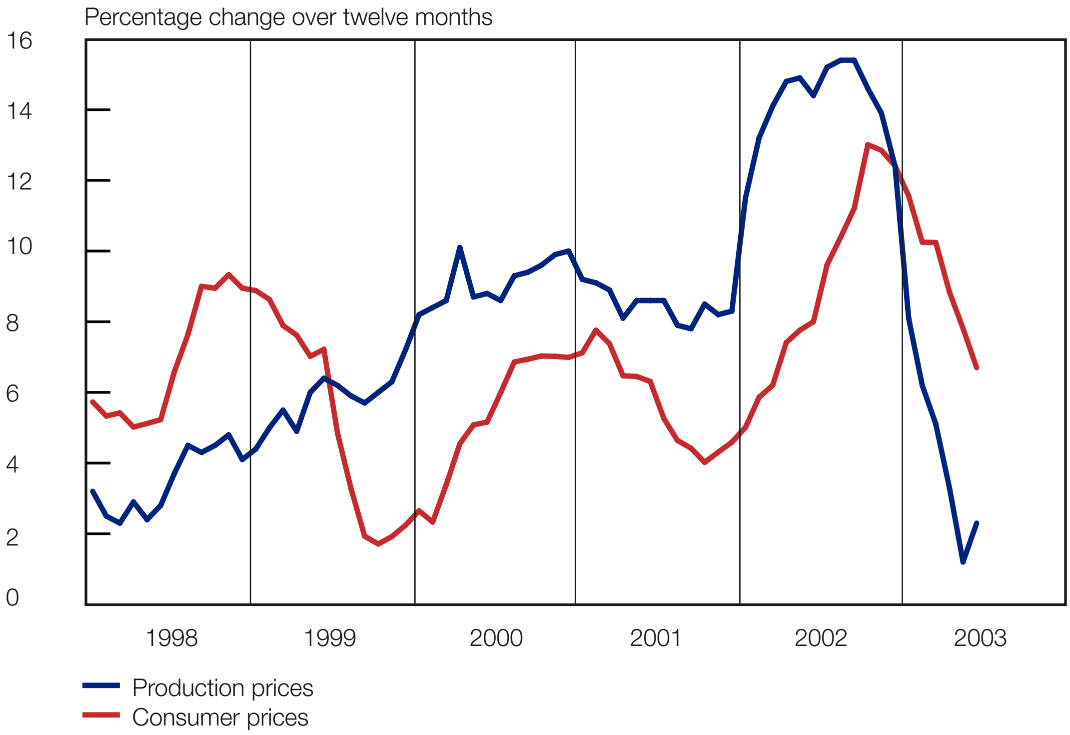



## All-goods production price index



A more restrictive monetary policy stance and the substantial recovery of the exchange rate moderated the inflationary momentum in the course of 2002. Lower consumer food price inflation in the final months of 2002, following a meaningful fallback in the production prices of food a few months earlier, assisted in lowering overall consumer price inflation towards the end of 2002 and the early part of 2003.

Production and consumer prices

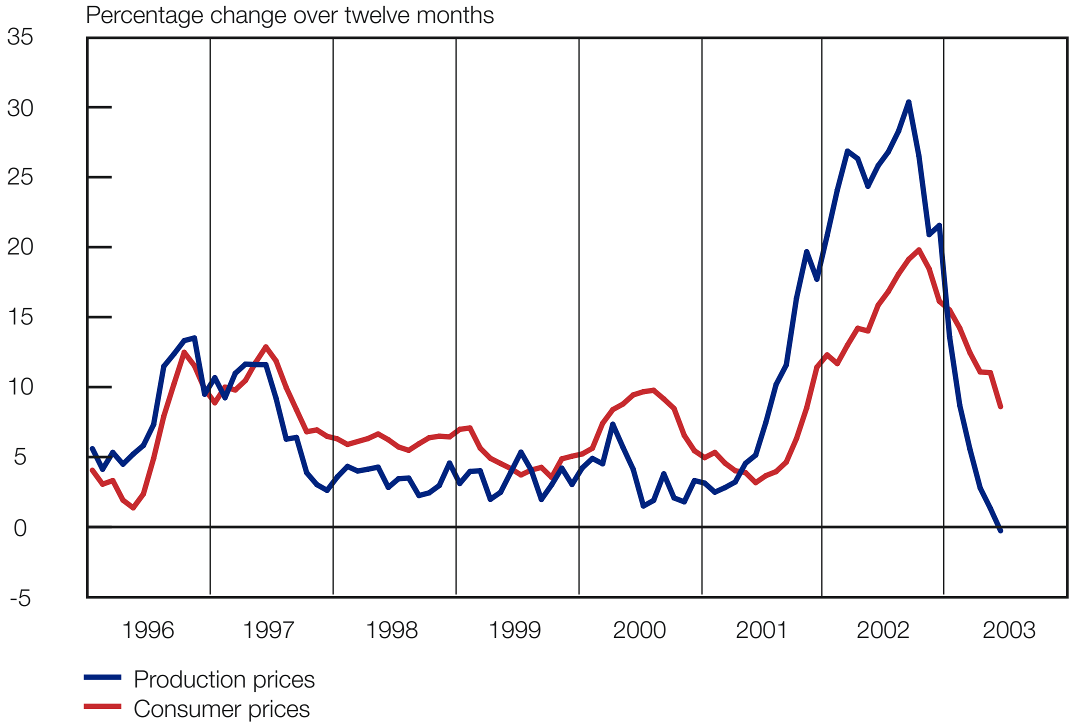



The year-on-year rate of increase in the *prices of consumer goods* rose almost threefold from its nadir of 4,9 per cent in September 2001 to 13,0 per cent in October 2002. Higher inflation in the prices of consumer goods in 2002 was not only due to rising food and energy prices, but also to a broadly based acceleration in prices covering most consumer goods categories. Nevertheless, food price inflation was the main driver of consumer goods price inflation during 2002. Goods price inflation would have been substantially lower at 6,9 per cent in 2002 as a whole if food price inflation was excluded.

The severity of food price inflation in 2002 prompted government to announce the implementation of a food relief programme directed at the poor. Following the recovery of the rand, and its lowering effect on the import and export parity price of key foodstuffs, domestic food price inflation receded meaningfully during 2003. A slowdown in inflation in the prices of furniture and equipment and in motor vehicles also contributed to the waning of overall goods price inflation to 4,6 per cent in the year to June 2003.

The quarter-to-quarter rate of inflation in the prices of consumer goods, a good indicator of the short-term momentum of price change, also slowed down. Annualised inflation in the prices of consumer goods fell from 13,2 per cent in the fourth quarter of 2002 to 3,0 per cent in the first quarter of 2003. All major consumer goods categories recorded lower rates of increase in their prices during the first quarter of 2003 compared with the previous quarter. Subsequently, the quarter-to-quarter pace of change in the prices of consumer goods declined at a rate of 1,2 per cent in the second quarter of 2003.

## Food prices




Year-on-year consumer services price inflation accelerated progressively from around 6 per cent in June 2002 to a peak of 13,2 per cent in December. The acceleration in services price inflation not only resulted from increases in home mortgage interest rates, occasioned by the implementation of a more restrictive monetary policy stance, but was also due to stronger increases in the prices of other non-housing related services. In subsequent months, year-on-year inflation in the prices of consumer services petered out to 9,5 per cent in June 2003. At this rate, services price inflation still exceeded goods price inflation by a fair margin during the eight-month period to June 2003. The quarter-to-quarter pace of services price inflation, however, slowed down markedly in the second quarter of 2003.

With the publication of the April 2003 figures, Statistics South Africa introduced a correction in the calculation of the consumer price index (CPI). In particular, the way in which the rent component was dealt with became problematic and occasioned a revision of the index, backdated to February 2002. The revision entailed that the year-on-year rates of overall consumer price inflation had to be revised downwards by up to 2,3 percentage points in March 2003. To the extent that recent inflation outcomes influence expectations of the rate of future price increases, the revised figures can contribute to a moderation in the inflation process.

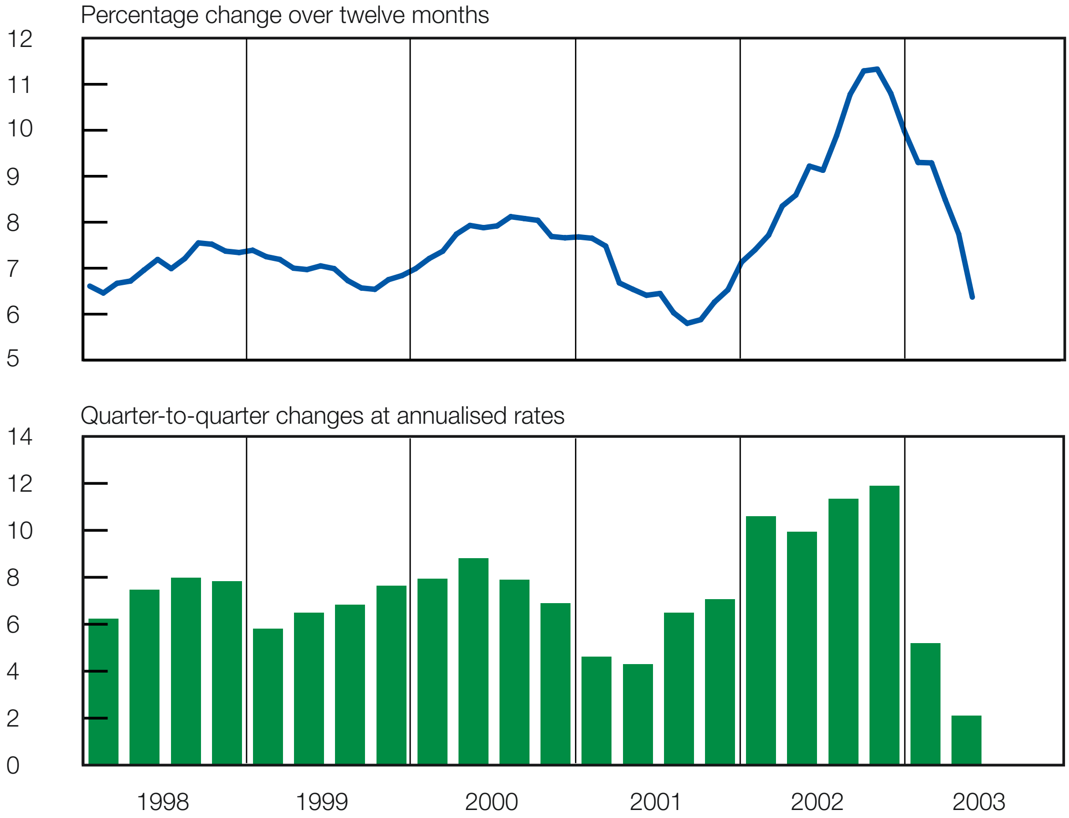
*CPIX inflation* accelerated from 6,6 per cent in 2001 to 9,3 per cent in 2002. This rate of increase in 2002 exceeded the upper limit of the inflation target range by a sizeable margin of 3,3 percentage points. Year-on-year CPIX inflation rose steeply from a low rate of 5,8 per cent in September 2001 to 11,3 per cent in November 2003. As inflation in especially food prices (accounting for 25,66 per cent of the CPIX) slowed down, CPIX inflation moderated meaningfully to 6,4 per cent in the year to June 2003.

The quarter-to-quarter pace of increase in CPIX accelerated progressively from the fourth quarter of 2001 to reach 11,9 per cent in the fourth quarter of 2002. Not least due to the substantial fall in food price inflation, the short-term pace of increase in CPIX fell to 2,1 per cent in the second quarter of 2003. The fall in the momentum of CPIX inflation in the opening months of 2003 was fairly pervasive throughout the economy as price increases in all major categories slowed down appreciably.

By June 2003, the Monetary Policy Committee (MPC) of the Bank was of the opinion that inflationary pressures had subsided sufficiently to warrant the relaxation of monetary policy. On 12 June 2003 the Reserve Bank announced a reduction of 150 basis points in its repurchase rate. All major banks responded by announcing a similar cut in their prime overdraft rates, effective from 13 June 2003.

The easing of monetary policy at the time was substantiated by the following factors:
- a low level of inflation in South Africa's major trading partners;
- reduced geopolitical uncertainty in the Middle East and a related reduction in the risk of excessively rising oil prices;

CPIX



- a general waning of inflation expectations;
- considerable surplus capacity in the domestic economy which reduced the likelihood of increased inflationary pressures;
- prudent fiscal policy; and
- a slower expansion in money supply.

Notwithstanding an improvement in inflation prospects in the middle of 2003, high salary and wage increases were still of concern. Salary and wage increases that exceed productivity growth lead to an increase in nominal unit labour cost which has a direct bearing on end-product prices. The relative robustness in domestic demand at the time and the downward rigidity in administered prices cautioned against an aggressive relaxation of monetary policy.

# Foreign trade and payments

## Policy issues and trade reforms

A strong recovery in the external value of the rand, underpinned by positive sentiment towards South Africa, the underlying strength of the balance of payments and relatively stable financial market conditions provided a window of opportunity for the authorities to further relax foreign exchange controls. Accordingly, further steps along the path of gradual exchange control liberalisation were announced in the Budget delivered in February 2003. The broad direction pursued is a shift away from exchange controls as such towards a system of prudential regulation governing the foreign portfolio investment of institutional investors, with the aim of protecting policyholders, pensioners and investors from excessive risk.

The key exchange control liberalisation measures announced were:

- Institutional investors would be allowed to invest abroad, on approval, up to existing foreign asset limits. These foreign asset limits remained unchanged at 15 per cent of total assets for long-term insurers, pension funds and fund managers, and 20 per cent of total assets for unit trust companies. The previous additional restriction based on 10 per cent of the prior year's net inflow of funds was abolished.

- Institutional investors would be required to submit, in accordance with the move to prudential regulation as from 1 August 2003, additional information when applying for a foreign investment allowance. In terms of the new dispensation, improved data reporting is required on each institution's foreign investment and the foreign diversification levels of the industry as a whole.

- The use of South African funds by South African corporates to finance new approved foreign direct investment outside of Africa would be increased from R500 million to R1 billion and up to R2 billion in the case of investments earmarked for Africa.

- The use of South African funds for investment outside of Africa was furthermore expanded to include top-up funding for the financing of new approved expansion of existing foreign direct investments.

- Dividends repatriated from foreign subsidiaries would be eligible for an exchange control credit, and could be re-exported upon application.

Simultaneously, a foreign exchange control amnesty with an accommodating tax dispensation was announced. It allows individuals to repatriate funds which they had previously accumulated abroad in contravention of the exchange control regulations. No charges would be laid against persons declaring such funds to the authorities between 1 June and 1 October 2003; however, they would be subject to a 5 per cent exchange control charge on funds repatriated back to South Africa, or a 10 per cent charge on any foreign assets remaining offshore.

A dispensation for the unwinding of emigrants' blocked funds was also announced. Emigrant blocked assets to the amount of R750 000 per person would be eligible for exit without charge. The settling-in allowance was set at R750 000 per individual for emigrants.

## Balance on current account [3]

3 The current-account flows referred to in this section are all seasonally adjusted and annualised.

In 2002 the current account has recorded its first surplus on an annual basis since 1994. This was achieved notwithstanding relatively subdued growth in the global economy and the recovery in the external value of the rand in the course of the year. However, the surplus on the current account narrowed appreciably from the first half to the second half of 2002, before reverting to a deficit in the first half of 2003. Relative to gross domestic product, the deficit on the current account amounted to 1,0 per cent in the first half of 2003 compared with a modest surplus of 0,1 per cent in the second half of 2002.

As shown in the accompanying table, the current-account deficit in the first half of 2003 resulted from a significant narrowing of the trade surplus.

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

| | 2001 | 2002 | | | 2003 |
|---|---|---|---|---|---|
| | Year | 1st half | 2nd half | Year | 1st half |
| Merchandise exports | 233,2 | 282,8 | 284,0 | 283,4 | 253,4 |
| Net gold exports | 29,4 | 41,6 | 43,6 | 42,6 | 34,7 |
| Merchandise imports | -221,6 | -274,8 | -284,9 | -279,8 | -260,2 |
| **Trade balance** | **41,0** | **49,6** | **42,7** | **46,2** | **27,9** |
| Net service, income and current transfer payments | -43,8 | -44,1 | -41,6 | -42,9 | -39,6 |
| **Balance on current account** | **-2,8** | **5,5** | **1,1** | **3,3** | **-11,7** |

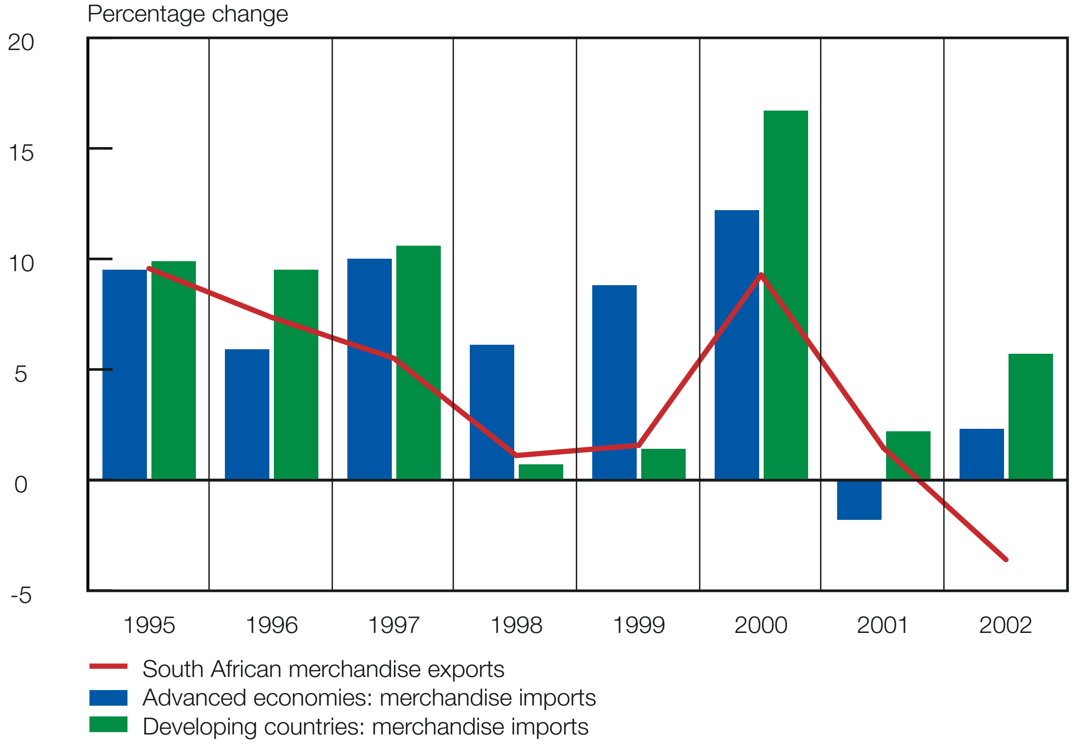
## Exports

The nominal value of merchandise exports, which had increased robustly in the first half of 2002, remained more or less flat in the second half of the year before falling by about 10½ per cent in the first half of 2003. While *export volumes* displayed considerable volatility from quarter to quarter, the volume of exports for 2002 as a whole fell back by 4 per cent. Weak demand conditions in the global economy impacted negatively on world trade, negating the improved competitiveness enjoyed by South African producers on account of the lower real effective exchange rate in 2002 compared to 2001. Global demand remained weak in early 2003, and was reflected in a decrease of ½ a per cent in the volume of merchandise exports in the first half of 2003 compared to the second half of 2002.

The higher rand value of merchandise exports in the first half of 2002 was related to the sharp depreciation of the external value of the rand in the last quarter of 2001.

*Export prices* in rand, which had increased solidly in the first half of 2002, increased at a much lower rate in the second half before falling back by about 10½ per cent in the first half of 2003. Again, the decline in export prices in the first half of 2003 was dominated by the recovery in the exchange rate.

## International trade volumes




The nominal value of net gold exports rose robustly by almost 45 per cent in 2002, raising the share of gold exports in the total value of merchandise and gold exports to 13,1 per cent from 11,2 per cent in 2001. Gold exports were boosted by a significant rise in the gold price in 2002, whereas the volume of the country's net gold exports fell back by 1 per cent compared to 2001. In the first half of 2003 the physical quantity of gold exported declined by a further 9½ per cent, mainly related to a reduction in the physical production of gold by the mines. Over the same period the monthly average fixing price of gold on the London market rose significantly, reaching a peak of US$371 per fine ounce in May 2003. The substantial increase in the dollar price of gold over this period could be attributed, among other things, to:

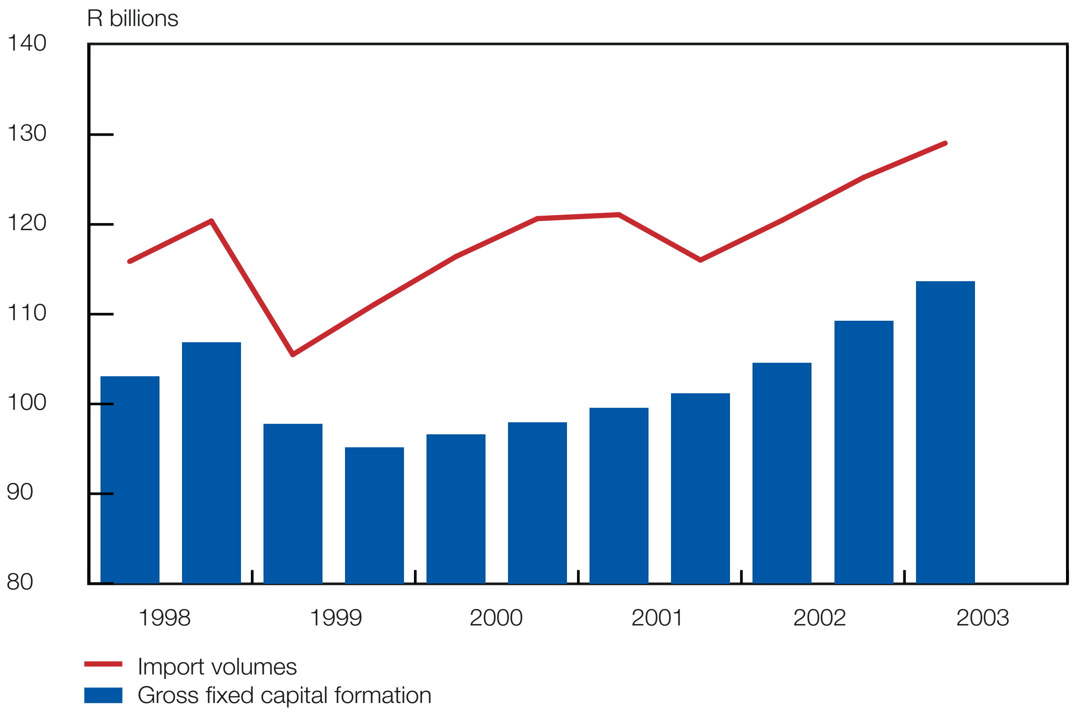
- bullish sentiment towards gold which was boosted by the relative weakness of the dollar and gloomy international stock markets;
- war in Iraq and tension in other conflict areas; and
- buoyant demand for gold from countries like China and India.

In rand terms, however, the gold price lost some of its sparkle in the first half of 2003. The appreciation of the external value of the rand drove down the average rand price of gold to R2 813 per fine ounce in the first six months of 2003 compared to R3 242 in 2002 as a whole. Consequently the value of net gold exports contracted strongly in the first half of 2003.

## Imports

Despite the higher rand prices of imported goods prevailing in 2002, *import volumes* remained firm. The physical quantity of imports rose by 3½ per cent in 2002, coinciding with an increase in real gross fixed capital formation and the accumulation of inventories. Both of these expenditure components have a fairly high import content. The correlation between imports and capital formation is depicted in the accompanying graph. Import volumes showed little change from the second half of 2002 to the first half of 2003, rising by 2 per cent.

Import volumes and gross fixed capital formation




Primarily as a consequence of exchange rate movements, the *rand prices of imported goods* rose by 22 per cent in 2002, while in the first half of 2003 they fell back by 10½ per cent compared to the second half of 2002. After having risen at a year-on-year rate of 26,3 per cent in 2002, the value of merchandise imports decreased by about 8½ per cent in the first half of 2003. The share of mining imports in total merchandise imports, which had declined marginally from the first half of 2002 to the second half, contracted further in the first six months of 2003 when the growth in the value of crude oil imports petered out. As a percentage of total merchandise imports, the value of oil imports declined from 10,8 per cent in the first half of 2002 to 9,7 per cent in the second half and 9,1 per cent in the first half of 2003. The share of manufactured goods in total merchandise imports remained at a constant level of around 77,0 per cent from the second half of 2002 to the first half of 2003, while within the imports of manufactured goods there was a slight shift towards the importation of machinery and electrical equipment, and vehicle and transport equipment.

