Annual Economic Report

2004

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-fourth ordinary general meeting to be held on 24 August 2004. The review also forms part of the Reserve Bank's report to Parliament in terms of Section 31 of the South African Reserve Bank Act No 90 of 1989.

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Introduction

Global economic growth gathered momentum from the second half of 2003, with the United States growing briskly alongside a particularly strong acceleration of activity in China, India and elsewhere in Asia. The upturn also started spreading to Japan. Early indications are that prospects for the euro area, South Africa's most important trading partner, have also improved somewhat in the first half of 2004. Most transition economies experienced strong growth, with some benefiting from higher oil export revenues. Africa recorded a growth rate of some 4 per cent in 2003, which was the highest in four years.

While global consumer price inflation accelerated very little in 2003 and early 2004, concerns regarding international oil prices intensified during this period. Against the background of rising global demand for oil and concerns about lack of spare production capacity, oil prices rose to more than US$40 per barrel by early August 2004 – levels last observed around October 1990 in the build-up to the first Gulf War.

The recovery in global economic activity contributed to the commodity price boom in the latter part of 2003 and into 2004. However, the full benefits of this bull market in commodities eluded some of South Africa's exporting firms, partly as a result of the recovery in the exchange rate of the rand. Accordingly, the growth in South Africa's export volumes remained subdued, but import volumes rose considerably.

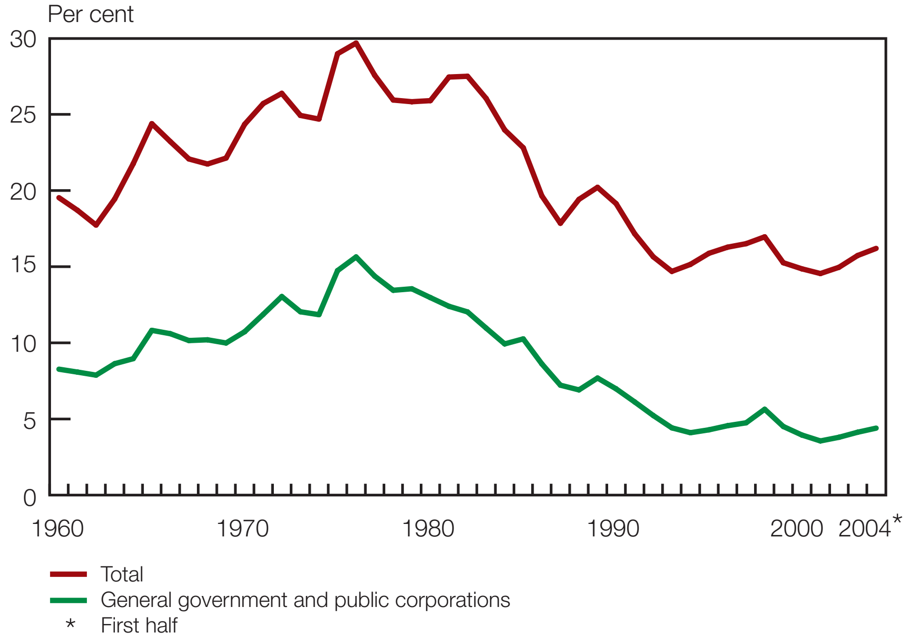
Real economic growth in the domestic economy decelerated to only 2 per cent for the year 2003 as a whole. Production volumes in manufacturing contracted, partly due to the weakness of demand in the euro area and the decline in international price competitiveness experienced by domestic producers. Output in agriculture fell back as a result of poor climatic conditions and relatively low product prices.

In the first half of 2004 growth in South Africa's real gross domestic product picked up decisively to an annualised rate of more than 3 per cent. Lower interest rates, a growth-supportive fiscal policy stance and higher international prices for export commodities raised business as well as consumer confidence and was translated into higher real output. All the main economic sectors recorded increases in output in the first half of 2004. Platinum production continued along a strong upward trajectory. In manufacturing the increases in production were mainly a response to the strength of the domestic market, since export volumes were subdued. Real value added in the construction sector also rose briskly, consistent with buoyant demand for buildings and structures. Transport, storage and communication services displayed the strongest growth among the tertiary sectors.

While domestic production volumes were weak in 2003 but recovered in early 2004, real domestic expenditure rose strongly throughout this period. Household consumption benefited from rising real disposable income, lower interest rates and attractive prices of imported items, while government consumption rose on account of the adoption of a somewhat more expansionary fiscal programme incorporating improved service delivery and the procurement of a number of corvettes for the South African Navy. Fixed capital formation was supported by the enhanced affordability of imported capital goods, lower interest rates, strong business confidence, and the higher priority assigned to infrastructural development in public-sector programmes. A sizeable expansion of the fleet of the South African Airways also contributed to the acceleration in fixed capital formation.

Nevertheless, the ratio of fixed investment to gross domestic product in South Africa remained low relative to that of many other developing countries and to investment levels needed to obtain high growth. Enhanced levels of capital formation, allocated to economically efficient and sustainable ventures and projects, would go a long way towards strengthening the job-creating capacity of the economy.

Gross fixed capital formation as percentage of gross domestic product



Underpinned by stronger increases in real gross domestic expenditure than in real gross domestic production, the deficit on the current-account of the balance of payments widened significantly in the first half of 2004. The size of the deficit was moderated by an improvement in the terms of trade, as rising commodity prices boosted South African export earnings. Even after the international prices of export commodities had fallen back in the second quarter of 2004 when the Chinese authorities indicated that they would introduce steps to stem the vibrant growth in their economy, South Africa's terms of trade moved broadly sideways. The current-account deficit continued to be easily financed through a combination of foreign direct investment and portfolio and other types of foreign capital inflows. The improvement in the overall balance of payments was reflected in the exchange value of the rand, which over the year to the end of December 2003 appreciated by 16 per cent against a basket of currencies, followed by a further 9 per cent over the seven months to the end of July 2004. This appreciation helped to moderate inflationary forces.

In May 2003 the Reserve Bank's oversold net open foreign-currency position was expunged and in February 2004 the Bank's oversold forward book in foreign currency was brought in balance. This was achieved after a protracted period of measured foreign exchange purchases by the Bank, with the foreign currency obtained in the process being delivered against forward contracts. Once the forward book was closed out, the Bank shifted its attention to gradually strengthening its foreign reserve holdings.

Growth in the broad money supply (M3) receded from twelve-month levels in excess of 20 per cent in early 2002 to levels generally between 12 and 15 per cent in 2003 and the first six months of 2004 as the lower rate of inflation helped to moderate the transactions demand for money. Bank loans and advances recorded twelve-month rates of increase of around 12 per cent during most of 2003 and the first half of 2004. However, growth in mortgage advances, instalment sale and leasing finance was significantly higher, signifying buoyant activity in the fixed property and durable consumer goods markets. During the past year the level of disintermediation, or the use of non-bank financing mechanisms, increased noticeably.

Share prices rose briskly from around May 2003 to the beginning of 2004, but thereafter fell back somewhat, with a high degree of sensitivity to changes in the exchange rate. Against this, real-estate prices continued to rise strongly. Bond prices moved higher in 2003, also following the general strengthening of the rand and lower inflation expectations, but lost their momentum in the first half of 2004.

The authorities continued to pursue a cautiously expansionary fiscal policy, recording a public-sector borrowing requirement of 3,2 per cent of gross domestic product in the 2003/04 fiscal year – higher than before, but nevertheless consistent with the principles of fiscal prudence. Rising capital expenditure by the public sector will not only contribute towards the more efficient functioning of the economy but through certain public works programmes also develop skills and increase employment.

At the time of the June 2003 meeting of the Monetary Policy Committee (MPC) the twelve-month rate of CPIX inflation still exceeded the 6-per-cent upper limit of the target range, but the inflation rate was decelerating and projections indicated that it would recede further to within the target range within a matter of months. Under these circumstances the MPC decided to lower the repurchase rate from 13,5 per cent – the level where it had been held for the preceding nine months – to 12 per cent. Further reductions were announced following the MPC's subsequent meetings, leading to the normalisation of the yield curve and the eventual attainment of a repurchase rate level of 8 per cent from mid-December 2003. In the tightening phase the repurchase rate was raised by a cumulative total of 4 percentage points over a period of nine months in 2002; it was lowered by a cumulative total of 5,5 percentage points over a period of six months in 2003.

Broadly consistent with the view of the MPC, the twelve-month CPIX inflation rate decelerated from 11,3 per cent in October and November 2002 to below the 6-per-cent mark from September 2003. By June 2004 inflation had been within the target range for ten successive months, responding to the prudent monetary and fiscal policies followed and the recovery of the exchange rate. As inflation concerns abated, long-term bond yields also declined significantly. With better-than-expected inflation outcomes feeding into a lower projected path for future inflation, the MPC on 12 August 2004 decided to lower the repurchase rate by a further 50 basis points to 7,5 per cent.

By the end of 2003 both short-term and long-term interest rates had receded to levels last encountered more than 22 years before. However, in the early 1980s inflation was higher than nominal interest rates, making the then prevailing level of interest rates unsustainable. The current configuration of interest rates and inflation implies positive real interest rates, signalling a healthier and more sustainable monetary environment. At or around current levels, nominal interest rates should contribute to easier cash flows for borrowers and a greater willingness to undertake investment projects. Under these circumstances South Africa could achieve stronger trend growth and more job creation on a sustainable basis.

Domestic economic developments

Gross domestic production

Following a firm increase of 3½ per cent in 2002, South Africa's *real gross domestic product* increased at a more moderate pace of 2 per cent in 2003. These developments broadly reflected the performance of the primary and secondary sectors of the economy. The secondary sector of the economy, of which the manufacturing sector is the largest, performed exceptionally well in 2002, partly as a result of the surge in manufactured exports which benefited to a large extent from the weaker exchange rate of the rand. The recovery of the exchange rate, which started in the second half of 2002 and continued throughout 2003, contributed to a contraction in the real value added by the manufacturing sector, thus leading to virtually no change in the real output of the secondary sector for 2003 as a whole.

Similarly, the expansion in the real output of the primary sector in 2002 can partly be attributed to buoyant activity in the agricultural sector which thrived in favourable climatic conditions. As weather conditions deteriorated in 2003, agricultural output was adversely affected. Despite an improved performance by the mining sector, this led to a decline in the real value added by the primary sector.

Prospects for the South African economy improved in the first half of 2004. This can mainly be ascribed to a recovery in real economic activity in the primary and secondary sectors of the economy. Real output of the tertiary sector remained strong and growth accelerated from 3 per cent in the second half of 2003 to 3½ per cent in the first half of 2004. As a result, real economic growth increased from an annualised rate of 1 per cent in the second half of 2003 to 3 per cent in the first half of 2004.

The real value added by the *primary sector* increased substantially in the first half of 2004. After declining at an annualised rate of 6 per cent in the second half of 2003, the real output of the primary sector rose at a rate of 2 per cent in the first half of 2004. A recovery of real agricultural output was supported by a solid expansion of the mining sector.

Real gross domestic product
Percentage change at seasonally adjusted annualised rates

	2002	2003			2004
Sectors	Year	1st half	2nd half	Year	1st half
Primary sector	3	-2	-6	-1	2
Agriculture	6½	-6½	-18½	-6	1½
Mining	½	1½	4½	2½	2½
Secondary sector	4½	-2	-1½	0	3
Manufacturing	5½	-3½	-3	-1	2½
Electricity, gas and water	2	2½	2½	2½	2½
Construction	4½	5	4½	5	6½
Tertiary sector	3½	3	3	3	3½
Commerce	3	2½	3½	3	3½
Transport and communication	6½	6½	6	6	6
Financial and other services	4	3	2	3	3½
Non-agricultural sector	*3½*	*1½*	*2*	*2*	*3½*
Total	3½	1	1	2	3

Following an annualised decline of 18½ per cent in real agricultural output in the second half of 2003, growth in the real value added by the *agricultural sector* reversed to a small positive annualised rate of 1½ per cent in first half of 2004. The decline in the first half of 2003, and indeed throughout 2003, was mainly a result of poor field crop production. The 2003 maize crop, for instance, was smaller than that of 2002.

Although the real value added by the agricultural sector improved somewhat in the first half of 2004, this was from a low base. In fact, the latest estimate of the 2004 maize crop, at 8,3 million tons, is considerably less than the 2003 crop, which amounted to 9,7 million tons. When measured over one year, the level of the real value added by the agricultural sector in the first half of 2004 declined when compared with the first half of 2003. The overall performance of the agricultural sector was, however, not as bleak as that of field crops. Real output of horticulture remained steady in 2003 and rose somewhat in the first half of 2004.

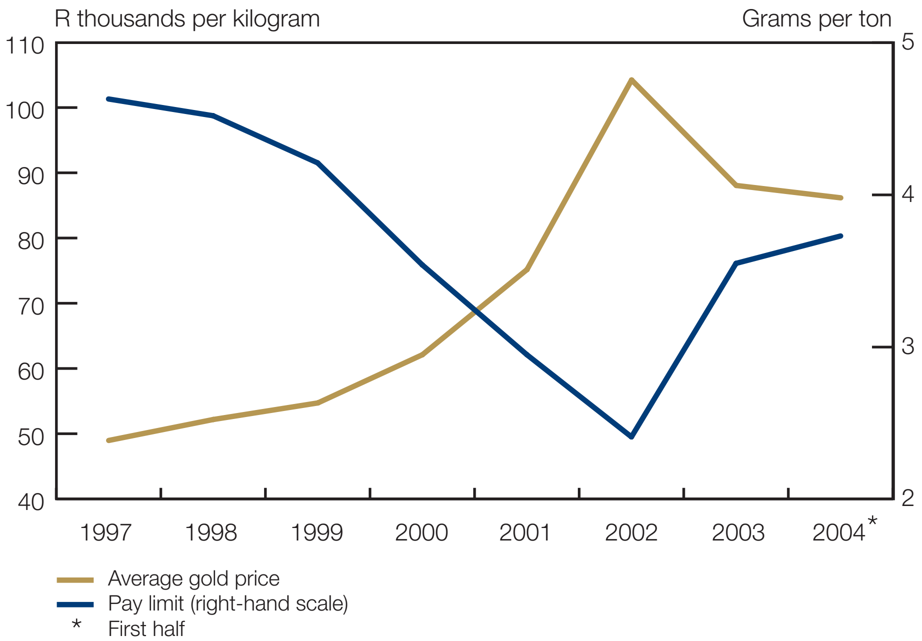
Following an increase of ½ a per cent in 2002, growth in the real value added by the *mining sector* accelerated to 2½ per cent in 2003. On an annual basis, this is the highest growth rate for well over a decade. The strength of the performance of the mining sector in 2003 was mainly based on increased output by diamond and platinum mining. Diamond mining also benefited from the recovery of global demand and the demand for rough diamonds to replenish inventories.

In the first half of 2004, the real value added by the mining sector increased at an annualised rate of 2½ per cent, down from the rate of 4½ per cent attained in the second half of 2003. The growth in the first half of 2004 was mainly supported by increased platinum production, which more than offset declines recorded in the real value added by gold and diamond mining. The platinum group metals benefited from sustained demand from manufacturers as these metals form an essential part of modern production processes. Globally, South Africa is a leading provider of platinum accounting for more than half of the world's production.

Production in the gold-mining industry during the past three decades was hampered by the mining of ore with a lower gold content and deeper ore bodies. To some extent, this was instrumental in lowering the contribution of the value added of gold mining relative to economy-wide nominal value added; over the past decade the contribution of the gold-mining industry to overall gross domestic product receded by half from about 4 per cent in 1993 to only 2 per cent in 2003. Profit margins generally suffered from lower income and high costs, resulting in reduced output levels and less-than-optimal performance at some shafts. The year 2002 was an exception when the real value added of gold mining rose by ½ a per cent – the only positive growth rate recorded since 1993. This occurred against a background of a record high average rand gold price of R104 000 per kilogram.

At the same time, the average industry pay limit in grams per ton (i.e. the minimum amount of gold which needs to be recovered from a ton of gold ore milled to break even at a certain working cost and gold price) increased from 2,41 in 2002 to an average of 3,55 in 2003. The pay limit, which increases either when the gold price declines or when operating costs increase, rose marginally to an estimated 3,73 grams per ton during the first half of 2004. To remain profitable at an increased pay limit, a mine could contemplate the mining of ore with a higher gold content, but this might shorten the mine's lifespan.

Average gold price and pay limit



The real value added by the *secondary sector* remained unchanged in 2003. This was mainly due to a contraction of real manufacturing output which neutralised the growth in the construction and the electricity, gas and water sectors. However, this setback was short-lived and growth subsequently accelerated to an annualised rate of 3 per cent in the first half of 2004.

In sharp contrast to an increase of 5½ per cent recorded in 2002, the real value added by the *manufacturing sector* declined by 1 per cent in 2003. In 2002, with the weakened exchange rate of the rand, South African manufactured exports became highly competitive, thus boosting domestic manufacturing production. The recovery of the exchange rate of the rand in 2003, further exacerbated by comparatively subdued real growth in the euro area, resulted in a decline in the demand for South African manufactured exports. Consequently, manufacturing production in the export-oriented sectors like chemical products and machinery was particularly hard hit. Import-competing local manufacturers could also not fully capitalise on the robust domestic demand, particularly for durable goods, due to import substitution.

The decline in manufacturing output, however, bottomed out towards the end of 2003. Following an annualised decline of 3 per cent in the second half of 2003, the real value added by the manufacturing sector increased at a rate of 2½ per cent in the first half of 2004. This growth was spread over a broad spectrum of production subsectors. Manufacturing production of food and beverages, petroleum and chemical products, basic iron and steel, and radio and television equipment recovered strongly in the first half of 2004. The solid expansion of the Asian economies, particularly China, and the resultant need for infrastructure boosted the global demand for steel, which lifted growth in the real value added by the basic metals and steel subsector. The textile subsector continued to remain under considerable pressure from inexpensive imports. Therefore, the buoyant conditions in the domestic retail sector only supported the real output of these manufacturers to a limited extent.

The improvement in real manufacturing production in the first half of 2004 was, among other things, underpinned by the robustness of domestic demand which provided some support to sales and new orders going forward and a recovery in global demand, especially in the euro area; South Africa's largest trading partner.

The growth in real value added by the sector that supplies *electricity, gas and water* increased from 2 per cent in 2002 to 2½ per cent in both 2003 and the first half of 2004. The sustained growth can be attributed to increased production in the electricity subsector. More electricity has been exported to neighbouring countries since the second half of 2003. This was counteracted to some extent in the first half of 2004 by tepid growth in domestic demand for electricity due to the initial mildness of the 2004 winter. In addition, there was also an increase in electricity imports during the first half of 2004. Increased domestic demand related to the recovery of manufacturing production and sustained activity in the mining sector supported growth in the real value added by the electricity sector.

Growth in the real value added by the *construction sector* accelerated from an annualised rate of 4½ per cent in the second half of 2003 to 6½ per cent in the first half of 2004. The increase in the value added by the construction sector can mainly be attributed to lively conditions in the construction of private residential buildings. The favourable economic environment also had a positive effect on the construction of non-residential structures such as the expansion of office space and shopping and entertainment facilities. In addition, the ongoing activity in the Eastern Cape province at the Coega Development Project underpinned the demand for civil engineering construction. Infrastructural development by general government was somewhat subdued but contributed to growth in the first half of 2004.

The real value added by the *tertiary sector* increased by 3 per cent in 2003, marginally lower than the rate of 3½ per cent attained in 2002. This sector enjoyed stable growth rates of at least 3 per cent per annum during the past five years, and this continued into the first half of 2004 with growth accelerating to an annualised rate of 3½ per cent from 3 per cent in the second half of 2003. The solid performance of the tertiary sector in the first half of 2004 centred around an acceleration in growth in the real value added by the financial intermediation, insurance, real-estate and business services sector. This was further underpinned by a firm expansion in the real value added by the commerce and transport, storage and communication sectors.

Growth in the real value added by the *commerce sector* continued at an annualised rate of 3½ per cent from the second half of 2003 into the first half of 2004. This can mainly be attributed to lively activity in the retail and motor trade sectors that more than compensated for the more modest performance of the wholesale, and the catering and accommodation sectors. The retail sector benefited from strong domestic demand for both durable and semi-durable goods. Durable-goods demand thrived amidst a lower interest rate environment, which enhanced the attractiveness of credit financing. Especially the demand for new motor vehicles by both households and businesses increased strongly from the second half of 2003 to the first half of 2004. Demand for semi-durable goods like clothing and audio and entertainment goods was boosted due to attractive prices in the wake of the recovery in the exchange rate of the rand.

The real value added by the catering and accommodation sector faltered in the first six months of 2004. This is not surprising, especially when measured over a year, as this sector benefited from the increased tourist activities generated by the Cricket World Cup during the same period in the previous year.

The vigorous expansion of the cellular telephone industry had a considerable impact on the real value added by the communication sector of the economy. The frequent introduction of new products and increased competition among the three service providers continued to boost growth in this subsector. The ratio of the value added of the use of cellular phones to the value added of the transport, storage and communication sector increased from around ½ a per cent in 1994 to over 20 per cent in 2003. Real output growth by the communication subsector was also consistently high throughout this period and continued into the first half of 2004.

In contrast to the sturdy performance of the communication sector, growth in the transport sector slowed down from the second half of 2003 to the first half of 2004. Growth in the real value added by the goods transport and the harbour and docks sectors softened somewhat on account of freight bottlenecks occurring at national rail networks and harbours. Despite these developments, growth in the real value added by the *transport, storage and communication sector* was sustained at an annualised rate of 6 per cent in the second half of 2003 and into the first half of 2004.

Growth in the real value added by the *financial intermediation, insurance, real-estate and business services sector* accelerated from 2 per cent in the second half of 2003 to an annualised rate of 3½ per cent in the first half of 2004. This can mainly be attributed to an improvement in the real output by banks and other financial service providers. The increased volume of activity took place against the background of lower interest rates. In addition, the real-estate sector continued to grow briskly, positively influenced by lower interest rates and the strong demand for residential buildings. By contrast, activity on the Johannesburg Securities Exchange SA (JSE) fluctuated downward, causing the real value added by securities dealers to edge down somewhat.

The contribution of *general government* to real gross domestic product remained virtually unchanged from 2002 to 2003, reflecting government's commitment to manage its employment numbers prudently. However, growth in the real value added by general government accelerated from ½ a per cent in the second half of 2003 to 1 per cent in the first half of 2004. This was partly due to the employment of temporary workers to assist with the administration of the general election.

Growth in *real gross national income* slowed down from an annualised rate of 5 per cent in 2002 to 3 per cent in 2003, consistent with the slowdown in real economic growth. However, the increase in gross national income has subsequently improved and growth accelerated from an annualised rate of 3½ per cent in the second half of 2003 to 4½ per cent in the first half of 2004. The growth in the first half of 2004 was underpinned by a recovery in real gross domestic product and an improvement in the terms of trade. In addition, net primary income payments to the rest of the world contracted. This was mainly on account of lower interest payments to non-resident holders of South African fixed-interest securities. Dividend payments by resident companies to non-resident parent companies also declined. Real national income per capita increased at an annualised rate of 2½ per cent in the first half of 2004, following growth at a rate of 1½ per cent in the second half of 2003.