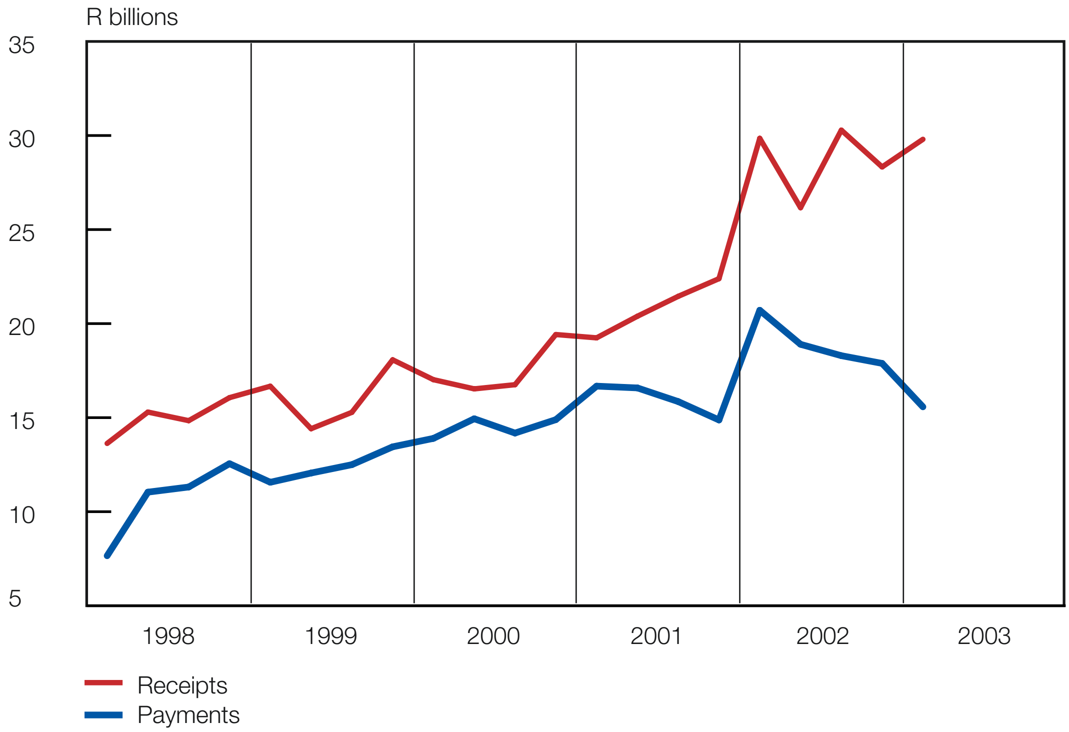
## Terms of trade

In 2002 the average rand price of exports of merchandise and services rose faster than the prices of imports, leading to an improvement of 2½ per cent in the country's terms of trade. With downward inflexibility in the rand prices of services rendered to foreign visitors, the higher gold price and stronger prices of South African export commodities, the terms of trade rose by a further 2½ per cent in the first half of 2003 when compared to the second half of 2002.

## Net service, income and current transfer payments

The net shortfall in the net service, income and current transfer account with the rest of the world remained relatively high in the first half of 2002, but contracted significantly in the second half. The resultant deficit for 2002 as a whole was smaller than the amount recorded in 2001. The contraction could partly be ascribed to an increase in receipts for services rendered to non-residents, which continued to benefit from increased spending by foreign tourists visiting South Africa. Due to the lower external value of the rand in 2002, the World Summit on Sustainable Development and the ICC Cricket World Cup, the number of tourists entering South Africa increased significantly when compared to 2001. This boosted travel receipts by almost 37 per cent which is evidently reflected in a widening in the gap between travel receipts and travel payments. The higher number of visitors arriving coincided with increases in passenger fares over the same period.

Foreign tourism: Receipts and payments




The services account also improved on account of lower interest and dividend payments to non-residents in 2002. This reflected some disinvestment by non-residents through the domestic bond and share markets, more conservative dividend policies and a reduction in profit margins of some South African companies. Payments by South Africans for services rendered by non-residents rose as a result of higher freight and insurance charges stemming from the increase in the value and volume of merchandise imports. On balance, the size of the deficit on the services account receded slightly from R43,8 billion in 2001 to R42,9 billion in 2002.

In the first half of 2003, service payments rose more rapidly than receipts for services rendered to non-residents. This, together with high net income payments, resulted in a significantly higher deficit on the net service, income and transfer account of the balance of payments in the first half of 2003.

## Financial account and foreign debt

A strong inflow of capital during 2002 contributed to a widening of the surplus on South Africa's financial account with the rest of the world. During the first half of 2002 South Africa recorded a large net capital inflow, mainly due to the relatively low prices of domestic financial assets following the depreciation of the rand towards the end of 2001 and an improvement in international investors' sentiment towards emerging markets. The virtual cessation of the inflow of capital during the second half of 2002 could mainly be attributed to the volatile nature of portfolio investment flows, which changed to an outflow during the period. The financial account of the balance of payments improved during the first half of 2003 as capital started flowing back into the country.

Net financial transactions not related to reserves
R billions

| | 2001 | 2002 | | | 2003 |
|---|---|---|---|---|---|
| | Year | 1st half | 2nd half | Year | 1st half |
| Liabilities | | | | | |
| Direct investment | 58,4 | 6,5 | 1,4 | 7,9 | 0,6 |
| Portfolio investment | -24,0 | 20,1 | -14,7 | 5,4 | 15,9 |
| Other investment | -10,2 | 10,5 | -11,6 | -1,1 | -1,7 |
| Assets | | | | | |
| Direct investment | 27,4 | 4,1 | 0,1 | 4,2 | 0,4 |
| Portfolio investment | -43,6 | -7,6 | -2,0 | -9,6 | -0,2 |
| Other investment | -12,3 | -1,5 | 13,5 | 12,0 | -0,9 |
| **Total financial transactions*** | **10,3** | **33,1** | **0,4** | **33,5** | **24,0** |

* Including unrecorded transactions

### *Foreign-owned assets in South Africa*

*Foreign direct investment* flows into South Africa amounted to no less than R58,4 billion in 2001, largely dominated by the restructuring of the shareholding in the De Beers mining company. During 2002 a far smaller inflow was recorded. Non-resident investors obtained a dominant interest in two South African steel companies and also increased their shareholding in a domestic car manufacturing company. Outflows occurred as Transnet reacquired a 20 per cent shareholding in South African Airways, previously held by Swissair. Other short and long-term direct investment loan capital, as well as the time lag between dividend declarations and the payment thereof, were also responsible for changes in direct investment liabilities. During the first half of 2003 a foreign investor further increased its shareholding in a South African steel company, resulting in a small inflow in this category.

*Portfolio investment* liabilities were again volatile. Non-residents became net sellers of shares and bonds listed on South African exchanges during the second half of 2002, whereas they were net buyers of these instruments during the first half of

2002. The inflow during the first half of 2002 was also enhanced by the reopening of an existing US dollar facility to the value of US$0,25 billion as well as loan funding in the international capital markets to an amount of US$1,0 billion by the national government. Heightened risk aversion towards emerging markets by international investors, as well as the leaking of the draft empowerment charter for the mining industry, contributed to the substantial outflow of portfolio capital during the second half of 2002, as did the redemption of a domestic bond by the national government. Portfolio inflows resumed during the latter part of the first half of 2003 as non-residents again became net buyers of shares and bonds and the national government issued a bond of €1,25 billion in the international capital markets.

*Other investment* liabilities recorded an inflow of R10,5 billion during the first half of 2002 followed by outflows of R11,6 billion and R2,5 billion in the second half of 2002 and the first half of 2003, respectively. The inflow during 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 government. The outflow during the second half of 2002 resulted from the withdrawal by non-resident depositors of their rand-denominated deposits and the repayment of short-term foreign loans by domestic banks. During the first half of 2003, the outflow occurred as a result of further repayment of short-term foreign loans by domestic banks and the withdrawal of foreign-currency denominated deposits by non-resident depositors.

### *South African-owned assets abroad*

In 2002 *foreign direct investment* assets of South African entities were reduced, thereby recording an inflow of R4,2 billion. This may be compared to an inflow of R27,4 billion, which was also influenced by the restructuring of the De Beers mining company in 2001. While South African companies continued to acquire a dominant interest in offshore companies, a domestic mining company disposed of part of its foreign asset holdings in 2002. A decline in offshore open account balances also contributed to the inflow of capital during the year. During the first half of 2003 the accumulation of foreign direct investment assets resumed at a subdued rate.

Investment in *portfolio* assets abroad rose by almost R10 billion during 2002, with the bulk of the outflow recorded in the first half of the year. The outflow in the first half of 2002 partly consisted of the allocation of a minority shareholding in a non-resident company to South African companies in the metals and steel sectors of the economy as part compensation for the selling of their holdings in a domestic steel company to a non-resident company. The slowdown in these outflows continued into the first half of 2003 to an amount of R0,2 billion, as the lacklustre performance of global equity markets and the non-renewal of the cashflow-linked avenue through which institutional investors could previously transfer funds abroad took their toll.

In the *other investment* category a fairly small outflow was recorded in the first half of 2002, followed by inflows of R13,5 billion and R0,1 billion in the second half of 2002 and the first half of 2003, respectively. The outflow during the first half of 2002 could be attributed *inter alia* to individuals that made use of the R750 000 allowance under the Exchange Control concession. During the second half of 2002 and the first half of 2003 South African companies repatriated short-term foreign assets acquired through exporting; the repatriation generally coincided with the recovery in the exchange rate of the rand.

## *Foreign debt*

South Africa has been managing its external debt prudently in comparison to other developing countries. The country's debt level as a percentage of gross domestic product, for instance, is significantly below that of Western-hemisphere countries. South Africa's export earnings have been growing at a faster rate than its foreign borrowing, and less than one year's export proceeds would currently be sufficient to pay off the country's entire foreign debt. By contrast, the Western-hemisphere countries' ratio of foreign debt to export proceeds has been more than double the ratio for South Africa.

### Debt ratios

| | Foreign debt to GDP | | Foreign debt to export proceeds | |
|---|---|---|---|---|
| | South Africa Percentage | Western hemisphere Percentage | South Africa Percentage | Western hemisphere Percentage |
| 1995 | 23,4 | 41,2 | 98,6 | 251,9 |
| 1996 | 24,0 | 39,6 | 94,8 | 235,9 |
| 1997 | 26,3 | 37,7 | 103,6 | 224,1 |
| 1998 | 28,0 | 37,7 | 105,0 | 258,4 |
| 1999 | 29,7 | 44,2 | 110,3 | 256,4 |
| 2000 | 28,8 | 38,9 | 94,8 | 212,5 |
| 2001 | 27,0 | 38,8 | 82,7 | 212,8 |
| 2002 | 31,3 | 44,6 | 87,8 | 211,5 |

South Africa's total outstanding foreign debt rose from US$30,8 billion at the end of 2001 to US$32,7 billion at the end of 2002. This increase occurred as a result of an increase in both foreign-currency and rand-denominated debt. Foreign-currency denominated debt increased by US$1,0 billion to a level of US$25,0 billion from the end of 2001 to the end of 2002. This increase occurred as a result of foreign borrowing by the national government on the international capital markets through bond issues as well as loans to finance the arms procurement programme. However, the increase was checked by a decline in non-resident foreign-currency deposits with the domestic banking sector.

As a result of the appreciation of the exchange rate of the rand, the country's foreign debt measured in rand declined from R373 billion at the end of 2001 to R283 billion

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

| | 1998 | 1999 | 2000 | 2001 | 2002 |
|---|---|---|---|---|---|
| **Foreign-currency denominated debt** | **24,9** | **23,9** | **24,9** | **24,0** | **25,0** |
| Bearer bonds | 4,4 | 4,8 | 5,5 | 6,0 | 7,8 |
| Converted long-term loans | 0,8 | 0,4 | 0,2 | 0,1 | 0,0 |
| Public sector | 4,7 | 4,0 | 4,2 | 3,0 | 5,0 |
| Monetary sector | 8,9 | 8,3 | 8,3 | 8,9 | 6,3 |
| Non-monetary private sector | 6,1 | 6,4 | 6,7 | 6,0 | 5,9 |
| **Rand-denominated debt** | **12,5** | **15,0** | **12,0** | **6,8** | **7,7** |
| Bonds | 8,3 | 10,7 | 8,3 | 4,3 | 4,5 |
| Other | 4,2 | 4,3 | 3,7 | 2,5 | 3,2 |
| **Total foreign debt** | **37,4** | **38,9** | **36,9** | **30,8** | **32,7** |

at the end of 2002. But in converting debt and gross domestic product to dollar values, the ratio of total external debt to gross domestic product increased from 27,0 per cent from the end of 2001 to 31,3 per cent at the end of 2002. The ratio of total external debt to export earnings also increased from 82,7 per cent to 87,8 per cent over the same period.

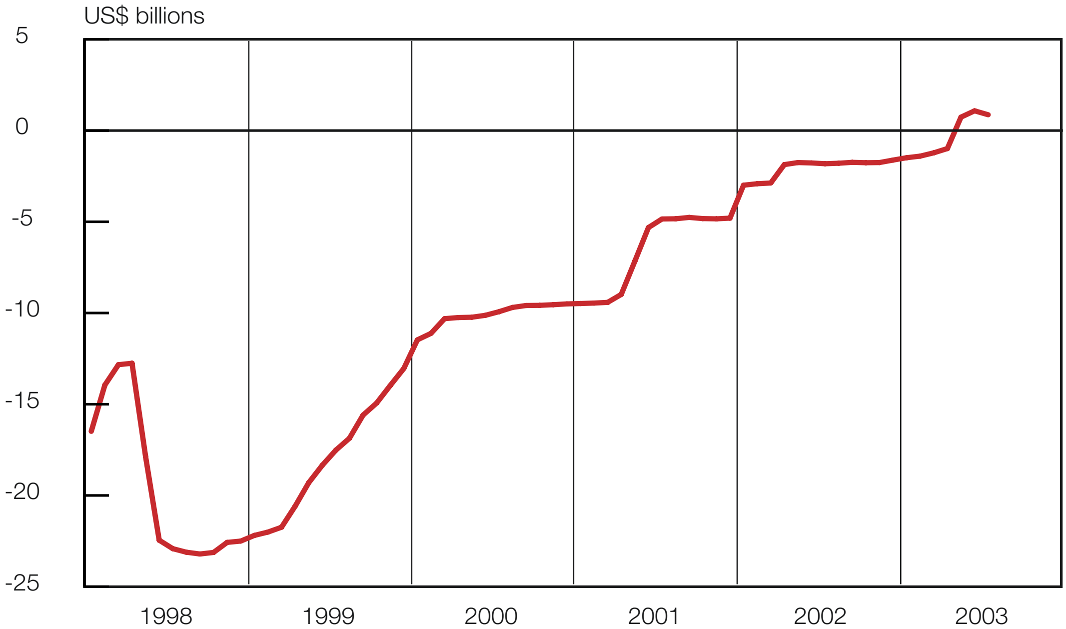
## Foreign reserves

Surpluses on both the current account and the financial account of South Africa's balance of payments resulted in an increase in the country's net international reserves to an amount of R36,6 billion in 2002. The increase during 2002 was concentrated in the first half of 2002 when the net international reserves rose by R36,9 billion. During the second half of 2002 a decline of net international reserves to an amount of R0,3 billion was recorded. In the first half of 2003 a further increase was recorded in the net international reserves.

South Africa's gross gold and other foreign reserves increased healthily during the past eighteen months and amounted to US$18,5 billion at the end of June 2003. The exchange rate played a significant role in the calculation of the ratio of gross international reserves relative to the value of imports of goods and services, as import cover declined from 23½ weeks' worth at the end of 2001 to 17½ weeks' worth at the end of 2002. It rose to 20½ weeks' worth at the end of June 2003.

The Bank's net oversold open position in foreign currency declined gradually from its high point of more than US$23 billion in 1998 to US$4,8 billion at the end of 2001. Factors which contributed to its subsequent further reduction included:
- the transfer of a syndicated loan liability to an amount of US$1,5 billion from the Reserve Bank to the national government early in 2002;
- the reopening by the South African government of an existing US dollar bond to an amount of US$274 million;
- the issue of a bond amounting to US$1,0 billion in the international capital markets by the national government;

Reserve Bank open position in foreign currency



- purchases of some foreign exchange by the Reserve Bank in 2003; and
- valuation adjustments as a result of the increase in the gold price.

On 16 May 2003 the net open position recorded its first-ever positive balance when the proceeds of a €1,25 billion bond raised by the government were sold to the Reserve Bank and applied against the forward book. At the end of July 2003 the net open position was a positive amount of US$0,9 billion.

## Exchange rates

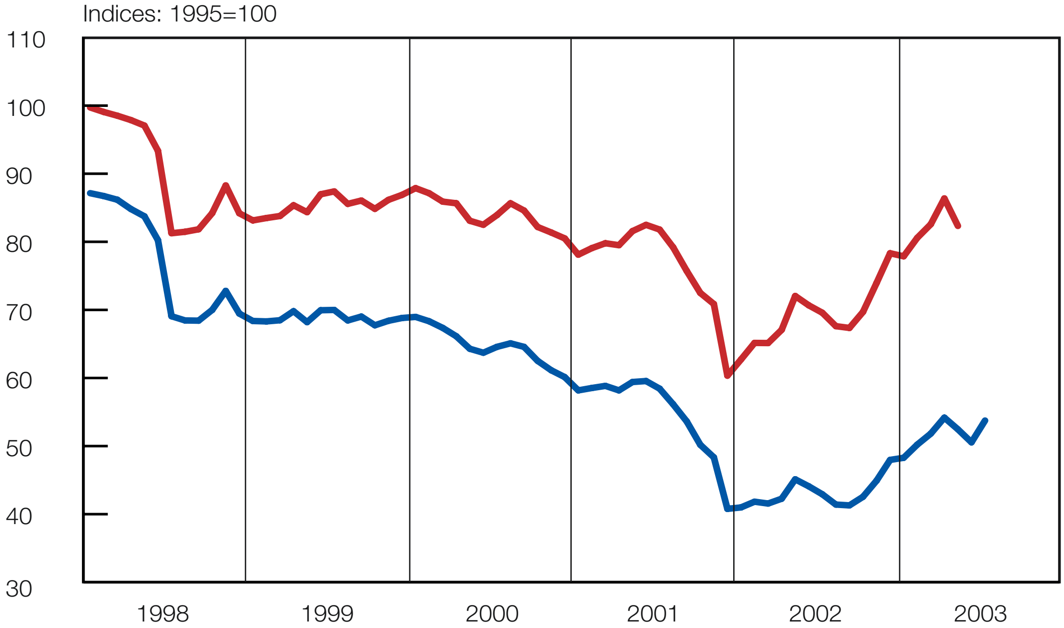
The exchange rate of the rand continued to be determined in a fairly liquid market. The net average daily turnover in the domestic market for foreign exchange declined to US$7,9 billion in the first half of 2002 from US$9,2 billion in the second half of 2001. It continued to decline in the second half of 2002, recording a level of US$7,8 billion before increasing in the first half of 2003 to an average level of US$9,2 billion.

During 2002 international sentiment turned positive towards emerging markets, with South Africa in particular receiving favourable attention. After having depreciated on balance by 34½ per cent during 2001, the nominal effective exchange rate of the rand appreciated by 24 per cent during 2002 and by a further 12 per cent during the first half of 2003. The improved confidence in the prospects for the South African economy exhibited by foreigners could, amongst other factors, be attributed to:
- their positive assessment of the macroeconomic policies pursued by the South African authorities;
- the continued reduction in the net oversold position in foreign currency of the Reserve Bank;
- the continued large positive interest rate differentials between South Africa and its main trading partners;
- a rise in international commodity prices in the first quarter of 2002;
- the expectation that a synchronised global upswing in economic activity in the second half of 2002 could boost the country's export performance;
- an improvement in international investors' sentiment towards emerging markets in general, despite uncertainty about developments in some Latin American economies;
- the accelerated repatriation of export proceeds in anticipation of a further appreciation in the domestic currency; and
- the closing of loss-making long dollar positions by investors and the overall weakness of the US dollar due to concerns about the strength of the US economic recovery.

In the first half of 2002 the nominal effective exchange rate of the rand appreciated by 6,9 per cent. During this period non-residents' sentiment towards South Africa turned positive and investors demonstrated confidence in the prospects for the South African economy by increasing their holdings of domestic fixed-interest and equity securities. This improved confidence was both cause and effect of a healthy overall surplus on the balance of payments during the first half of 2002.

Most of these gains were however reversed during June 2002, with the nominal effective exchange rate of the rand depreciating by 9,5 per cent from the end of May 2002 to the end of June 2002. This coincided with an aggressive reduction by non-resident investors of their exposure to South African debt and equity securities, and a more sceptical view of emerging-market assets following problems in Argentina and the fear of debt default in Brazil. More specific to the Southern African region were concerns that the situation in Zimbabwe might in various ways spill over into neighbouring countries.

Effective exchange rates of the rand *



* Consistently excluding Zimbabwe

In the second half of 2002 the nominal effective exchange rate of the rand resumed its sound performance and on balance appreciated by 16,2 per cent from the end of June to the end of December. This healthy overall performance was, however, initially preceded by a period of excessive closing of long rand positions. This occurred as continued uncertainty among non-resident investors about developments in the mature equity markets of the world and in some emerging markets, contributed towards a net withdrawal of foreign portfolio capital from South Africa during the third quarter of 2002. Among the more obvious domestic and international developments that weighed heavily on the external value of the rand during this period was the continued land reform programme in Zimbabwe. The leaking of the draft empowerment charter for the mining industry, as well as increasing uncertainty with regard to stability in some Latin American countries, also played a role.

This initial downward trend was, however, soon reversed as market participants recognised various positive aspects of the South African economy. Amongst these was the restatement by the South African government of its commitment towards the process of restructuring state assets. This added momentum to the strengthening of the exchange rate of the rand which in turn caused leads and lags in foreign payments and receipts to be reversed, adding extra support to the currency.

Additional factors that probably supported the improvement of the exchange rate in the second half of 2002 were:

- positive statements about South Africa's credit outlook by international credit ratings agencies and the International Monetary Fund;

- a general reduction in risk aversion towards emerging-market asset classes;
- prolonged uncertainty about the general state of the US economy and the associated weaker trend in the value of the US dollar;
- an improvement in South Africa's terms of trade; and
- improved perceptions regarding South Africa's status as a safe haven.

After a brief depreciation in January 2003 when tensions about a possible war in Iraq and a world-wide decline in the value of financial asset prices caused non-resident investors to reduce their holdings of domestic fixed-interest and equity securities, the rand continued its impressive performance. It appreciated by 12,2 per cent during the first half of 2003, recording its strongest levels around the end of April 2003. South Africa further distinguished itself from other emerging-market countries when Standard & Poor's and Fitch Ratings upgraded South Africa's foreign and local currency sovereign debt ratings and assigned a stable outlook to the country.

Before the June 2003 MPC meeting a reduction of 100 basis points in the Reserve Bank's repurchase rate was widely discounted. When a reduction of 150 basis points was announced, the effective exchange rate of the rand immediately started appreciating. Apparently a policy move which is seen as coming from a position of strength and which projects confidence gets factored into the exchange rate in a more sophisticated way than just evaluating interest rate differentials.

Adjusted for the inflation differential between South Africa and its most important trading partners, the real effective exchange rate of the rand increased by 17,1 per cent over the first six months of 2002. During the second half of 2002 the real effective exchange rate still increased, although at a slower rate of 10,8 per cent. Preliminary indications are that it strengthened by some 8 per cent during the first five months of 2003.

While different views regarding the appropriate level for the exchange rate are likely to persist in the economic debate, there is broad agreement that excessive exchange rate volatility is undesirable; it hinders rather than guides the appropriate allocation of resources.

### Coefficient of variation of nominal effective exchange rates[1]

| | Per cent |
|---|---|
| South African rand | 23,5 |
| Other emerging-market currencies[2] | 17,9 |
| Developed-market currencies[3] | 6,0 |

1 Percentage standard deviation of each currency's monthly average nominal effective exchange rate from January 1997 to the present
2 Unweighted average of Cameroon, Chile, China, Colombia, Costa Rica, Ecuador, Guyana, Israel, Oman, Paraguay, Philippines, Poland, Romania, United Arab Emirates and Venezuela
3 Unweighted average of Australia, Canada, the euro area, Japan, New Zealand, Norway, Sweden, Switzerland, the United Kingdom and the United States

A comparison between the volatility of the rand's exchange rate and that of other countries reveals that, over the period from 1997, the rand's effective exchange rate has been more volatile than the average of a selection of emerging-market currencies. Not surprisingly, however, the rand has been far more volatile than a selection of developed-market currencies.