Gross domestic expenditure

Aggregate real gross domestic expenditure has increased at an average annualised rate of 4 per cent since the fourth quarter of 1999. While this rate is relatively low compared with the rates of increase recorded in the previous four upward phases of the business cycle, real gross domestic expenditure again rose at a faster pace than real gross domestic production.

Growth in real gross domestic expenditure amounted to an annualised rate of 5 per cent in the second half of 2003, accelerating to 6½ per cent in the first half of 2004. This can mainly be attributed to buoyant growth in real domestic final demand, which accelerated from 4½ per cent in the second half of 2003 to an annualised rate of 6 per cent in the first half of 2004. All three components of domestic final demand – final consumption expenditure by households, final consumption expenditure by general government and real gross fixed capital formation – boosted the performance of domestic final demand in the first half of 2004.

Real gross domestic expenditure

Percentage change at seasonally adjusted annualised rates

	2002	2003			2004
Components	Year	1st half	2nd half	Year	1st half
Final consumption expenditure by households	3	2½	3½	3	4½
Final consumption expenditure by general government	3½	4	6½	4½	6½
Gross fixed capital formation	6	7	6½	8½	12
Change in inventories (R billions)	5,7	7,7	7,9	7,8	5,5
Gross domestic expenditure	4½	3½	5	4	6½

Real final consumption expenditure by households

Real *final consumption expenditure by households*, which currently accounts for about 62 per cent of expenditure on gross domestic product, increased by 3 per cent in 2003, the same rate as attained in 2002. In the first half of 2003, growth in real household spending faltered somewhat as a result of higher interest rates. From the middle of 2003 consumers became more confident as monetary policy was eased, leading to a particularly sharp increase in real expenditure on durable and semi-durable goods. This continued into 2004, boosting growth in aggregate household spending to an annualised rate of 4½ per cent in the first half of 2004 compared with an average rate of increase of 3½ per cent recorded in the second half of 2003. Real outlays on non-durable goods and services increased at a more moderate pace.

The growth in real expenditure on *durable goods* decelerated from 2 per cent in the second half of 2002 to 1 per cent in the first half of 2003 before surging to 10½ per cent in the second half of 2003. The tight monetary conditions in 2002 and part of 2003 put a damper on the demand for durable goods, which was exacerbated by the increases in the prices of such goods on account of the exchange rate depreciation of late 2001. Demand for vehicles subsequently increased in the second half of 2003 and into 2004 as monetary conditions eased. Besides the lower cost of credit, motorcar dealers structured maintenance and other packages to entice buyers in an increasingly competitive market. The demand for household appliances increased as the prices of these goods, which have a high import content, fell partly in response to the recovery in the exchange rate of the rand.

Real expenditure on *semi-durable goods* increased briskly in the first half of 2004. This was particularly noticeable in outlays on clothing and footwear, motorcar parts and accessories, and recreational and entertainment goods where growth actually accelerated. Expenditure on clothing and footwear benefited from the continued decline of prices in this spending category. Real spending on household textiles and furnishings remained strong although the growth momentum edged down somewhat.

While households made the most of favourable conditions to increase spending on discretionary items, growth in expenditure on less-discretionary categories such as *non-durable goods and services* remained at fairly stable rates in the first half of 2004. However, consumers economised on purchases of medical and pharmaceutical items as their prices increased at rates well above the general inflation level.

The buoyant demand for consumer goods can be attributed, among other things, to:
- an increase in real household disposable income;
- a reduction in tax rates and a further widening of the child grant in the 2003/04 Budget;
- easier monetary conditions that prevailed from the middle of 2003;
- property values that increased at near-record high rates, creating positive wealth effects; and
- one of the highest levels of consumer confidence ever experienced in the country.

The confidence of the South African consumers regarding economic prospects as well as the lower cost of credit seem to have made households somewhat less averse to incurring debt than before. As a result, the ratio of household debt to disposable income increased from a low of 52 per cent in 2002 to 54 per cent in the first half of 2004. Both increased participation of households in the property market and the acquisition of consumer goods and services on credit contributed to the current higher debt level.

Real final consumption expenditure by general government

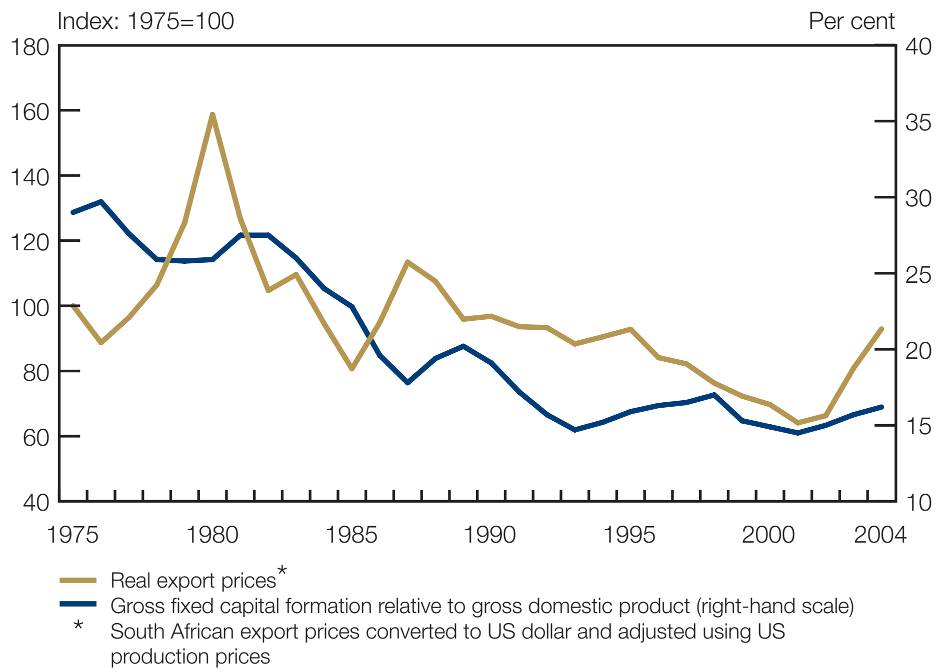
Growth in *real final consumption expenditure by general government* remained at an annualised rate of 6½ per cent in both the second half of 2003 and the first half of 2004. This can mainly be attributed to expenditure on non-wage goods and services. Included in these figures are the South African Navy's acquisition of naval vessels: One in the second half of 2003 and two in the first half of 2004. Expenditure on these extraordinary items helped to lift the ratio of collective final consumption expenditure as a percentage of total general government final consumption expenditure from 55½ per cent in 2002 to almost 58 per cent in the first half of 2004. As a result of these developments, government consumption expenditure as a percentage of gross domestic product increased from 18½ per cent in 2002 to 19½ per cent in the first half of 2004.

Notwithstanding the solid growth in real final consumption expenditure, the ratio of total compensation of employees to total consumption expenditure by general government decreased from 64 per cent in 2002 to 61½ per cent in the first half of 2004.

Real gross fixed capital formation

Following an increase of just 2 per cent in 2001, growth in *real gross fixed capital formation* accelerated to 6 per cent in 2002 and further to 8½ per cent in 2003. This improvement in the performance of capital formation can partly be attributed to a reversal of declines in real fixed capital spending by the public sector. The contraction in real fixed capital spending by both the public corporations and general government in 2001 was arrested and growth in these aggregates subsequently resumed in 2002 and in 2003. Growth in real gross fixed capital formation accelerated from 6½ per cent in the second half of 2003 to 12 per cent in the first half of 2004. This lifted the ratio of gross fixed capital formation to gross domestic product from 14½ per cent in 2001 to 16 per cent in the first half of 2004. This is still below the long-term average of 20 per cent and certainly falls short of the fixed capital formation ratio in more rapidly growing emerging markets.

Real export prices and the fixed capital formation ratio



An analysis of investment growth per institutional sector indicates that real capital outlays by public corporations increased substantially while that of the private sector grew at a strong pace. Growth in capital spending by general government, conversely, remained comparatively subdued because the base for year-on-year growth calculations had been lifted by a significant increase in such expenditure in 2002 when government raised its capital formation, prioritising spending on infrastructure in order to underpin longer-term economic growth.

Growth in real gross fixed capital formation by the *private sector* increased from an annualised rate of 5 per cent in 2002 to 7 per cent in 2003. Increased spending by the mining, manufacturing and transport and communication sectors offset a decline in real capital outlays by the agricultural sector. The strength of the exchange rate of the rand reduced the cost of imported capital goods. In addition, businesses responded to buoyant domestic demand by increasing real fixed capital outlays. Notwithstanding the weak performance of real manufacturing output in 2003, these developments prompted manufacturing firms to step up capital expenditure.

Growth in real capital expenditure by the private sector slowed down somewhat from 8 per cent in the second half of 2003 to 7½ per cent in the first half of 2004. This was partly due to a slowdown in capital spending by the mining sector. Income from this sector came under pressure despite the dollar commodity price boom, as this was not translated into correspondingly high rand prices. As a result, the profitability of some mines was negatively affected. Capital spending was therefore either postponed or altogether cancelled. Gold mining was particularly adversely affected by additional cost pressures. However, mining projects which are already underway are continuing, particularly in platinum mining.

The recovery of real manufacturing production in the first half of 2004 contributed to increased capital expenditure in this sector. In the retail sector, the construction and upgrading of entertainment complexes and shopping malls augmented real gross fixed capital formation. Although a portion of capital expenditure by cellular phone networks was geared towards foreign expansion, they also continued to add to their domestic capacity.

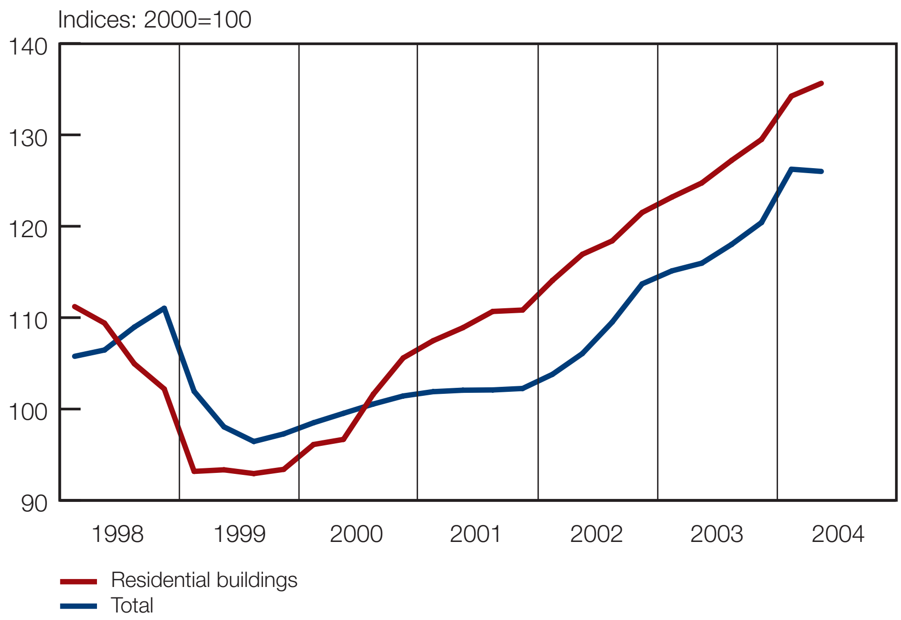
Public corporations increased their capital spending substantially in the first half of 2004. Accordingly, growth accelerated from 3½ per cent in the second half of 2003 to an annualised rate of 56½ per cent in the first half of 2004, mainly on account of the addition of several aircraft to the fleet of South African Airways. Ongoing development of Coega added further impetus to growth in this sector, together with sustained activity by other public corporations to maintaining and expanding infrastructure.

Growth in real gross fixed capital formation by *general government* remained comparatively subdued at an annualised rate of 1½ per cent in both the second half of 2003 and the first half of 2004.

An analysis of real gross fixed capital formation *by asset type* indicates that residential buildings and transport equipment were the main contributors to growth in capital expenditure in the second half of 2003 and the first half of 2004. Nonetheless, since 2002 the growth in all asset types has been impressive.

The lower interest rate environment that prevailed provided a fillip for capital expenditure on residential buildings from the middle of 2003, not only as primary dwellings but also as investments expected to generate rental income and capital gains. There was also a solid expansion in real outlays on non-residential buildings, particularly retail-related property.

Real gross fixed capital formation



Change in inventories

The inventory cycle reached a lower turning point in 1998. Subsequent to that, inventories were steadily replenished to higher levels over the following five years, with the accumulation in 2003 amounting to R7,8 billion at constant 1995 prices. In the first half of 2004, the rate of inventory accumulation slowed down to an annualised R5,5 billion from an annualised R7,9 billion in the second half of 2003, thus subtracting marginally from real gross domestic expenditure growth.

The lower accumulation of inventories in the first half of 2004 was somewhat unexpected, given the backdrop of brisk increases in aggregate demand and business confidence which should have encouraged enterprises to accumulate inventories at a faster pace. The lower pace of inventory accumulation was broadly based, occurring in most sectors of the economy.

The ratio of industrial and commercial inventories to non-agricultural gross domestic product moved broadly in tandem with the inventory cycle and reached a lower turning point in 1998 and 1999. In the ensuing build-up of inventories during the past five years, this ratio increased to 16 per cent in 2003 before slowing to an average of 15½ per cent in the first half of 2004.

Factor income

The growth in *total nominal factor income* slowed down markedly from 14 per cent in 2002 to only 7½ per cent in 2003. Measured over a period of one year, a slight acceleration to 7 per cent was recorded during the first half of 2004 compared with a rate of only 6 per cent during the second half of 2003. A growth rate of just 4½ per cent was registered during the fourth quarter of 2003 – this was the lowest quarterly growth rate recorded since the third quarter of 1968.

An analysis of the developments in nominal factor income indicates that the sharp slowdown in this aggregate in 2003 can be attributed to weaker growth in operating surpluses. Following an exceptional growth rate of 19½ per cent attained in 2002, the gross operating surplus increased by only 6 per cent in 2003. The weakness in total operating surpluses in 2003 mainly stemmed from a decline in the operating surpluses of goods-producing industries, i.e. agriculture, mining and manufacturing.

A long-term analysis indicates that the share of surpluses of goods-producing industries in total surpluses declined from an average of almost 60 per cent in the 1980s to an average of 45 per cent during the 1990s and to 40 per cent since 2000. The contribution to nominal growth of the gross operating surpluses of goods-producing industries to total operating surpluses is much more volatile than that of services-providing industries. The contribution of the goods-producing industries to the growth in overall operating surpluses declined from an exceptionally high 11 percentage points in 2002 to *subtracting* ½ a percentage point in 2003. As a substantial part of commodities produced in these industries is destined for the export market, particularly mining, a portion of their profit margins is inversely linked to movements in the exchange rate of the rand. As the rand weakened in 2001, profit margins increased, and subsequently declined when the exchange rate recovered in 2002 and 2003.

In the first half of 2004, the growth in operating surpluses, measured over a year, improved to 5½ per cent compared with just 2 per cent in the second half of 2003. The increase was mainly a result of a reversal of a decline in the manufacturing sector underpinned by a solid performance of surpluses in the services sector of the economy.

Growth in *nominal compensation of employees* accelerated from 9 per cent in 2002 to 9½ per cent in 2003. Measured over a period of one year, the growth has tapered off from an average of 9½ per cent in the second half of 2003 to 9 per cent in the first half of 2004. This was fairly broad-based throughout the economy and was mainly due to wage settlements which, based as they often are on past inflation, reflected the comparatively higher average inflation of the past eighteen months.

The growth in compensation of employees in 2003 outstripped that of gross operating surpluses by 3½ percentage points, in contrast to 2002 when the growth in operating surpluses outstripped that of labour compensation by a margin of 10½ percentage points. This might be an indication that labour compensation, in contrast to operating surpluses, adjusts much more slowly to changed macroeconomic circumstances, such as lower inflation. Remuneration agreements are generally effective for a period of one year or longer whereas surpluses are more prone to changing economic conditions over the short term. This is also reflected in the increase in the share of compensation of employees in total factor income from 50 per cent in 2002 to 51 per cent in 2003 and further to an average of 51½ per cent in the first half of 2004.

Gross saving

Gross saving as a percentage of gross domestic product, or the national saving ratio, declined from 16½ per cent in 2002 to 16 per cent in 2003. Current estimates indicate that the downward trend continued into the first half of 2004 when an average level of 14½ per cent was obtained. This can mainly be attributed to a deteriorating saving performance by general government which offset increases in corporate and household saving.

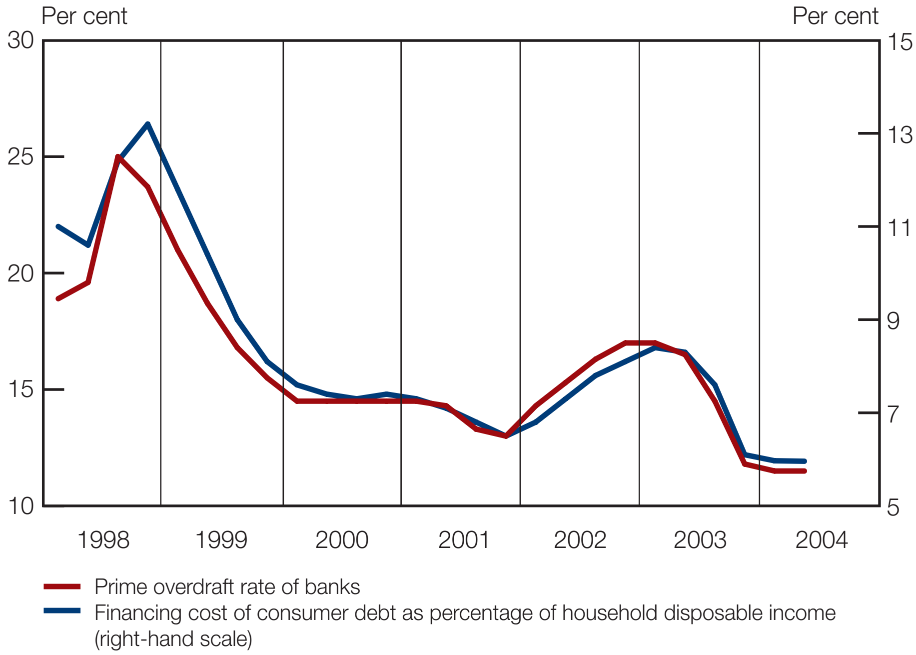
The ratio of *gross household saving* to gross domestic product has remained around 3 per cent since 1998. While it increased to 3½ per cent for most of 2003, it again receded to about 3 per cent in the first half of 2004. The saving level of households was sustained despite strong increases in final consumption expenditure of households, as this was counteracted by strong and continuous increases in households' disposable income.

The real disposable income of households increased continuously from 1993 at annualised growth rates fluctuating between ½ a per cent and 5 per cent. The compound annualised growth from 1993 to 2003 was 3 per cent. In the first half of 2004 the real disposable income of households grew further by 4 per cent. This sustained growth in the real disposable income is the result of, among other things:

- wage increases which, on average, exceeded the increase in consumer prices;
- sustained high levels of income from property, which only faltered in the last half of 2003;
- lower personal income tax rates; and
- lower financing cost of household debt.

The taxes on income and wealth as a ratio of current income of households declined continuously from a high of 16 per cent in the second quarter of 1999 to 12 per cent in the first half of 2004, thereby contributing to a rise in nominal disposable income of households from 1999 to 2004. Likewise, financing costs of consumer debt to household disposable income declined from a peak of 13 per cent at the end of 1998 to 6½ per cent at the end of 2001. Partly in response to global instability in the latter part of 2001 as well as the unprecedented decline in the value of the rand, interest rates increased and the financing cost ratio crept up to 8½ per cent by the middle of 2003. Thereafter it declined again to 6 per cent in the first half of 2004 with the easing of monetary policy. This is the lowest ratio since 1987, when financing cost as a percentage of disposable income amounted to 5½ per cent.

Prime rate and financing cost of consumer debt



Gross *corporate saving* relative to gross domestic product recovered from a low of 10 per cent in 2001 to 11½ per cent in 2002 and 2003, increasing further to 12 per cent in the first half of 2004. This was instrumental in keeping the national saving rate at 14½ per cent in the first half of 2004, underlining the importance of corporate saving in total saving.

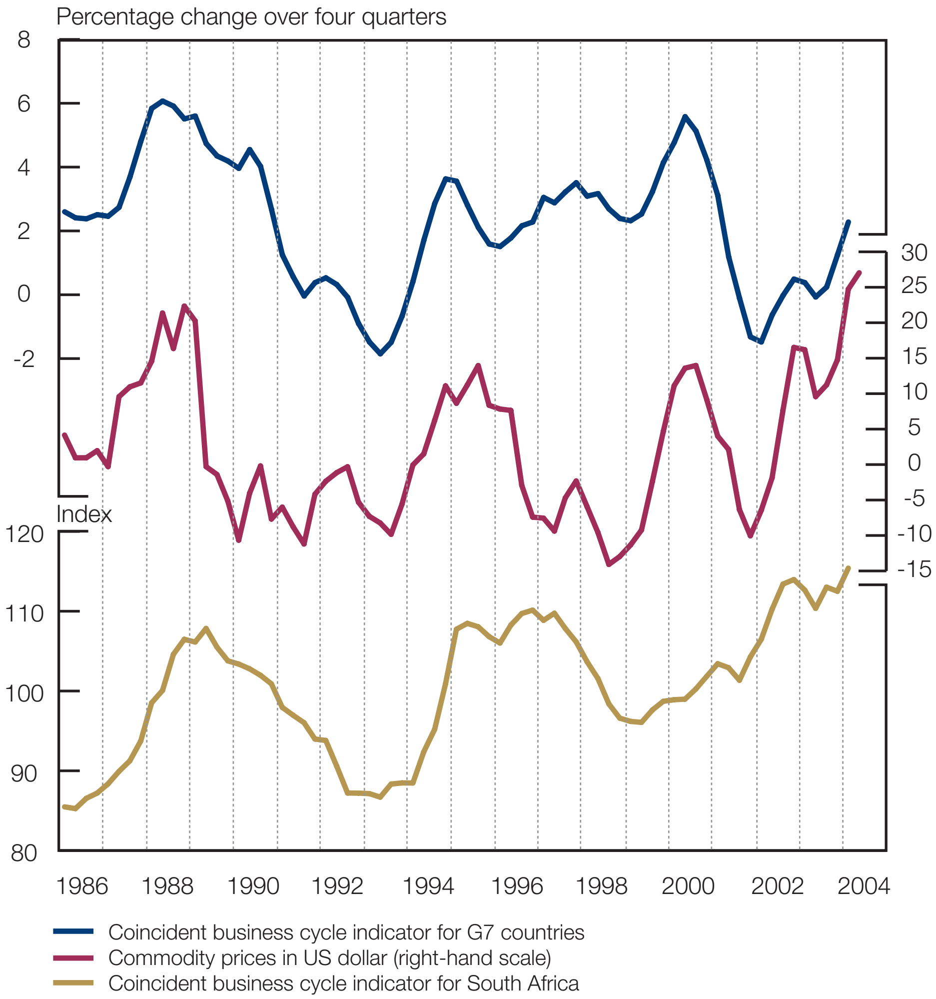
Gross saving by *general government* as a percentage of gross domestic product fell from 1½ per cent in 2002 to 1 per cent in 2003 before sliding down further in the first half of 2004. This can partly be ascribed to slower growth in overall government revenues and relatively rapid growth in government's recurrent expenditure.