# Monetary developments and interest rates

## Structural and regulatory issues

During the past year the banking sector was characterised by consolidation as it settled down following the turbulence experienced during the first six months of 2002 – turbulence in which depositors lost confidence in some smaller and medium-sized banks. Faced with large-scale withdrawals of deposits and other problems, curatorship was imposed on Saambou Bank Limited (Saambou). The National Treasury eventually had to issue a guarantee to all depositors in order to stem the tide of withdrawals experienced by BoE Bank Limited (BoE). Subsequently, Nedbank acquired BoE, while Saambou's assets were sold to other institutions. No depositors lost their money. Following these events the Reserve Bank adopted, instituted and published a policy framework for dealing with banks in distress.

Apart from the demise of the above-mentioned two institutions, no fewer than nine smaller banks and branches of foreign banks cancelled their registration during 2002. In August 2003, however, a foreign banking group bought a domestic online retail bank and was awarded a banking licence in South Africa.

The remaining banks, together with other financial institutions, committed themselves to enthusiastically play their role in uplifting and empowering all the people of the country at the Financial Sector Summit which was held in August 2002 under the auspices of Nedlac. Currently, action plans are being developed to give practical content to the agreements reached at the summit.

From February 2003 banks have had to report suspicious transactions that may involve money laundering to the Financial Intelligence Centre. They also had to implement a range of know-your-customer and record-keeping measures from June 2003.

Further regulatory changes which may have a profound impact on South African banks include:
- the minimum targets for low and medium-income housing advances proposed in the Community Reinvestment (Housing) Bill;
- the proposed introduction of legislation providing for narrow and core banks, with limited business scope but less restrictive entry criteria; and
- the new Capital Accord, or Basel II, which is likely to be introduced in the second half of the decade.

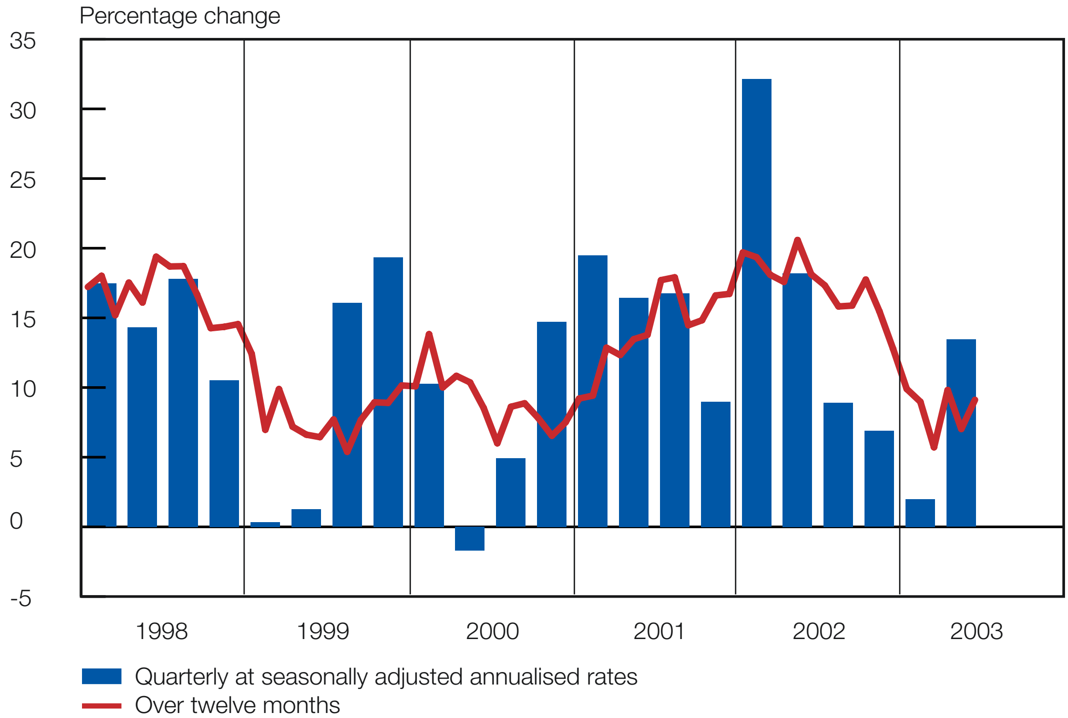
Of more immediate concern to the interpretation of economic analyses based on banks' balance sheet data are recent changes to accounting standards. These changes originated with International Accounting Statement IAS 39, which formed the basis for Accounting Statement AC 133, issued by the South African Institute of Chartered Accountants. AC 133 applies to financial year-ends commencing on or after 1 July 2002, and requires in most instances the use of fair value in accounting for financial instruments. All derivatives positions must, for instance, be reported on the balance sheet at fair value. Its implications will be illustrated further on.

## Money supply

In the first half of 2002 money supply growth accelerated to very high levels as rapidly rising inflation and a climate of general uncertainty and volatility were reflected in the demand for money. The monetary policy steps taken, the recovery in the exchange rate of the rand and the associated slowdown in inflation that followed brought about a remarkable deceleration in monetary growth within a very short timespan. The steepness of the deceleration was comparable to that in late 1998 and early 1999.

The broadly defined money supply (M3) recorded an all-time high annualised quarter-to-quarter growth rate of 32 per cent in the first quarter of 2002 as prices and nominal expenditure rose briskly in the wake of the sharp depreciation of the rand in late 2001. A still-high growth rate of 18 per cent was recorded in the second quarter of 2002, but thereafter M3 growth fell to below 10 per cent and sank as low as 2 per cent in the first quarter of 2003.

M3




Notable factors underpinning the remarkable slowdown in monetary growth included:

- the significant deceleration in consumer price inflation and deflation in production prices which was, in turn, related to disciplined financial policies and the recovery in the exchange rate;
- slower growth in real gross domestic output with less buoyant growth in real gross domestic expenditure;
- negative wealth effects as the value of investors' equity and offshore asset holdings declined;
- the recording of profits on foreign exchange forward cover by the Reserve Bank; and

- falling export revenues following the strengthening in the exchange rate of the rand and possibly some delays in the repatriation of export proceeds on occasions when exporters expected a reversal in the strength of the rand.

The downward trend in M3 growth was equally evident in the narrower monetary aggregates. Nevertheless, within M3 there has been some substitution between deposit classes over the past year, with a growing preference for short and medium-term maturities at the expense of long-term maturities. This could be attributable to a growing speculative motive for holding money balances in preparation for the return of optimism to the financial markets after a period of heightened uncertainty.

In the second quarter of 2003 M3 growth rebounded to an annualised rate of 13½ per cent. The twelve-month growth in M3, however, remained below 10 per cent throughout the first half of 2003 and amounted to 9,1 per cent in June 2003 – roughly half the rate of 18,1 per cent registered in June 2002.

Growth in the corporate sector's M3 holdings slowed down over the past year, whereas households' M3 holdings picked up markedly. Households' deposits rose by R35 billion over the twelve months to the end of June 2003 in comparison to R20 billion for the twelve months to June 2002.

The sustained high rate of increase in households' deposits could partly be attributed to income tax relief given to individuals, relatively high wage settlements and an active drive by banks to attract deposits through lucrative interest rate packages. An increase in farm income following high product prices and fair crops during 2002 could also have contributed to higher levels of household money balances. It is also possible that households, experiencing sharp declines in the value of their equity-based investments, opted to place a larger part of their funds in deposit-type assets.

Society's high liquidity preference was reflected in a decline in the income velocity of circulation of M3 to levels last seen in 1975. It reached a low point of 1,71 in the second and third quarters of 2002, but increased to 1,75 in the last quarter of 2002 and then remained roughly unchanged in the first quarter of 2003. It receded slightly in the second quarter.

From the end of June 2002 to the end of June 2003, the M3 money supply increased by R58 billion. In an accounting sense the change in M3 was explained by increases of R120½ billion in the banks' claims on the private sector, R26 billion in banks' net claims on the government sector and R37½ billion in net foreign assets. Part of the

## Counterparts of change in M3

R billions

| | Twelve months to the end of June 2003 | |
|---|---|---|
| Net foreign assets | | 37,7 |
| Net claims on the government sector | | 25,8 |
| Gross claims | 29,8 | |
| Government deposits (+decrease; -increase) | -4,0 | |
| Claims on the private sector | | 120,4 |
| Net other assets and liabilities | | -126,0 |
| **Total change in M3** | | **57,9** |

increase in banks' claims on the government sector resulted from reclassifications out of "other assets" of the banking sector to claims on the government sector when the National Treasury issued zero-coupon bonds to the Reserve Bank in partial settlement of losses incurred on forward foreign-currency transactions.

The increases in counterparts of change in M3 were partly offset by a contraction of R126 billion in "net other assets and liabilities". The sharp decline in this category was mainly caused by technical factors, notably a sharp increase in liabilities on account of derivatives positions and repurchase transactions, as will be discussed in the next section.

## Credit extension

Traditionally, changes in the outstanding stock of claims on the domestic non-bank sectors as reported on the banks' balance sheets have been interpreted as signifying flows of credit to these sectors. With the implementation of Accounting Statement AC 133, derivatives positions had to be marked to market and reported on a gross rather than on a net basis. Previously, coverage of on-balance sheet derivatives was narrower and netting was widespread. Those derivatives assets with counterparties falling in the domestic non-bank sector form part of the *investments* category of banks' claims on the domestic private sector, which accordingly rose very strongly. This one-off increase which was recorded in the period January to April 2003, clearly did not signify any new flows of credit. More problematically, the marking to market of derivatives and other investments such as bonds at each month-end leads to a situation where, in a typical month, the bulk of the change in the stock of claims on the domestic non-bank sectors is likely to be due to revaluation rather than to actual transaction flows of credit.

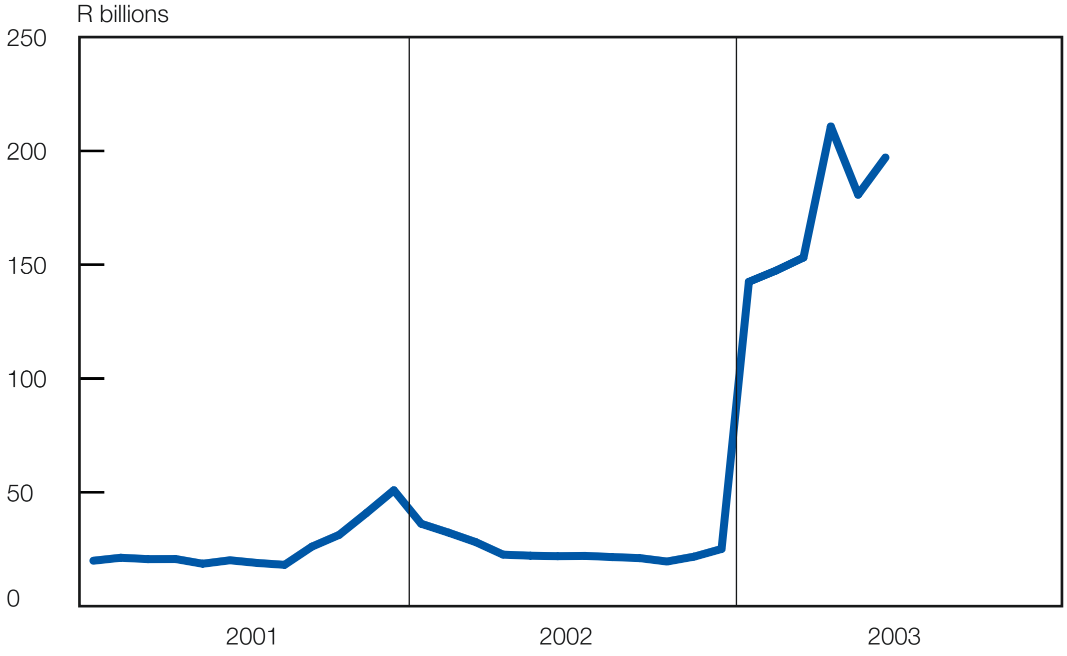
The increase in banks' on-balance sheet derivatives assets is illustrated in the graph on the opposite page. It also shows that foreign exchange and money-market interest rate derivatives constituted the bulk of total derivatives assets.

Accordingly, in analysing credit extension, it is advisable to de-emphasise the reported stock of banks' claims on the domestic private sector and to pay more attention to banks' *total loans and advances*. These are reported at nominal value including accrued interest, and do not change on account of mark-to-market practices as with *investments* and to some extent with *bills discounted.* Banks' *total loans and advances* includes mortgage advances, instalment sale credit, leasing finance, overdrafts, credit card and general advances (with the last three categories together known as *other loans and advances* in the Reserve Bank's analyses).

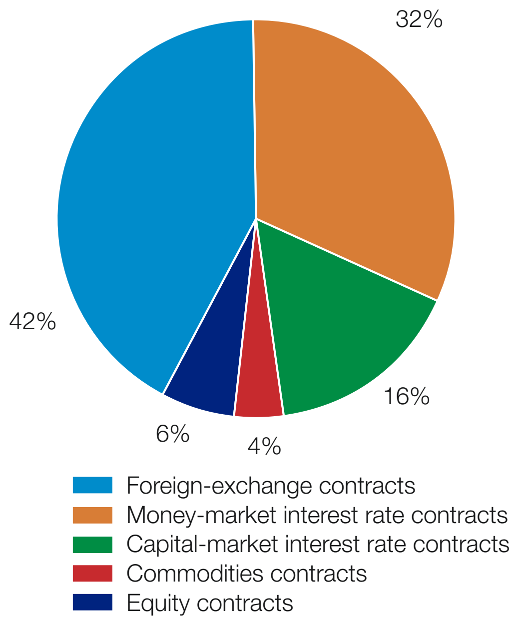
Growth in banks' total loans and advances to the domestic private sector slowed down significantly in the course of 2002. In the first quarter of 2002 it still rose at a brisk annualised rate of 14 per cent. Rising inflation and pre-emptive buying ahead of anticipated further price increases supported the demand for credit and helped to ensure that growth in real domestic production and expenditure remained fairly buoyant. However, in the second quarter of 2002 growth in loans and advances receded to a single-digit annualised rate as real domestic expenditure growth faltered.

Growth in loans and advances remained below 10 per cent for the remainder of 2002, falling as low as 6½ per cent in the third quarter. Given the increases in the level of short-term interest rates during the first nine months of the year and the slower pace of economic growth, this is hardly surprising. On occasion, credit extension was also kept in check by reversals of leads and lags in the payments for and receipts from foreign transactions when the exchange rate of the rand trended stronger.

Banks' derivatives assets as reported on their balance sheets

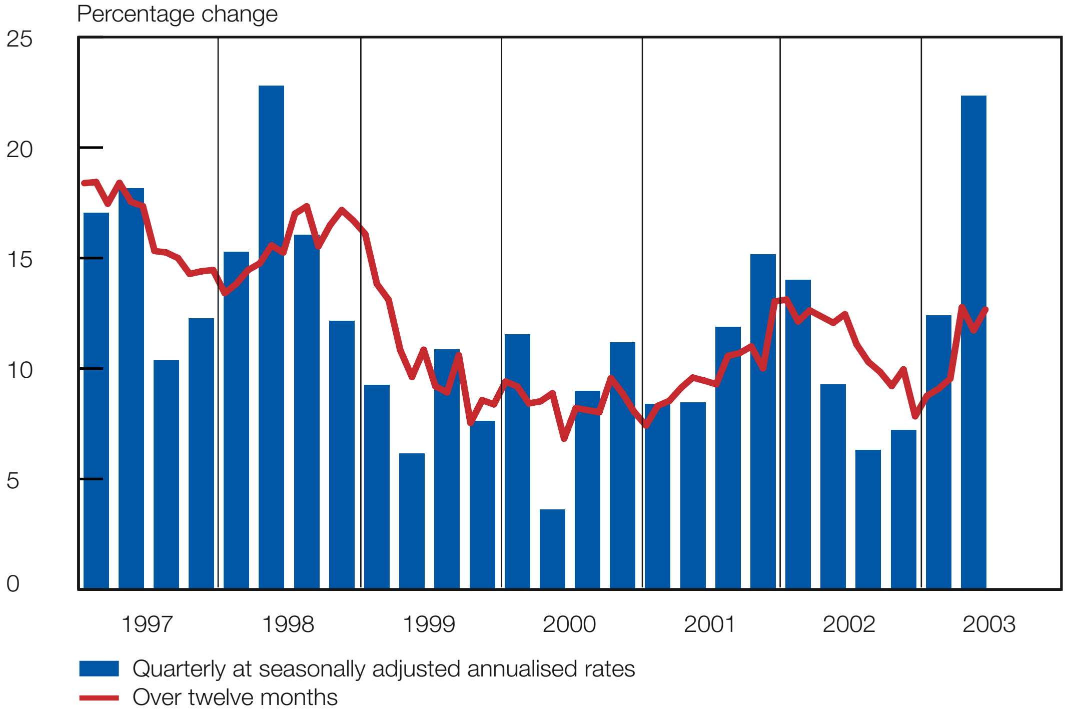



Total derivatives assets by type – 30 June 2003




In the first half of 2003, growth in loans and advances started picking up again, reaching an annualised rate of 22½ per cent in the second quarter. This was partly a reflection of the continued growth in real fixed capital formation. At the same time, many households – having worked down the ratio of their debt to disposable income to its lowest level in ten years – were in a position to incur some debt without excessive strain on their finances, and were encouraged by rising house prices and projections of declines in interest rates.

Total loans and advances extended to private sector*




* Excluding investments and bills discounted

An analysis of credit extension by type of credit reveals that during the past twelve months, mortgage advances remained the largest component of total credit extended to the private sector. For the twelve months to June 2003, the contribution of mortgage advances to banks' claims on the private sector receded slightly to 38½ per cent. Relatively subdued and even declining twelve-month growth rates masked some strong month-on-month increases. In absolute terms, this category has registered month-on-month increases above R3,5 billion or around 1,3 per cent since February 2003. This strong growth in mortgage advances is, amongst other factors, a reflection of:

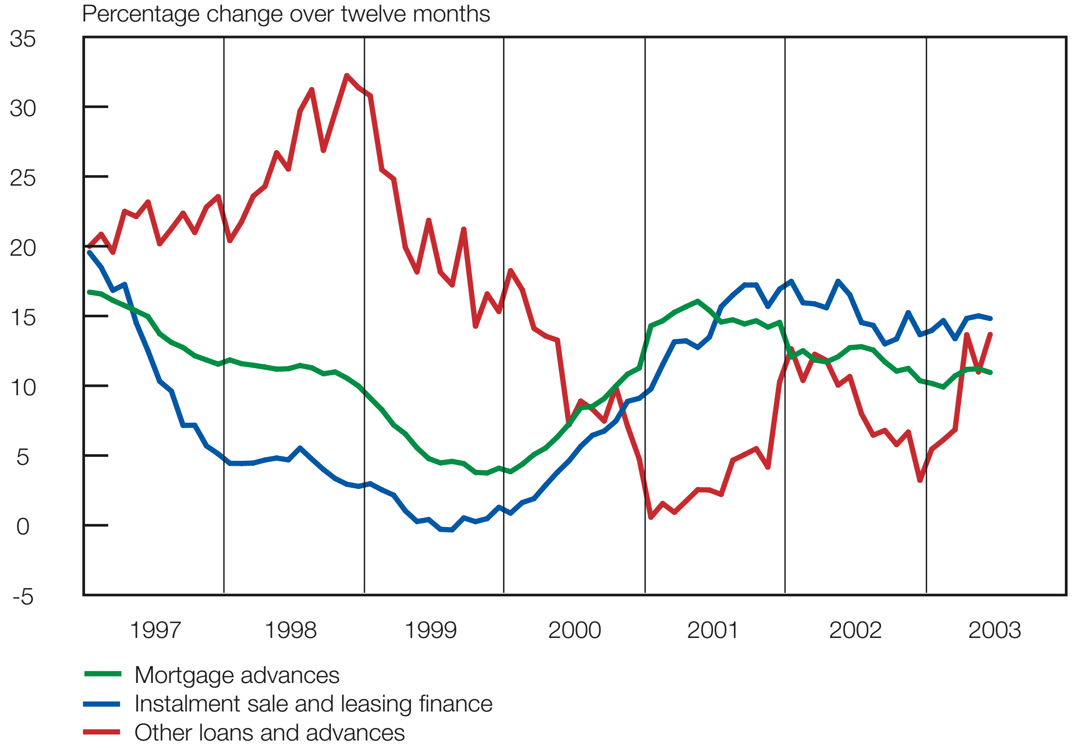
- the attractiveness of investment in residential property given the impressive performance of house prices relative to other asset prices;
- urbanisation and other demographic changes against the background of the historical housing backlog in South Africa;
- improved levels of disposable income;
- households' safety and security concerns, leading to a strong demand for security complexes;
- more competition in the supply of mortgage finance and improved efficiency in the processing of applications;
- the initiative by government to boost owner-occupied dwelling units among lower income communities; and
- the sophistication and flexibility of mortgage products such as the possibility to withdraw funds against net housing equity or to obtain a re-advance without incurring significant transaction costs.

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

| | June 2002 | June 2003 |
|---|---|---|
| Mortgage advances | 40,8 | 38,4 |
| Instalment sale credit and leasing finance | 15,1 | 14,7 |
| Other loans and advances | 38,1 | 36,8 |
| Investments and bills discounted | 6,0 | 10,1 |
| Total | 100,0 | 100,0 |

Growth in *other loans and advances,* including overdrafts on current accounts, general and credit card advances, slowed down significantly from mid-2002 to early 2003. This category is a major source of corporate borrowing, and historical data indicate that amongst other important economic variables, its trend is usually inversely related to developments in the exchange rate of the rand. During the second half of 2002, lags in foreign payments due to the recovery of the exchange rate and the increased cost of credit could have contributed to the slowdown in the demand for this type of credit. Recently, reduced profitability along with capital commitments probably weakened corporate cashflows to the point where the demand for credit started to rise more briskly. On this occasion the inverse correlation with the exchange rate did not hold.

Credit extension to the private sector by type of credit




Reflecting the resilient strength of the private sector's demand for durable goods, *instalment sale credit and leasing finance* grew by 14,7 per cent in the year to June 2003 compared to 15,1 per cent in the year to June 2002. Financing of motor vehicles accounted for the bulk of the increase in such credit in the year to June 2003 – with new and used vehicles more or less equally important. New payouts of such credit amounted to R37 billion in the second half of 2002 and R36 billion in the first half of 2003.

Of the overall increase in total loans and advances to the private sector for the twelve months to June 2003, households accounted for 50,5 per cent whilst companies accounted for the remaining 49,5 per cent. The bulk of the household sector's borrowing was in the form of mortgage advances.

Viewed by industry, the strongest growth in banks' loans and advances over the past year was recorded by the producers of electricity, gas and water, individuals, and the agricultural sector. At the other extreme, loans and advances to the community, social and personal services sector, and the manufacturing sector contracted significantly, as shown in the accompanying table.

Banks' loans and advances by industry

| | June 2002 R billion | June 2003 R billion | Change Per cent |
|---|---|---|---|
| Agriculture, forestry and fishing | 14,3 | 16,7 | 17 |
| Mining | 12,5 | 13,4 | 7 |
| Manufacturing | 47,8 | 41,9 | -12 |
| Construction | 7,7 | 8,5 | 10 |
| Electricity, gas and water | 10,4 | 14,6 | 40 |
| Trade and accommodation | 24,5 | 26,7 | 9 |
| Transport and communication | 14,3 | 15,9 | 11 |
| Finance and insurance (including interbank) | 282,8 | 310,3 | 10 |
| Real estate and business services | 65,4 | 71,2 | 9 |
| Community, social and personal services | 41,5 | 31,4 | -24 |
| Individuals | 281,0 | 333,7 | 19 |
| Other | 62,2 | 75,8 | 22 |
| **Total** | **864,3** | **960,1** | **11** |

Regarding banks' claims on the government sector, a substantial increase was recorded in the third quarter of 2002 when the National Treasury issued zero-coupon bonds to the Reserve Bank in partial settlement of the outstanding balance on the Gold and Foreign Exchange Contingency Reserve Account. The latter account's balance forms part of *other assets* of the banking sector, while the Reserve Bank's bond holdings fall under *claims on the government*. A further acceleration occurred in the fourth quarter of 2002. This increase was of a technical nature as government funding requirements did not rise. Instead, the measured claims on government were raised when the banks' regulatory authority instructed that assets and liabilities arising from all types of repurchase transactions should be fully reported on the balance sheet by all banks. A significant portion of repurchase transactions involves government securities and this regulatory action accordingly raised the measured amount of claims on the government sector in the monetary statistics. Simultaneously the "other liabilities" item *loans received under repurchase agreements* was also raised.