Business cycle developments

The first democratic elections in 1994 paved the way for greater integration of the South African economy into the global community. The liberalisation of trade policies, leading to increased competition in the domestic market, had a profound effect on economic activity in South Africa. Among other things, the volume of trade with the rest of the world rose significantly. The volume of South Africa's exports, excluding gold, rose by as much as 60 per cent between 1994 and 2003. Alongside increased trade volumes, South Africa became more exposed to international business cycle developments.

Historically, international business cycles have been the main drivers of commodity-price cycles in international markets, as portrayed in the accompanying graph, where G7 economic activity usually leads commodity prices.

Business cycle indicators and commodity prices



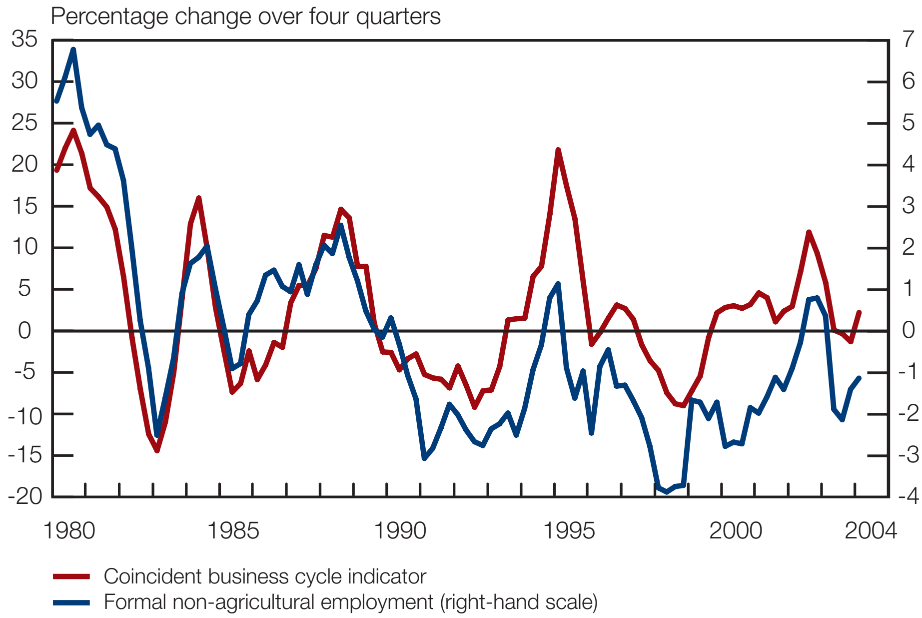
In turn, international commodity-price cycles are closely related to the changes in aggregate economic activity in South Africa. As indicated in the graph, downturns in the South African coincident business cycle indicator are generally preceded by weaker international commodity prices, while a rise in commodity prices usually precedes a recovery in the composite business cycle indicator. This follows from the importance of commodity exports, which represented roughly 53 per cent of South Africa's total export earnings in 2003 and accordingly have a strong influence on business cycle developments.

The upward movement in South Africa's coincident business cycle indicator faltered in 2003 as real economic growth fell from 3,6 per cent in 2002 to 1,9 per cent in 2003. The recovery set in quickly in early 2004, consistent with the recovery in the international business cycle and with the pick-up in commodity prices.

Employment

Changes in the level of formal non-agricultural employment in South Africa are closely related to the domestic business cycle, as shown in the accompanying graph. This relationship not only results from the purely statistical fact that the composite coincident business cycle indicator incorporates a measure of employment, but more importantly from the causal interrelationships between changes in economic activity and changes in employment.

Coincident business cycle indicator and formal non-agricultural employment



Medium and long-term analyses of employment trends are complicated by breaks in the consistency and coverage of the available data. However, interpreted carefully the time series on employment and earnings are useful for shorter-term analysis, such as those within an inflation-targeting or a business-cycle time horizon.

According to the *Survey of Employment and Earnings* by Statistics South Africa, the level of enterprise-surveyed *employment in the formal non-agricultural sectors* declined by 1,1 per cent, or approximately 73 000 jobs, over the twelve months to the end of March 2004. There was a slight increase in overall employment levels in the third and fourth quarters of 2003, but this improvement was not maintained in the first quarter of 2004. Factors contributing to the subdued employment conditions include the consistent pressure on domestic producers to be competitive in an increasingly globalised market, increasing rates of capital intensity and exchange rate volatility.

As shown in the table on the following page, the decline in private-sector employment opportunities during the twelve months to March 2004 was most pronounced in the construction sector and the finance, insurance, real-estate and business services sector. By contrast, employment in the non-gold mining sector, constituting 57 per cent of total mining-sector employment in March 2003, increased by 12,5 per cent as international commodity prices soared, most notably for platinum. The positive effects of rising commodity prices were, however, somewhat mitigated by the recovery in the exchange rate of the rand. Nonetheless, changes in mining-sector employment are strongly related to international commodity price changes measured in foreign currency.

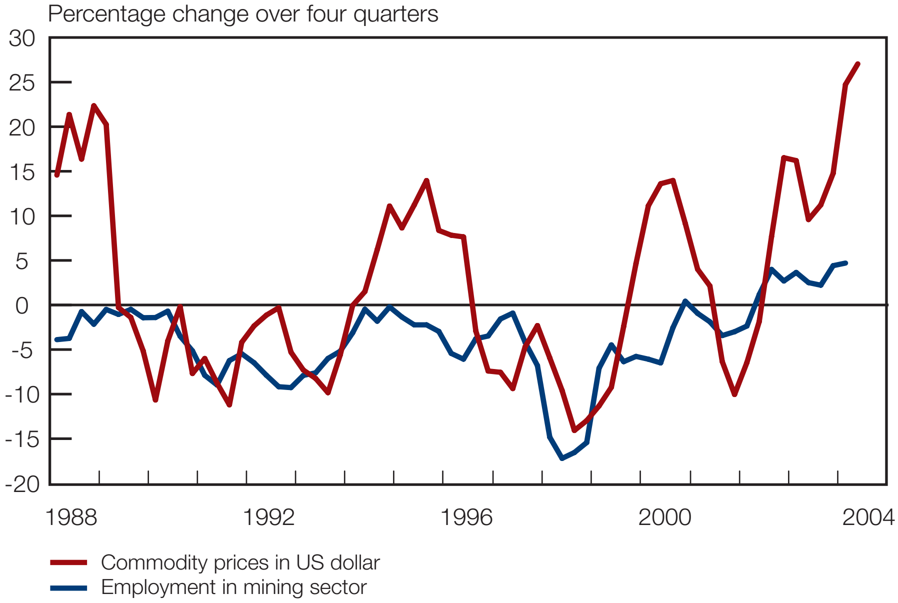
Change in enterprise-surveyed formal non-agricultural employment over the twelve months to March 2004

Sector	Percentage change
Gold mining	-4,0
Non-gold mining	12,5
Manufacturing	0,2
Electricity supply	-2,9
Construction	-15,6
Trade, catering and accommodation services	2,3
Transport, storage and communication	5,1
Finance, insurance, real-estate and business services	-7,4
Total private sector	**-1,5**
General government	0,7
Public-sector business enterprises	-7,1
Total public sector	**0,1**
Grand total	**-1,1**

Source: *Survey of Employment and Earnings* by Statistics South Africa

Since 1994, tourism has increasingly become an important contributor to job creation in South Africa. The number of holiday makers visiting this country increased from 2,6 million in 1994 to 5,6 million in 2002. In 2003, this number increased further by an estimated 5 per cent. The hosting of the World Cup soccer tournament by South Africa in 2010, one of the largest sporting events in the world, augurs well for the creation of employment in construction, tourism, retail, security and transport in the coming years.

Commodity prices and employment in the mining sector



In manufacturing – responsible for some 26 per cent of total private-sector employment in 2003 – employment rose slightly over the twelve months to March 2004. Strong domestic and foreign demand in recent months contributed meaningfully to an improvement in manufacturing sector prospects. Given the fairly close historical relationship between changes in manufacturing production and changes in the level of employment, it seems likely that employment growth will also be enhanced by a pick-up in manufacturing production. The sustained improvement in the Investec Purchasing Managers sub-index for employment since the start of 2004 is particularly noteworthy.

The level of *public-sector employment* rose by about 29 000 in the year to the fourth quarter of 2003, but declined slightly in the first quarter of 2004. Increases in employment were recorded at national, provincial and local government level in the year to the first quarter of 2004. In fact, employment at national department level increased by 1,4 per cent when the first quarter of 2004 is compared with the same period in the preceding year.

Unemployment remained at undesirably high levels throughout the past decade. Findings from the most recent household-based *Labour Force Survey* by Statistics South Africa indicate that 28,2 per cent of the economically active population was unemployed in September 2003. When those who quit actively seeking work are also included, the unemployment rate amounts to around 42 per cent. The high degree of slackness in the labour market is also indicated by the labour absorption rate, i.e. the total number of employed persons as a percentage of those aged between 15-65 years of age. This rate amounted to only 38,8 per cent in September 2003.

In an effort to address the high level of unemployment in the country, the government launched an Expanded Public Works Programme in April 2004. This programme aims to give substance to the recent Growth and Development Summit's undertaking to halve unemployment in the country by 2014. The main thrust of the programme will be investment in physical infrastructure in order to create jobs and provide training opportunities. The programme aims to create more than one million temporary jobs over the next five years.

The past decade witnessed a consistent decline in the number of workdays lost due to strikes and other forms of industrial action, from 3,9 million in 1994 to 700 000 in 2003. The decline in the incidence of strikes and other forms of work stoppages was partly due to the successful implementation of new labour legislation over this period. This legislation formalised the relationship between employer and employee and established legalised rules of conduct between all parties. Among these laws are the Labour Relations Act, the Basic Conditions of Employment Act, the Skills Development Act and the Employment Equity Act.

The amicable resolution of disputes is aided by institutions such as the National Economic Development and Labour Council (Nedlac), where government, labour and business attempt to find common ground regarding economic strategies and policies, while at the microeconomic level the Commission for Conciliation, Mediation and Arbitration settles disputes. According to Andrew Levy Employment Publications (a private-sector labour consultancy) 52 per cent of the work force was covered by long-term salary and wage agreements in 2003, with some of these extending for two to three years. These arrangements have contributed to a more stable labour relations environment.

A further development during the past ten years was the recognition of domestic workers and farm labourers in terms of the Basic Conditions of Employment Act. This recognition has resulted in the Minister of Labour announcing minimum wages for domestic workers and farm labourers. The Black Economic Empowerment strategy of government, aimed at encouraging stronger participation of black South Africans in the formal economy, has contributed to changes in the labour market over the past ten years.

Labour cost and productivity

Growth in *nominal remuneration per worker* in the formal non-agricultural sectors of the economy slowed down meaningfully over the past decade. The year-to-year increase in nominal remuneration per worker in the formal non-agricultural sectors of the economy amounted to 8,7 per cent in 2003, substantially down from 13,1 per cent in 1994[1]. Over the four quarters to the first quarter of 2004 the increase came to 9,4 per cent. The deceleration in remuneration growth was consistent with the general moderation in price inflation over this period.

1 The enterprise-surveyed remuneration and employment data underlying the analysis are not fully consistent over this period.

The year-to-year rates of increase in nominal remuneration per worker in the public sector have historically been more volatile than in the private sector. This notwithstanding, nominal remuneration in both the public and private sector increased at an average annual rate of around 11 per cent over the past decade.

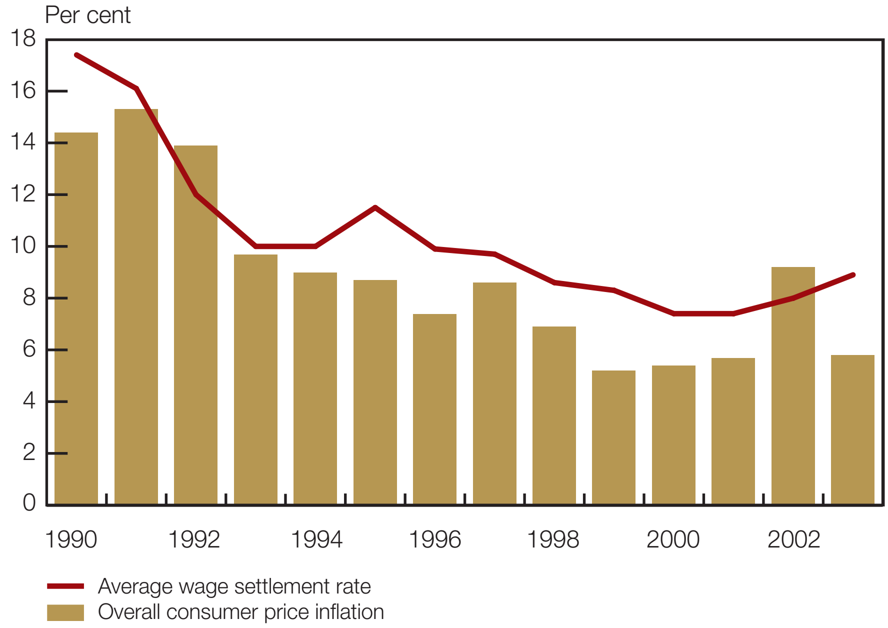
The most recent slowdown in remuneration growth in the *private sector* was not uniform and varied substantially between subsectors. When measured over periods of four quarters, average nominal remuneration per worker in the finance, insurance, real-estate and business services sector increased by 15,7 per cent in the year to the first quarter of 2004. By contrast, average earnings in the transport, storage and communication sector rose by 1,4 per cent, while for all private-sector employees the increase amounted to 9,3 per cent. When allowance is made for the statistical break in the time series in the third quarter of 2002, following the publication of a new expanded *Survey of Employment and Earnings* by Statistics South Africa, nominal remuneration growth in the private sector amounted to 8,1 per cent in 2003 – the lowest rate of increase in more than thirty years.

Alongside declining consumer price inflation in recent years, the average rate of wage settlements in collective bargaining agreements declined from a recent high of 11,5 per cent in 1995 to 7,4 per cent in both 2000 and 2001. Throughout this period, settlement rates exceeded overall consumer price inflation by an average margin of 2 percentage points, as shown in the graph on the following page. The sudden rise in consumer price inflation in 2002, following the sharp depreciation in the exchange rate of the rand towards the end of 2001, added additional pressure on the wage negotiation process and resulted in the average settlement rate increasing to 8,0 per cent in 2002. This rate was nevertheless still 1,2 percentage points lower than overall consumer price inflation in that year. To compensate for the shortfall in the previous period, an average settlement rate of 8,9 per cent was negotiated in 2003, thereby exceeding overall consumer price inflation by a considerable margin.

According to the most recent *Wage Settlement Survey* by Andrew Levy Employment Publications, the average level of wage settlements in collective bargaining agreements fell to 7,3 per cent in the first half of 2004. It is predicted that the average settlement rate in 2004 will be between 7,5 per cent and 8,5 per cent. While this outcome will be lower than in preceding years, it is still considerably in excess of productivity increases, with resultant implications for overall cost pressures in the economy.

Salary and wage increases granted by the *public sector* were, on average, more generous than those granted by the private sector during the four years to 2003.

Wage settlement rate and overall consumer price inflation



Nonetheless, public-sector wage growth at an annual average rate of 9,0 per cent in 2003 was the lowest it had been in this four-year period, falling from 10,2 per cent in the preceding year. Nominal wage growth also varied considerably within the public sector. For instance, workers employed by parastatals, universities and technikons, and public corporations outside the transport and communication area received increases at a rate of 5,1 per cent in the year to the first quarter of 2004, compared with those employed by national government departments whose average remuneration rose by more than 10 per cent during this period, and an increase of 9,4 per cent for the average public-sector employee.

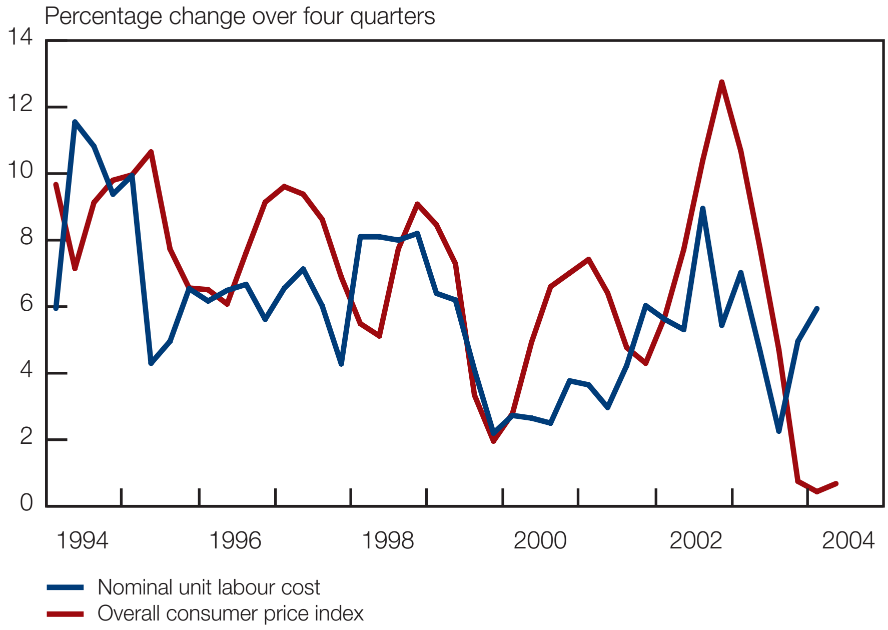
Growth in *output per worker* in the formal non-agricultural sectors of the economy at an average annual rate of around 3,5 per cent in the past two years was more sedate than in preceding years as further rationalisation and staff reductions became increasingly difficult in already-lean organisations. It should, however, be remembered that estimates of productivity growth based on the number of people employed could sometimes give a somewhat distorted impression because the intensity of labour usage in terms of hours worked is not taken into account.

Production per worker in the *manufacturing sector* decreased by 3,1 per cent in 2003. This resulted from a decrease in manufacturing production alongside employment numbers that remained fairly constant. In response to stronger domestic and foreign demand, the level of manufacturing production rebounded in the opening months of 2004. This development mitigates the acutely high rates of increase in the cost of labour per unit of production in the manufacturing sector which occurred in the past year.

Inflationary pressures arising from the labour market are best assessed through an analysis of movements in *nominal unit labour cost*. Nominal unit labour cost is derived as a ratio of nominal remuneration per worker to output per worker, i.e. money wages adjusted for productivity. Changes in nominal unit labour cost normally precede or coincide with changes in consumer price inflation. When labour productivity growth is exceeded by nominal remuneration growth, inflationary pressures in the labour market are reflected in the rise in unit labour cost.

Growth in non-agricultural nominal unit labour cost receded to a historically low rate of only 2,9 per cent in 2000 as labour productivity growth peaked. The progressive acceleration in nominal unit labour cost since 2000 was contained at a year-to-year rate of 5,0 per cent in 2003, noticeably lower than the 6,0 per cent increase in the preceding year. In the first quarter of 2004 the year-on-year rise in nominal unit labour cost amounted to 5,9 per cent. Lower rates of increase in nominal unit labour cost contributed meaningfully to the waning of price inflation in recent years.

Non-agricultural nominal unit labour cost and consumer prices



Prices

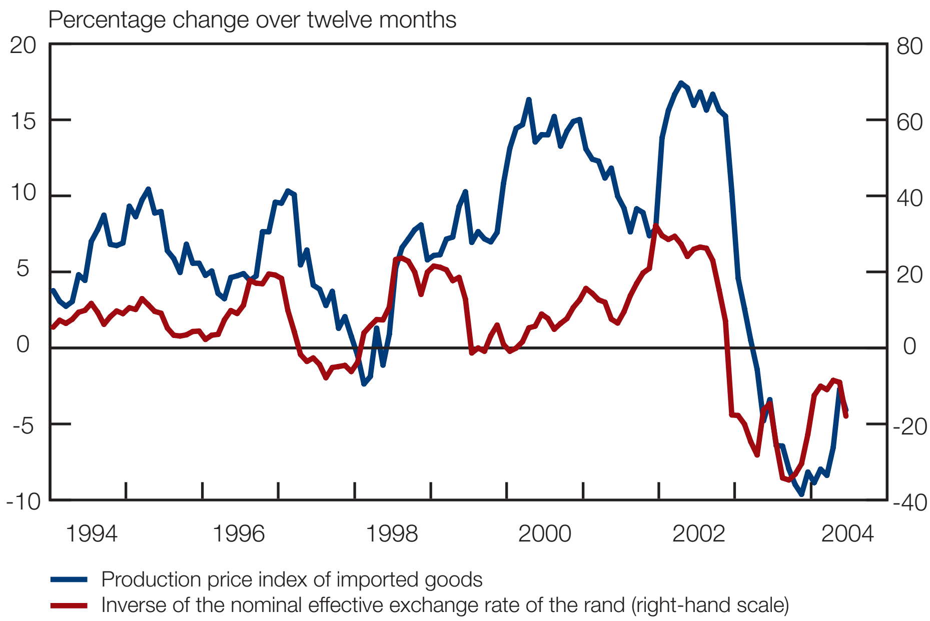
The broad downward trend in price inflation in the South African economy since the late 1980s was interrupted in 2002 when inflationary pressures mounted in the wake of the sharp depreciation in the exchange value of the rand and rising food prices. Inflation accelerated rapidly but temporarily. Subsequently, price inflation receded to historically low levels following a substantial appreciation in the exchange rate of the rand since around the second half of 2002. The consistent application of disciplined monetary and fiscal policies contributed meaningfully to the waning of inflationary pressures. The moderation of inflationary pressures over the past fifteen years also conformed to the world trend towards greater price stability.

All-goods production price inflation declined from 19,6 per cent in 1986 to a thirty-five-year low of 1,7 per cent in 2003. Consistent with the moderation in production price inflation, overall consumer price inflation receded markedly from 18,6 per cent to 5,8 per cent over the same period. CPIX inflation, the inflation target measure that omits changes in interest rates on mortgage bonds from the calculation of consumer price inflation, declined from 9,3 per cent in 2002 to 6,8 per cent in 2003. Especially due to a reduction in goods price inflation, both at the production and consumer level, year-on-year CPIX inflation has been maintained within the 3-to-6-per-cent target range since September 2003, or for ten successive months.