## Interest rates and yields

The South African Reserve Bank inaugurated its MPC in September 1999. Having started against the background of high nominal and real interest rates and improving actual and expected inflation, the MPC eased monetary policy considerably during its first two years of operation. The lowering of the repurchase rate by 50 basis points on 21 September 2001 to a recent low of 9,50 per cent was the last step in that direction.

The sharp depreciation of the rand in the fourth quarter of 2001 and the subsequent deterioration in inflation expectations and outcomes in the first half of 2002 convinced the MPC to tighten monetary policy decisively. The repurchase rate was increased on four occasions during 2002, each time by 100 basis points – from a starting level of 9,50 per cent in early January 2002 to 13,50 per cent in September 2002. At the November 2002 and March 2003 MPC meetings, the repurchase rate was left unchanged, reflecting caution as convincing evidence of a decline in inflation and inflation expectations was awaited.

Such evidence was found, and on 13 June 2003, the MPC reduced the Bank's official repurchase rate by 1,50 percentage points to 12 per cent. Important factors underpinning this decision included:
- the major indicators of inflation were clearly decelerating;
- a 1,9 percentage-point downward revision in the CPIX following a correction of its rental component;
- a fall in inflation expectations; and
- the widening of the interest rate differential between South Africa and its major trading partners, following a general decline in international interest rates.

Cumulative increase in prime overdraft rate during policy-tightening episodes

| Episode* | Increase<br>Percentage points |
|---|---|
| Jun 1983 – May 1985 | 11 |
| Jan 1988 – Apr 1991 | 8½ |
| Sep 1994 – Oct 1997 | 5 |
| Jun 1998 – Oct 1998 | 7¼ |
| Jan 2002 – Jun 2003 | 4 |

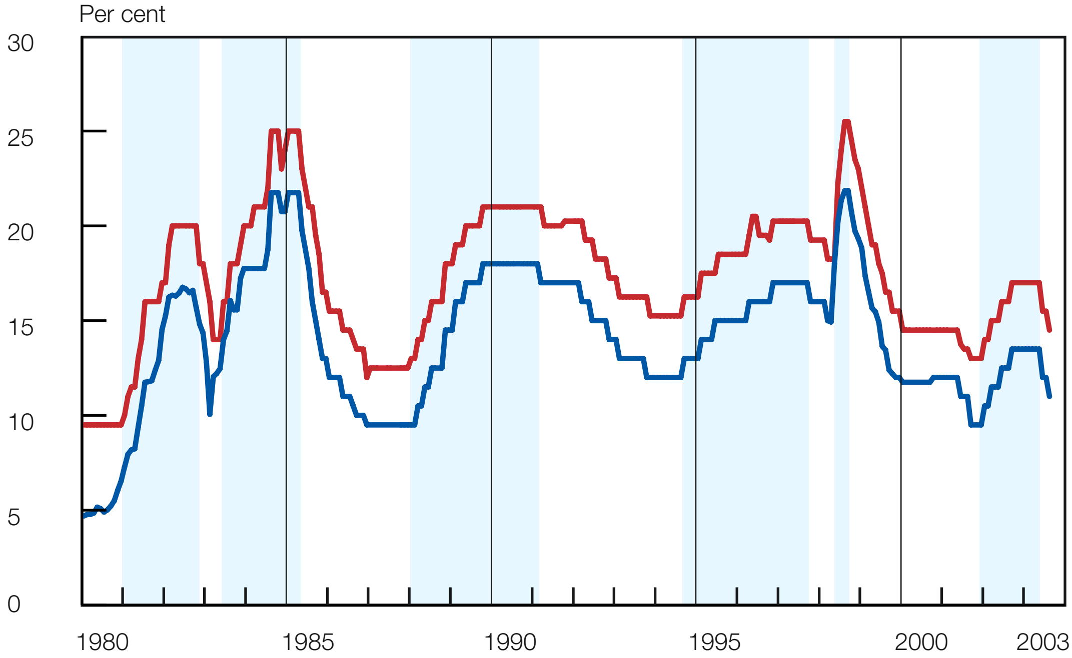
* From month of first increase to month of first decrease

The upward phase in the Bank's official repurchase rate started on 16 January 2002 and came to an end on 13 June 2003 with a reduction in the rate. In total it therefore lasted for 17 months and involved tightening by a total of 400 basis points. Against the previous five episodes of tightening, the magnitude of the overall increase was the smallest. The period of 17 months before the interest rate reduction was also one of the shortest, as illustrated in the graph on the following page.

On 14 August the Reserve Bank announced a further decrease in its repurchase rate, this time by 100 basis points.

The private-sector banks responded to the increases in the repurchase rate during 2002 by lifting their *prime overdraft rate* and the *predominant rate on mortgage loans* in four steps from their initial levels of 13 per cent in early January to 17 per cent in September 2002. These high rates – previously experienced in mid-1999 – were maintained until May 2003, whereafter they were reduced to 15½ per cent in June and 14½ per cent in August, coinciding with the declines in the repurchase rate. Similarly, the *predominant rate on twelve-month fixed deposits with banks* was raised from 8 per cent in January 2002 to 12 per cent in September 2002 where it remained until April 2003. In anticipation of a lowering of the repurchase rate banks reduced their fixed-deposit rates to 11 per cent in May 2003 and further to 9½ per cent in June when the lower repurchase rate materialised.

## Lending rates




Prime overdraft rate
Repurchase rate
Shaded areas: From first increase to first decrease in overdraft rate during each tightening episode

Although other money-market interest rates moved broadly in line with developments in the repurchase rate, they were also responsive to market forces unique to their respective sub-markets. In the first nine months of 2002, the evolution of these rates reflected market expectations of upward adjustments in the repurchase rate. Under these circumstances, the South African Overnight Interbank Average (SAONIA) rate increased from 8,51 per cent on 15 January 2002 to 12,45 per cent on 30 September 2002. Over the same period, the three-month Johannesburg interbank agreed rate (Jibar) rose from 9,73 per cent to 12,99 per cent.

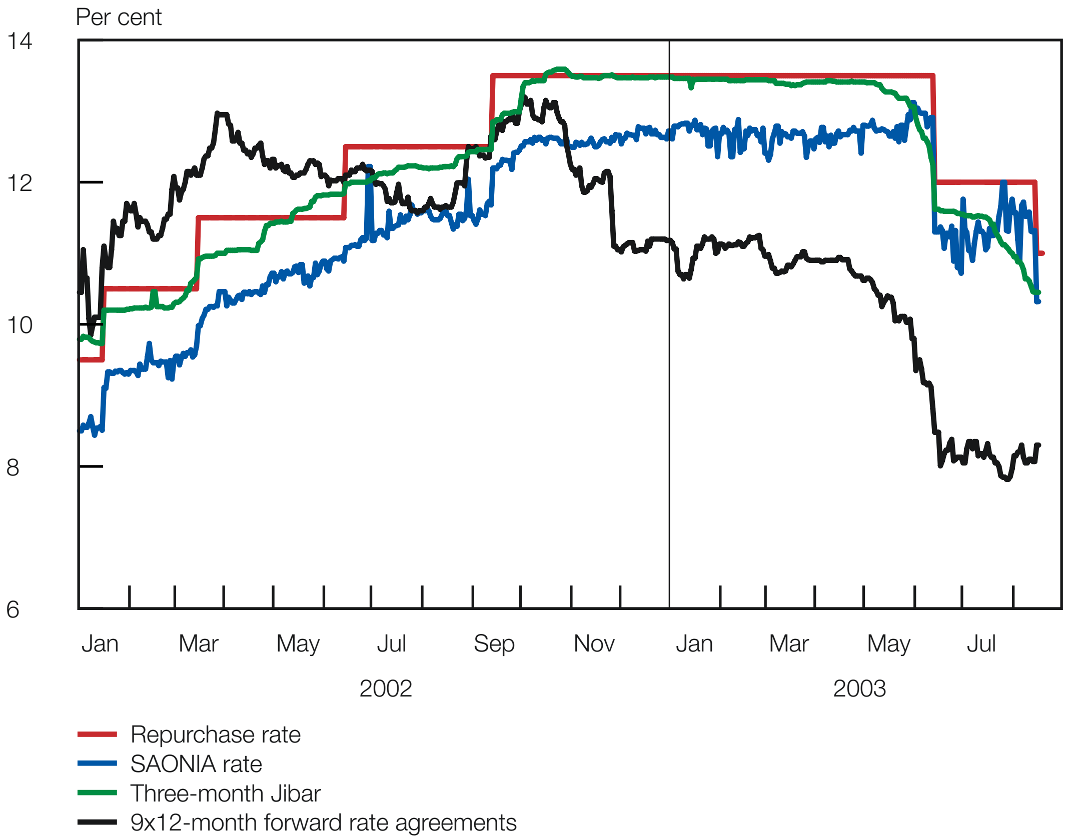
Against the background of an unchanged repurchase rate of 13,50 per cent during the nine months to 12 June 2003, the SAONIA rate fluctuated sideways. It tended to edge higher whenever liquidity conditions in the money market tightened, as sometimes happened around the start of a new required cash reserve maintenance period or around the last trading day of the month.

In May and early June 2003, expectations of lower inflation fuelled by the downward revision of the CPI and therefore an imminent reduction in the Reserve Bank's repurchase rate drove most money-market interest rates significantly lower. These expectations were also evident across the entire forward rate agreement curve.

In response to the reduction in the repurchase rate on 13 June 2003, the SAONIA rate declined by 161 basis points to 11,30 per cent. Following the Reserve Bank's decision on 14 August to lower its repurchase rate by a further 100 basis points, the SAONIA rate decreased by a roughly similar magnitude.

A comparison of the rate on 9x12-month forward rate agreements with the three-month Jibar on 15 August 2003 reveals market expectations of a further 215-basis-point decrease in three-month interest rates by mid-May 2004.

Money-market interest rates

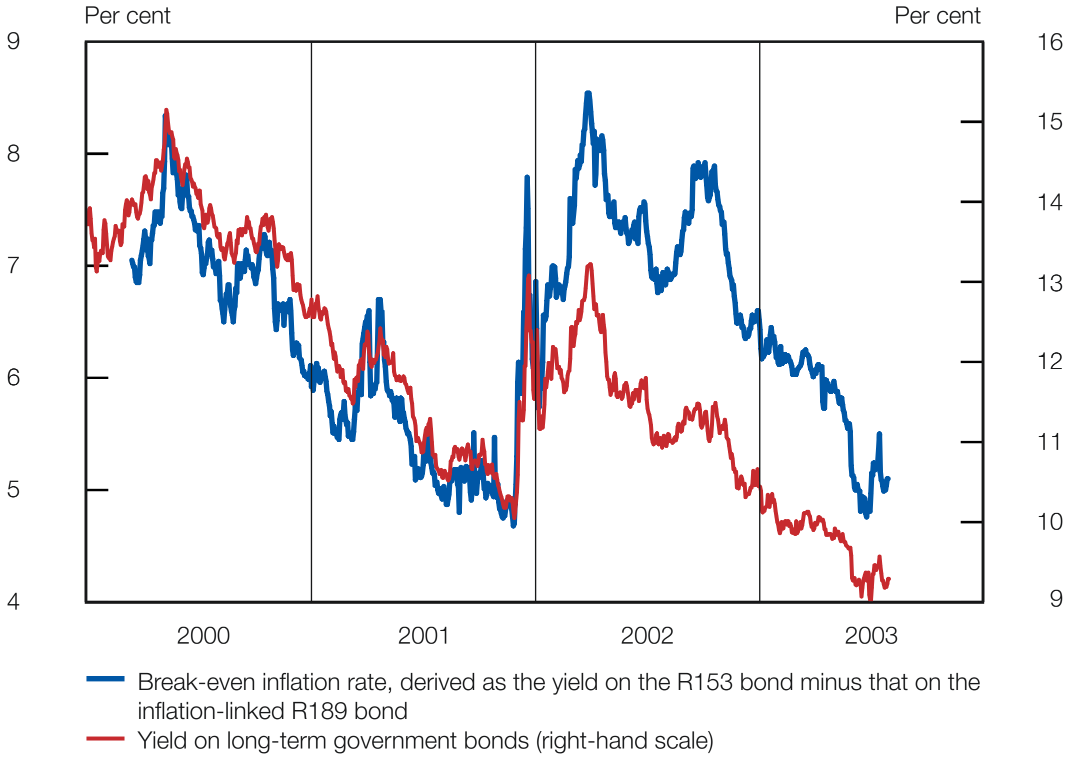



During 2002, in the aftermath of the abrupt depreciation of the rand in December 2001, the market for fixed-interest securities remained sensitive to the vagaries of the rand as market participants reassessed longer-term inflation risks and their implications for monetary policy. International geopolitical tensions, weak global growth prospects and concerns regarding the SARS virus also affected market sentiment.

The monthly average yield on long-term government bonds increased from 10,3 per cent in November 2001 to 12,6 per cent in March 2002, notwithstanding the steps taken to contain inflation through a tightening of monetary policy in January and March 2002. By the end of March 2002 the market settled down and the yield on long-term government bonds resumed its downward path to reach 11,1 per cent in August. Despite a strong demonstration by the Reserve Bank of its commitment to contain inflation through further increases in the Bank's repurchase rate in June and September 2002, bearish sentiment returned to the bond market in September and October. Disappointingly high inflation figures and concerns regarding the situation in Zimbabwe coincided with concerns about financial contagion arising from developments in emerging markets such as Argentina and Brazil, and contributed to the bearish sentiment.

From November 2002 the sustained appreciation in the value of the rand bolstered the bond market by improving the near-term inflation outlook, and yields on long-term government bonds moved downwards. In February 2003 long-term bond yields breached the 10-per-cent level for the first time since 1980. The bond market rally temporarily lost momentum in March in response to the uncertainties created by the United States-led invasion of Iraq and a somewhat slower than expected moderation of inflation. Expectations of an aggressive decline in short-term interest rates were fuelled by the release by Statistics South Africa of significantly lower revised inflation numbers on 30 May. The Reserve Bank's announcement of a reduction of 150 basis points in the repurchase rate on 13 June 2003 contributed further to bond yields receding to 9,3 per cent in June 2003. The bond market rally remained unaffected by government's increased recourse to domestic borrowing in fiscal 2003/04 – following two years of net redemptions.

Bond yield and break-even inflation rate




In response to the deterioration in the inflation outlook, the *real yield on government's R189 inflation-linked bond* decreased from 5,0 per cent in December 2001 to 3,7 per cent in September 2002, before increasing somewhat to 4,0 per cent in June 2003 as inflation expectations improved. During this period the downward revision in the CPI in May 2003, backdated to the beginning of 2002, impacted on the prices and coupon payments of inflation-linked bonds. However, investors were not compensated as National Treasury regarded the CPI changes as a technical correction. Since the introduction of inflation-linked bonds in March 2000, the nominal value of the amount in issue has increased to R21,6 billion at the end of June 2003, comprising approximately 4,8 per cent of total outstanding marketable domestic government bonds.

Actual and expected inflation affects the attractiveness of fixed-interest securities through its influence on real returns. Persistent inflation at first caused the *real* or *inflation-adjusted yield on long-term government bonds* (using historical year-on-year increases in CPIX as an indicator of future price changes) to decline sharply from 4,8 per cent in December 2001 to a negative value of 0,4 per cent in November 2002 – the first negative real return since January 1994. The strong performance of the rand from the latter part of 2002 bolstered the market for fixed-interest securities by reinforcing expectations of lower inflation. With the subsequent deceleration of

CPIX inflation exceeding the decline in nominal bond yields, the real yield returned to positive values in January 2003 and reached 2,7 per cent in June 2003.

The improvement in longer-term inflation expectations as reflected by the bond market is confirmed by the progressive decline in the *break-even inflation rate*. Expected longer-term inflation, measured as the difference between the nominal yield on conventional bonds and the real yield on inflation-linked bonds within the six-to-ten-year maturity range, on balance decreased by 353 basis points from the end of March 2002 to 12 June 2003. Following the lowering of the repurchase rate on 13 June, this indicator of expected long-term inflation increased moderately to the end of July.

In an international context South African domestic government debt yielded a favourable return to international investors. Shorter-term yields increased as interest rates were raised on four occasions in 2002; simultaneously central banks in most other parts of the world were reducing interest rates to fend off a slowdown in economic growth. The *currency risk premium* on South African government bonds in the one-to-three-year maturity range, calculated as the difference between the nominal yields in the domestic market and in the United States market, increased by 164 basis points from March 2002 to May 2003. The currency risk premium increased notwithstanding the strengthening of the exchange rate of the rand, as the decline in the yield on foreign-currency denominated debt exceeded the decline in the yield on rand-denominated debt. In June 2003 the currency risk premium declined by 158 basis points as nominal yields in the domestic market followed the reduction in the repurchase rate downwards.

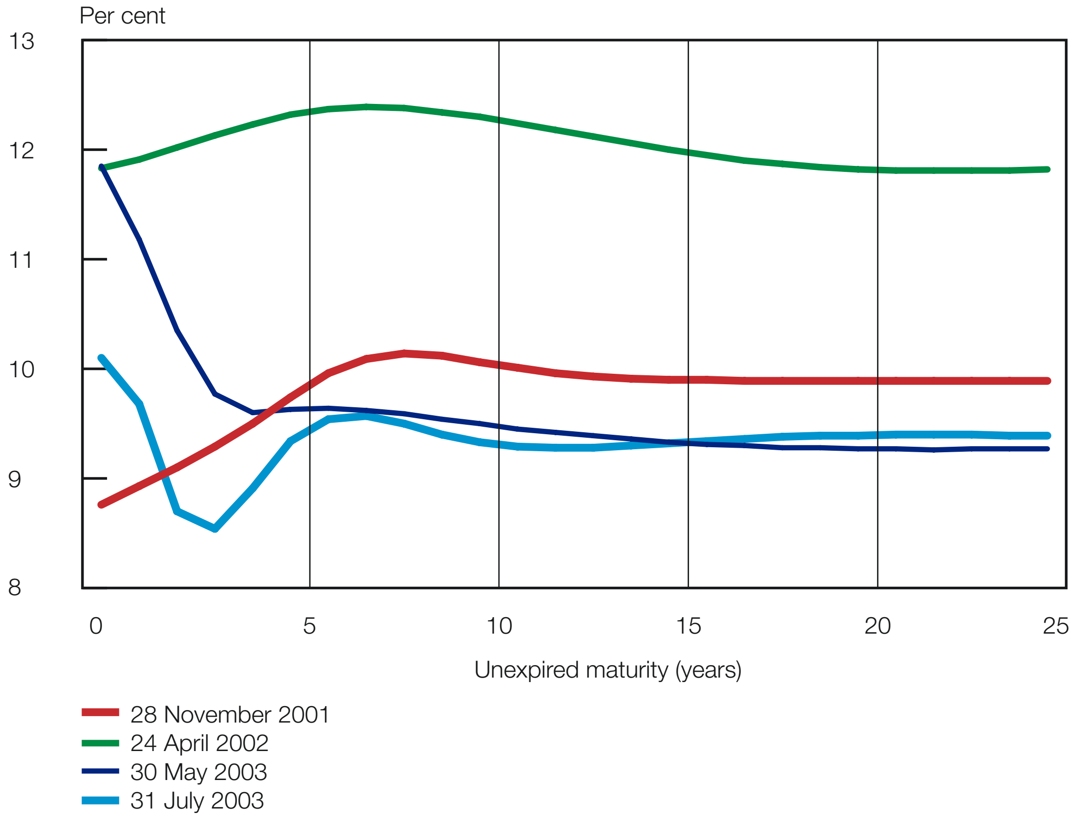
From September 2002 emerging-market debt generally became less sensitive to global risk indicators, supported by easy monetary policy in the US and Europe, weak global equity markets, and fiscal stimulus. The yield spread of emerging markets' sovereign debt over benchmark United States Treasury Bonds (as measured by the JP Morgan Emerging Markets Bond Index or EMBI+) narrowed significantly by 494 basis points from September 2002 to June 2003 to its lowest level since the emerging-markets financial crisis in 1998, despite benchmark long-bond yields in the US and UK declining to record lows. In absolute terms, the *sovereign risk premium* of South African government foreign-currency denominated debt is far less than that of typical emerging-market debt. Supported by six ratings agency upgrades over the nineteen months to June 2003, including the upgrades by Fitch Ratings and Standard & Poor's in May 2003, the sovereign risk premium of South African government bonds tightened significantly. The sovereign risk premium on the South African government dollar-denominated bonds issued in the North American market declined, on average, by about 134 basis points from September 2002 to June 2003.

Influenced by the exchange value of the rand and its simultaneous impact on inflation prospects, as well as the reduction in supply of fixed-interest securities, the level and shape of the *yield curve* changed substantially during the past two years. From 10 May 2000 to 28 November 2001, the yield curve flattened considerably reflecting market participants' confidence that the monetary policy strategy of the Reserve Bank would ensure a steady decline in CPIX inflation to within the target range. The yield curve then rose sharply from 28 November 2001 to 20 December 2001 as the sudden and sharp depreciation of the rand and related inflation concerns had a pronounced effect on long-dated bond yields.

Money-market interest rates followed the repurchase rate of the Reserve Bank upwards during the first ten months of 2002, matched by upward movements in bond yields at the short end of the yield curve. However, since late March 2002, the yield on long-term fixed-interest securities has generally declined in tandem with the appreciation of the exchange value of the rand, interrupted only briefly by bearish sentiment in September and October 2002.

The divergent movements of long-bond and short-bond yields resulted in a drastic change in the slope of the yield curve. During April 2002 the slope of the yield curve changed from upwards to downwards, driven by expectations of slower economic growth, and persisted with this inverted shape throughout the rest of 2002 and into the first half of 2003. The downward sloping yield curve reflected the relatively tight monetary policy regime and the concomitant prospect that inflation will be enduringly reduced in the long term. Market commentators also agree that the limited demand for loanable funds by the public sector contributed to the decline in long-bond yields, exaggerating the inversion in the slope of the yield curve.

Yield curves




With long-term yields declining to substantially lower levels than short-term yields and interest rates, the *inverse yield gap*, i.e. the difference between bond yields at the extreme long and short ends of the yield curve, increased gradually from March 2002 to amount to 234 basis points on 10 June 2003, prior to the MPC meeting. The Reserve Bank's reduction of its repurchase rate by 150 basis points, effective from 13 June 2003, resulted in the yield-curve inversion unwinding to 102 basis points at the end of June 2003. Yields at the long end of the maturity spectrum showed only a limited reaction to the decline in the repurchase rate as the decline was widely discounted. The short end of the curve was the main beneficiary of the decline while the intermediate segment reacted only moderately.

# Financial markets

## Structural and regulatory changes in financial markets

Developments in the regulatory and supervisory framework during 2002 and the first part of 2003 focused on improving the quality of financial reporting, enhanced record-keeping measures and consumer protection, the prevention of criminal conduct and misuse of the financial system, empowerment issues, and further exchange control liberalisation.

Laying the foundation for the improved integrity of the financial services industry, the Financial Advisory and Intermediary Services Act, Act No 37 of 2002, was signed into law on 15 November 2002. The legislation aims to protect investors from poor and misleading advice, and the conditions imposed by the Act include:
- licensing requirements for financial service providers and advisers;
- the approval of representatives, key individuals and compliance officers by the Financial Services Board's registrar of financial services providers;
- record keeping of all client communication and advice given for at least 5 years;
- sufficient information on financial products must be provided to investors to enable them to make informed decisions, including full disclosure of the adviser's actual or potential own interest, commission and fees paid, and details of how underlying assets are valued;
- investors must sign off asset allocation and product selection decisions, at least annually or when these are changed; and
- reports showing all transactions must be sent to investors at least quarterly.

Another important development was the Collective Investment Schemes Control Act, Act No 45 of 2002, which became effective on 3 March 2003 replacing the Unit Trust Control Act, 1981 and the Participation Bond Act, 1981. The Act facilitates product innovation, allowing fund managers greater flexibility to create and manage flexible funds and to be more competitively aligned with foreign products. The legislation simultaneously improves investor protection in the case of misrepresentation and imposes certain investment limits on managers; their investments may for instance not exceed 24 per cent of the shares in issue of any one company, or 15 per cent of the shares of companies that are in the same group as the manager. The Act enables the expanded use of derivatives and derivative-based hedge funds in unit trust portfolios. These derivatives are, however, limited to securities listed on the South African Futures Exchange or JSE Securities Exchange SA, to limit the danger of counterparty risk.

The Financial Intelligence Centre Act, Act No 38 of 2001, came into effect in February 2002 and deals with law enforcement issues surrounding the protection of South Africa's financial resources. The Act contains a number of measures aimed at controlling money laundering. Accountable institutions had to start reporting suspicious transactions to the Financial Intelligence Centre from February 2003, while improved client identity verification and record-keeping measures have been required from 30 June 2003.

Financial reporting standards were revised in terms of international standards and generally accepted accounting practice (GAAP) and resulted in the adoption of

AC 133, already discussed earlier in this report. Reporting in the insurance industry will also be affected by AC 133 as, among other things, investment products that carry financial risk without insurance risk will fall within the scope of the accounting standard.

Further legislative changes contributing to the effectiveness and development of the financial sector announced in the Budget of National Government for fiscal 2003/04 included, among other things, the following:

- A proposal to reform the current tax dispensation for securities lending in order to improve liquidity on the JSE Securities Exchange SA, and enhance South Africa's position as an international financial market.

- The removal of stamp duties on insurance policies and fixed deposits, effective from 1 April 2003.

- An increase in the exemption regarding interest income and distributions from unit trusts to R10 000 for individuals younger than 65 and R15 000 for individuals older than 65.

- A reduction in the rate of tax on retirement funds from 25 per cent to 18 per cent from 1 March 2003.

- A reduction in the transfer duty rate structure in respect of the acquisition of fixed property, effective from 1 March 2003.

Rationalisation of the clearing, settlement and depository functions in South Africa's financial markets is currently in progress. In December 2002, subsequent to the merger discussions of 1999 between the Bond Exchange of South Africa, the JSE Securities Exchange SA and the South African Futures Exchange, an agreement in principle was reached between the two existing clearing, settlement and security depository companies, namely Share Transactions Totally Electronic (STRATE), involved in the clearing, settlement and custody of *equities*, and the Universal Exchange Corporation Limited (UNEXcor) and the Central Depository Limited, dealing with the clearing, settlement and custody of *bonds*. The agreement encompasses a plan for the amalgamation of STRATE, UNEXcor and the Central Depository Limited so that all the various financial market instruments trading in South Africa can be cleared, settled and registered by one single entity, namely STRATE; this will include money-market instruments. The new entity became a reality on 1 August 2003 and this should bring the settlement environment of local financial markets in line with international best practice and improve the international competitiveness of South Africa's financial markets. The benefits envisaged from the integration include:
- a centralised register;
- elimination of duplication in record-keeping;
- implementation of the International Securities Services Association recommendation that there should be a convergence of securities systems that will lead to increased efficiency and reduced risk; and
- an increase in the pace of progress towards a shorter settlement period in the equities market.

A course of action has been laid out for the dematerialising of the current paper-based instruments of the money market, planned for implementation in the first half of 2004, through the technology company UNEXcor, in conjunction with the Central

Depository. The project aims to improve the efficiency of the market and reduce the risk of theft, forgery and failed settlements.

The JSE Securities Exchange SA progressed in the area of financial market infrastructure by converting to the London Stock Exchange's Sequential Equity Trading System and their real-time information dissemination system. In June 2002 the JSE adopted the FTSE Global Classification system and implemented the FTSE/JSE Africa index series. The FTSE Group has collaborative arrangements with, *inter alia*, the London, Norex, Cyprus, Euronext, Athens, Luxembourg and Madrid stock exchanges, as well as with Nikkei of Japan (Nihon Keizai Shimbun, Inc). FTSE indices are used extensively by investors world-wide for investment analysis, performance measurement, asset allocation and for creating a wide range of index-tracking funds. Furthermore, listing requirements were changed to align them with global best practice. Additional indices are also planned, such as a Social Responsibility Index, whereby corporate social and environmental responsibility will be highlighted, to be launched later in 2003. Four new benchmark indices, two capped indices and two shareholder weighted indices came into operation on 1 July 2003. These indices focus on local constituent weights, with the goal to eventually exclude foreign free float, and will more closely represent the current investment patterns of asset managers.

On 23 June 2003 the JSE Securities Exchange SA announced the first alternative exchange in Africa, named AltX, that will list small and medium companies, specifically targeting black empowerment and junior mining companies. The new market will open in October 2003 and will run parallel to the Main Board, with separate listings requirements and reduced fees. Companies with a pre-tax profit of no more than R8 million and a minimum share capital of R2 million can apply for a listing. These companies will get support from the JSE Securities Exchange SA through public forums and directors' education courses subsidised by the Department of Trade and Industry. AltX will ultimately replace the venture capital market and the development capital market established by the JSE in the late eighties.

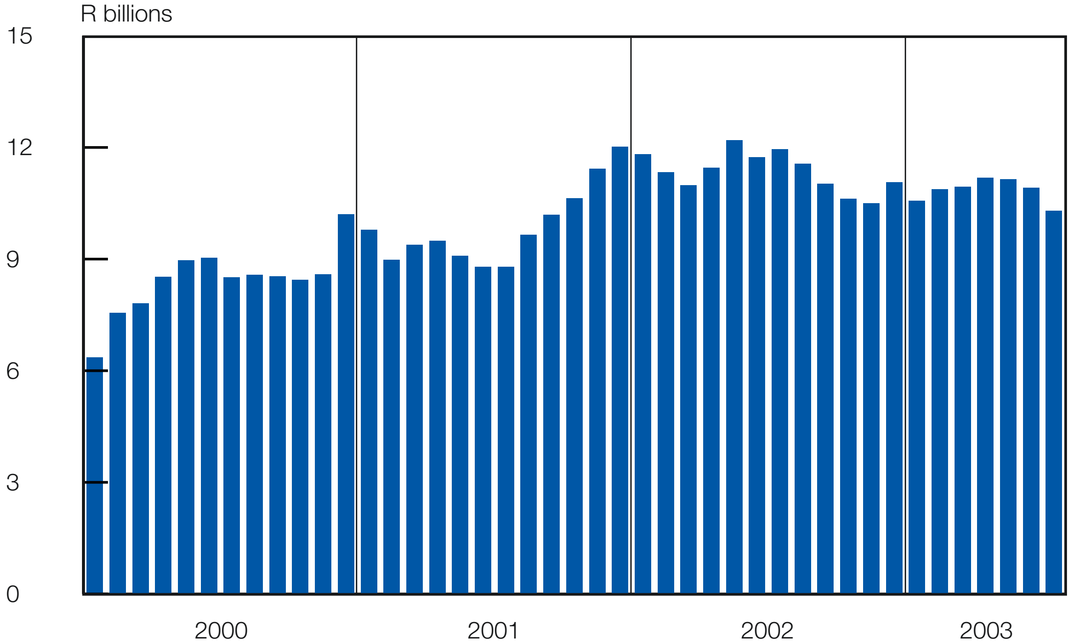
Draft empowerment charters are currently under discussion by the banking, short-term insurance and long-term insurance industries. The process is being driven by the industry itself, and is supported by government. Discussions at the Growth and Development Summit held in June 2003 included proposals for financial instruments such as specialised bonds for institutional investors and individual saving schemes that would be used for job-creating purposes. Institutional investors would be encouraged to place a percentage of investable income in these instruments.

## Money market

The average daily liquidity requirement of private-sector banks varied between R10,5 billion and R11,9 billion during the period June 2002 to July 2003. The Reserve Bank's operations in the money market during this period were generally directed towards neutralising changes in liquidity conditions arising from various sources; the Bank preferred to maintain a fairly stable level of the liquidity requirement.

The maintenance of a fairly stable level of the liquidity requirement over the past year was achieved despite a remarkable reduction in the Reserve Bank's use of liquidity-draining intervention instruments. Such intervention reached a peak in August 2002, when the Bank drained more than R69 billion from the market. By the end of July 2003, the amount drained had fallen to R36 billion.

Total liquidity requirement




Monthly averages of daily values

Several factors contributed to the decrease of some R33 billion in the Bank's liquidity-draining intervention over the past year:

- From September 2002 the banks were only allowed to deduct 50 per cent of their vault cash holdings when calculating their required cash reserve balances with the Reserve Bank, rather than 75 per cent as before. This drained R1,7 billion from the money market.

- An increase of R3 billion in notes and coin in circulation outside the Reserve Bank over the year to the end of July 2003 tightened the market by an equivalent amount.

- Repayments of lender-of-last-resort assistance provided to certain troubled banks early in 2002 were received by the Bank during the past twelve months.

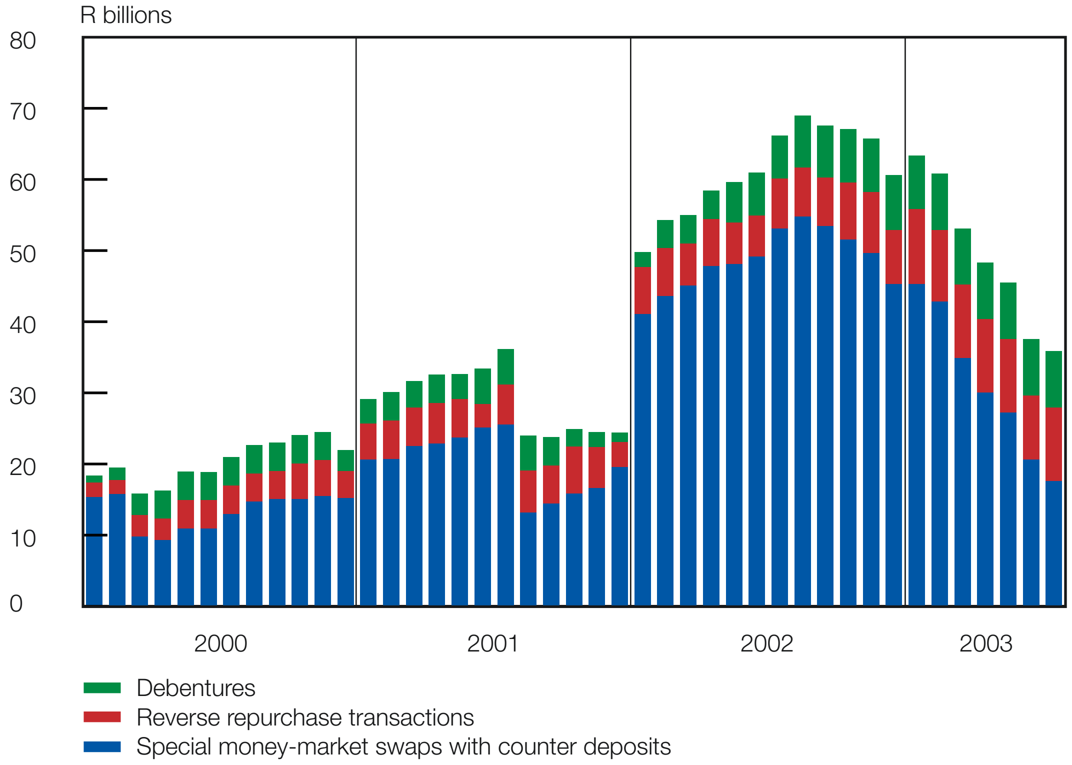
- With the recovery in the exchange rate of the rand, the Bank realised significant profits on foreign exchange forward cover, which tightened the money market.

- Government in September 2002 issued zero-coupon bonds amounting to R7 billion to the Reserve Bank, as partial compensation for losses previously incurred on forward foreign-currency transactions. In March 2003, R4 billion in such bonds were bought by the National Treasury from the Bank for cash, thus draining liquidity from the money market.

- The Reserve Bank in June 2003 repaid US$500 million on a syndicated gold loan facility, drew down US$1 billion on a syndicated loan facility, and delivered the net proceeds of US$500 million against the forward book, causing counterparties to pay in rand for the foreign currency delivered. Rand liquidity was thereby destroyed.

As shown in the accompanying graph, the reduction in the use of intervention instruments over the past year found expression in a decrease in outstanding foreign exchange swaps with counter-deposits. These swaps with deposits fell from a peak of R54,8 billion at the end of August 2002 to R17,6 billion at the end of July 2003.

Open-market operations




The Bank at the same time stepped up its use of the other two liquidity-draining instruments depicted in the graph. Its *reverse repurchase transactions* are conducted using government securities, and have maturities of 28 days and 91 days. On balance, outstanding reverse repurchase transactions were increased from R7,1 billion in July 2002 to R10,3 billion in July 2003. The Bank also issues its own *debentures* to drain liquidity. In August 2002, debentures with a maturity of 91 days were introduced to complement those with a maturity of 28 days. The total outstanding amount of debentures was increased from R6 billion to R8 billion between July 2002 and July 2003.

National Treasury has budgeted for an issue of zero-coupon bonds with a face value of R7 billion a year over the next three years to the Bank as payment in respect of cumulative losses incurred on forward foreign-currency transactions. Such instruments, once converted into interest-bearing bonds, are also likely to be used for monetary operation purposes.

Apart from the weekly main repurchase tender and the use of the main money-market intervention instruments described above, the Reserve Bank's operations in the money market were complemented by the use of supplementary repurchase auctions and, on occasion, final repurchase auctions. The private-sector banks also actively made use of their cash reserve accounts, withdrawing or depositing funds for short periods while still having to comply with the statutory cash reserve requirements on an average basis over the monthly maintenance period.

In spite of all these mechanisms to buffer liquidity fluctuations, orderly conditions in the money market are best ensured by pairing large liquidity-injecting and liquidity-absorbing actions. For instance, on 16 May 2003, government sold the foreign-currency proceeds of its eurobond issue to the Bank. The Bank transferred the rand equivalent or some R10,6 billion to government's Tax and Loan accounts. The expansionary effect on money-market liquidity of this transaction was immediately neutralised as the Bank delivered a similar amount in foreign currency to counterparties in terms of forward contracts previously entered into. The Bank's forward book and net open position in foreign currency were simultaneously reduced.

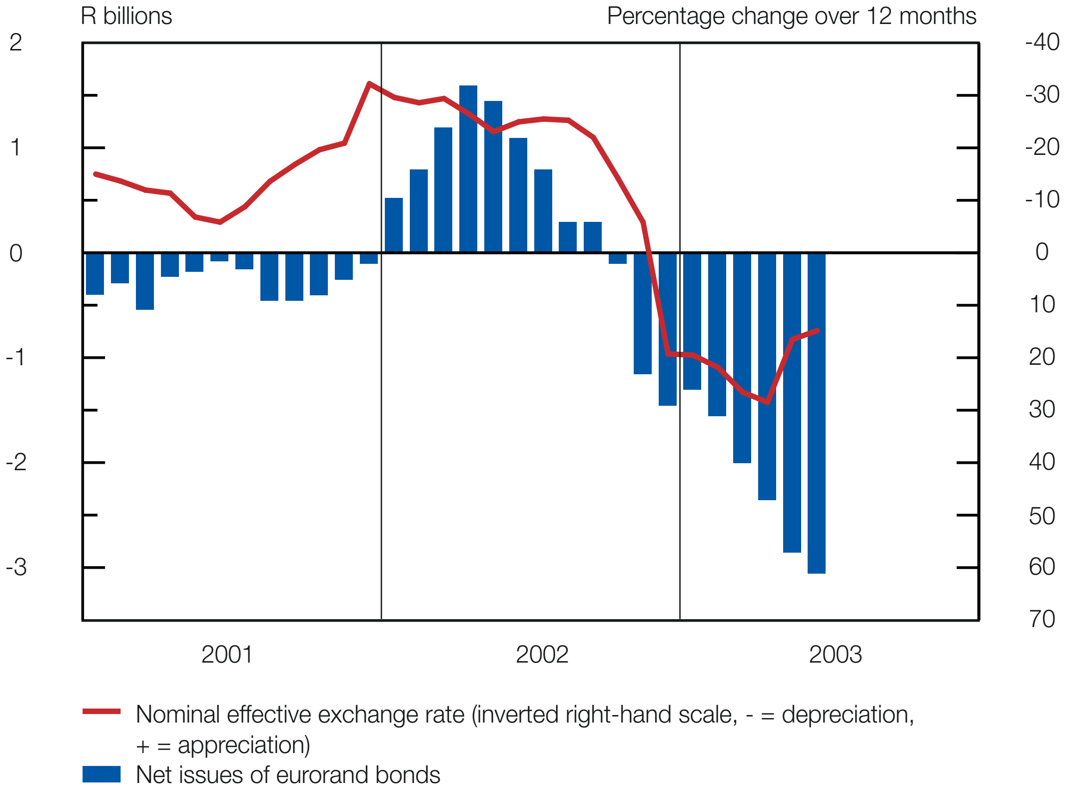
## Bond market

Following two consecutive years of net bond redemptions by the public sector, net issues of bonds are likely in the current fiscal year. In the domestic primary bond market *public-sector borrowers* retired debt to the net amount of R9,7 billion in fiscal 2002/03 in addition to net redemptions of R10,3 billion in the previous fiscal year. A net amount of R6,9 billion was raised in the first half of fiscal 2002/03 which included a R7 billion zero-coupon bond issued by the national government to reimburse the Reserve Bank for the shortfall on its Gold and Foreign Exchange Contingence Reserve Account. Public-sector borrowers then repaid fixed-interest securities to the net amount of R16,6 billion in the second half of the fiscal year. After two years of net redemptions, *national government* announced a budgeted domestic funding requirement of R9,3 billion in the 2003/04 Budget. Net domestic funding already amounted to R11,3 billion in April and May 2003, but redemptions to the amount of R26,4 billion fall due only towards the end of the current fiscal year.

The national government has in recent years made more use of foreign borrowing than in the past. In fiscal 2002/03 the national government raised R10,7 billion through foreign-currency denominated debt issues in the *international bond markets.* The public utility company, Eskom, raised R2 billion by issuing a three-year eurobond in October 2002, replacing a maturing bond. In the current fiscal year national government raised R10,6 billion in May 2003 through the issuance of a ten-year €1,25 billion global bond at a coupon rate of 5,25 per cent and a spread of 142 basis points over benchmark bonds of the German Federal Government. The proceeds of the issue were used to reduce the Reserve Bank's forward book and net open position in foreign currency. With this issue, government took advantage of low international interest rates and foreign investor appetite for high-yielding South African securities.

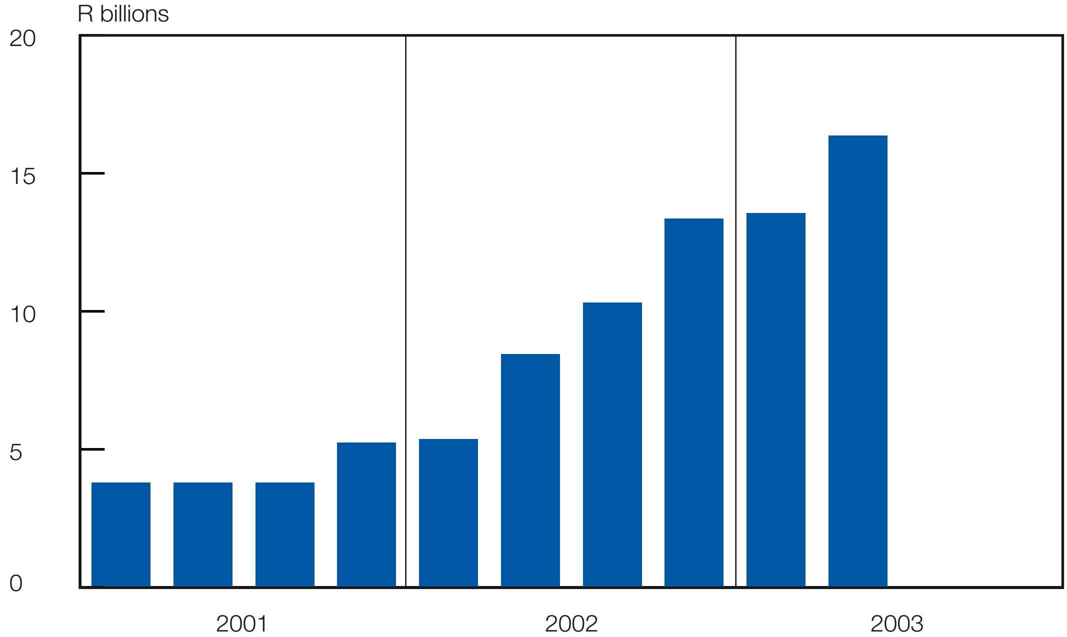
Although the South African global bond issue enjoyed strong foreign investor support, the picture is less favourable in the *eurorand bond market.* In 2002, the scheduled redemptions of rand-denominated bonds issued by non-residents in the *European bond markets* exceeded new issues by some R1,4 billion. Sentiment among potential borrowers towards rand-denominated bonds in the eurobond market apparently deteriorated in the course of 2002 and new issues declined from R3,6 billion in the first half of the year to only R0,6 billion in the second half. The strengthening of the exchange rate of the rand presumably discouraged unhedged issues. Net redemptions by non-residents amounted to R1,6 billion in the first half of 2003.

Cumulative net issues of eurorand bonds by non-residents and the nominal effective exchange rate of the rand



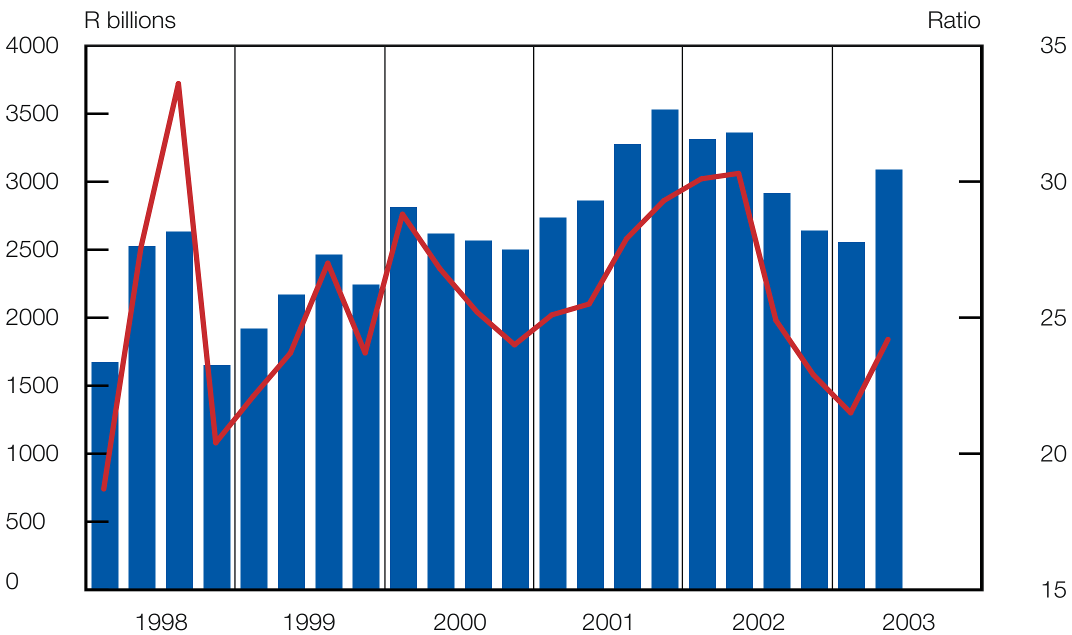

Supported by, among other things, the somewhat more favourable cost of funding in the bond market relative to the cost of borrowing in the money market and the dearth of public-sector fixed-interest securities, the *outstanding nominal value of private-sector loan stock* listed on the Bond Exchange of South Africa increased rapidly in 2002 with a marked increase in the second half of the year. Listed private-sector loan stock increased by R10 billion from R28,9 billion in June 2002 to R38,9 billion in December. The market ran out of steam early in 2003 and private-sector loan stock increased only modestly to R42,0 billion in June 2003 as money-market rates moved closer to corporate bond yields. The sharp increase in private-sector bond issuance in 2002 was aided by the rapid growth in asset-backed securitisation and collateral debt obligations. The outstanding nominal value of these securities on the Bond Exchange of South Africa increased from R5,3 billion at the end of 2001 to R13,4 billion at the end of 2002 following the amended banking regulations for asset securitisation published in December 2001. This market effectively transforms non-marketable assets into tradeable securities. As shown in the accompanying graph, the outstanding nominal value of these securities increased further to R16,4 billion at the end of June 2003, and included a diverse range of assets, such as mortgage-backed securities, collateralised debt obligations and commercial paper conduits.

Securitisation issues listed on the Bond Exchange of South Africa




Despite heightened volatility in bond yields, trading activity on the Bond Exchange of South Africa slowed down during 2002. The slowdown in turnover on the *domestic secondary bond market* became more pronounced in the second half of the year as bonds gradually became more expensive in an environment of declining yields and the appreciating exchange value of the rand. Turnover declined from a record R3,5 trillion in the last quarter of 2001, at the height of the exchange rate depreciation, to R2,6 trillion in both the last quarter of 2002 and the first quarter of 2003. Such low levels

Secondary bond market



were last recorded at the end of 2000. From April 2003 turnover on the Bond Exchange of South Africa improved as investors anticipated a relaxation in monetary conditions. In June, the month in which the repurchase rate was reduced, trading in the short-dated R150 government bond dominated transactions on the Bond Exchange, recording a turnover of 6,3 times the amount in issue. Turnover on the Bond Exchange of South Africa eventually amounted to R3,1 trillion in the second quarter of 2003 and the annualised liquidity ratio, measured as the nominal value of bonds traded relative to the nominal value of bonds listed, amounted to 24,2.