Exchange rate developments play an important role in the evolution of price inflation in South Africa due to its effect on the prices of tradeables in general and *imported goods* in particular. The imported goods component constitutes 27 per cent of the all-goods production price index. Historically, international business cycles acted as the main driver of commodity price cycles in international markets. Developments in the exchange rate of the rand usually dovetail with the changes in the international prices of commodities. The quarter-to-quarter rate of change in the nominal effective exchange rate of the rand is generally preceded or accompanied by international commodity price changes. Notably, the sharp depreciation in the exchange rate of the rand in 2001 was preceded by a significant fall in international commodity prices. The subsequent strong recovery in the exchange rate of the rand in 2002 was again preceded by a meaningful acceleration in the rate of increase in international commodity prices. Given the fairly consistent historical relationship between these two indicators, the marked increase in international commodity prices in recent months is supportive of the recent behaviour of the exchange value of the rand in international currency markets.

When the nominal effective exchange rate of the rand is inverted to show the rand price of a basket of foreign currencies, the effect of exchange rate changes on imported goods inflation is clearly visible in the accompanying graph. The abrupt depreciation of the rand in 2001, markedly increasing the rand price of a basket of foreign currencies, clearly pushed the year-on-year inflation rate in the prices of imported goods to a record high in early 2002. In fact, the prices of imported goods increased by as much as 17,4 per cent in the year to April 2002. The subsequent appreciation in the exchange rate of the rand again resulted in imported goods prices *declining* by 9,6 per cent in the twelve months to November 2003.

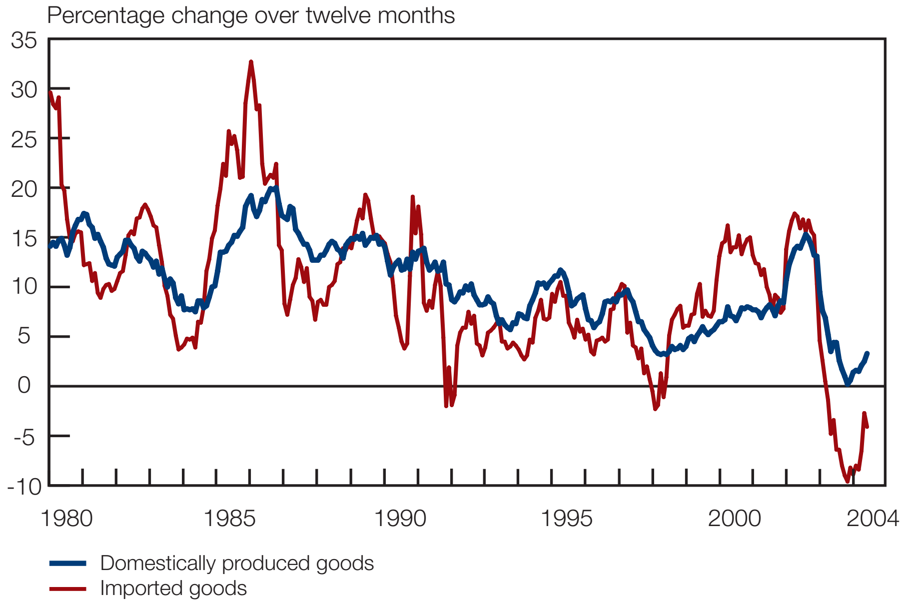
Rand price of a basket of foreign currencies and production prices of imported goods



The inflation-moderating effect of the exchange rate appreciation of the past two years was, however, tempered somewhat by an acceleration in production price inflation in South Africa's main trading partners from -0,6 per cent in 2002 to 1,8 per cent in 2003, and by a significant increase in the international price of crude oil since the end of 2003. Nevertheless, imported goods prices still *declined* by 4,1 per cent in the year to June 2004.

The decline in the prices of imported goods also assisted in moderating *domestically produced goods inflation*. Historically, changes in the prices of imported goods showed larger fluctuations than changes in the prices of domestically produced goods. Nonetheless, changes in the prices of imported goods almost always preceded changes in the prices of domestically produced goods, thereby substantiating its effect on production prices in the domestic economy.

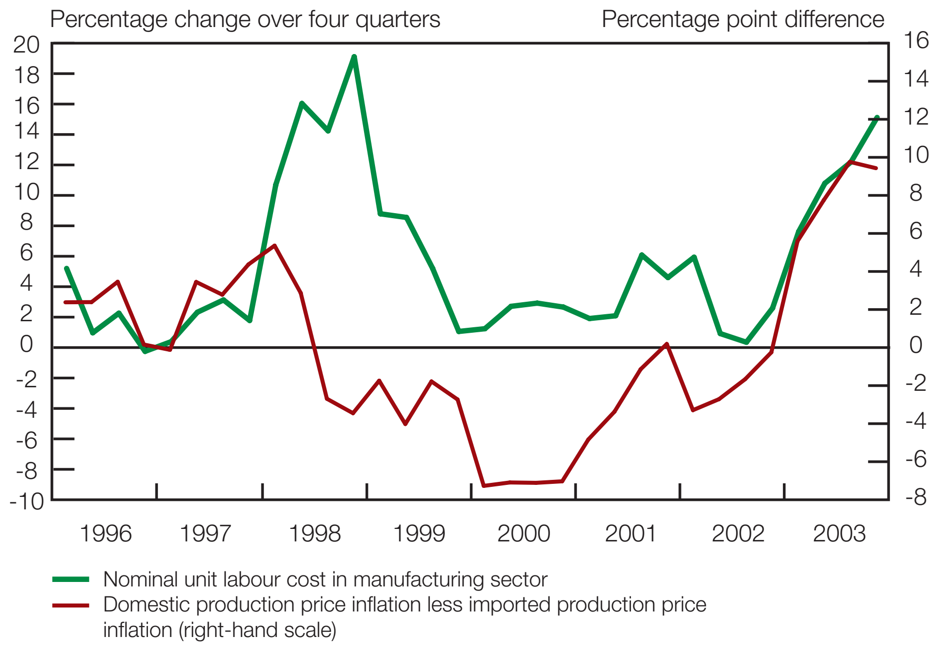
Production prices



When inflation in the prices of domestically produced goods exceeds that in the prices of imported goods, this is essentially a reflection of heightened cost pressures emanating within the domestic market. Nominal unit labour cost, i.e. the cost of labour per unit of production, reflects changes in production costs that can be directly associated with the utilisation of labour in the production process. Typically more than half of the income accruing to production factors is allocated to employees. It can therefore be expected that changes in nominal unit labour cost should broadly move in tandem with an indicator of domestically generated inflation as approximated by the excess of domestically produced goods inflation over imported goods inflation. This relationship is clearly indicated in the graph on the following page.

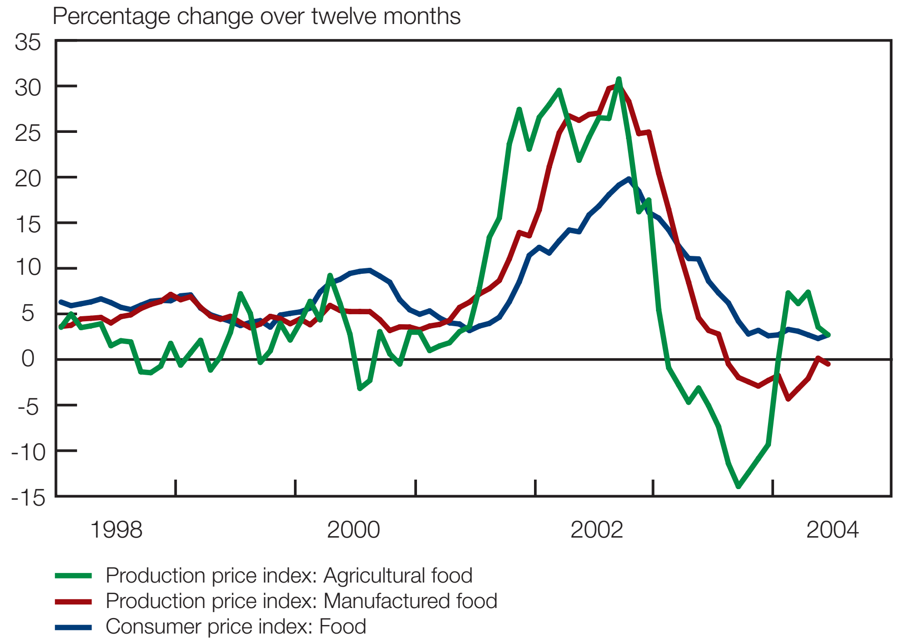
The faster pace of increase in the production prices of domestically produced goods relative to changes in the prices of imported goods since 2002, was accompanied by a much faster pace of increase in the cost of labour per unit of production in the manufacturing sector. Most recently, the prices of domestically produced goods had increased at an annualised rate of 3,1 per cent in the first quarter of 2004, while the prices of imported goods had *declined* at an annualised rate of 8,1 per cent. The wide differential between these two rates of change can partly be attributed to the steep increases in nominal unit labour cost.

Domestically produced goods inflation in excess of imported goods inflation and growth in nominal unit labour cost in the manufacturing sector



Changes in food prices also had a major influence on the outcome of production price inflation in the past two-and-a-half years. Agricultural and manufactured food prices, constituting around 22 per cent of the production price index for domestically produced goods, rose by a year-to-year rate of 25,2 per cent in 2002. In the course of 2003, the monthly year-on-year rates of increase in the production prices of food initially slowed down before prices started to decline. The net result for the year as a whole was that the production prices of food remained unchanged compared with the preceding year,

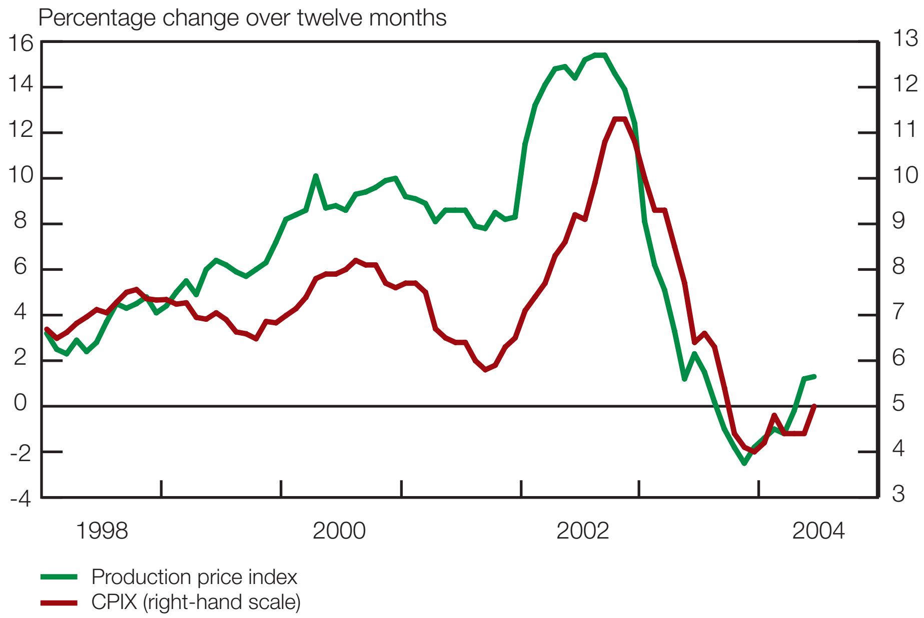
Food prices



dragging down overall domestically produced goods inflation to 3,9 per cent. At this rate, inflation in the prices of domestically produced goods had declined to its lowest level in the past five years. Following severe drought conditions in certain parts of the country in the second half of 2003, the production prices of agricultural food products started to increase from February 2004, when measured over periods of twelve months, after they had been declining for a whole year. The production prices of manufactured food products also rose in May 2004 when measured over periods of twelve months, but decreased somewhat in June.

By April 2004 meaningful decreases in the prices of imported goods, combined with subdued increases in the prices of domestically produced goods, led to *all-goods production prices* recording declines at year-on-year rates for eight months in succession. Alongside the dissipation in production price inflation, consumer price inflation receded to historically low levels in recent months.

Production price index and CPIX



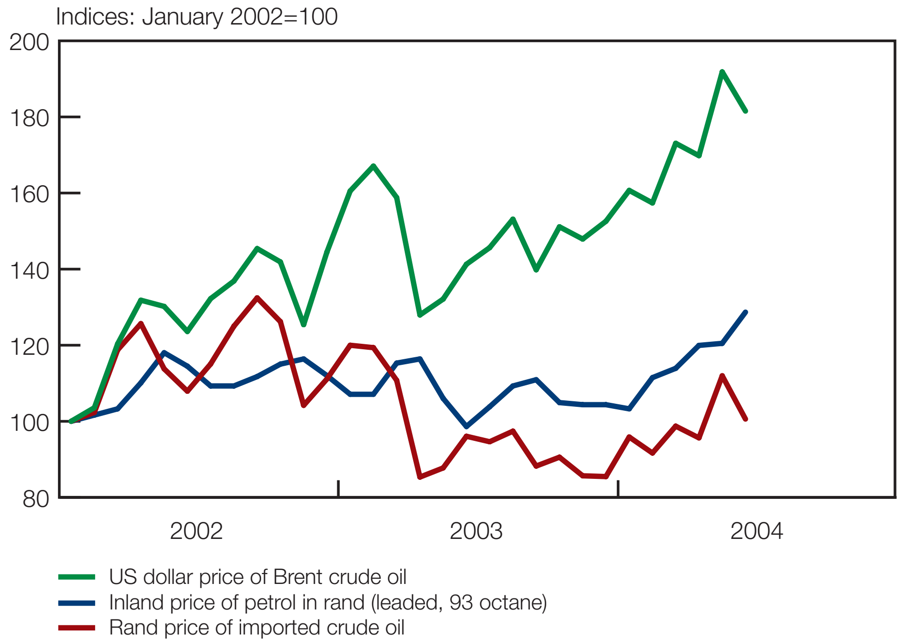
Year-on-year CPIX *goods price inflation* receded from 13,4 per cent in October 2002 to around 3 per cent in recent months. Following an increase in especially petrol prices, CPIX goods prices rose by 4,1 per cent in the year to June 2004. Changes in food prices, with a weight of around 40 per cent in the CPIX goods component, can again be singled out as one of the main factors influencing the outcome of consumer goods price inflation during the past two years or so. From year-on-year rates in excess of 20 per cent in the closing months of 2002, as food shortages and import-parity pricing practices drove prices higher, consumer food price inflation receded to around 3 per cent – roughly on a par with what it had been prior to the strong rise in prices.

A disaggregation of consumer food price changes shows that increases in the prices of vegetables outpaced that in all other food categories during the past three-and-a-half years, increasing by 44 per cent between January 2001 and June 2004. By contrast, the prices of coffee and tea increased by less than 19 per cent while those of the main food products consumed, namely grain and meat – comprising almost half of the food basket – increased by roughly 30 per cent. Notwithstanding the dissipation in consumer food price inflation in the past year-and-a-half, the average level of food prices still rose by 32 per cent during this period. This was almost double the increase of about 19 per cent in the average level of overall consumer prices.

One of the main disinflationary benefits of the meaningful appreciation of the rand was the extent to which it contained the rise in the rand price of imported crude oil. From January 2002 to June 2004 the price of a barrel of Brent crude oil in US dollar increased by roughly 82 per cent while its rand price remained essentially unchanged. Due to increases in various indirect taxes and local distribution margins, the domestic petrol price, however, increased by roughly 29 per cent over the same period.

Given the typical relationship between crude oil prices and ex-refinery prices of petrol and diesel, the increase of US$18 per barrel in the price of crude oil from January 2002 to May 2004 would have raised the pump price of liquid fuels by roughly 108 South African cents. Notwithstanding the introduction of higher indirect taxes and distribution margins, the price of petrol had only risen by 75 cents per litre due to the price-containing effect of the appreciation of the rand. The average level of CPIX was lowered by 0,5 per cent in 2003 due to the moderating effects of declining petrol prices, but was raised by 1,0 per cent in the year to June 2004 as petrol prices rose.

Crude oil and domestic petrol prices



Unlike the steep decline in CPIX goods price inflation, *year-on-year CPIX services price inflation* remained high at around the 8-per-cent level in the past twelve months, moderating somewhat to 7 per cent in June 2004. The main factors that contributed to the high level of inflation in the prices of services were the relatively high wage increases of domestic workers, marked increases in medical costs and increases in certain administered prices. The rate of increase in the wages of domestic workers has, however, started to moderate since March 2004. A new pricing policy to contain increases in the prices of medicine was also instituted. Recent announcements indicate a greater determination by the authorities to pursue a policy of moderate increases in administered prices within the context of inflation targeting.

Inflation in the components of CPIX

Percentage change over same period in the previous year

	Weights	2003	Jun 2004
Transport running cost	*5,7*	*-0,4*	*23,2*
Alcoholic beverages and tobacco	*3,1*	*11,2*	*10,5*
Total housing services	*13,4*	*9,7*	*9,2*
Services excluding housing and transport	16,5	7,3	5,9
Total other goods	17,5	5,9	3,8
Total transport services	3,9	5,5	3,1
Food	26,9	8,5	2,3
Furniture and equipment	3,2	4,1	1,2
Vehicles	5,7	4,2	-0,8
Clothing and footwear	4,1	2,0	-4,5
Total CPIX	100,0	6,8	5,0

Italics denote year-on-year increases above the upper limit of the inflation target range of 6 per cent for the latest available observation

Notwithstanding CPIX inflation being well within the inflation target range and only three categories showing year-on-year rates of price increase in excess of the upper limit of the inflation target range by June 2004, some factors were still of concern, necessitating continued vigilance in the application of anti-inflationary policy. These included:

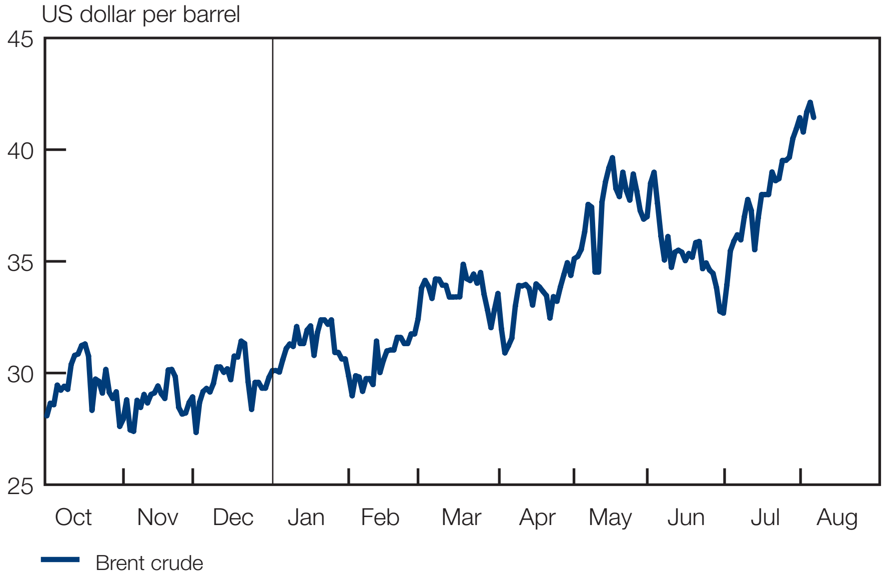
- high and volatile international crude oil prices;
- possible secondary effects of rising energy prices;
- uncertainty concerning exchange rate developments;
- some salary and wage settlements significantly in excess of the inflation target range;
- fairly high rates of growth in money supply and bank loans and advances;
- buoyantly rising domestic demand and positive wealth effects; and
- increases in certain administered prices in excess of the inflation target range.

Foreign trade and payments

International economic developments

Global economic growth gathered momentum from the second half of 2003, with the United States growing briskly alongside a particularly strong acceleration of activity in China, India and elsewhere in Asia. While growth in Japan also recovered significantly, early indications are that prospects for the euro area, South Africa's most important trading partner, have also improved somewhat in the first half of 2004. Most transition economies experienced strong growth, with some benefiting from higher oil export revenues. Africa recorded a growth rate of some 4 per cent in 2003, which was the highest in four years.

International oil price



The recovery of the global economy contributed to the commodity price boom in the latter part of 2003 and into 2004. This rendered support to South Africa's export receipts. However, crude oil prices also rose considerably over this period, with the average price of Brent crude oil for example increasing from US$25 per barrel in 2002 to almost US$29 in 2003 before rising to US$34 per barrel in the first seven months of 2004. In early August it reached levels in excess of US$40 per barrel against the background of accelerating demand and concerns about lack of spare production capacity and supply disruptions. Despite the marked increases in the prices of important commodities, global consumer price inflation accelerated very little in 2003 and early 2004. Nevertheless, a few central banks pre-emptively started tightening monetary policy; most notably, in a long-awaited move the United States authorities increased their target interest rate by 25 basis points in June 2004 and again by a similar magnitude in August. By mid-2004, however, inflation had risen noticeably, especially in a number of Asian economies.

Balance on current account

Although world economic activity gained momentum in the second half of 2003, South African export volume growth was subdued, partly due to relatively unfavourable circumstances in some export destinations and the appreciation of the exchange rate of the rand. Simultaneously, the firm growth in domestic demand, alongside exchange-rate induced reductions in import prices, encouraged increases in import volumes. This resulted in a substantial reduction in the trade surplus, causing the deficit on the current account of the balance of payments to widen from R5,3 billion in the first half of 2003 to R14,9 billion in the second half.