*Non-resident* participation in trading on the Bond Exchange of South Africa, measured as the sum of their purchases and sales as a percentage of total purchases and sales of bonds, accounted for 11,7 per cent of the total turnover in the first six months of 2003. Their participation in 2002 fluctuated between levels of 8 per cent and 14 per cent.

*Non-resident investor* interest fluctuated noticeably during 2002 and the first half of 2003, vacillating between episodes of net bond purchases and net bond sales depending to a large extent on the relative strength or weakness of the exchange rate of the rand. Net purchases of bonds by non-resident investors of R7,3 billion in the first half of 2002 turned into net sales of R7,1 billion in the second half. In total, their net purchases amounted to a small R0,2 billion in 2002 after recording net sales in 2000 and 2001. Sentiment remained negative in the first quarter of 2003 as non-residents once more reduced their holdings of South African debt securities by R5,6 billion. In the build-up to and then confirmation of further improvements in South Africa's foreign credit ratings, non-resident net purchases of bonds amounted to R8,3 billion in the second quarter of 2003. In the first six months of 2003 non-residents' cumulative transactions therefore reflected net purchases of bonds to the value of R2,7 billion.

## Share market

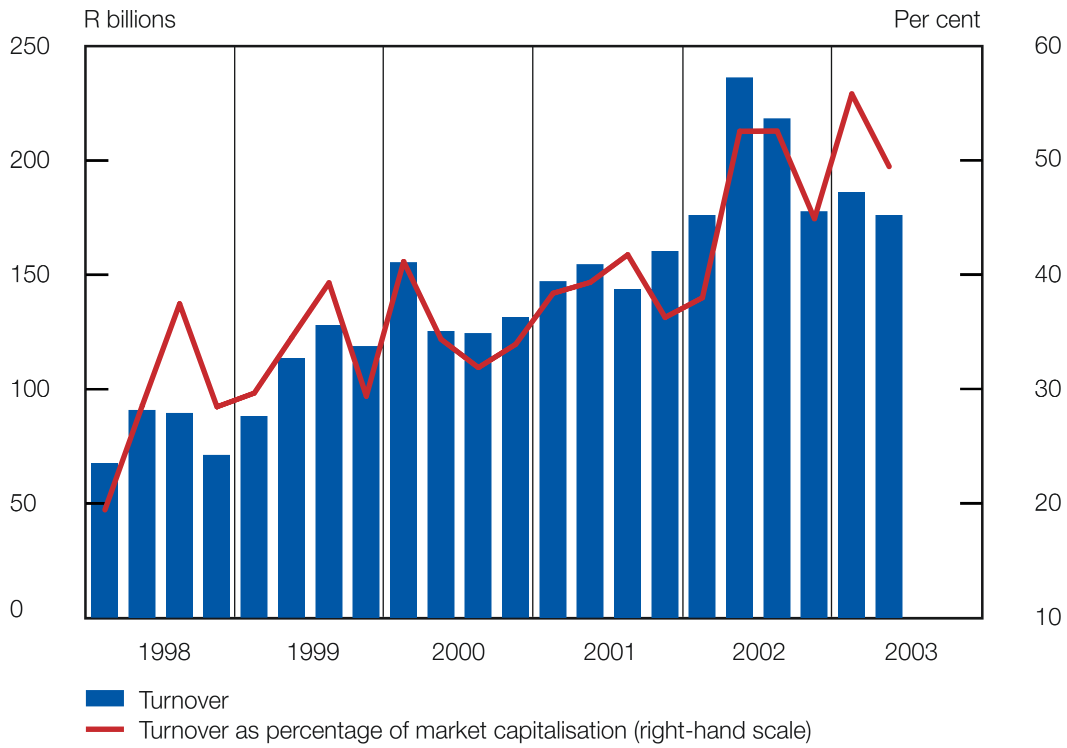
The total value of equity capital raised in the domestic and international *primary share markets* by companies listed on the JSE Securities Exchange SA increased strongly during 2002 and reached R28 billion in the third quarter of 2002 – its highest value since the third quarter of 2000. Included in the third quarter statistics was an amount of R18½ billion related to the acquisition of the United States brewing company, Miller, by South African Breweries plc which culminated in the creation of the merged entity SABMiller plc. Although a total value of R60 billion in share capital was raised in 2002 – more than double the amount raised in 2001 – this was still substantially less than the R74 billion raised in 2000. The decline in funding was related to a culmination of events which dampened investor sentiment, such as the technology bubble bursting in 2000, the terrorist attacks in September 2001 and corporate governance issues in the United States in 2002. Disappointing domestic and international share-market returns and international geopolitical risks further resulted in equity financing progressively declining from the third quarter of 2002 to the first quarter of 2003. From May 2003 optimism improved somewhat as the outlook for the global economy improved and the Iraq war ended with less damage than feared initially. Funding in the primary equity market amounted to R10,2 billion in the first half of 2003, of which 47 per cent was earmarked for the industrial sector, 27 per cent for the resources sector, 23 per cent for the financial sector and 3 per cent for other categories.

The programme for the restructuring of government assets took a step forward on 4 March 2003 with the domestic and New York listing of the state-owned telecommunications utility company, Telkom SA Limited. The listing included a discount share offer to previously disadvantaged individuals, stokvels and church groups. Government raised R3,9 billion through this partial privatisation, and despite the depressed telecommunications market the listing was adjudged a reasonable success. Subsequently, Telkom was included in the Alsi 40 Index at the end of its first week of trading.

In April 2003 SASOL issued American Depository Receipts on the New York Stock Exchange. The listing replaced SASOL's listing on the technology board of Nasdaq as part of the group's globalisation strategy while maintaining a primary listing on the JSE Securities Exchange SA. Although dual listings on the New York and other stock exchanges have served to heighten the international profiles of these and other South African companies, the number of companies listed on the JSE Securities Exchange SA had declined substantially from over 700 in the early 1990s to only 442 in June 2003, with 34 delistings and only 4 new listings in the past six months. Takeovers and mergers, and stringent listing requirements, amongst others, contributed to the delistings. The fall-off in new listings could be ascribed to prevailing bear market conditions. Notwithstanding the decline in the number of listed shares, the market capitalisation of the JSE Securities Exchange SA amounted to R1 420 billion at the end of June 2003, making it the seventeenth largest exchange in the world.

The volatility in share prices, falling from record highs in May 2002 to consecutive lows thereafter, in response to the worsening global economic outlook and the fluctuations around a recovery trend in the exchange value of the rand, resulted in buoyant *secondary share market turnover* in 2002. The value of listed shares traded on the JSE Securities Exchange SA rose by 33 per cent from R606 billion in 2001 to a record R809 billion in 2002. The value of shares traded peaked at R413 billion in the first half of 2002 before receding to R396 billion in the second half and R362 billion in the first half

Secondary share market



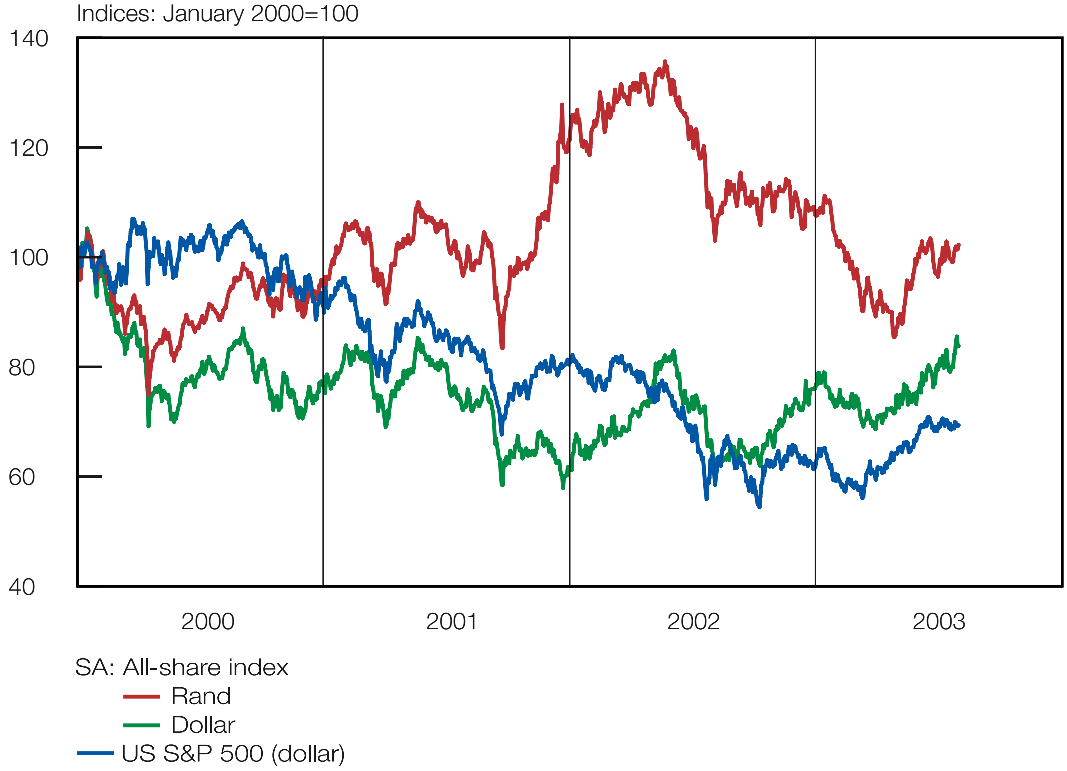
of 2003 as the appreciation of the exchange value of the rand and the concomitant decline in share prices dampened trading activity. Market liquidity (turnover expressed as a percentage of market capitalisation) gradually increased from 35 per cent in 2000 to 47 per cent in 2002 and an annualised 53 per cent in the first half of 2003.

*Non-resident* net transactions in the *secondary share market* switched from net purchases of R5,4 billion in the first half of 2002 to net sales of R11,0 billion in the second half of the year. On balance, net sales of R5,6 billion were recorded for 2002 as a whole – the first annual net sales since 1992. However, from the beginning of 2003 to the end of June non-residents recorded cumulative net purchases of R0,6 billion. Non-resident participation in the share market, measured as the sum of their purchases and sales as a percentage of the total value of shares traded on the JSE Securities Exchange SA, moderated from 26 per cent in 2002 to 23 per cent in the first six months of 2003.

In the aftermath of the attacks on America in September 2001 the *monthly average price level of all classes of shares* listed on the JSE Securities Exchange SA increased markedly to an all-time high in May 2002 as world bourses recovered. The sharp decline in domestic share prices that followed was primarily due to the recovery of the exchange rate of the rand and lower profitability of companies, while weak global economic growth, and more recently the war in Iraq and fears regarding the SARS virus, contributed to the negative sentiment. The monthly average price level of all classes of shares fell by 31 per cent from May 2002 to April 2003, before recovering by 11 per cent to June 2003. In dollar terms, the all-share price index declined by only 2 per cent from May 2002 to June 2003, due to the strength of the rand, compared to a decline of 8 per cent in the S&P 500 composite index.

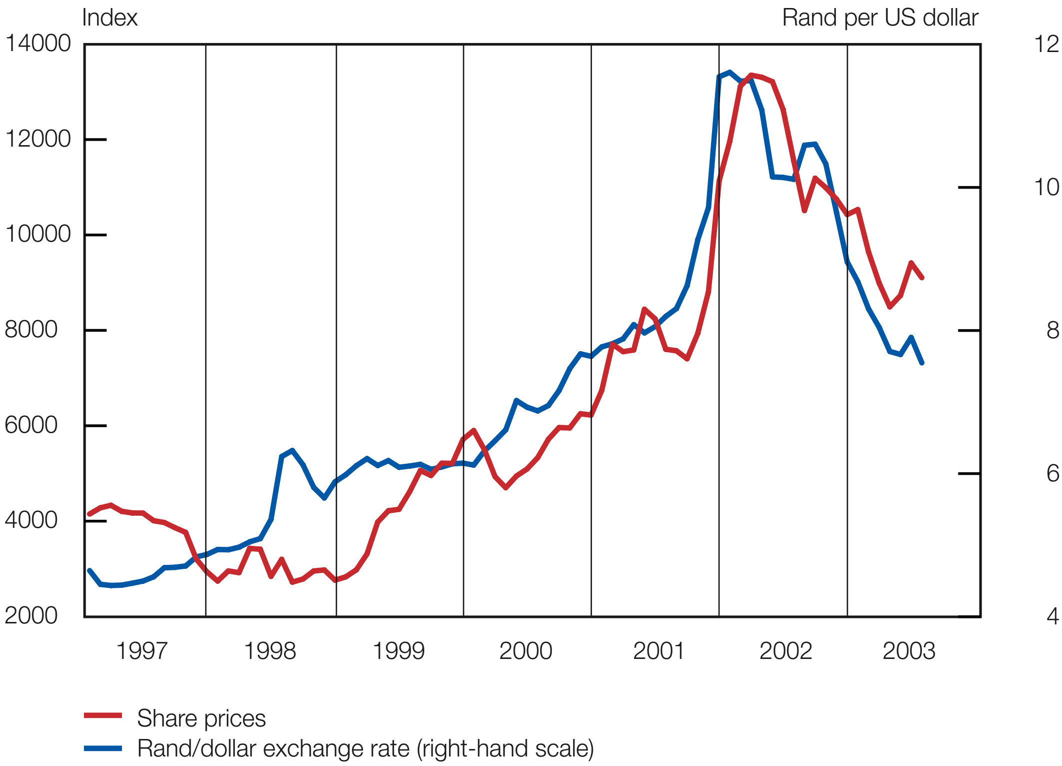
Share prices

Indices: January 2000=100



Worst affected by the vagaries of the rand were rand-hedge shares and companies with exposure to foreign earnings as the strength of the exchange value of the rand diluted earnings in rand terms. The monthly average price level of companies listed in the *resources* sector initially increased by 50 per cent from November 2001 to March 2002 as the rand weakened, but subsequently fell by 36 per cent to April 2003. The decline over the thirteen months occurred even though gold regained some of its safe-haven status in the international community.

Resources share prices and exchange rate




Various other developments in the mining industry contributed to the sustained decline in these share prices. In the second half of 2002 the unofficially leaked draft Mining Charter caused panic among investors when a first draft set out very ambitious empowerment targets. A revised and more investor-friendly version of the charter was subsequently approved, but mining shares failed to recover fully. In addition, the proposed Mineral and Petroleum Royalty Bill introduced in the National Assembly on 10 March 2003, setting out the government's planned charge on mining companies for the extraction and transfer of mineral resources, contributed to concern about the future profitability of the mining industry. The bill proposes a sliding scale of royalty rates, with coal levied at 2 per cent, gold at 3 per cent, platinum at 4 per cent and diamonds at 8 per cent. The provisions will be phased in over four years. National Treasury is currently revisiting the proposals after submissions from the private sector. From April to June 2003 the prices of resources shares recovered by 10 per cent as the exchange value of the rand weakened moderately and the outlook for the global economy improved, the war in Iraq ended and concerns about the SARS virus and its risk on growth appeared to be dissipating.

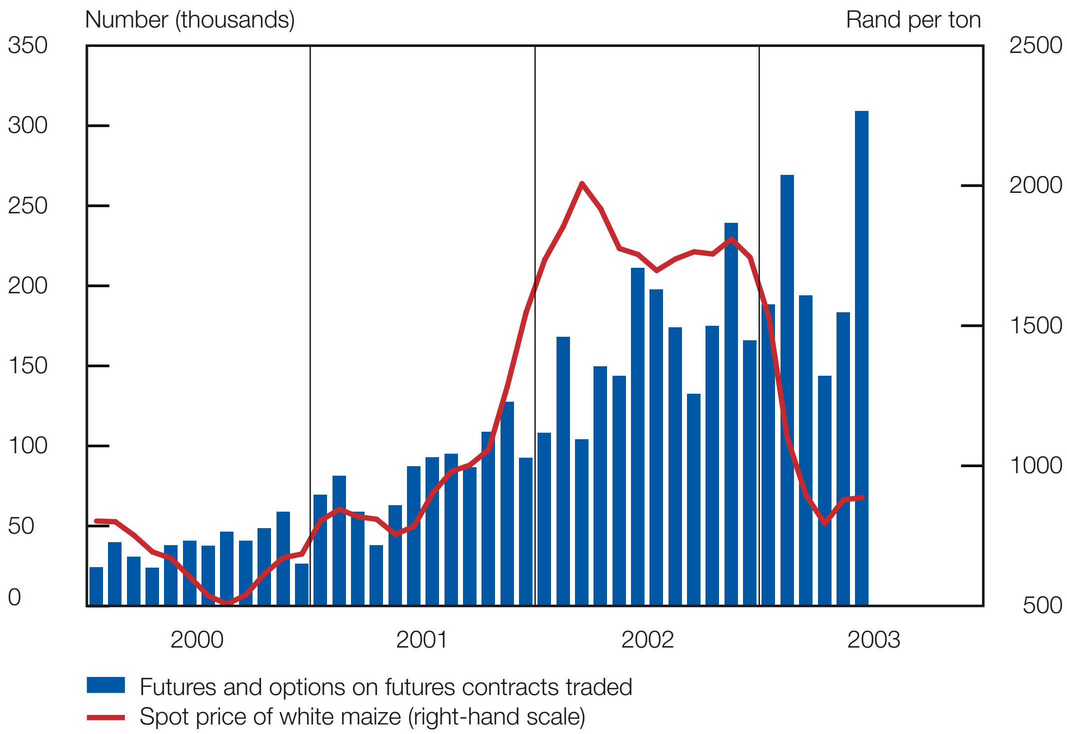
By contrast, *financial share prices* registered a decline of 24 per cent from May 2002 to March 2003. The effect of the stronger rand on earnings was muted in the banking sector as most of the larger banks still rely on the earnings of their South African operations. The stronger rand ultimately benefited the sector as inflation declined and expectations of lower interest rates led to the prospect of increased credit extension and fewer bad debts. The Community Reinvestment Bill, which suggested enforced lending to the low income market, was released for comment in the second half of 2002 but was later withdrawn for reconsideration due to the discontent that ensued. The prices of financial shares improved by 9 per cent over the three months to June 2003, supported by the life assurance sector which benefited from the lower tax rate announced in the 2003 Budget and banking share prices discounting monetary easing.

Mirroring the decline in share prices, the *dividend yield* on all classes of shares increased from 3,0 per cent in May 2002 to 4,6 per cent in April 2003, the highest level since 1990 – before receding to 4,0 per cent in June. The price-earnings ratio of all classes of shares fell from 13,7 in May 2002 to 9,7 in April 2003 – its lowest level since September 2001 – before increasing to 10,6 in June. The relatively low level of the price-earnings ratio, comparable to the levels reached during the 1997 Asian market crisis, the 1998 Russian debt default and the September 2001 attacks on America, reflected the cheapness of shares on the JSE Securities Exchange SA.

## Derivatives

Trading activity in the formal derivatives market fell back during 2002 in tandem with the number of shares traded on the JSE Securities Exchange SA as the all-share

Derivatives market: Agricultural products



price index declined rapidly. The slowdown continued into the early months of 2003 until the surge in domestic share prices in May again boosted trading activity.

The combined number of *futures and options on futures contracts* traded on the Financial Derivatives Division of the JSE Securities Exchange declined from 35,6 million in 2001 to 29,4 million in 2002, coinciding with the general decline in share market activity. Increased activity in May and June 2003 caused the number of contracts traded in the first six months of 2003 to amount to 14,3 million, more or less on par with the 14,2 million traded in the first half of 2002.

The number of *warrants* traded on the JSE Securities Exchange SA declined by 23,4 per cent from 2001 to 2002 and by 72,6 per cent in the first half of 2003 compared to the corresponding period in 2002. Warrants are put or call options issued by a third party on individual securities or a basket of securities of listed companies. At the end of June 2003 there were 216 warrants listed compared to 304 at the end of December 2002, with four warrant issuers active in the warrants sector of the JSE Securities Exchange SA. Warrant issues were biased towards shares comprising the Top 40 Index.

By contrast, the number of *commodity futures contracts and options* on such contracts traded on the Agricultural Products Division of the JSE Securities Exchange SA increased by 96,7 per cent from 2001 to 2002 and by 18,8 per cent from the second half of 2002 to the first half of 2003. The buoyancy was underpinned by the volatile price movements of agricultural products, caused by supply and demand imbalances as well as changes in the exchange value of the rand. Volumes increased noticeably from September 2002 as the spot prices of maize products began to decline in conjunction with a stronger exchange value of the rand and indications of increased supply. On balance, the spot price of white maize nearly halved from R1 764 per ton to only R887 per ton from September 2002 to June 2003. The JSE Agricultural Products Division covers commodities futures and options on maize, sunflower, wheat and soya beans, but trade is dominated by white maize contracts, accounting for three quarters of all commodity related trading and more than 80 per cent of all maize related contracts. After reaching a 22-month low in April 2003 the spot price of white maize increased slightly from May, despite the higher stock levels, driven by the weaker exchange value of the rand.

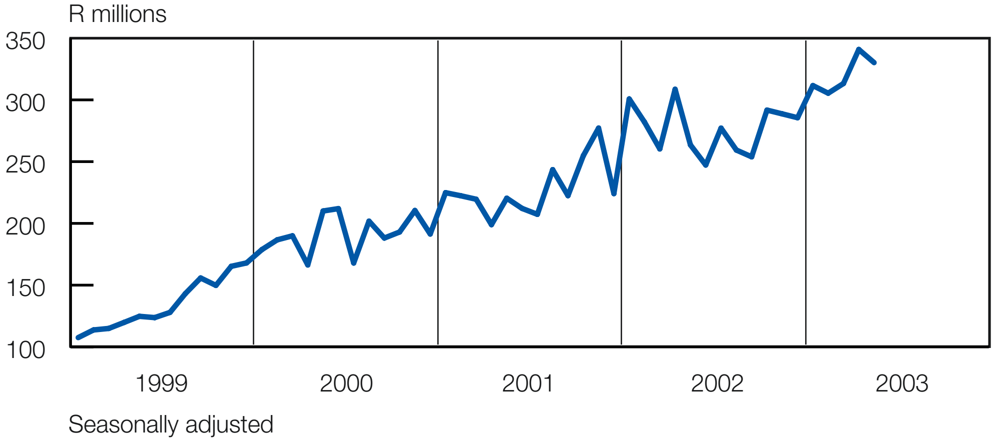
## Real-estate market

The *real-estate market* remained buoyant throughout 2002 and the first half of 2003, regardless of the increase in the cost of mortgage finance in the first nine months of 2002. The overall seasonally adjusted value of turnover, measured by *transfer duty paid,* increased by 22 per cent in 2002 and by 17 per cent when the first half of 2003 is compared with the latter half of 2002, even though transfer duty rates were lowered and the exemption threshold increased from March 2003.

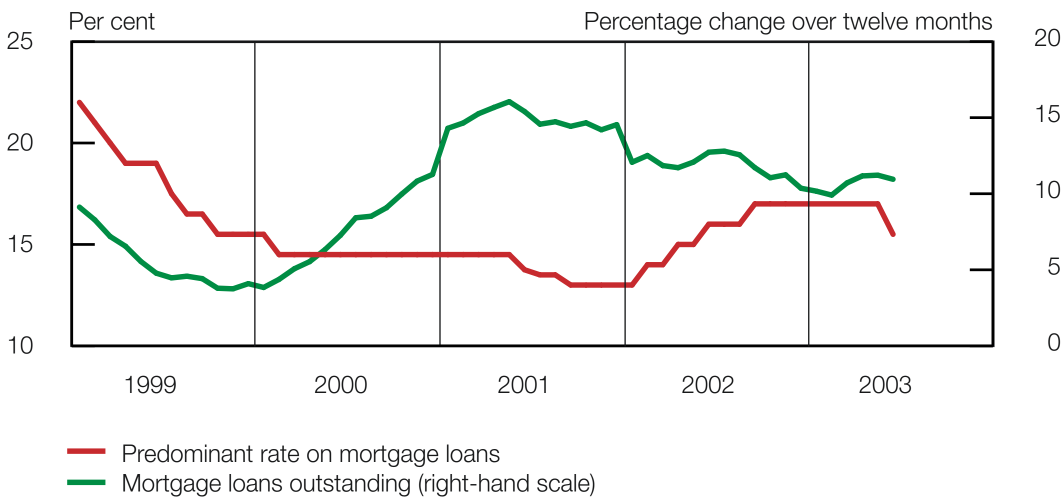
Contrasted to the consistent buoyancy of turnover in the real-estate market, growth in *home loans granted by banks* slowed down during 2002. Growth over twelve months in outstanding home loan balances, on balance, declined from a recent high of 16,1 per cent in May 2001 to 11,0 per cent in June 2003. The absolute increase in mortgage advances of R26,8 billion for 2002 was nevertheless still substantial, and a further increase of R19,0 billion was recorded in the first six months of 2003.