Balance of payments on current account

Seasonally adjusted and annualised
R billions

	2002	2003			2004
	Year	1st half	2nd half	Year	1st half*
Merchandise exports	286,4	260,6	251,5	256,0	269,3
Net gold exports	43,1	35,4	35,3	35,3	33,0
Merchandise imports	-280,6	-262,0	-263,5	-262,8	-297,5
Trade balance	**48,9**	**34,0**	**23,3**	**28,5**	**4,8**
Net service, income and current transfer payments	-42,2	-39,3	-38,2	-38,6	-39,6
Balance on current account	**6,7**	**-5,3**	**-14,9**	**-10,1**	**-34,8**

* Preliminary estimates

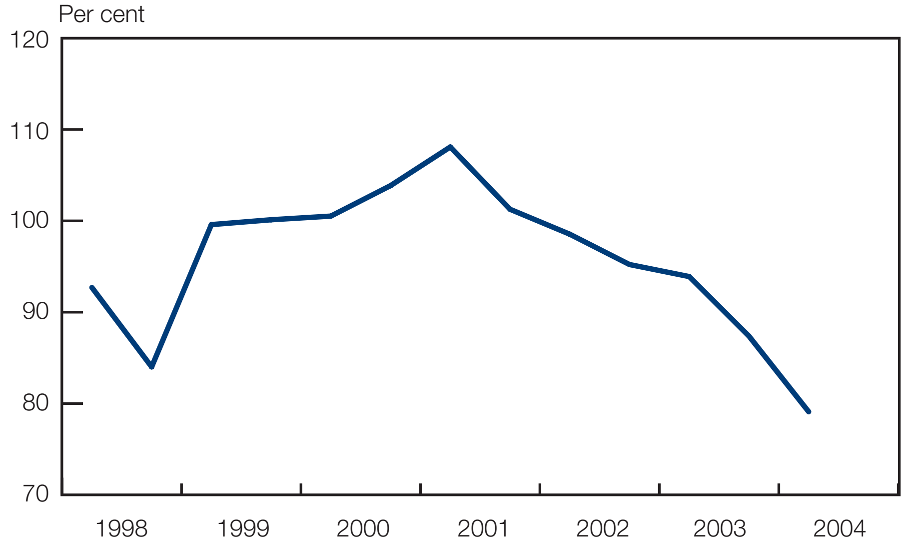
The strong growth in import volumes continued into the first half of 2004. However, real exports moved sideways while export values were raised on account of higher international commodity prices. Despite the higher export earnings, an increase in the shortfall on the services and income account with the rest of the world together with higher import values caused the current-account deficit to rise to R34,8 billion in the first half of 2004. As a ratio of gross domestic product, the deficit on the current account increased from 0,5 per cent in the first half of 2003 to 1,2 per cent in the second half and 2,7 per cent in the first half of 2004. The average deficit ratio over the past eight years amounts to 0,6 per cent of gross domestic product.

Exports

The *value of merchandise exports* declined by 3½ per cent in the second half of 2003 but rose by 7 per cent in the first half of 2004. The prominent decline in the second half of 2003 was partly due to a strong recovery in the exchange value of the rand, particularly against the US dollar. In the first half of 2004, the effect on nominal export earnings of the further appreciation in the external value of the rand was more than fully offset by higher commodity prices.

The share of mining exports (excluding gold) in total merchandise export values increased from 45 per cent in the first half of 2003 to 46½ per cent in the second half of the year. As demand from the Asian economies strengthened alongside rising commodity prices, the relative share of mining exports rose to 48 per cent in the first half of 2004. In particular, increases were recorded in the subcategories for platinum group metals, and base metals and articles of base metals. Conversely, the value of manufactured exports as a percentage of merchandise exports declined from the second half of 2003 to the first half of 2004.

Ratio of export to import volumes



Export *prices* expressed in domestic currency declined in both the first and second half of 2003 before rising by 7½ per cent in the first half of 2004. A meek rise in non-gold commodity prices, which could not counter the stronger external value of the rand, restrained the growth in the aggregate export-price level in 2003. Nonetheless, an acceleration in commodity prices in the first half of 2004 fuelled a rise in export prices measured in rand. The physical *quantity* of merchandise exports, which had increased marginally in 2003, remained broadly unchanged in the first half of 2004 as global economic activity accelerated. Foreign demand for South Africa's mining products, in particular platinum and coal, caused the physical quantity of mining exports to rise by about 13½ per cent from the first half of 2003 to the first half of 2004. By contrast, the physical quantity of manufactured exports contracted by about 7½ per cent over the same period. The subdued performance of the volume of manufactured exports could probably be attributed to several factors, including the following:

- Brisk increases in real domestic expenditure, which induce some manufacturers to focus more on the local and less on the export market.
- Fairly rapidly rising unit labour cost in the manufacturing sector.
- The recovery in the external value of the rand, which made South African producers less competitive in international markets.
- A decline in domestic agricultural production, which reduced the supply of agricultural commodities to domestic processing industries.
- In a few instances, transport and other logistical problems encountered by exporters.

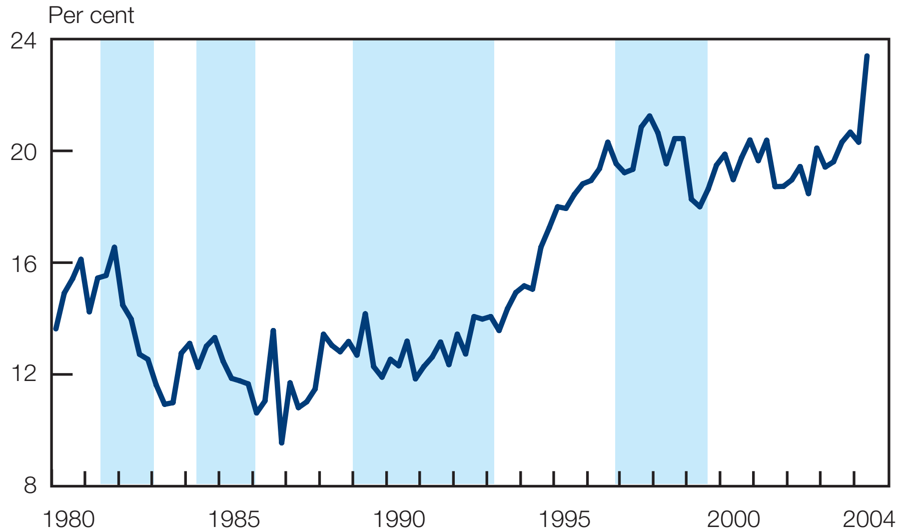
The *volume of net gold exports* contracted further in 2003, mainly due to a further reduction in the country's gold output. South Africa's gold production declined from 443 tons in 1999 to 396 tons in 2002. It then declined further by 6 per cent to 373 tons in 2003. The persistent increase in the operating cost of the South African gold-mining industry together with the recovery in the exchange value of the rand prompted the industry to counter the reduction in the throughput of ore by increasing the grade of ore milled in order to remain profitable. Although the average fixing price of gold on the London market rose from US$310 per fine ounce in 2002 to US$364 in 2003 (the highest average annual price since 1996), the average realised price in rand terms declined from R3 256 per fine ounce in 2002 to R2 749 in 2003, a decrease of about 16 per cent. For the calendar year as a whole, net gold export proceeds declined by 18 per cent.

In the first half of 2004 the value of gold exports declined by 6½ per cent to an annualised R33,0 billion, largely owing to a decrease of about 7½ per cent in the physical quantity of gold exports. Due to the further mild appreciation of the exchange rate of the rand, the average realised price of gold increased by about 1½ per cent to R2 669 per fine ounce in the first half of 2004, despite an increase in the dollar price. As demand for gold increased against the background of a weaker US dollar, the dollar price peaked at US$427 per fine ounce in January 2004; the fixing price of gold on the London market averaged US$401 per fine ounce in the first half of 2004.

Imports

Firm growth in gross domestic expenditure and generally low prices of imported goods arising from the appreciation of the rand, led to accelerated growth in the *volume* of merchandise imports. The physical quantity of imported goods rose by 3 per cent in the first half of 2003 and by 7½ per cent in the second half before increasing further by 10 per cent in the first half of 2004. Higher demand for capital goods related to the increase in fixed capital formation led to an increased share of domestic expenditure being met by the importation of goods. South Africa's import penetration ratio rose during all the previous upward phases of economic activity during the 1980s and 1990s. However, during the upward phase of the business cycle that began in September 1999, the increase in the country's import penetration ratio was interrupted and reversed in late 2001 and 2002 due to the sharp decline in the external value of the rand. Subsequently, the import penetration ratio again rose gradually to a level of 22 per cent in the first half of 2004.

Import penetration ratio*



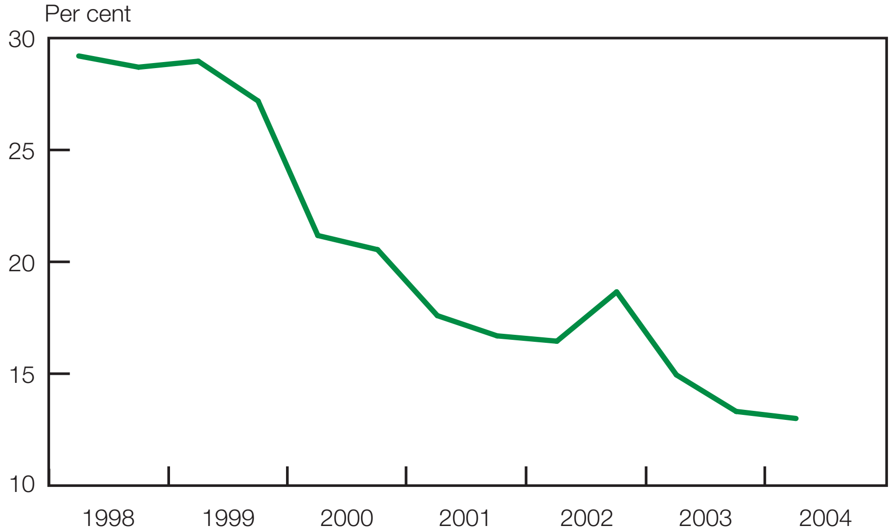
Shaded areas represent the downward phases of the business cycle
* Real imports as percentage of real domestic expenditure

Declining wholesale prices in South Africa's main trading partners and an increase in the average effective exchange value of the rand resulted in a decline of approximately 6½ per cent in the average level of *import prices* from the first to the second half of 2003. With an increase in import volumes of about similar magnitude, the *value* of imports displayed little change over this period. A robust increase in the value of imported goods was registered in the first half of 2004 when the rand prices of imported goods increased marginally as rising oil prices were largely countered by a stronger exchange rate, while quantities imported rose considerably.

Net service, income and current transfer payments

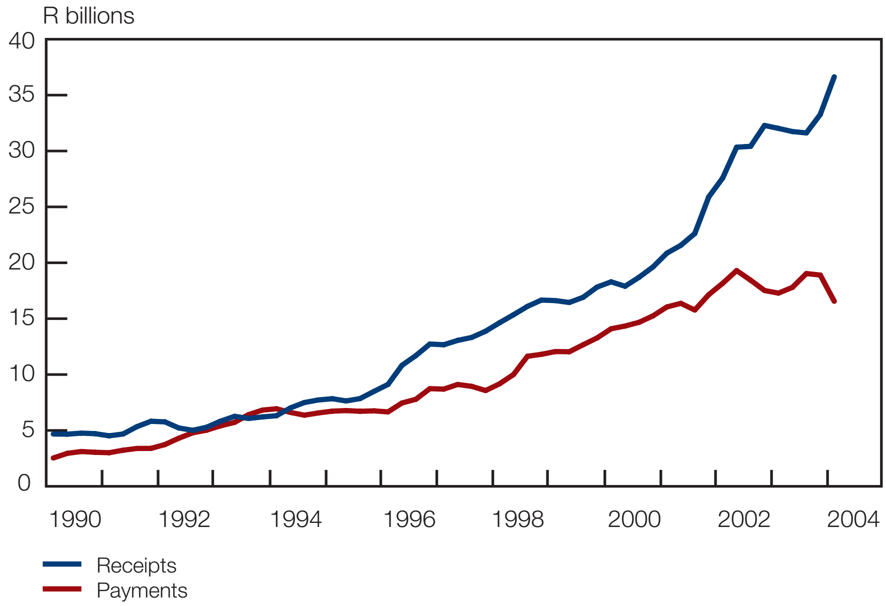
The deficit on the net service, income and current transfer account with the rest of the world narrowed during 2003 before widening in the first half of 2004. As domestic interest rates declined, lower interest payments to non-residents on deposits with South African banks and a reduction in investment in the South African securities market by non-residents, particularly in the second half of 2003, contributed to lower interest and dividend payments. Interest payments as a percentage of gross service and income payments to non-residents decreased from 17½ per cent in 2002 to 14 per cent in 2003 and 13 per cent in the first half of 2004. Income earned by South African residents on their foreign investments also receded somewhat.

Ratio of interest payments to total income and service payments



While on the services account as a whole South Africa continued to record a substantial deficit, within that account the travel component displayed significant changes in the long

Foreign travel: Payments and receipts



run. Whereas in the early 1990s travel payments by South African residents on occasion exceeded travel receipts from non-residents, travel receipts rose far more than travel payments once the domestic political situation had normalised, opening South Africa as a desirable tourist destination far removed from areas of tension or conflict. By the first half of 2004 travel receipts were twice the size of travel payments; at annualised rates they amounted to R35,5 billion and R17 billion, respectively, as shown in the graph on the previous page.

Terms of trade

South Africa's terms of trade improved significantly by more than 3 per cent in the first half of 2004 as prices of exports, assisted by higher non-gold commodity prices, rose faster than import prices. The terms of trade also improved by 4½ per cent in 2003, raising national income, boosting business and consumer confidence and supporting the exchange rate.

Financial account and foreign debt

After having attracted relatively moderate surplus savings from the rest of the world in the second half of 2002, the financial account recorded strong inflows of capital during 2003. The financial account of the balance of payments recorded a surplus of R18,5 billion in the first half of 2003, led by a strong inflow of portfolio investment capital. During the second half of 2003 South Africa recorded its largest capital inflow ever for any half-year period of R44,9 billion, driven mainly by a net inflow of investment capital other than direct and portfolio investment capital. The financial inflow continued unabatedly during the first half of 2004 when a net flow of R41,4 billion was recorded. The volatile nature of inward portfolio investment was again highlighted as large fluctuations were recorded over the past eighteen months.

Net financial transactions not related to reserves

R billions

	2002	2003			2004
	Year	1st half	2nd half	Year	1st half
Liabilities					
Direct investment	7,9	0,5	5,2	5,7	5,6
Portfolio investment	5,4	18,4	-10,5	7,9	19,2
Other investment	0,3	3,6	9,9	13,5	8,7
Assets					
Direct investment	4,2	-2,1	-3,3	-5,4	-9,3
Portfolio investment	-9,7	-0,2	-0,8	-1,0	-1,4
Other investment	16,7	6,9	16,6	23,5	2,9
Total financial transactions*	**30,6**	**18,5**	**44,9**	**63,4**	**41,4**

* Including unrecorded transactions

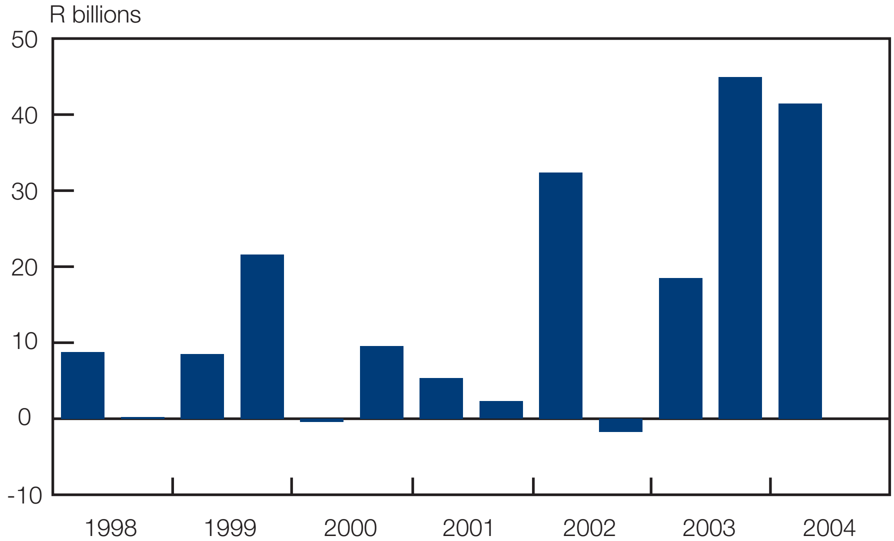
Foreign-owned assets in South Africa

Foreign direct investment liabilities recorded an increase of R0,5 billion in the first half of 2003 which rose to R5,2 billion in the second half. The inflows during 2003 were mainly brought about by an increase in the foreign shareholdings in Iscor, a South African-listed steel company, and the acquisition of a domestic technology firm by a company domiciled in the United Kingdom. An inflow of short-term loan capital to South African enterprises in direct investment relationships with non-resident companies also contributed towards these inflows during 2003. In the first half of 2004 non-resident investors obtained a significant interest in Gold Fields, a listed South African mining company, and a domestic energy exploration company was acquired by a non-resident company. These inflows were, however, partly countered by the sale of foreign direct investors' equity holdings in Telkom, as well as the sale of shares by a non-resident company in a domestic short-term insurance company. Foreign direct investment liabilities, on balance, recorded an inflow of R5,6 billion in the first half of 2004.

Portfolio investment liabilities recorded a sizeable inflow of R18,4 billion during the first half of 2003 when non-residents were net buyers of shares and bonds listed on South Africa's securities exchanges. The issue of an international bond by National Treasury to the value of 1,25 billion euro also contributed to the inflow during the first half of 2003. In the second half of 2003 non-residents became net sellers of South African debt securities and a bond to the value of 256 million euro matured, which resulted in an outflow of portfolio investment liabilities to an amount of R10,5 billion. In the first half of 2004, positive sentiment towards South Africa on account of, among other things, rising commodity prices and relatively low price-to-earnings ratios compared with foreign-listed shares may have encouraged non-resident investors to increase their holdings of South African equity securities. A South African gold-mining company also issued shares to non-residents as a payment for the acquisition of a foreign gold-mining company. However, non-residents remained net sellers of South African rand-denominated debt securities in the first half of 2004. Over the same period the National Treasury also issued bonds to the value of US$1 billion in the international capital market, while a ¥40 billion government bond matured. The net result of these portfolio flows was an inflow of portfolio capital to an amount of R19,2 billion in the first half of 2004.

Other investment liabilities consistently recorded inflows of R3,6 billion and R9,9 billion during the first half and second half of 2003, respectively, followed by a further inflow of R8,7 billion in the first half of 2004. The inflow during the first half of 2003 was mainly the result of an increase in non-resident rand-denominated deposits with South African banks. The inflow of capital in the second half of 2003 was the result of an increase in

Balance on financial account



Including unrecorded transactions

short-term loan capital and non-resident foreign-currency deposits with South African banks, as well as an increase in long-term external borrowing by the private sector. The inflow in the second half of 2003 occurred despite the repayment by National Treasury of a loan valued at US$750 million. In the first half of 2004 an inflow was recorded mainly due to an increase in both rand and foreign-currency denominated deposits of non-residents with South African banks, and despite a further loan repayment of US$750 million by National Treasury.

South African-owned assets abroad

Foreign direct investment assets increased by R2,1 billion and R3,3 billion in the first half and the second half of 2003, respectively, as South African companies continued to acquire dominant interests in offshore companies. An inflow of short-term loan capital was only partly countered by an outflow of long-term loan capital over this period. In the first half of 2004 an outflow of capital of R9,3 billion was recorded as a South African gold-mining company acquired a foreign gold-mining company. This outflow of capital was partly countered by a South African retailer selling its dominant interest in a foreign company and as the repatriation of short-term loan capital, which was previously provided to foreign subsidiaries, occurred.

Portfolio investment assets recorded a subdued total outflow of R1,0 billion for 2003 as a whole. This was partly due to the lacklustre performance of global equity markets and the closing of the cashflow-linked avenue through which institutional investors could previously transfer funds abroad. The acquisition of portfolio investment assets increased in the first half of 2004 as institutional investors increased their investments abroad in terms of the dispensation granted under the prudential regulations promulgated by the authorities.

Other investment assets declined by R6,9 billion in the first half of 2003 and R16,6 billion in the second half of 2003. These inflows during 2003 can largely be attributed to the repatriation of advances for financing foreign trade, which was a reaction to interest rates in South Africa exceeding those in other countries and the strengthening exchange rate. Other investment assets recorded a further net inflow of R2,9 billion in the first half of 2004, reflecting the further strengthening of the exchange rate of the rand over this period.

Foreign debt

Compared to international standards, South Africa's outstanding foreign debt is well within prudent levels – a fact which exerts a positive influence on the country's risk profile in international capital markets. South Africa's ratios of foreign debt to gross domestic product and export earnings have been well below average developing-country ratios for a considerable period of time, and have improved from 2002 to 2003. South Africa's foreign debt, for instance, amounted to only 77,7 per cent of annual export proceeds in 2003, compared with 85,8 per cent in 2002.

The country's total outstanding foreign debt increased from US$32,7 billion to US$37,2 billion from the end of 2002 to the end of 2003. This increase occurred as a result of a roughly equal increase in foreign-currency and rand-denominated debt. Foreign-currency denominated debt increased by US$2,4 billion to a level of US$27,4 billion from the end of 2002 to the end of 2003. This increase occurred as a result of an increase in the category for bearer bonds when the National Treasury issued bonds to the value of 1,25 billion euro on the international capital markets. This inflow was partly countered by the repayment of a 256 million euro bond by the National Treasury. An increase was recorded in the non-monetary private sector's foreign-currency denominated debt, which also reflected the strength of the exchange rate of the rand during 2003. However, these increases were tempered by marginal declines in non-resident foreign-currency deposits with the domestic banking sector and public-sector loan debt.

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

	1999	2000	2001	2002	2003
Foreign-currency denominated debt	**23,9**	**24,9**	**24,0**	**25,0**	**27,4**
Bearer bonds	4,8	5,5	6,0	7,8	9,7
Converted long-term loans	0,4	0,2	0,1	0,0	0,0
Public sector	4,0	4,2	3,0	5,0	4,9
Monetary sector	8,3	8,3	8,9	6,3	5,9
Non-monetary private sector	6,4	6,7	6,0	5,9	6,9
Rand-denominated debt	**15,0**	**12,0**	**6,8**	**7,7**	**9,8**
Bonds	10,7	8,3	4,3	4,5	4,2
Other	4,3	3,7	2,5	3,2	5,6
Total foreign debt	**38,9**	**36,9**	**30,8**	**32,7**	**37,2**

As a result of the appreciation of the exchange rate of the rand, the country's foreign debt measured in rand declined from R283,4 billion at the end of 2002 to R247,2 billion at the end of 2003. The ratio of total external debt to gross domestic product decreased substantially from 30,7 per cent at the end of 2002 to 23,2 per cent at the end of 2003.

Foreign reserves and liquidity

The record surplus on the financial account of South Africa's balance of payments in 2003 dwarfed the deficit on the current account and resulted in an increase in the country's net international reserves on account of balance-of-payments transactions to an amount of R53,3 billion, compared with an increase of R37,1 billion in 2002. The increase during 2003 was concentrated in the second half of the year when the net international reserves rose by R36,0 billion, following an inflow of R17,3 billion during the first half of 2003. During the first half of 2004 the net international reserve position increased further despite a widening deficit on the current account over this period.

The total of the South African Reserve Bank's gross gold and other foreign reserves and the private banks' gross foreign assets increased from US$15,4 billion at the end of December 2002 to US$24,9 billion at the end of December 2003 and further to US$27,9 billion at the end of June 2004. The ratio of gross liquid international asset holdings relative to the value of imports of goods and services (i.e. the import cover ratio) increased from 17,5 weeks' worth at the end of 2002 to 23,5 weeks' worth at the end of 2003. The import cover ratio decreased in the first half of 2004 to a level of 21 weeks' worth at the end of June 2004. Gross liquid international asset holdings now cover roughly 67 per cent of the country's outstanding foreign debt, compared with a ratio of 30 per cent in 2000.

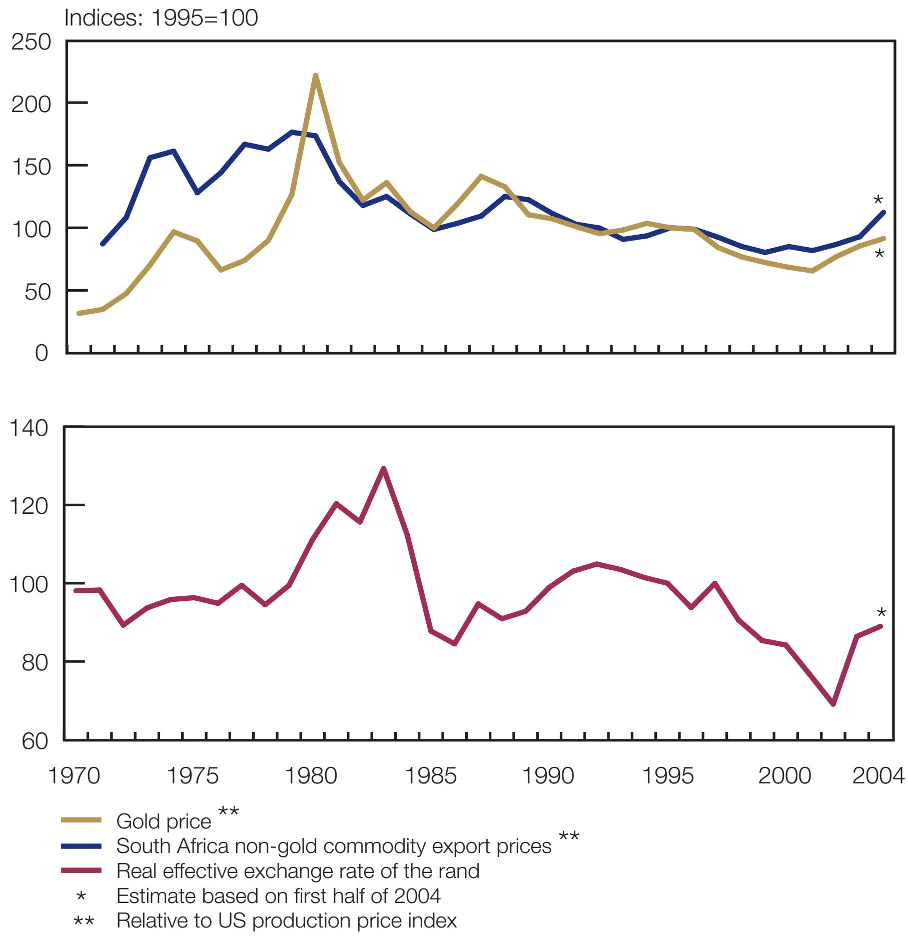
The oversold international liquidity position of the Reserve Bank (previously referred to as the net open position in foreign currency) of US$1,6 billion at the end of December 2002 changed to an overbought position in May 2003, and improved further to US$4,8 billion at the end of December 2003. During the first half of 2004 the international liquidity position continued to improve to a level of US$7,9 billion at the end of June 2004 as the Reserve Bank continued to build up reserves in a gradual fashion. Another milestone was reached when the oversold forward book was closed out during February 2004.

Exchange rates

The recovery in the exchange rate of the rand, which began in the final ten days of 2001, continued through 2002, 2003 and the first half of 2004. After having increased, on balance, by 24,2 per cent during 2002, the nominal effective exchange rate of the rand rose by 16,2 per cent in 2003 and by a further 8,2 per cent in the first half of 2004. This brought the appreciation of the weighted exchange rate of the rand from its low base level at the end of December 2001 to the end of June 2004 to 56,2 per cent.

The exchange rate of the rand continued to be volatile at times during 2003 and the first part of 2004. For example, during April 2003 the nominal effective exchange rate appreciated by 10,2 per cent, coinciding with aggressive buying of South African fixed-interest and equity securities by non-residents, but depreciated again by 14,8 per cent during June 2004. However, when compared with currencies of other commodity exporting countries, the rand in the first half of 2004 resisted some of the volatility in the global market. An analysis of the behaviour of a selection of commodity currencies against the US dollar also reveals that the rand has been less volatile, and even appreciated when other high-yielding currencies like the Australian dollar, New Zealand dollar and Turkish lira were plummeting.

Relative commodity prices and real effective exchange rate



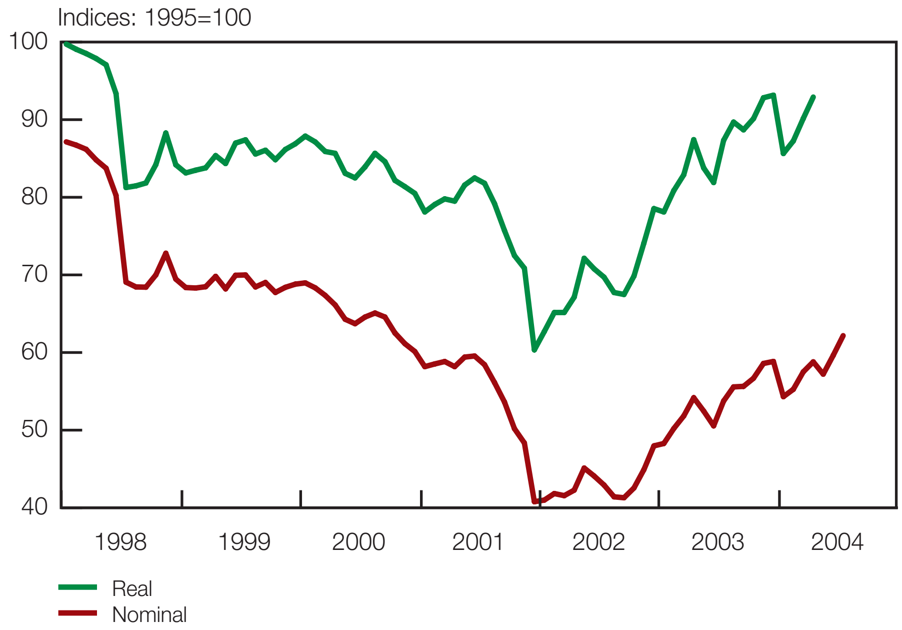
Coefficient of variation of domestic currency against US dollar*

Australian dollar	Turkish lira	New Zealand dollar	South African rand	Canadian dollar
8,28	6,11	4,31	2,62	2,11

* Percentage standard deviation of each currency's monthly average against US dollar from January to July 2004

The strong performance of the rand during 2003 and the first half of 2004 could be attributed, among other factors, to:
- rising foreign-currency prices of South Africa's main export commodities;
- the continued weakness of the US dollar;
- the positive interest rate differential between South Africa and its main trading partners;
- sound monetary and fiscal policies;
- improved international perceptions of the fundamentals of the South African economy, reflected *inter alia* in the upgrading of South Africa's foreign and local currency sovereign debt ratings in May 2003;
- positive perceptions arising from the elimination during May 2003 of the negative international liquidity position of the Reserve Bank and closing out of the Bank's oversold forward book during February 2004; and
- the self-reinforcing expectations arising from a protracted period of appreciation.

Effective exchange rates of the rand



The standard deviation, calculated on a daily frequency from the beginning of 2003 to the end of June 2004 using indices of the rand against the euro was 6,53 and the rand against the US dollar was 11,45. These statistics illustrate the volatility of the US dollar over the past year-and-a-half as well as the fact that the rand exchange rate tracks the movement of the euro, the country's main trading partner, more closely than the movement of the US dollar.

Exchange rates of the rand

Percentage change

	31 Dec 2002 to 30 Jun 2003	30 Jun 2003 to 31 Dec 2003	31 Dec 2003 to 30 Jun 2004
Weighted average*	12,2	3,6	8,2
Euro	7,2	0,7	10,5
US dollar	17,2	11,0	6,1
British pound	14,3	2,7	4,7
Japanese yen	18,4	-1,0	8,0

* Against a basket of 13 currencies

The net average daily turnover in the domestic market for foreign exchange increased to US$9,2 billion in the first half of 2003 from US$7,8 billion in the second half of 2002. It continued to increase in the second half of 2003 and the first half of 2004, recording levels of US$10,9 billion and US$11,0 billion, respectively. Transactions in which non-residents participated increased from 62,7 per cent of total turnover in the first half of 2003 to 68,0 per cent in the second half, and further to 69,3 per cent in the first half of 2004.

Adjusted for the inflation differential between South Africa and its most important trading partners, the average monthly real effective exchange rate of the rand increased by 6,1 per cent over the twelve months to April 2004. This brought the real effective exchange rate of the rand back to its levels of mid-1998, as illustrated in the graph on the previous page.

Monetary developments and interest rates

Structural and regulatory issues

The number of registered banks, mutual banks and local branches of foreign banks in operation declined from 45 at the end of 2002 to 38 at the end of 2003 as consolidation in the banking sector continued. The number rose to 39 at the end of June 2004. The sector remained well capitalised but fairly concentrated, with the five largest banks responsible for some 87 per cent of total banking-sector assets. Some banks consolidated their business positions and disposed of activities with the intention of concentrating on their core business. Domestic banks seeking new geographical markets entered into alliances with foreign banks equally interested in accessing the domestic market without having to set up costly networks. A foreign bank also acquired an online banking enterprise in order to gain entry into the domestic retail banking market.

There was an acceleration in the public offering of preference shares by banks for reasons such as re-capitalising, preparing for further balance sheet expansion, returning shareholders' equity and funding Black Economic Empowerment (BEE) deals. The preference share issues were well received and almost all of them were oversubscribed. The dividends of most of these shares were set around 70 to 75 per cent of the issuing bank's prime overdraft rate.

The new capital adequacy framework generally known as Basel II, developed by the Basel Committee on Banking Supervision, was endorsed by central bank governors and heads of bank supervisory authorities in the Group of Ten countries on 26 June 2004. The Basel II framework sets out the details for adopting more risk-sensitive minimum capital requirements for banking organisations. The less complex standardised and foundation approaches will be implemented from year-end 2006. Provision was made for one extra year of analysis and parallel implementation of the more complex approaches; these will therefore be implemented from the end of 2007. In South Africa it is expected that Basel II will be implemented in accordance with the Basel Committee time frame.

The impact of the implementation of accounting statement AC133 varied across banks. Generally, the results released by banks were not comparable with those published in earlier periods, as AC133 reporting introduced increased volatility. The volatility was further exacerbated by significant changes in interest rates and equity prices during the past year.

The Department of Trade and Industry proposed a new Consumer Credit Act that will replace the Usury Act of 1968, the Credit Agreements Act of 1980 and the Exemption Notices of 1992 and 1999. The new Act intends to improve consumer protection by curbing uncontrolled lending, creating mechanisms to restrict consumers from borrowing beyond their means and forcing creditors to disclose the true cost of debt. These aims were supported by the formation of a credit information ombudsman association and council during 2003. The ombudsman was appointed in February 2004. The revised Code of Banking – voluntarily adopted by the members of the Banking Council – was finalised in April 2004, but will become effective only on 1 October 2004.

The Broad-based Black Economic Empowerment Act, Act 53 of 2003, effective from April 2004, strives to promote economic transformation in order to enable meaningful participation of black people in the economy. The Act empowers government to issue codes of good practice and to publish transformation charters. As a precursor to the Act the Financial Sector Charter was signed on 17 October 2003 and took effect on

1 January 2004, marking the introduction of significant and important developments in the South African financial markets. The Charter aims to address:
- black ownership and participation in the financial sector;
- increased levels of investment in areas of national priority;
- the provision of access to financial services and products for the poor; and
- support to small and medium-sized enterprises.

The Charter sets out targets for the transformation of the industry while still recognising the need to maintain global competitiveness. The focus of the Charter is on management and skills development and a minimum of 25 per cent black ownership is envisaged by 2010. The Charter also emphasises targets for procurement, enterprise development and access to financial services, such as improved access to affordable banking services, contractual savings schemes and credit for small and micro enterprises and poor households.

Initiatives to bank the unbanked contained within the Charter took shape during 2004. Financial services companies agreed to offer banking services to 80 per cent of the population within 20 kilometres from their homes by 2008. The Dedicated Banks Bill and the Co-operative Banks Bill are aimed at addressing this by creating additional tiers of banks and issuing restricted banking licences to encourage new market entrants. These bills are currently in the process of being tabled in Parliament and will be effected within the next few years. Nevertheless, some banks have issued statements detailing their frameworks for broadening access to financial services to be implemented within the current year.

Of importance for the measurement and analysis of the monetary aggregates and credit intermediated by the banking system is disintermediation practices, as there has been a gradual shift from traditional bank lending to the issuance of corporate debt instruments in the recent past. Mergers and acquisitions and the securitisation of assets by banks have also resulted in short-term fluctuations in the measured monetary and credit aggregates. Moreover, deposits with banks faced competition from other financial asset classes during the past year. The increase in the issuance of preference shares at attractive yields and the launch of three retail bonds in two, three and five-year maturities by the National Treasury on 24 May 2004, were examples of this.

The monetary aggregates were revised for the period December 2001 to January 2004 with the release of the March 2004 *Quarterly Bulletin* to include negotiable promissory notes issued by the banks. This was necessitated by the marked shift in banks' issues of negotiable instruments from negotiable certificates of deposit (NCDs) to promissory notes. In turn, this shift was prompted by the scrapping from 1 April 2001 of stamp duties on promissory notes while NCDs remained subject to such duty. Accordingly, the amount of NCDs, which had for many decades been included in the domestic definition of broad money supply (M3), was reduced, while promissory notes with virtually identical economic properties to NCDs increased rapidly. In view of the similarity between NCDs and negotiable promissory notes it was decided to also include the latter in M3. This action noticeably raised the level and growth rate of M2 and M3 in particular.

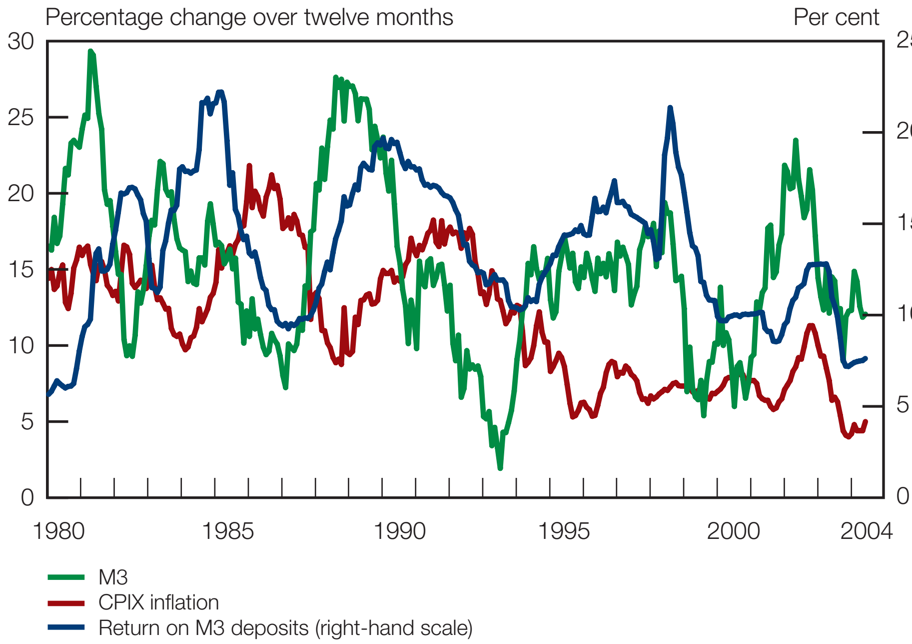
Subsequently, stamp duty on NCDs was eliminated from 1 April 2004. Nevertheless, since both negotiable promissory notes and NCDs are currently included in the calculation of M3, recoil to either instrument will not have any adverse implications for the calculated monetary aggregates.

Money supply

With the geopolitical uncertainties surrounding the war in Iraq abating during the second quarter of 2003 and with actual and projected inflation decelerating, the Reserve Bank started to reduce its repurchase rate. Lower inflation, lacklustre growth in real gross domestic product and declining interest rates combined to reduce money supply growth during the past year.

Growth over twelve months in the broad money supply (M3) accelerated considerably in 2001 and 2002 in the wake of increasing uncertainty induced by the exchange rate and higher interest returns on M3 deposits. M3 recorded a high growth rate of 23,5 per cent in May 2002. Growth in M3 remained high in the subsequent months up to early 2003, but thereafter fell back significantly. The own interest return on monetary assets receded while inflation decelerated simultaneously; at the production-price level extremely low and even negative inflation was recorded, moderating the transactions demand for money.

Growth in M3, CPIX inflation and return on M3 deposits



The nominal return on M3 deposits, although lowered considerably in the second half of 2003, consistently remained above CPIX inflation. Whereas lower interest rates somewhat perversely reduce the demand for M3 over the short term due to the interest-bearing nature of most of the deposits included in M3, they tend to raise the demand for cash and those deposits on which low or no interest is paid. Accordingly, growth in the narrower monetary aggregates M1A and M1, which had been on a downward trend since the first half of 2002 up to the third quarter of 2003, accelerated significantly in the ensuing months up to June 2004. The high growth rates recorded in these aggregates during this period were mainly on account of the decline in interest rates and above-inflation wage settlements effected during the second half of 2003. Both notes and coin in circulation outside the monetary sector and cheque and transmission deposits contributed significantly to the recently recorded brisk increase in M1A, as reflected in the table on the following page.

In the early months of 2004 there was also a growing preference for deposits with longer-term maturities, which was aligned to the movements in the interest rates offered by banks as some market participants discounted expected increases in the official rates towards the end of 2004 and during 2005.

Growth in monetary aggregates

Percentage change over twelve months to end of period

	2001	2002	2003	Jun 2004
Notes and coin in circulation	6,6	15,6	15,4	17,3
Cheque and transmission deposits	21,1	7,8	9,6	18,4
M1A	18,8	8,9	10,5	18,3
Other demand deposits	15,5	15,8	3,9	17,6
M1	17,3	11,9	7,5	18,0
Other short and medium-term deposits	13,4	20,8	25,3	1,5
M2	15,7	15,6	15,2	9,7
Long-term deposits	34,0	31,3	-10,8	29,5
M3	17,3	17,2	12,3	11,8

The corporate sector's deposit holdings rose by R69,8 billion in the twelve months to June 2004. Cash received at the end of February 2004 from the redemption and coupon interest payments on government bonds contributed to this increase although only on a temporary basis, as most of the funds were redirected and invested in other financial asset classes in the ensuing months. Conversely, the household sector's deposits rose by R18,4 billion over the twelve months to June 2004, partly reflecting growth in real disposable income discussed elsewhere and the decline in interest rates effected during the second half of 2003.

Growth in M3 exceeded growth in gross domestic product, causing the income velocity of circulation of M3 to recede from 1,73 in the first quarter of 2002 to reach record low levels of 1,60 in the first quarter and 1,58 in the second quarter of 2004. Conversely, M3 as a percentage of GDP increased noticeably from levels around 58 per cent in the fourth quarter of 2002 to 63 per cent in the second quarter of 2004.

The counterparts of the change in M3 are presented in the accompanying table. The net foreign assets of the monetary sector increased significantly during 2003, partly on account of the dispensation which came into effect on 1 May 2003 that allows South African branches of foreign banks to invest offshore up to 40 per cent of deposits raised domestically. However, during the first half of 2004 the reserves accumulation programme of the Reserve Bank also contributed meaningfully to the increase in the net foreign assets of the monetary sector. The Bank's reserves benefited from moderate foreign exchange purchases in the market and the foreign currency proceeds received from the government's issue of a US$1 billion ten-year global bond.

Counterparts of change in M3

R billions

Counterparts	2002	2003	1st half of 2004
Net foreign assets	76,0	61,6	20,8
Net claims on the government sector	19,8	-19,3	15,1
Gross claims	*17,5*	*19,2*	*0,4*
Government deposits (decrease +; increase -)	*2,3*	*-38,5*	*14,7*
Claims on the private sector	29,7	134,8	-1,2
Investments and bills discounted	*-18,5*	*51,8*	*32,8*
Total loans and advances	*48,2*	*83,0*	*31,6*
Net other assets and liabilities	-22,9	-91,6	15,4
Total change in M3	102,5	85,5	50,1

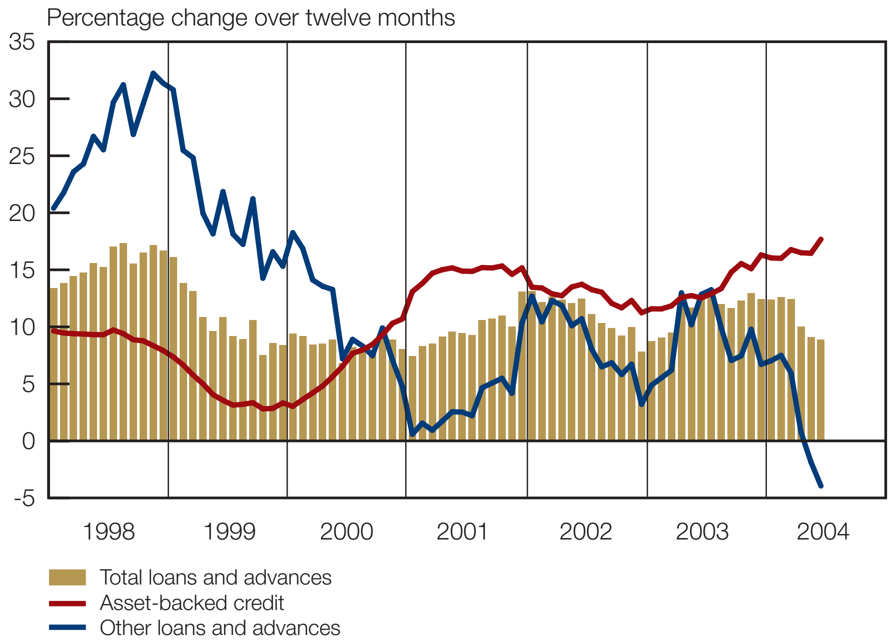
Net claims on the government sector declined during 2003, mainly on account of a build-up in government deposits in preparation for the redemption of the eurobond loan at the end of January 2004 coupled with the redemption of the R006 government bond and coupon interest payments on various government bonds at the end of February 2004. This decline in net claims on the government sector was reversed to an increase during the first half of 2004, partly reflecting the conclusion of the abovementioned transactions. The payment of R7 billion in zero-coupon bonds to the Reserve Bank on 1 April 2004 as part payment of the outstanding balance on the Gold and Foreign Exchange Contingency Reserve Account also contributed to the increase in claims on the government sector. However, in June 2004 government deposits increased, mainly reflecting the rand proceeds of the US$1 billion ten-year global bond issued.

With the effects of accounting statement AC133, which was first implemented in early 2003, fading away in the investments and the bills discounted categories, claims on the private sector declined significantly during the first half of 2004 following considerable increases recorded during 2003. A similar effect occurred in *net other assets and liabilities*, mainly due to the effect of AC133 on liabilities in respect of derivatives instruments, which form part of this accounting counterpart to changes in M3.