The month-to-month rate of increase in *residential property prices,* as measured by Absa Bank, remained steady at around 1 per cent in 2002, similar to the increases in 2001, before it accelerated to nearly 2 per cent from early in 2003. Calculated over twelve months the rate of increase averaged 17,5 per cent in the first six months of 2003. This buoyancy may be due to, among other things, purchases in anticipation of lower interest rates. The buoyancy in the property market is further explained by its relative attractiveness as an investment, given the poor state of many other asset classes in both the domestic and global markets, and the growing demand from the emerging black middle class.

Real-estate transfer duty collected




Home loan market

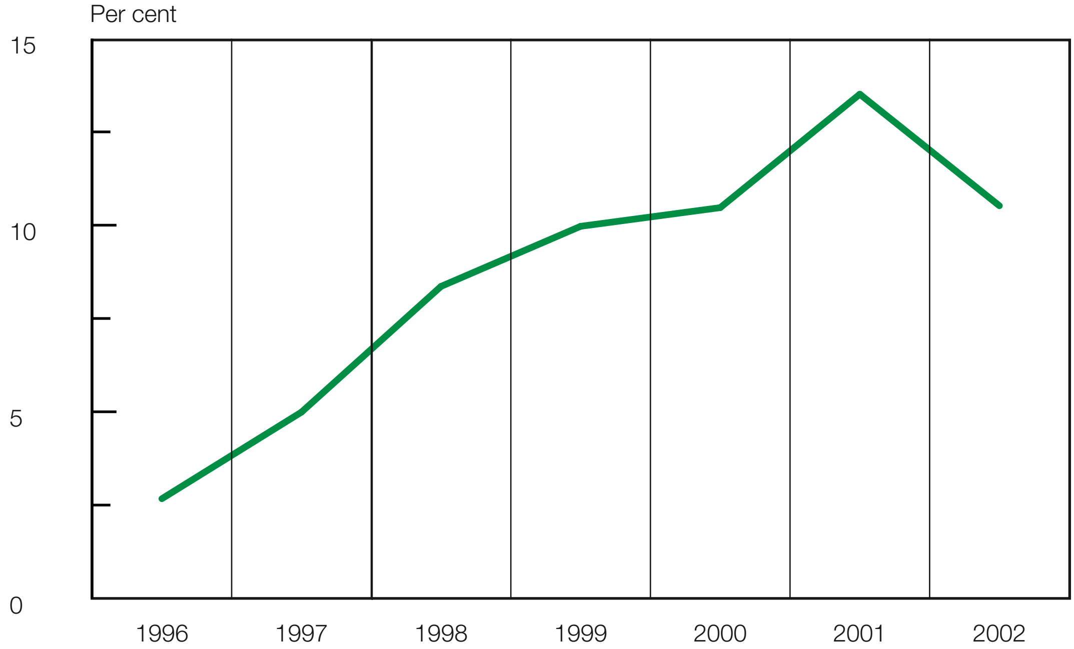



## Non-bank financial intermediaries

The non-bank financial intermediaries, consisting of unit trusts, long and short-term insurers, official and private pension and provident funds, experienced a significant slowdown in portfolio growth from the second quarter of 2002. This was partly due to the continued improvement in the exchange value of the rand which impacted negatively on the domestic share market. The stronger rand furthermore resulted in foreign exchange translation losses and, together with the weaker international financial markets, contributed to the decline in financial asset values; only domestic bond and money-market investments did well.

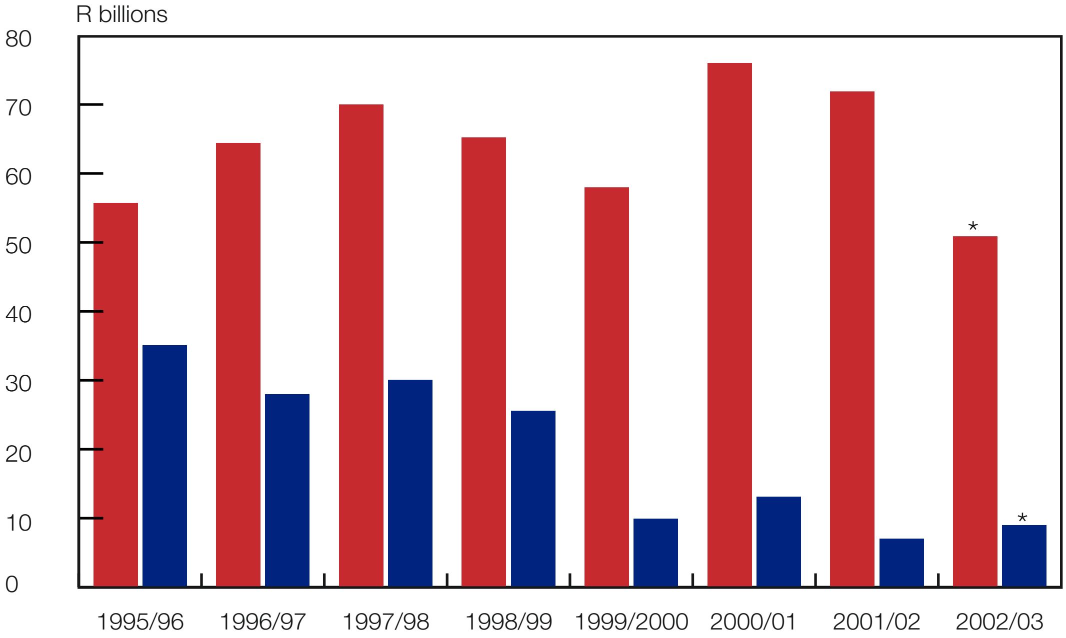
The foreign asset holdings of the non-bank financial intermediaries as a percentage of total assets, declined from around 14 per cent in the first quarter of 2002 to close to 10 per cent in the final quarter of 2002. This was due to foreign exchange translation losses and some of these institutions' decision to repatriate funds from abroad. From 1 May 2003 the percentage-of-cashflow restriction on offshore investment by domestic institutions was lifted and long-term insurers and pension funds can now remit 15 per cent of their total assets offshore, while unit trusts are allowed 20 per cent. It is therefore conceivable that domestic fund managers will again increase their underweight offshore investments when international conditions improve.

Non-bank financial institutions: Foreign assets as a percentage of total assets




The poor market conditions in 2002 were also reflected in a reduction in the cashflows of the non-bank financial institutions, as investors became wary of the poor performance of their long-term contractual savings and moved their investments towards the higher yielding money market. Notwithstanding the reduced cashflows (defined as current receipts less current expenditure of long-term insurers and pension funds, and the net sales of units by unit trusts) of these institutions, the public sector's reduced demand for loanable funds resulted in ample resources remaining available for private-sector borrowers. These institutional cashflows 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), even though their cashflows as a percentage of total assets declined from 5,4 per cent in fiscal 2000/01 to 3,1 per cent in fiscal 2002/03.

Institutional cash flows and demand for non-bank financing




Fiscal years
Cash flow
Net issues by private and public sector
* April to December 2002

# Public finance

## Fiscal policy

Over the past decade, poverty reduction was the overarching goal of the South African economic and social policy. Following successful but painful fiscal consolidation in the second half of the 1990s, the growth-orientated fiscal policy stance set out in the 2001, 2002 and 2003 *Budget Reviews* is set to continue, with strong emphasis on sustainable expenditure growth and continued tax relief, despite adverse global economic conditions.

In order to attain this goal, the South African tax system has undergone a thorough overhaul in recent years. Far-reaching reforms to the income tax structure and administration has resulted in improvements in tax compliance and tax morality. These reforms have also led to strong growth in tax collections, enabling the government to reduce its budget deficit while spending more on service delivery. It was also reiterated in the *Budget Review 2002* that the underlying objective is to encourage domestic development and growth, by providing tax relief to individual taxpayers and introducing tax incentives which encourage capital formation, job creation and enhanced international competitiveness of the business sector.

Against the background of an affordable and sustainable budget deficit, South Africa's public debt has stabilised as a percentage of gross domestic product. Reforms to the public debt management strategy involved an increase in foreign-currency denominated debt as a portion of total government loan debt, restructuring of the maturity profile of loan debt and introducing new loan instruments. 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. Fiscal prudence has led to declining interest costs, which enhanced government's flexibility in conducting fiscal policy: government can now contemplate higher levels of social spending without imposing a higher tax burden on the economy or increasing its borrowing requirement.

A significant recent reform is that in fiscal 2003/04, government departments will be obliged to table "measurable objectives" for the main budget divisions. Measurable objectives are defined as quantifiable results that can be achieved within a foreseeable time frame; they reinforce accountability for service delivery.

The *Medium-Term Budget Policy Statement* of the National Treasury for the past few fiscal years enunciated government's commitment to the progressive realisation of social and economic rights envisaged in South Africa's Constitution. This will materialise within a sound fiscal and budgetary framework. It is also within this framework that government formulates its revenue and expenditure strategies and measures the progress made towards meeting its policy objectives. The *Medium Term Budget Policy Statement 2002* reaffirms this commitment within a consistent, growth-oriented fiscal and budgetary framework, with strong emphasis on fiscal discipline.

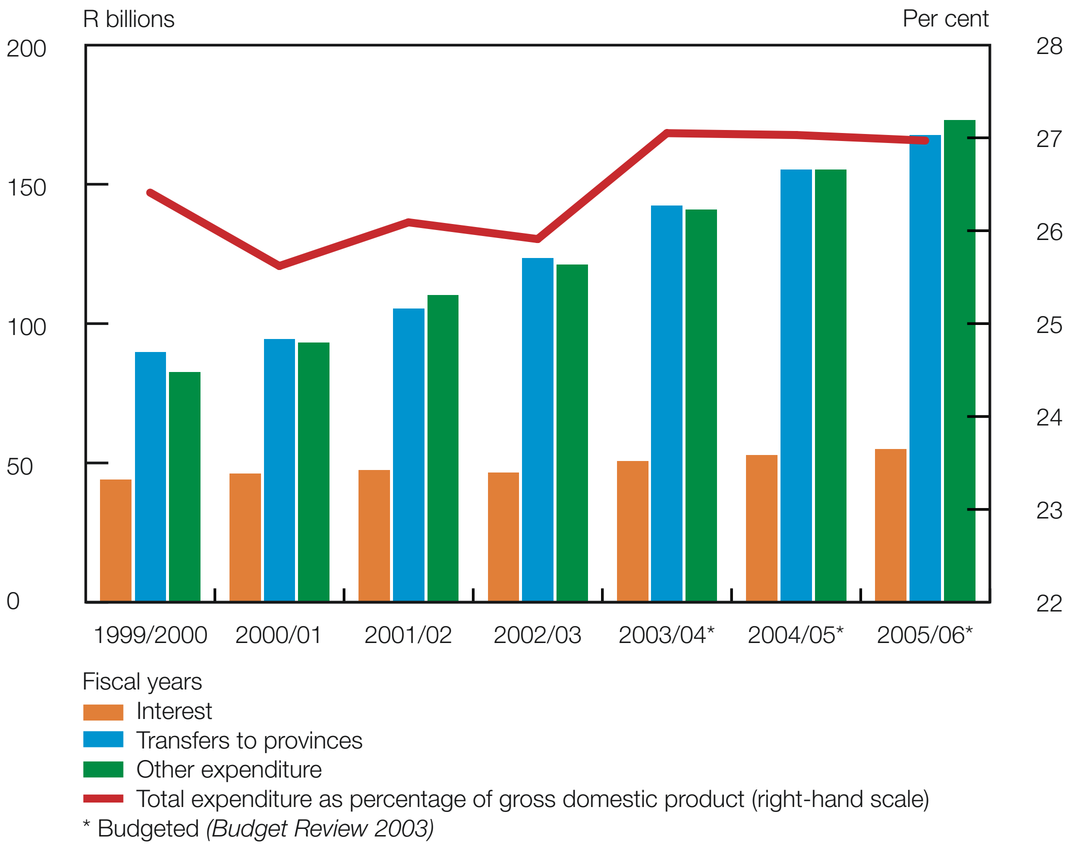
In his Budget Speech presented to Parliament on 26 February 2003, the Minister of Finance signalled the strong orientation towards economic growth through providing for a faster increase in real government spending over the medium term. In addition to the continued support for social development, emphasis was placed on increasing infrastructural investment in both urban and rural areas. It was also announced that renewed attention and funding would be devoted to the country's justice and protection services.

## National government expenditure

The March 2003 *Statement of Revenue, Expenditure and Borrowing* of national government indicates that national government expenditure in fiscal 2002/03 amounted to R291,2 billion. This implies a decrease in the ratio of national government expenditure to gross domestic product from 26,1 per cent in fiscal 2001/02 to 25,9 per cent in fiscal 2002/03, continuing the downward trend established in this ratio since the high of 28,9 per cent recorded in fiscal 1992/93. This downward ratio in recent years is testimony of the tight fiscal discipline applied by government. With fiscal discipline achieved, government has been in a position to adopt a cautiously expansionary fiscal policy stance geared towards growth and development.

The year-on-year rate of increase in national government expenditure amounted to 10,8 per cent in fiscal 2002/03 – well above the original budget projection of 9,5 per cent. The rate of increase in national government expenditure in fiscal 2001/02 amounted to 12,4 per cent, also exceeding 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 the past two years bears testimony

Total expenditure by national government



to the shift in the fiscal policy stance from emphasising cost saving to a more growth-oriented approach. This approach particularly emphasises social assistance, education, health and the enhancement of basic municipal infrastructure and services.

In the *Budget Review 2003* it was estimated that national government expenditure would increase at a rate of 14,7 per cent to R334,0 billion or 27,1 per cent of the projected gross domestic product in fiscal 2003/04. The projections provide for an average annual rate of increase of 10,8 per cent over the three-year planning period, implying that real growth in inflation-adjusted expenditure is likely to continue. The growth-oriented expansionary budget for the next three-year planning cycle has projected national government expenditure as a ratio of gross domestic product to be kept just above 27 per cent.

Interest paid on national government debt was well-contained and in fact decreased by 1,6 per cent to R46,6 billion in fiscal 2002/03 – the first time since fiscal 1974/75 that government recorded a decrease in its interest bill. The amount also fell slightly below the original Budget estimate of state debt costs. The 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. Although the restructuring and consolidation of debt caused additional extraordinary expenses of R0,3 billion in fiscal 2002/03, it also made a noteworthy contribution to the containment of interest payments and will continue to do so in future fiscal years.

Lower interest rates and appropriate borrowing strategies of national government in recent years, jointly contributed to the decline in the interest burden. In fiscal 2002/03, interest as a ratio of gross domestic product amounted to 4,1 per cent which fell well below the 5,4 per cent level recorded as recently as fiscal 1999/2000. In his presentation of the *Budget Review 2003* to Parliament, the Minister of Finance indicated that debt service cost as a share of government expenditure will continue to fall over the medium term, releasing resources for expenditure on service delivery.

Non-interest current expenditure mainly consists of transfers to provincial governments. In recent years, the shift was away from government employees' remuneration in favour of outlays on other goods and services and capital outlays. This enunciates government's commitment towards increasing the long-term growth capacity in the economy, *inter alia* by alleviating shortages of textbooks and the like in the education system and improving the infrastructure.

Provincial governments, being at the forefront of service delivery to the public, received substantial transfers from national government as their equitable share of the national revenue pool. In fiscal 2002/03 national government transferred R123,5 billion, or 42,4 per cent of its total expenditure, to provincial governments. It was envisaged that these transfers would grow at an average rate of 10,8 per cent over the next three years. Provinces also receive a substantial amount in conditional grants earmarked for specific services. This reaffirms government's commitment to the marked acceleration of the delivery of social services, investment in infrastructure and support for the domestic economy.

Although only 6,5 per cent of national government spending was of a capital nature, the capital expenditure recorded in fiscal 2002/03 represented an increase of 23,9 per cent from the previous fiscal year. Capital expenditure came from a low base in fiscal 2000/01 when it was at a level of 3,4 per cent of total expenditure.

Given government's optimistic view of the economy's future, the *Budget Review 2003* estimates government's capital expenditure to continue to grow at an average annual rate of 10,2 per cent over the next three years.

As indicated in the accompanying table, spending on community and social services remains the most important functional category of government spending and is projected to amount to 48,5 per cent of the projected national and provincial government expenditure in fiscal 2005/06. Spending on these services steadily increased due to government's resolve to improve the living conditions of the poor. This type of spending is expected to increase at an average annual rate of 10,6 per cent over the three-year budget cycle. In the area of protection services, the recent increase in the spending allocated to public order and safety will provide for the appointment of additional police officers. Although the provision for general government services over the medium term seems to be increasing, this is essentially due to the inclusion of a contingency reserve which is planned to rise from R3 billion in fiscal 2003/04 to R8 billion in fiscal 2005/06. The contingency reserve provides for unforeseen and unavoidable expenditure in all functional areas.

Functional classification of expenditure of consolidated national and provincial governments

| Spending category | Percentage of total expenditure | | Average growth 2002/03 – 2005/06 |
|---|---|---|---|
| | 2002/03[1] | 2005/06[1] | Per cent |
| General government services and unallocatable expenditure | 6,7 | 8,7 | 20,4 |
| Protection services | 17,7 | 16,9 | 8,3 |
| Defence and intelligence | 6,9 | 6,3 | 6,7 |
| Public order and safety[2] | 10,8 | 10,6 | 9,3 |
| Community and social services | 48,0 | 48,5 | 10,6 |
| Education | 20,8 | 19,6 | 8,0 |
| Health | 11,6 | 11,3 | 9,4 |
| Social security and welfare | 11,1 | 12,7 | 15,3 |
| Housing and community services[3] | 4,5 | 4,9 | 13,3 |
| Economic services | 12,0 | 12,3 | 11,3 |
| Fuel and energy | 0,5 | 0,5 | 12,5 |
| Agriculture, forestry and fishing | 1,9 | 1,9 | 9,7 |
| Mining, manufacturing and construction | 0,5 | 0,5 | 12,1 |
| Transport and communication | 4,6 | 4,7 | 11,4 |
| Other economic services[4] | 4,5 | 4,7 | 11,9 |
| Interest | 15,7 | 13,7 | 5,3 |
| Total | 100,0 | 100,0 | 10,2 |

1 *Budget Review 2003,* adjusted for comparability
2 Including police, prisons and justice
3 Including recreation and culture
4 Including water schemes, related services and environmental protection

## 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 12,2 per cent to R278,4 billion in fiscal 2002/03. This rate of increase was substantially higher than the rate of increase of 6,9 per cent originally envisaged in the Budget for fiscal 2002/03.

The rate of increase in national government revenue in fiscal 2002/03 was lower than the rate of increase of 15,1 per cent recorded in the previous fiscal year but higher than 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 processing of tax assessments and to a reduction in the time spent on the processing of tax returns. The better-than-expected collections also resulted from higher-than-expected inflation and economic growth as well as revenue gains from higher profits of export-oriented companies than in the preceding year, which were influenced by the depreciation of the exchange value of the rand in 2001. 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 R6,3 billion in fiscal 2002/03. These major contributors added to the buoyancy of tax collections.

## National government revenue in fiscal 2002/03

R billions

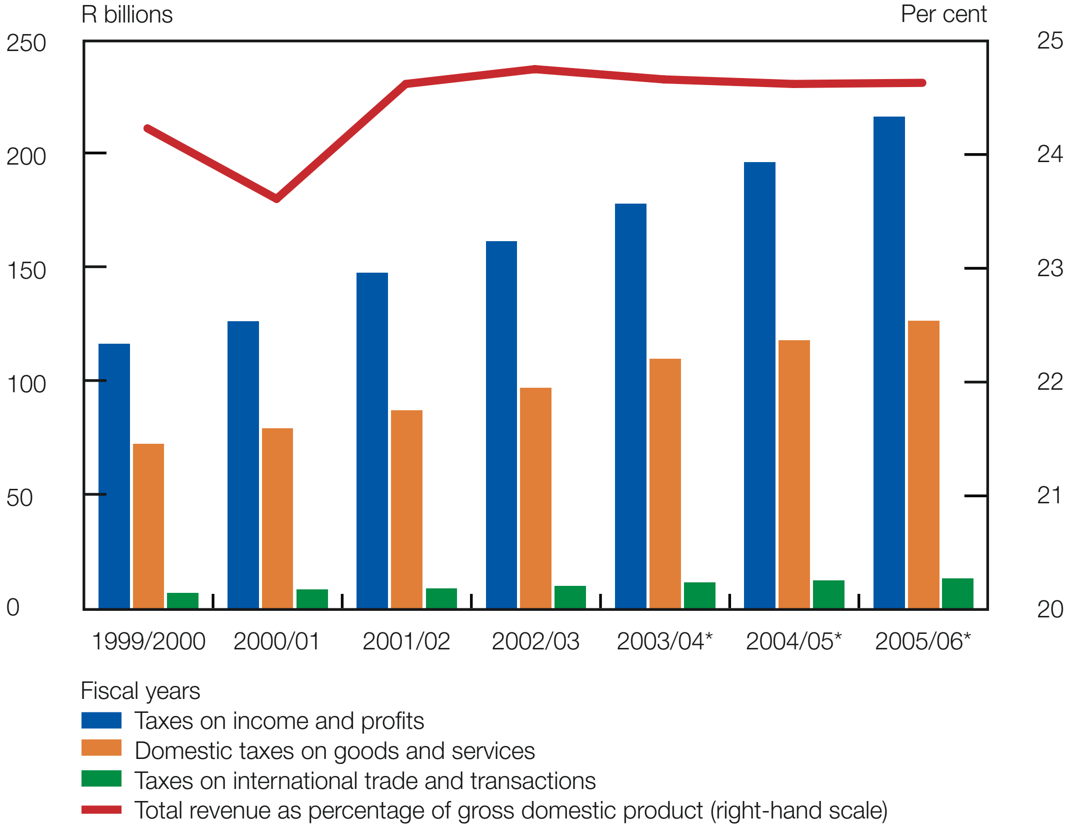
| Revenue source | Originally budgeted 2002/2003 | | Preliminary outcome 2002/03 | |
|---|---|---|---|---|
| | R billions | Percentage change* | R billions | Percentage change* |
| Taxes on income and profits | 155,7 | 5,7 | 164,6 | 11,7 |
| Payroll taxes | 3,0 | 8,6 | 3,4 | 23,4 |
| Taxes on property | 4,6 | -0,9 | 5,1 | 9,9 |
| Domestic taxes on goods and services | 92,8 | 6,9 | 97,6 | 12,3 |
| Taxes on international trade and transactions | 10,6 | 22,3 | 9,6 | 10,8 |
| Other revenue | 6,8 | 10,8 | 6,5 | 5,9 |
| *Less:* SACU** payments | 8,3 | 0,7 | 8,3 | 0,7 |
| Total revenue | 265,2 | 6,9 | 278,4 | 12,2 |

* Fiscal 2001/02 to fiscal 2002/03
** Southern African Customs Union

The total revenue of national government is estimated to amount to R304,5 billion in fiscal 2003/04, representing a year-on-year increase of 9,4 per cent. It was estimated that national government revenue will increase at an average annual rate of 9,1 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 R15,1 billion in fiscal 2003/04. The tax relief was primarily targeted at reducing personal income tax rates and providing some tax incentives for the small to medium enterprises sector, as such incentives are believed to strengthen the outlook for longer-term economic growth.

National government revenue as a ratio of gross domestic product amounted to 24,8 per cent in fiscal 2002/03, compared with 24,6 per cent in the previous fiscal year and 23,6 per cent the year before. Around these levels, government feels confident that sustainable development can proceed without being hampered by excessive taxation. Accordingly, national government revenue is estimated to average 24,6 per cent of gross domestic product over the current three-year budget cycle.