Credit extension

Twelve-month growth in total loans and advances extended to the domestic private sector fluctuated around 12 per cent during most of 2003 and the first few months of 2004. Notable factors supporting this firm growth were the reduction in the level of interest rates during the second half of 2003, increases in real disposable income, the positive wealth effects associated with rising homeowners' equity following the sustained increases in fixed property prices, and more generally improved consumer and business confidence. These factors supported strong growth in domestic expenditure. However, growth in credit extended by the banks was moderated by disintermediation evidenced by the funding of the corporate sector's capital outlays outside the banking sector, mergers and acquisitions, and the securitisation of loans.

Total loans and advances



Growth in total loans and advances was mainly driven by the brisk demand for asset-backed credit. Such loans increased by R75,0 billion in the twelve months to June 2004. Measured over twelve months, growth in asset-backed credit had reached levels of around 16 per cent since December 2003.

A disaggregated analysis of total loans and advances shows that a large share of asset-backed credit extended during the year to June 2004 was in the form of mortgage advances. Mortgage advances contributed R54,7 billion to the overall increase in asset-backed credit. This strong growth was consistent with the buoyant trading conditions in the real-estate market which were supported by lower interest rates and wealth effects emanating from increases in fixed property prices. The changing socioeconomic environment with a growing black middle class also contributed to the demand for mortgage advances. Moreover, the relative attractiveness of fixed property as an investment asset class supported brisk demand for mortgage advances judging from the demand by foreigners and the popularity of buy-to-let properties.

Instalment sale credit and leasing finance, which are mainly directed at financing expenditure on vehicles and other durable goods, remained strong in the twelve months to June 2004. This credit category contributed R20,3 billion to the overall increase in asset-backed credit. However, the twelve-month growth in instalment sale and leasing finance was restrained briefly during the fourth quarter of 2003 by the securitisation of a portion of a bank's instalment sale agreements book. The brisk demand for instalment sale credit and leasing finance was consistent with strong growth in domestic expenditure supported by the moderation in the prices of motor vehicles, fleet replacement programmes in some sectors of the economy and the relative price competitiveness of imported durable goods following the sustained strength of the exchange rate of the rand.

Increases in credit extended to the private sector by type of credit

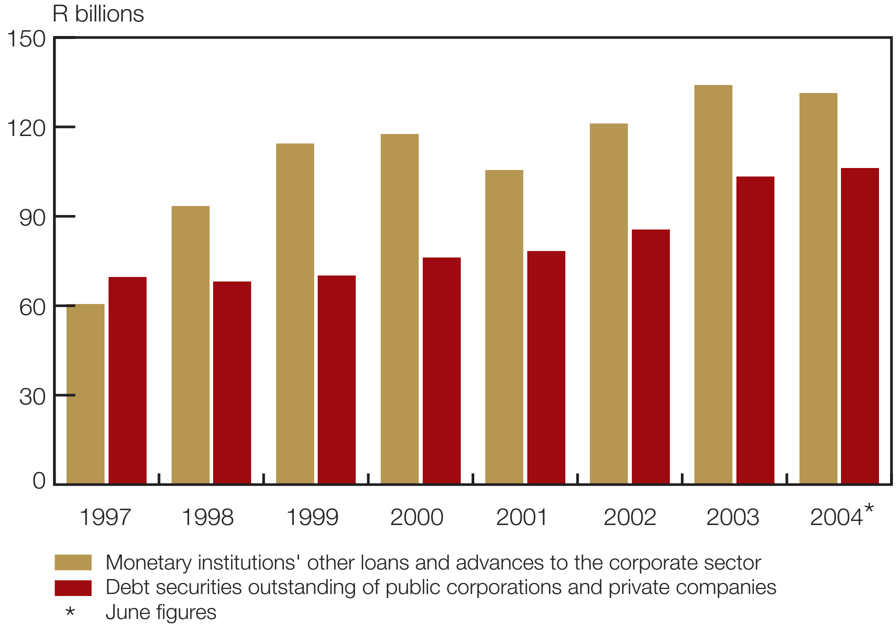
R billions

	2001	2002	2003	1st half of 2004
Instalment sale credit	7,8	11,7	12,6	8,4
Leasing finance	5,9	1,3	5,8	2,6
Mortgage advances	32,9	26,8	45,8	29,9
Other loans and advances	24,4	8,4	18,7	-9,2
Total loans and advances	**71,1**	**48,2**	**82,9**	**31,7**

The *other loans and advances* category comprises overdrafts on current-account, credit card and general advances to the private sector. The corporate sector in particular makes use of facilities in this credit category. Over the years, gradual exchange control relaxation, actual and envisaged changes in the financial regulatory environment, changes in the corporate tax structure, innovation and technological advancement, and the implementation of black economic empowerment policies are among the factors that contributed to the structural changes in the financial markets and the economy in general. These factors, in turn, resulted in changes in the competitive structure of the financial sector and the funding strategies of the corporate sector, notably in the area of capital management where there has been an expansion in the range of available financial instruments.

Depending on the nature of the projects undertaken by the corporate sector and the available opportunities and incentives in the respective financial sub-markets, co-movement or an inverse relationship exists between and among different sources of funding. While *other loans and advances* is a relatively volatile credit category, historical data indicate that it is affected by, among other factors, changes in the exchange rate of the rand and its impact on the direction of international trade-related capital movements, corporate sector expectations of changes in the exchange rate, fixed capital formation and inventory accumulation.

Selected sources of funds for the corporate sector



Although banks remain the most important source of funding for the corporate sector through loans and advances, the issuance of corporate debt securities grew significantly, as shown in the graph. Private-sector corporate debt securities relative to total outstanding bank credit to the corporate sector in the other loans and advances category increased markedly from 3,7 per cent in 1997 to 16,1 per cent in 2002, 24,6 per cent in 2003 and further to 34,8 per cent in the first half of 2004. However, it should be noted that in May 2004

Banks' loans and advances by industry

	Jun 2003 R billions	Jun 2004 R billions	Change Per cent
Agriculture, forestry and fishing	16,7	20,9	25,1
Mining	13,4	14,4	7,5
Manufacturing	42,0	47,4	12,9
Construction	8,5	8,1	-4,7
Electricity, gas and water	14,6	18,1	24,0
Trade and accommodation	26,7	30,6	14,6
Transport and communication	15,9	15,0	-5,7
Finance and insurance	248,8	259,7	4,4
of which interbank	*68,4*	*66,4*	*-2,9*
Real estate and business services	71,2	99,5	39,7
Community, social and personal services	31,4	35,8	14,0
Individuals	333,7	366,5	9,8
Other	75,4	65,5	-13,1
Total	966,6	1 047,9	8,4

the absorption of the assets of a monetary bank into a non-monetary institution heightened the decline in *other loans and advances* of the banking sector.

Banks' loans and advances by industry is shown in the table on the previous page, indicating that over the past year a significant amount of credit was extended to the real-estate and business services sector of the economy.

While banks and their clients are currently experiencing favourable bank lending conditions as evidenced by the brisk growth in asset-backed credit, the downward trend displayed by banks' non-performing loans suggests that banks have remained prudent in their lending activity.

Interest rates and yields

The framework for monetary policy was adjusted during the past year when, following a review of the inflation-targeting framework, the Minister of Finance and the Governor of the Reserve Bank agreed in November 2003 to change the measurement option for targeted inflation to a *continuous* twelve-month basis. Thus, CPIX inflation must remain in the 3-to-6-per-cent target range at all times, and this target range will apply at least until 2006. Previously the annual average CPIX inflation rate, calculated on a calendar-year basis, was formally targeted.

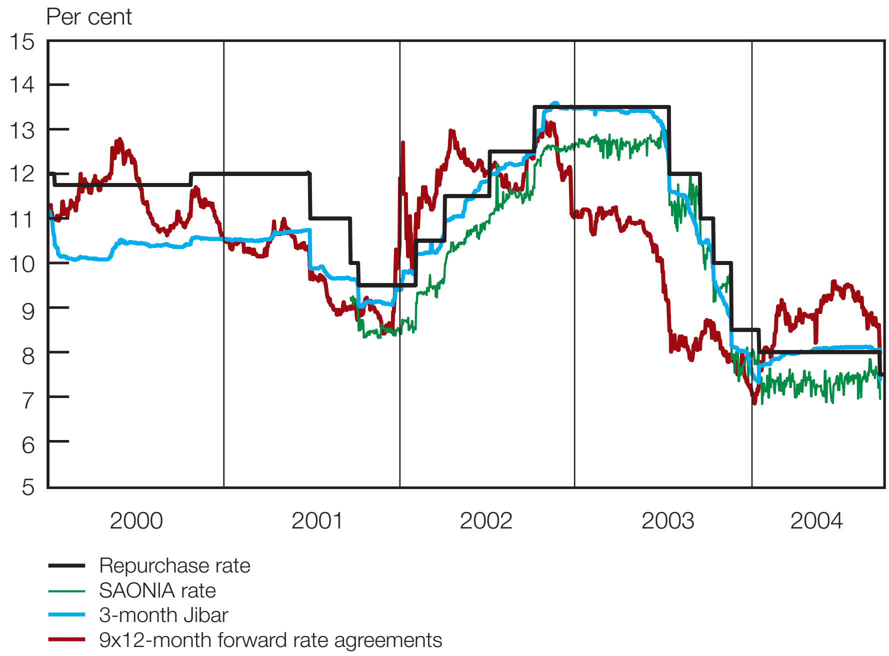
The Reserve Bank's repurchase rate was maintained at 13,5 per cent from September 2002 to mid-2003 in order to first contain and then reverse the acceleration in inflation which followed the depreciation of the exchange rate of the rand in 2001. Besides the downward revision of the CPIX inflation data by almost 200 basis points in May 2003, the sustained prudent monetary and fiscal policies and the significant recovery in the exchange rate were important factors that brought the inflation rate to levels within the target range.

Against the background of these developments, the repurchase rate was reduced by a cumulative 5,5 percentage points during the period from 13 June 2003 to 11 December 2003. This downward movement of the repurchase rate was also characterised by some of the biggest single interest rate reductions since the formal targeting of inflation had started in 2000, when the repurchase rate was reduced by 1,5 percentage points on 13 June and again on 17 October 2003. On one occasion an unscheduled MPC meeting was convened to review the policy stance, necessitated by the release of economic indicators with a significant bearing on the outlook for inflation. As can be seen from the graph on the opposite page, the downward adjustments in the repurchase rate during 2003 more than reversed the 400-basis-point increase during 2002.

With the outlook for inflation remaining consistent within the inflation target, the MPC left the repurchase rate unchanged at 8,0 per cent at its meetings in February, April and June 2004. Better-than-expected inflation outcomes fed into a lower projected path for future inflation at the August 2004 meeting, whereupon the MPC decided to lower the repurchase rate by a further 50 basis points to 7,5 per cent. The official policy rate of the Reserve Bank is currently at the lowest level since 1980.

Throughout the period of the decline in the repurchase rate, the South African Overnight Interbank Average (SAONIA) rate broadly followed the movements of the repurchase rate and declined by a total of 559 basis points from 12,91 per cent on 12 June to 7,32 per cent on 12 December 2003. With the repurchase rate subsequently unchanged, the SAONIA rate remained within a range of 6,84 per cent to 7,84 per cent up to early August 2004. It receded in response to the lowering of the repurchase rate announced on 12 August.

Money-market interest rates



Other money-market interest rates also responded to the successive reductions in the repurchase rate since mid-2003. For instance, the 3-month Johannesburg Interbank Agreed Rate (Jibar) shed a total of 493 basis points from 12,25 per cent to 7,32 per cent during the declining phase of the repurchase rate in 2003. The Jibar reversed this trend, consistent with the correction in other money-market interest rates, following the less-than-expected repurchase rate reduction in December 2003. This upward trend continued into 2004, partly reflecting market expectations of interest rate increases going forward, but was abruptly reversed following the 12 August reduction of the repurchase rate.

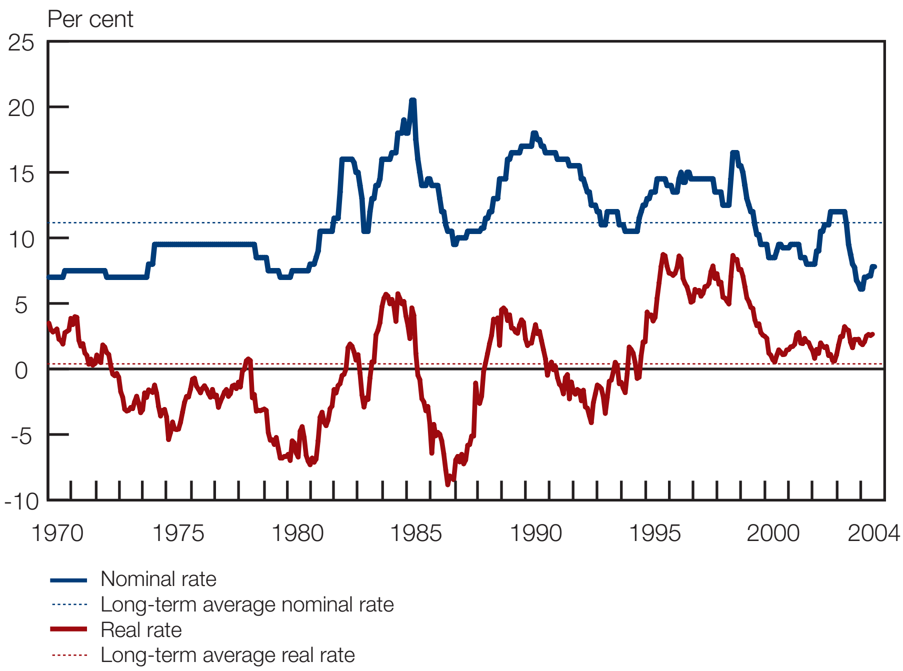
The rate on 91-day Treasury bills also mirrored the downward trend in the repurchase rate. The Treasury bill rate was influenced by the demand for liquid assets, which was raised towards the redemption of the R006 government bond at the end of February 2004. On 2 January 2004, the National Treasury increased the amount of such bills on offer at its weekly auction from R1,5 billion to R1,8 billion mainly to raise additional funding for the redemption of debt securities and interest payments at the end of February 2004. Nevertheless, the rate on 91-day Treasury bills continued to vary in a relatively narrow range of 7,46 per cent to 7,87 per cent in the six months to June 2004.

Rates on forward rate agreements (FRAs) increased across the money-market yield curve from late 2003 to mid-2004, indicating expectations of higher interest rates. The FRA curve by mid-2004 appeared to discount increases in the repurchase rate towards the end of 2004 and during 2005. An improvement in inflation expectations led to a reduction in forward rates in July and August 2004.

The private banks lowered their *predominant rate on mortgage loans* in five steps from 17 per cent in May 2003 to 11½ per cent in December 2003, the lowest level since February 1980. The rate declined further to 11 per cent in August 2004, as did the banks' *prime overdraft rate*.

Private banks reduced their *predominant rate on twelve-month fixed deposits* by 590 basis points from 12,0 per cent in April 2003 to 6,1 per cent in December – a level previously experienced in 1966. As the expectations of further reductions in short-term interest rates waned and rising money-market interest rates became more widely expected, the private banks raised the predominant rate on twelve-month fixed deposits to 7,1 per cent in April 2004 and further to 7,8 per cent from June. Currently, nominal deposit rates are well below their long-term average of around 11 per cent. In real terms, using historical year-on-year increases in CPIX to adjust nominal rates, twelve-month fixed deposits offered investors a real pre-tax return of 2,7 per cent in June 2004, somewhat better than the average real return of 1,8 per cent since January 2000, much higher than the long-term average of 0,4 per cent, and a vast improvement on the negative real rates frequently encountered in the 1970s and 1980s. The highest real rates were recorded from 1995 to 1998.

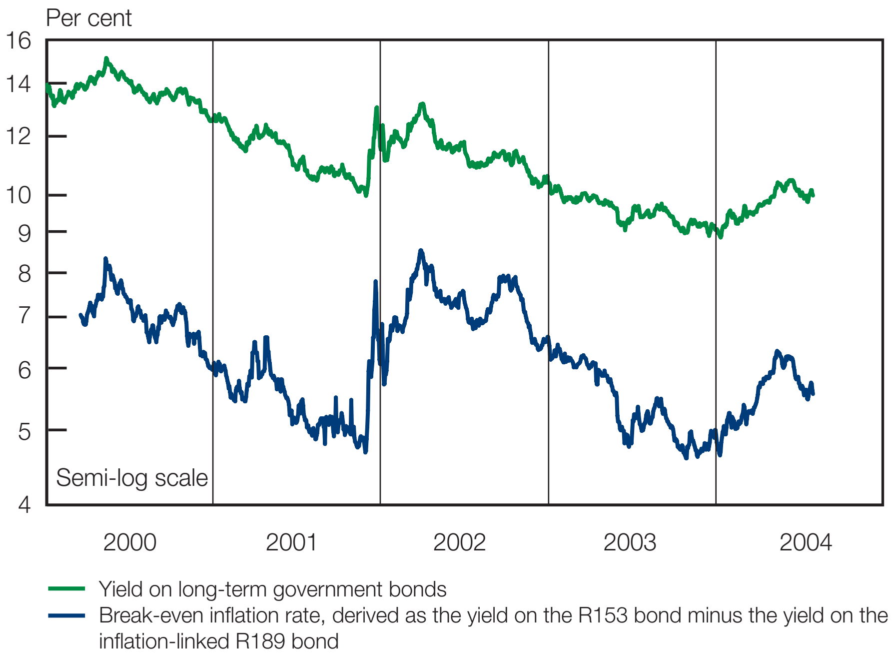
Banks' nominal and real 12-month fixed deposit rate



The *official rate of interest* applicable to fringe benefit taxation was reduced on four occasions from 14½ per cent in March 2003 to 9 per cent effective from 1 March 2004. On 6 February 2004 the *maximum annual finance charges rates* on money loans and credit and leasing transactions, as laid down by the Usury Act, were lowered by one percentage point to 21 per cent for amounts of less than R10 000 and to 18 per cent for amounts above R10 000, but not exceeding R500 000. The decrease brings the total reduction in the usury rates to 800 basis points for each category since June 2003.

Long-term bonds enjoyed a bull run from April 2002 in the wake of the sustained recovery in the exchange value of the rand and improved near-term inflation prospects. The *yield on long-term government bonds* fluctuated downwards, briefly declining to a recent daily low of 8,88 per cent on 12 January 2004 – its lowest level since 1979. An upward bias then set in, resulting from, among other things, the bottoming out of the downward trend of inflation. Expectations were that inflation may increase following higher oil prices, while there was a steady supply of both government and corporate bonds, and bond yields in the developed markets began to rise. In response, long-term bond yields increased rapidly to a high point of 10,53 per cent on 15 June 2004 as the market increased its focus on the risks to domestic inflation. Subsequently, bond yields eased somewhat to 10,06 per cent at the end of July following a firmer exchange value of the rand that resulted in market participants postponing their expectations of a tightening of the domestic monetary policy stance.

Bond yield and break-even inflation rate



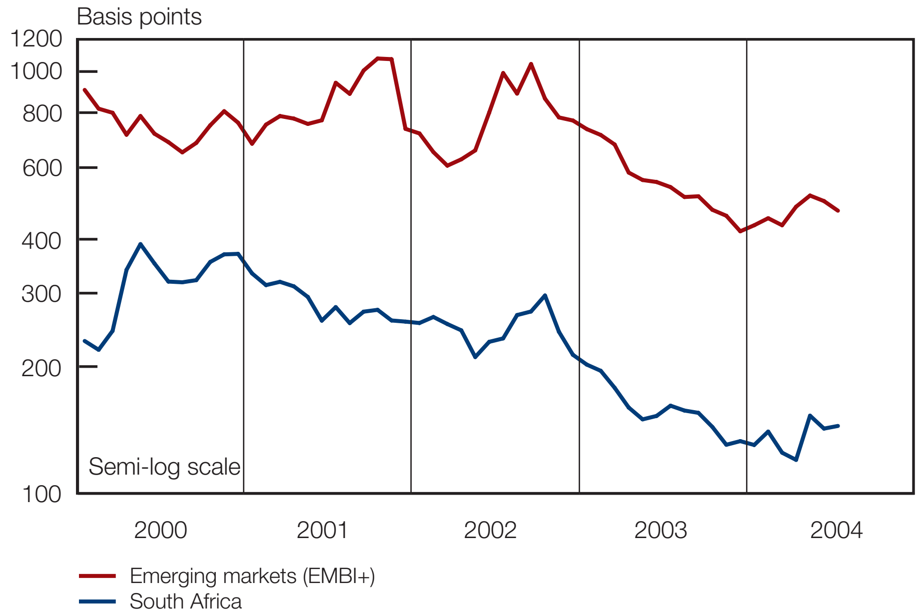
Due to the brisk deceleration in CPIX inflation in 2003 the *real or inflation-adjusted yield on long-term government bonds* (using historical year-on-year increases in CPIX as an indicator of expected future price changes) improved markedly from a negative value of 0,4 per cent in November 2002 to a positive level of 4,9 per cent in December 2003. In 2004 the sharply higher bond yields and subdued inflation resulted in the real yield improving further to 5,6 per cent in May, the highest real yield since June 2000, before declining somewhat to 5,1 per cent in June. Long-term government bonds presented investors with positive real yields of, on average, 5,8 per cent from January 1995 despite a general downward bias in nominal yields over this period.

After declining by 102 basis points in 2002, the *real yield on government's R189 inflation-linked bond* remained relatively stable at just below 4,0 per cent in 2003. It declined to a low of 3,6 per cent in April 2004, increasing somewhat to 3,8 per cent in July. The sharp increase in nominal yields on conventional bonds during the first half of 2004, alongside the lower yields on inflation-linked bonds, resulted in a rapid increase in the *break-even inflation rate.* This approximation of expected long-term inflation is calculated as the difference between the nominal yield on conventional bonds and the real yield on inflation-linked bonds within the five-to-nine-year maturity range. After declining progressively from a monthly average level of 6,3 per cent in January 2003 to a recent low of 4,8 per cent in December, expected long-term inflation derived in this way increased sharply to 6,1 per cent in May 2004. It thereafter levelled out and declined slightly to 5,6 per cent in July on account of the positive impact of the renewed strengthening of the exchange value of the rand and inflation, which remained at a low level.

Because of the sharp increase in bond yields in the domestic market the *currency risk premium* on South African government bonds (measured as the differential between yields on rand-denominated South African government bonds in the five-year-maturity range issued in the domestic market and those issued in the United States market and denominated in dollar) widened by 130 basis points from October 2003 to March 2004. The currency risk premium, however, narrowed by 90 basis points to July when the yields on foreign-issued South African bonds also moved higher, exceeding the increase in domestic yields.