Total revenue of national government



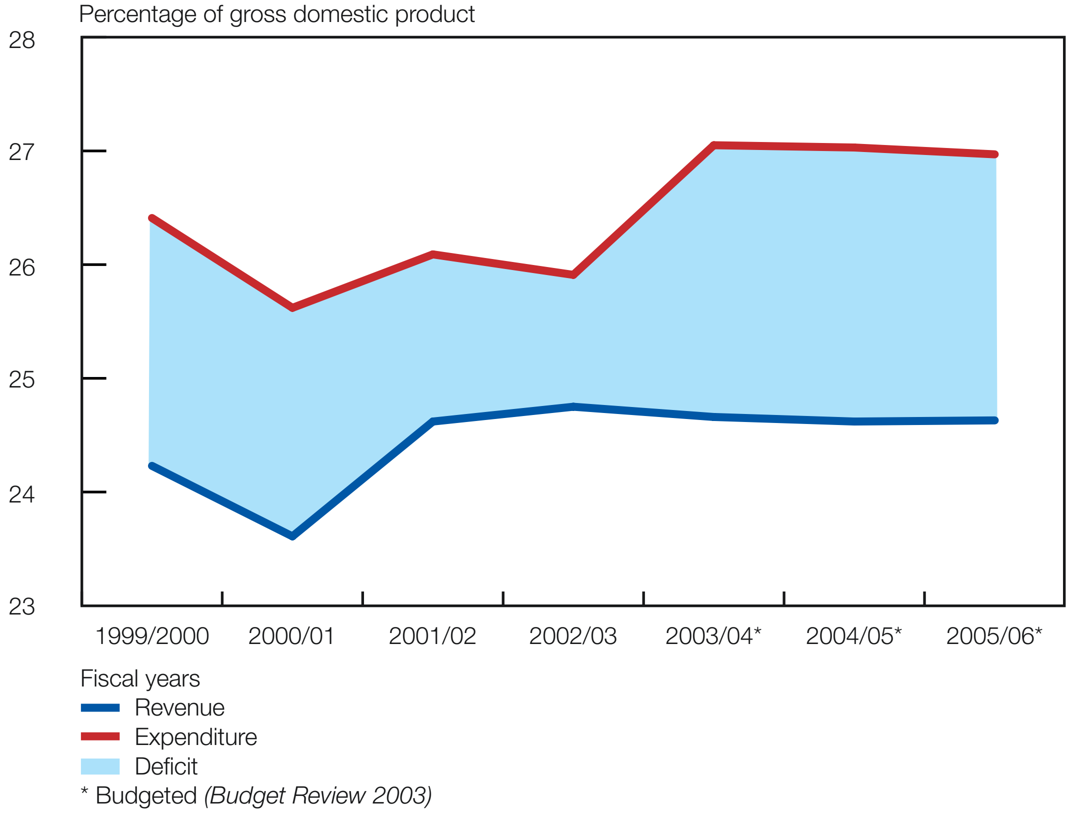

* Budgeted *(Budget Review 2003)*

## 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 R12,8 billion in fiscal 2002/03. The actual deficit was far below the originally budgeted deficit of R22,7 billion. The national government deficit before borrowing and debt repayment as a ratio of gross domestic product amounted to 1,1 per cent in fiscal 2002/03 compared with a ratio of 1,5 per cent recorded in the previous fiscal year. The ratio of 1,1 per cent is the lowest deficit ratio recorded since fiscal 1989/90.

Government's commitment to prudent fiscal policy reform contributed to the containment of the deficit over the past five years. With the containment of the deficit in place, government is now in a position to pursue a more expansionary approach. As a result, the deficit is expected to rise and be maintained at the level of 2,4 per cent of gross domestic product over the medium term.

National government revenue and expenditure




The primary balance (i.e. the deficit recalculated by excluding interest payments from total expenditure) remains at levels consistent with fiscal sustainability. It reached a surplus of 3,0 per cent of gross domestic product in fiscal 2002/03, slightly lower than the 3,2 per cent recorded in the previous fiscal year. A decrease to 1,7 per cent is envisaged for fiscal 2003/04, a level expected to be maintained during the remainder of the current three-year budget cycle.

## Financing of national government debt

After taking into account cash-flow adjustments (i.e. transactions recorded as a result of timing differences between the recording of transactions and bank clearances, and late departmental requests for funds), government's cash deficit amounted to R11,1 billion in fiscal 2002/03. Apart from financing the shortfall of cash revenue relative to cash expenditure, the national government also had to pay a premium of R0,3 billion on the restructuring of its domestic debt portfolio. In addition, the National Treasury made an extraordinary payment of R7,0 billion to the South African Reserve Bank. This was in partial payment of the liability resulting from the losses accumulated on the Gold and Foreign Exchange Contingency Reserve Account which was managed by the Bank on behalf of the National Treasury.

As originally anticipated in the *Budget Review 2001*, an extraordinary entry towards the end of fiscal 2002/03 to the amount of R0,6 billion provided for the debt of the former Regional Authorities and of the South African Housing Trust to be assumed by national government in terms of Section 239 of the Interim Constitution Act 1993 and the Disestablishment of the South African Housing Trust Limited Act, Act No 26 of 2002, respectively.

National government financing in fiscal 2002/03
R billions

| | Originally budgeted | Actual |
|---|---|---|
| **Deficit** | **22,7** | **11,1**[1] |
| *Plus*: Extraordinary payments | 1,6 | 8,0 |
| Cost/profit on revaluation of maturing foreign loans[2] | ... | -1,0 |
| *Less*: Extraordinary receipts | 12,0 | 8,0 |
| **Net borrowing requirement** | **12,3** | **10,1** |
| Domestic primary capital market | | |
| Government bonds | ... | -2,6 |
| *Less*: Discount on government bonds | ... | 1,6 |
| **Net receipts from government bonds issued** | **-10,9** | **-4,2** |
| Treasury bills | 4,0 | 4,2 |
| Foreign loans | 16,3 | 13,3 |
| Change in available cash balances[3] | 2,9 | -3,2 |
| **Total net financing** | **12,3** | **10,1** |

1 Cash deficit
2 Cost +, profit -
3 Increase -, decrease +

The dual-currency term loan issued in July 2001 to the amount of US$1,5 billion allows government to convert between a dollar and a euro instrument. Any profit or loss on the exchange rate movements prior to the conversion is for the account of the National Treasury. In fiscal 2002/03 net profit on the conversion of the foreign loan amounted to R1,0 billion. These proceeds added to the reduction in the net borrowing requirement of government.

Although the proceeds from the restructuring of state assets contributed less than originally anticipated, extraordinary revenue from this source nevertheless made a significant contribution towards reducing the net borrowing requirement of national government in fiscal 2002/03. Proceeds from the restructuring of state assets included R4,2 billion from the Initial Public Offering (IPO) of shares in Telkom – an information and telecommunications company – and R1,6 billion from the monetisation of the transport utility Transnet’s interest of 20 per cent in M-Cell – a mobile telecommunications company – by means of an innovatively structured financial mechanism. Government revenue was also bolstered by R2,2 billion on account of the restructuring of the Central Energy Fund. After taking these extraordinary receipts and payments as well as the net profit on conversion of maturing foreign loans into account, the net borrowing requirement of national government amounted to R10,1 billion.

The greater part of national government’s net borrowing requirement in fiscal 2002/03 was financed through the issuance of bonds in the international capital market. A ten-year dollar denominated bond with a coupon rate of 7,375 per cent was issued in the amount of US$1 billion in April 2002, yielding R10,8 billion for the national government. This concluded government’s budgeted funding programme in the international bond market. During July 2002 government had to provide for an amount of R920 million to compensate for adjustments in the outstanding rand value of a dual-currency loan which arose from changes in the exchange value of the euro vis-à-vis the US dollar. In addition, amounts drawn on the export credit facility arranged specifically for the Special Defence Procurement Programme amounted to R4,9 billion in fiscal 2002/03.

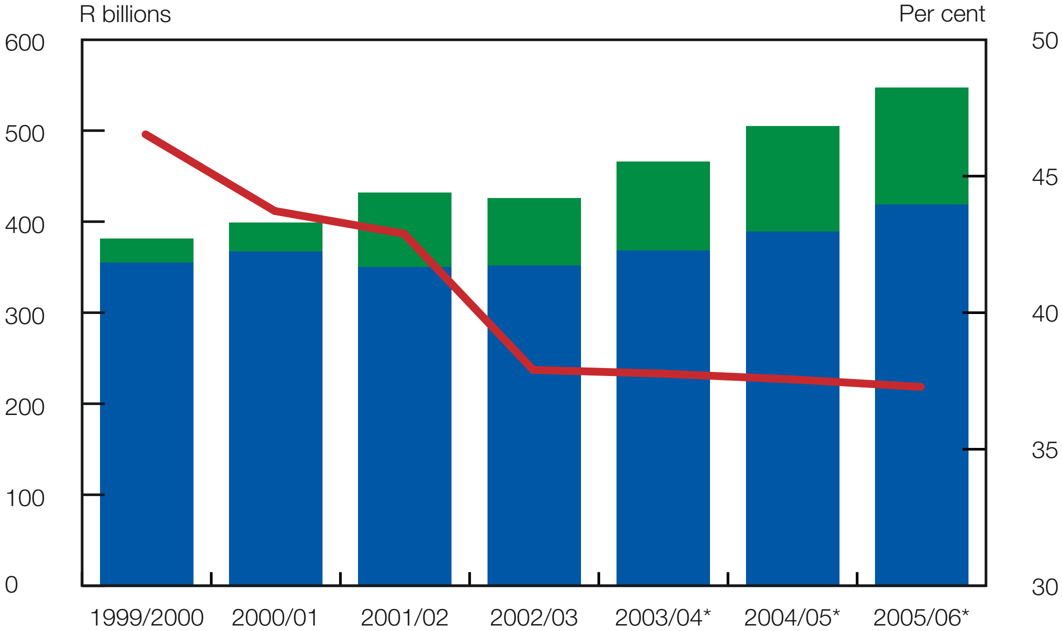
On balance, the average outstanding maturity of foreign government bond debt declined from 89 months at the end of March 2002 to 85 months at the end of March 2003.

The heavy emphasis on foreign funding enabled the National Treasury to redeem net amounts of domestic government bonds in fiscal 2002/03. The average maturity of marketable government bonds was reduced to 101 months at the end of March 2003 compared with 110 months at the end of March 2000. Long-term fixed-interest bonds were issued at an average rate of 11,1 per cent per annum in fiscal 2002/03, compared with a budget assumption of 11,4 per cent. The indicated cost of the past fiscal year excludes the cost of revaluing the inflation-linked bonds. The unexpectedly high inflation in 2002 resulted in strong demand for inflation-linked bonds. The inflation-linked bonds were issued at an average real rate of 5,2 per cent in fiscal 2002/03. Against the background of fairly tight monetary policies, short-term instruments were sold at an average rate of 11,6 per cent per annum, compared with a budget assumption of 9,7 per cent.

In the *Budget Review 2003* the funding estimates for the medium term were announced. Funds will be generated from the restructuring of state-owned enterprises which should contribute R5 billion each year to the financing of national government over the next two fiscal years, and R3 billion in the subsequent year. The *Budget Review 2003* also provides for the issuance of zero-coupon bonds to the amount of R7 billion a year over the next three years to the South African Reserve Bank in respect of the deficit on the Gold and Foreign Exchange Contingency Reserve Account.

The issuance of debt instruments, the discount on new government bond issues and the revaluation of foreign debt at an improved exchange value of the rand, led to a decrease in the loan debt of national government from R432 billion at the end

Total loan debt of national government




As at 31 March of each fiscal year
Domestic debt
Foreign debt
Total loan debt as percentage of gross domestic product (right-hand scale)
* Budgeted loan debt (*Budget Review 2003*)

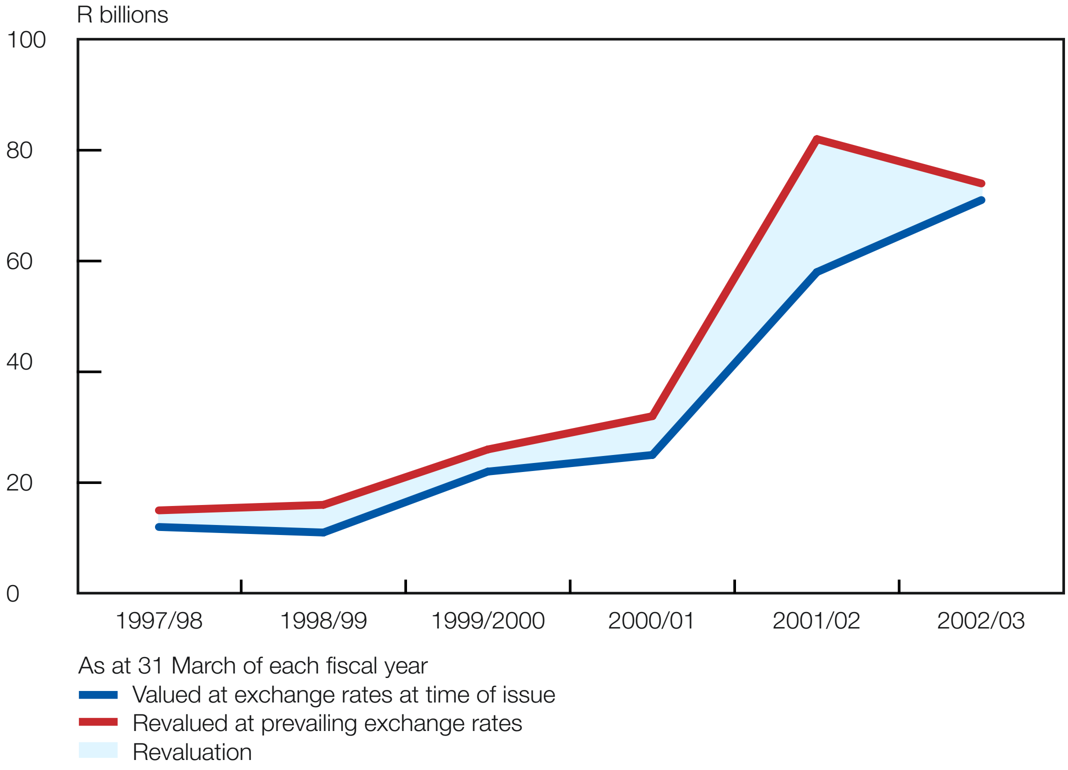
of March 2002 to R426 billion at the end of March 2003. As a ratio of gross domestic product, national government loan debt decreased from 42,9 per cent at the end of March 2002 to 37,9 per cent at the end of March 2003.

The loan debt as a ratio of gross domestic product stood at 48,0 per cent at the end of March 1998, steadily decreasing to its current levels. Based on the National Treasury's projections on the financing requirements of government and assumptions on future interest rates and exchange rates as contained in the *Budget Review 2003,* total gross loan debt as a ratio of gross domestic product is expected to decline further to 37,3 per cent at the end of fiscal 2005/06.

The contribution of foreign loans to the total loan debt of the national government decreased from 8,1 per cent of gross domestic product at the end of March 2002 to 6,6 per cent at the end of March 2003. This was mainly due to the effect of the recovery in the exchange value of the rand on the revaluation of foreign loans.

As indicated in the accompanying graph, the high rand value of foreign debt at the end of March 2002 is partly due to the revaluation of outstanding foreign loans at a weaker exchange rate of the rand. At the end of March 2003, the value of the revaluation amounted to R3,0 billion compared to R24,2 billion at the end of March 2002. In the modified cash accounting system currently used by government, the revaluation of foreign loans is not recognised as expenditure but it increases overall financing needs when the debt has to be retired on reaching maturity.

Total foreign debt of national government




The total debt of national government increased from R460 billion at the end of March 2002 to R463 billion at the end of March 2003. This aggregate includes the unaudited outstanding balance on the Gold and Foreign Exchange Contingency

Reserve Account which increased from R28,0 billion at the end of March 2002 to R36,6 billion at the end of March 2003. However, as a ratio of gross domestic product, total debt of national government still decreased from 45,7 per cent at the end of March 2002 to 41,2 per cent at the end of March 2003.

## General government finance

The borrowing requirement of the consolidated general government shrank from 4,4 per cent of gross domestic product in fiscal 1997/98 to 1,1 per cent in fiscal 2002/03. In the course of the next three fiscal years, the borrowing requirement will average 2,5 per cent of the estimated gross domestic product. This increase reflects government's prioritisation of investment in general, with emphasis on infrastructure expenditure in particular.

An analysis of the *Statement of Revenue, Expenditure and Borrowing* of the provincial governments indicates that these administrations recorded a deficit of R3,1 billion in fiscal 2002/03 compared with a surplus of R3,8 billion in fiscal 2001/02. This is the first deficit recorded since fiscal 1997/98. At the provincial level, capital spending on public infrastructure projects has grown substantially since 1999/2000 and is projected to continue to increase robustly. Capital spending by provincial governments amounted to R13,8 billion during 2002/03, representing an increase of 21,8 per cent over the rather low level of such spending in the previous fiscal year. Although capital expenditure increased quite substantially in the past fiscal year, it still represented only 9,5 per cent of the total expenditure by provincial governments.

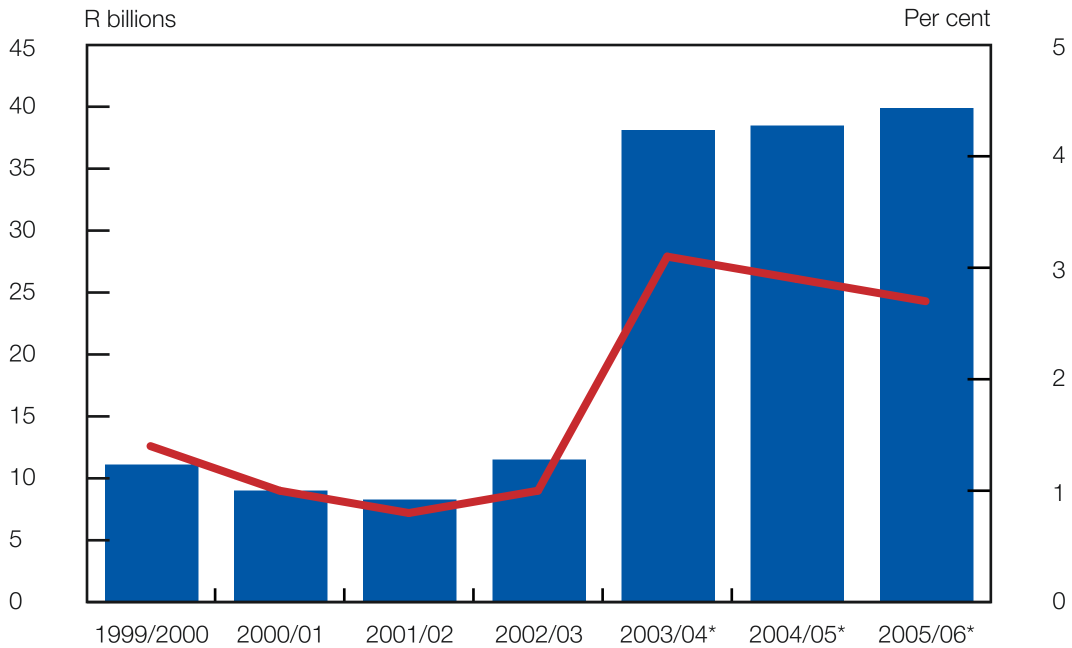
At the level of local government, a concerted drive is under way to put municipal government on a sound footing and to give impetus to the rural development and urban renewal strategies. Preliminary local government statistics indicate an improvement from a financial deficit of R4,4 billion recorded in fiscal 2001/02 to a deficit of R1,5 billion in fiscal 2002/03. Nevertheless, the financial position of some local governments was adversely affected by large-scale non-payment for services.

Preliminary indications are that the surplus position of both the extra-budgetary institutions and social security funds strengthened considerably in fiscal 2002/03 compared with their results reported in the previous fiscal year. At the level of social security funds, the improvement in their financial position was essentially brought about by new legislation which resulted in workers at all remuneration levels contributing to the Unemployment Insurance Fund. Apart from this, the National Treasury also made additional transfers to finance the restructuring of this fund.

## Non-financial public-sector borrowing requirement

The non-financial public-sector enterprises and corporations recorded a lower surplus in fiscal 2002/03 compared with the previous fiscal year, essentially because of higher capital expenditure. This decrease in their financial *surplus* during fiscal 2002/03 together with the turnaround in the financial position of provincial governments from a surplus to a deficit caused the borrowing requirement of the non-financial public sector (i.e. the consolidated central government, provincial governments, local governments and non-financial public enterprises and corporations) to rise from R8,3 billion in fiscal 2001/02 to R11,5 billion in fiscal 2002/03. As a ratio of gross domestic product, this borrowing requirement amounted to 1,0 per cent in fiscal 2002/03 compared with 0,8 per cent in the previous fiscal year. Medium-term estimates contained in the *Budget Review 2003* indicate that the borrowing requirement of the non-financial public sector, although still well-contained, will increase to 3,1 per cent of gross domestic product in fiscal 2003/04 and to 2,9 per cent and 2,7 per cent in the ensuing two fiscal years.

Non-financial public-sector borrowing requirement

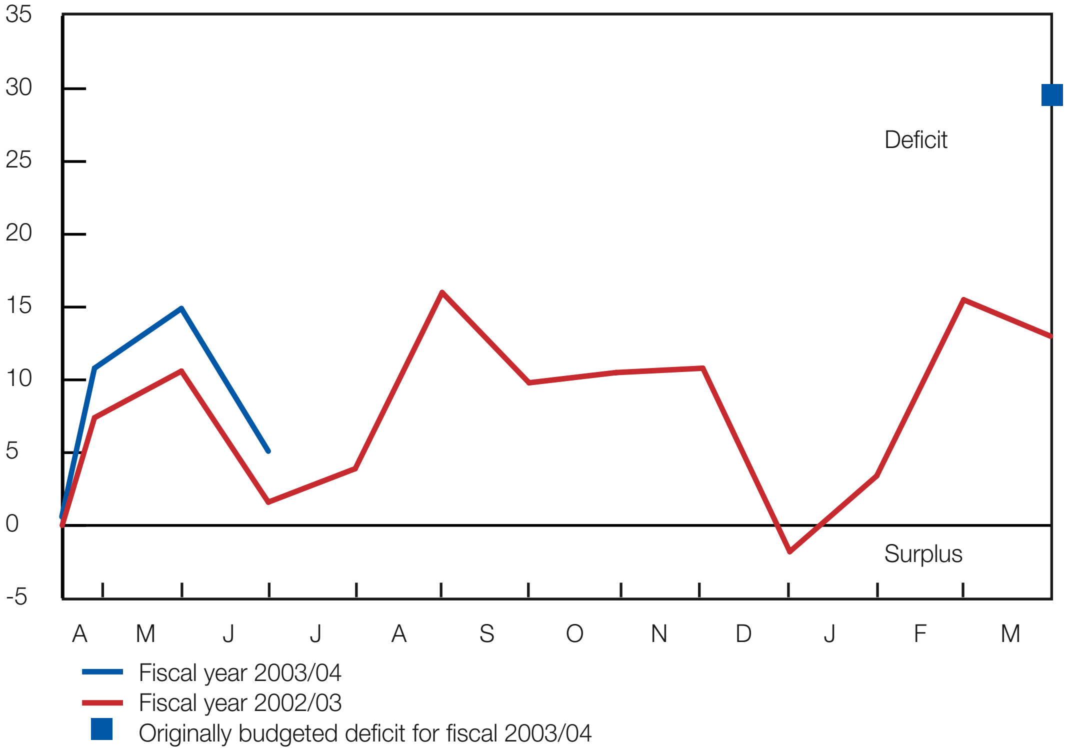



Fiscal years
R billions
Percentage of gross domestic product (right-hand scale)
* Budgeted (*Budget Review 2003*)

## National government finance in the April-June quarter of fiscal 2003/04

National government expenditure and revenue in the first quarter of fiscal 2003/04 resulted in a deficit of R5,1 billion compared with R1,6 billion in the previous fiscal year mainly as a result of sluggish tax revenue, especially from mining companies. With virtually no extraordinary receipts and payments reported for April-June 2003, the net borrowing requirement amounted to R4,7 billion. In May 2003 the National Treasury issued a new €1,25 billion global benchmark bond which carries an annual coupon rate of 5,250 per cent with a maturity of 10 years and yielded R10,6 billion to the National Revenue Fund. The proceeds from this global issue were used to bring the NOFP of the Reserve Bank close to zero. This net position, which measures the Bank's uncovered exposure in the forward currency market, stood at an oversold US$1,2 billion at the end of March 2003, but swung around to an overbought dollar position in the subsequent quarter.

Cumulative deficit of national government




National government financing in fiscal 2003/04
R billions

| | Budgeted – full year 2003/04 | Actual April-June 2003 |
|---|---|---|
| **Deficit** | **29,5** | **4,7**[1] |
| *Plus*: Extraordinary payments | 7,0 | 0,0 |
| Cost/profit on revaluation of maturing foreign loans[2] | 1,9 | 0,0 |
| *Less*: Extraordinary receipts | 6,3 | 0,0 |
| **Net borrowing requirement** | **32,0** | **4,7** |
| Domestic primary capital market | | |
| Government bonds | ... | 13,8 |
| *Less*: Discount on government bonds | ... | 0,4 |
| **Net receipts from government bonds issued** | **9,3** | **13,4** |
| Treasury bills | 6,0 | -3,5 |
| Foreign loans | 13,6 | 11,7 |
| Change in available cash balances[3] | 3,1 | -16,9 |
| **Total net financing** | **32,0** | **4,7** |

1 Cash deficit
2 Cost +, profit -
3 Increase -, decrease +