Foreign investors reassessed their exposure to emerging-market sovereign debt against the backdrop of generally rising yields on bonds issued by the United States Federal Government. Reflecting this change in foreign investor sentiment in the North American market, the yield spread of emerging markets' sovereign debt over benchmark United States Treasury Bonds (measured by the JP Morgan Emerging Markets Bond Index or EMBI+) widened significantly from 418 basis points in December 2003 – its lowest level since before the emerging-markets financial crisis in 1998 – to 508 basis points in May 2004 before narrowing to 466 basis points in July 2004.

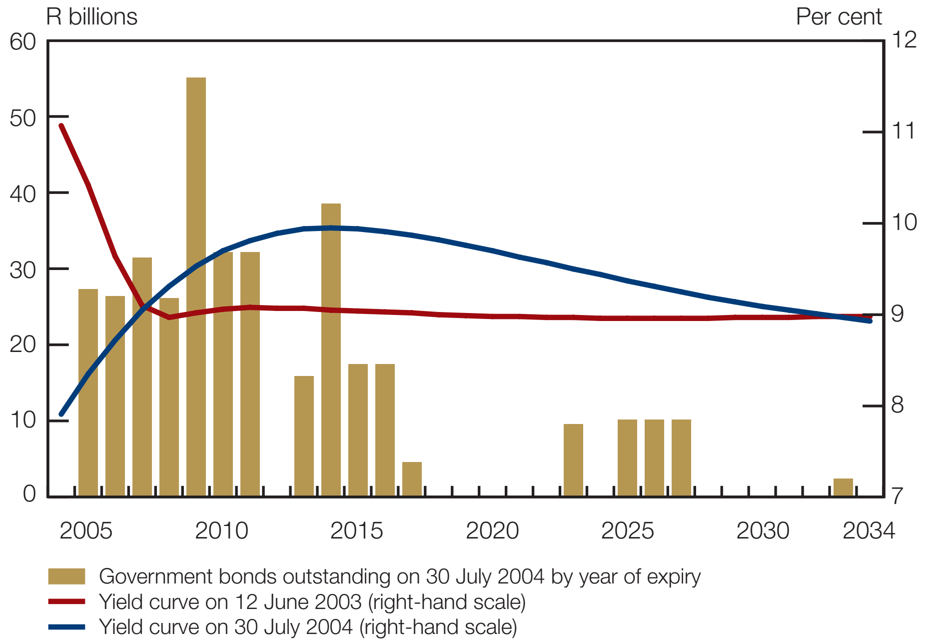
Yield spreads over United States government bonds of emerging-market foreign-currency denominated debt



Broadly echoing this, the *country risk premium* on South African bonds continued to narrow until April 2004 before picking up from May 2004. South Africa's foreign-currency denominated bonds that trade in international bond markets are rated considerably higher than those issued by governments of other emerging-market economies. Therefore, notwithstanding a higher emerging-markets risk premium, the issue by South Africa of a ten-year US dollar-denominated bond at the end of May 2004 was priced at only 195 basis points above US Treasury notes of similar maturity – the country's lowest ever spread in the dollar bond market.

The new issue was supported by investment grade ratings assigned to South Africa by several international ratings agencies. These ratings were in line with South Africa's sovereign credit risk ratings and recognise the prudent macroeconomic policies, declining debt and political stability of the country. The yield spread on the South African dollar-denominated bond stood at 157 basis points at the end of July 2004, compared with the sovereign risk premium of 466 basis points of emerging markets in general.

Government bonds in issue and the yield curve



The downward sloping *yield curve,* which persisted from April 2002 into the first half of 2003 flattened out and began to assume a normal shape following the change to a more accommodative monetary policy stance. The level of the inverted yield curve at first shifted downwards across the full maturity spectrum from the end of May 2003 to 17 June in the wake of the reduction of the repurchase rate on 13 June. Following further successive relaxations of the monetary policy stance, the yield curve changed to sloping upwards from 9 September and continued to shift downwards until 12 January 2004 – more at the short end than at the long end – as bond yields across the maturity spectrum declined to levels previously experienced in the 1980s. The slope of the yield curve subsequently steepened significantly in the months that followed. Yields on short-dated bonds remained anchored to the repurchase rate while bond yields across the rest of the maturity spectrum moved upward in response to a steady supply of bonds and the prospect of somewhat higher inflation during the latter part of 2004. At the end of July the yield curve flattened somewhat as the inflation outlook became more benign, with the continued resilience of the exchange value of the rand resulting in market participants postponing their expectations of an increase in the repurchase rate.

Financial markets

Structural and regulatory changes in financial markets

The South African financial environment continued to undergo regulatory and legislative reform. Within a framework of sound regulation, supervision and increased transparency, the focus remained on consumer protection and the promotion of black economic empowerment. Some of the developments have been discussed in the section on *Monetary developments and interest rates*, while others are discussed below.

The status of the Public Investment Commissioners is currently under review. The Public Investment Corporation Bill, currently in draft format, aims to establish a statutory corporation to be known as the Public Investment Corporation. The corporation will be subject to regulation through the Financial Markets Control Act, 1989 and the Stock Exchanges Control Act, 1985. The corporatised institution will be governed by a board of directors and shall continue to be accountable to government.

The Financial Services Board is in the process of considering whether hedge funds should be formally accommodated in the existing regulations governing collective investments and the market conduct of financial intermediaries. Currently, hedge funds fall outside the scope of existing regulation and, as such, may not be marketed as a regulated product. Regulation will legitimise the hedge fund industry and create a more transparent and sound environment for managers and make it accessible to the general investing public through responsible marketing.

The Insurance Amendment Act, No 17 of 2003, was introduced in August 2003 to substitute some definitions and refine some of the schedules in the Long-term Insurance Act, No 52 of 1998 and Short-term Insurance Act, No 53 of 1998. The amendments improve consumer protection and existing defences against systemic risk through the adoption of prescribed requirements for calculating the value of assets, liabilities and capital adequacy requirements. In terms of the Act the Financial Services Board must be kept informed of appointments and departures of executive officers.

Two supplementary Acts to the Pensions Fund Act, No 24 of 1956, Pensions (Supplementary) Act, No 8 of 2003 and the Pensions Second (Supplementary) Act, No 39 of 2003, were introduced in April and December 2003 to provide for the award of certain pension benefits, such as arrear pension benefits. Legislation and regulation in process, among other things, deal with the requirement of formal statutory valuations and the fair apportionment of surplus funds between existing members, pensioners, previous members and employers. The intention is also to prevent pension funds from maintaining reserves at unreasonable levels to smooth investment returns or meet future increases in costs.

The Financial Advisory and Intermediary Services Act (FAIS), No 37 of 2002, requires financial service providers to be registered with the Financial Services Board from October 2004. Those who do business without licences risk prosecution under the Act, which provides for harsh punishment. The purpose of the Act is to promote sound advice to consumers by ensuring that any person performing a function as a financial adviser is competent to do so and adheres to an appropriate code of conduct.

The deadline for client verification by banks and providers of investment services, a requirement of the Financial Intelligence Centre Act, No 38 of 2001, was initially 30 June

2004 but was extended by the Minister of Finance due to difficulties experienced by these institutions in meeting their obligations. Subject to progress reports and the verification of categories of clients according to a series of time frames, brokers and investment managers now have until June 2005, and banks until September 2006, to complete client verification.

Other legislative changes affecting financial markets announced in the Budget of the national government for fiscal 2004/05 include the following:

- A further reduction in the transfer duty rate structure in respect of the acquisition of fixed property, effective from 1 March 2004.

- Proposed legislation to allow for the tax-free transfer of shares to employees (capped at a certain amount) in order to encourage broad-based employee participation in companies.

- A proposal to address the tax treatment of hybrid financial instruments.

- The removal of stamp duties on mortgage bonds, effective from 1 March 2004, and on negotiable certificates of deposits from 1 April.

- Removing uncertainty by declaring that derivatives are a VAT exempt financial service.

- Refinements to the Mineral and Petroleum Royalty Bill which include a delay in the introduction of mining royalties until 2009 while an overall review of the mining industry tax regime is undertaken.

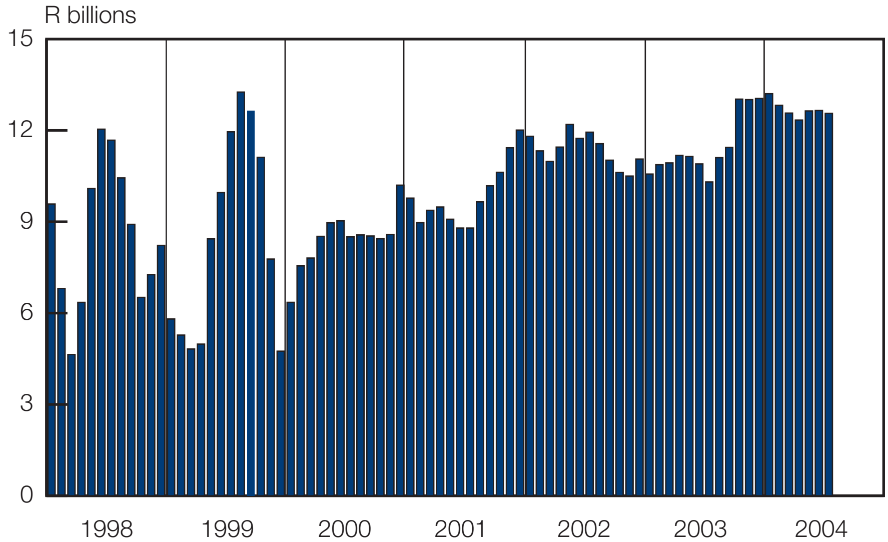
In recent months various initiatives were undertaken by the JSE Securities Exchange SA (JSE) to broaden services rendered to the financial markets. To promote the equity financing of small and medium companies the first alternative exchange in Africa, named Alt^{x}, was launched by the JSE on 27 October 2003. Alt^{x} will replace the venture and development capital markets established by the JSE in the late 1980s. The first listings took place on 29 January 2004 when Beige Holdings and Insurance Outsourcing Managers Holdings transferred their listings to the new market. In addition, a number of new indices were launched by the JSE in the first months of 2004. Those included, among other things, the launch of the Social Responsibility Investment Index on 20 May, which highlights corporate social and environmental responsibility. In addition, a Style Index series, based on the value and growth characteristics of companies, is planned for the third quarter of 2004. Together with the Department of Trade and Industry the JSE further aims to allow other African exchanges to leverage off the JSE's infrastructure with the ultimate objective of creating a Pan-African Board.

Money market

The average daily liquidity requirement of the banks was raised moderately from around R11 billion in the first nine months of 2003 to around R13 billion in the subsequent period up to July 2004. This upward adjustment coincided with the draining of an additional R2 billion in liquidity as banks had to top up their cash reserve balances with the Reserve Bank. In turn, this resulted from the penultimate step in the phasing out of vault cash as a recognised part of the banks' qualifying cash reserve holdings: From September 2003 the banks were only allowed to deduct 25 per cent of their vault cash holdings when calculating their required cash reserve deposits with the Reserve Bank.

The weekly main repurchase auction continued to be the main conduit for meeting the banks' liquidity requirement, with supplementary and final repurchase auctions and banks' recourse to their cash reserve accounts absorbing smaller fluctuations in liquidity. Some technical refinements to the Reserve Bank's refinancing system are currently under investigation, but would not alter the central feature – that of a repurchase rate, announced by the Bank's Monetary Policy Committee, serving as an anchor for short-term interest rates.

Total liquidity requirement



Monthly average of daily values

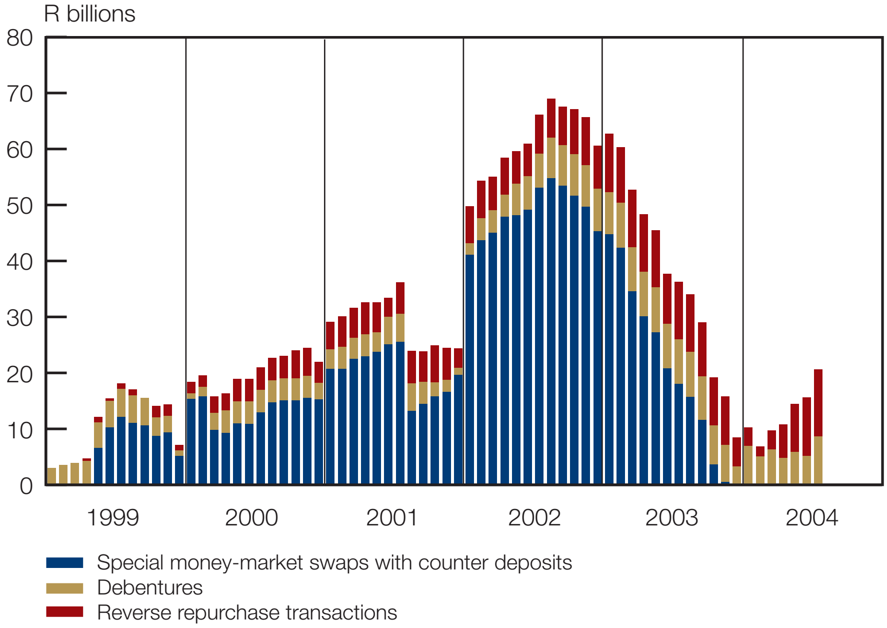
While the liquidity requirement was kept fairly steady, a number of factors enabled the Bank to scale down its use of liquidity-draining instruments over the past year – with such scaling down already having started in 2002. These liquidity-absorbing factors included the realisation of profits on maturing forward exchange contracts in the wake of the appreciation of the rand, payments received from government through the maturing of bonds in the Bank's asset portfolio, outright sales of bonds by the Bank, and the gradual expansion of notes and coin in circulation outside the Reserve Bank with the increase in nominal income and expenditure in the economy.

The overall amount which the Bank had to drain from the market through its three key interest-bearing liquidity-draining instruments declined from R37,7 billion at the end of June 2003 to a low point of R6,8 billion at the end of February 2004. This allowed the Bank to discontinue the use of money-market swaps with counter deposits towards the end of 2003; liquidity is now drained by means of Reserve Bank debentures and reverse repurchase transactions.

In February 2004 a further milestone was reached when the Bank squared off its oversold forward foreign exchange book. From that point onward the Bank's focus shifted to gradually building up its foreign exchange reserves, "creaming off" foreign exchange from the market. In doing so the Bank raised its gross gold and foreign exchange reserves from US$8,2 billion at the end of February 2004 to US$11,7 billion at the end of July. Rand liquidity was created by purchasing the foreign exchange; accordingly the overall amount of liquidity that the Bank had to drain from the market started rising from its low point of

R6,8 billion at the end of February 2004, reaching R15,6 billion at the end of July. Of the latter amount R5,1 billion constituted Reserve Bank debentures and the remaining R10,5 billion reverse repurchase transactions.

South African Reserve Bank liquidity draining operations



An agreement between National Treasury and the Reserve Bank on 20 October 2003 allowed the Bank to restructure and shorten the average maturity of interest-bearing government bonds held in its monetary policy portfolio by conducting cash-neutral auctions. The Bank has since 22 October 2003 conducted 11 switch auctions in government stock with private-sector parties to a total value of R14,2 billion. The availability of instruments allowed the Bank to diversify its liquidity management operations and to conduct outright sales of government bonds in its portfolio. A summary of switch auctions and outright sales conducted by the Bank up to July 2004 is provided in the table below.

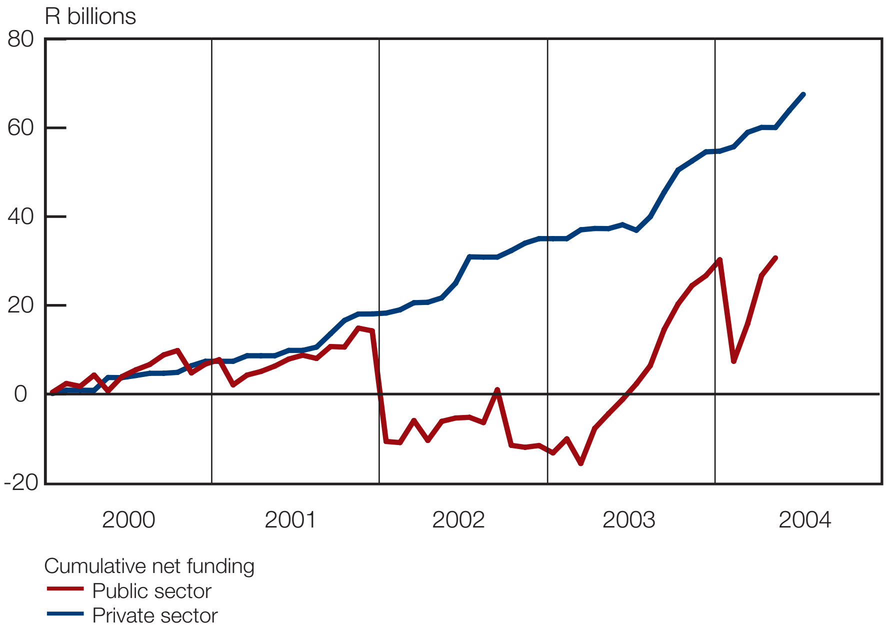
Banks' outright sales of and switch auctions in government bonds
R billions

	Outright sales				Switch auctions				
					Code of securities switched				
	R150s	R194	R201s	Total	R194s into R150s	R194s into R006s	R194s into R201s	R194s into R151s	Total
4th qr 2003	0,5	0,9		1,4	3,5	3,4	2,0	3,3	12,2
Jan to Jul 2004		0,5	0,5	0,5		1,0	1,0		2,0

Bond market

Net issues of fixed-interest securities by the *public sector* in the *domestic primary bond market* increased markedly in fiscal 2003/04, primarily due to national government directing its funding strategy more towards the domestic market than to the international markets. Sizeable net issues amounting to R42,3 billion from April 2003 to December were followed by net redemptions of R10,8 billion in the first quarter of 2004 when national government, *inter alia*, repaid the first of three tranches of the R150 government bond on 28 February 2004, this tranche being named the R006 bond. The total net issuance of public-sector securities in 2003/04 amounted to R31,5 billion, against net redemptions of R9,7 billion in fiscal 2002/03. Net domestic funding amounted to R14,9 billion in April and May 2004 and included the third of four instalments of R7 billion in zero-coupon bonds issued to the Reserve Bank in terms of the Gold and Foreign Exchange Contingency Reserve Account Defrayal Act No 4 of 2003.

Funding in the domestic primary bond market



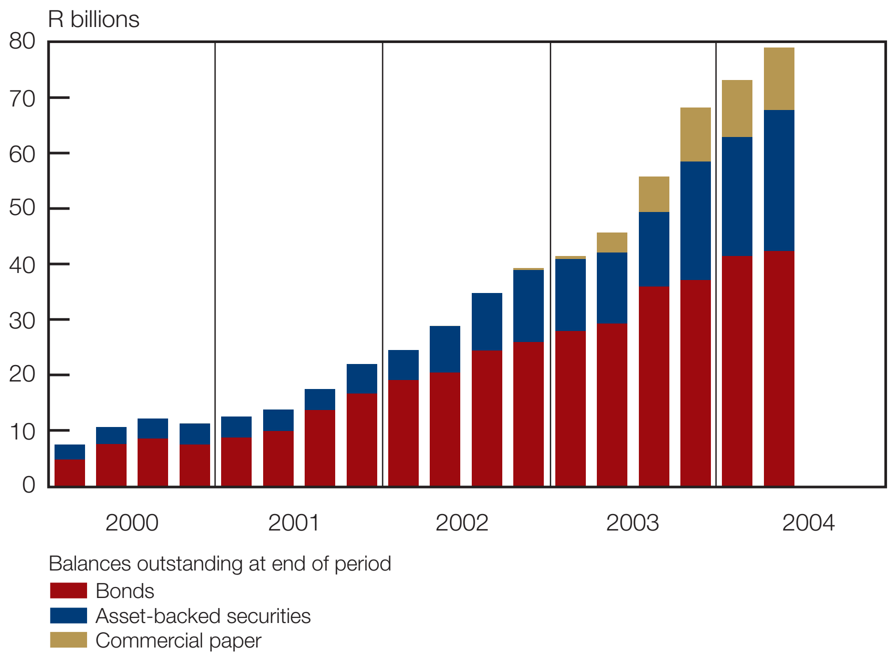
Thus far in the 2004/05 fiscal year the national government funded itself through a wide spectrum of domestic bond issues, relying somewhat more on the longer end of the maturity spectrum. In addition, the National Treasury launched the RSA Government Retail Bond on 24 May 2004 to promote a savings culture among citizens. Funds amounting to R326 million were raised through the retail bonds up to the end of July.

Although the greater part of the public-sector funding requirement in the past fiscal year was satisfied by borrowing in the domestic market, national government mobilised R10,6 billion in the *international markets* in fiscal 2003/04. In total, foreign debt was reduced by R2,4 billion; this included the early repayment of a dual-currency loan, partly on account of favourable exchange rate considerations. On 25 May 2004 National Treasury announced the successful issue of a 6½-per-cent US$1 billion ten-year global bond maturing on 2 June 2014. This translated to an amount of R6,4 billion and would primarily be used for the purpose of redeeming maturing foreign bonds. The transaction yielded the full budgeted amount of national government's international funding programme for fiscal 2004/05.

Municipalities returned to the capital market during 2004, empowered by the new Municipal Finance Management Act, Act 56 of 2003, which allows municipalities to borrow without national or provincial government guarantees. On 6 April 2004 the City of Johannesburg raised R1 billion by issuing a bond with a coupon rate of 11,95 per cent and maturing in 2010 – the first municipal bond issue since 1990. The bond was not secured by the national government nor secured by city assets. The City of Johannesburg issued a further R1 billion bond during June 2004 with a coupon rate of 11,90 per cent and maturing in 2016. The Development Bank of Southern Africa and the International Finance Corporation guaranteed 40 per cent of this bond.

Alongside the healthy supply of bonds by the public sector, the issuance of fixed-interest securities in the domestic *primary corporate bond market* continued to remain brisk in 2003. The outstanding nominal value of private-sector loan stock listed on the Bond Exchange of South Africa (BESA) increased from R38,9 billion in December 2002 to R58,4 billion in December 2003, with most of the increase recorded in the second half of 2003. Issuers took advantage of investor appetite for higher-yielding securities in an environment of low interest rates and declining yields on government securities. The amount listed increased to R71,4 billion in July 2004 of which 37 per cent, or R26,6 billion, was in the form of asset-backed securities compared with 33 per cent at the end of 2002.

Private-sector funding in the interest-bearing securities markets



Private-sector interest in short-term funding in the form of *commercial paper* similarly gained momentum during 2003. The outstanding nominal value of commercial paper listed on the BESA grew tenfold from an initial listing of R364 million in December 2002 to R3,7 billion in June 2003 and subsequently increased to R9,8 billion in December 2003 and R12,8 billion in July 2004. Currently, the commercial paper listings comprise almost entirely subordinated debt issued by banks.

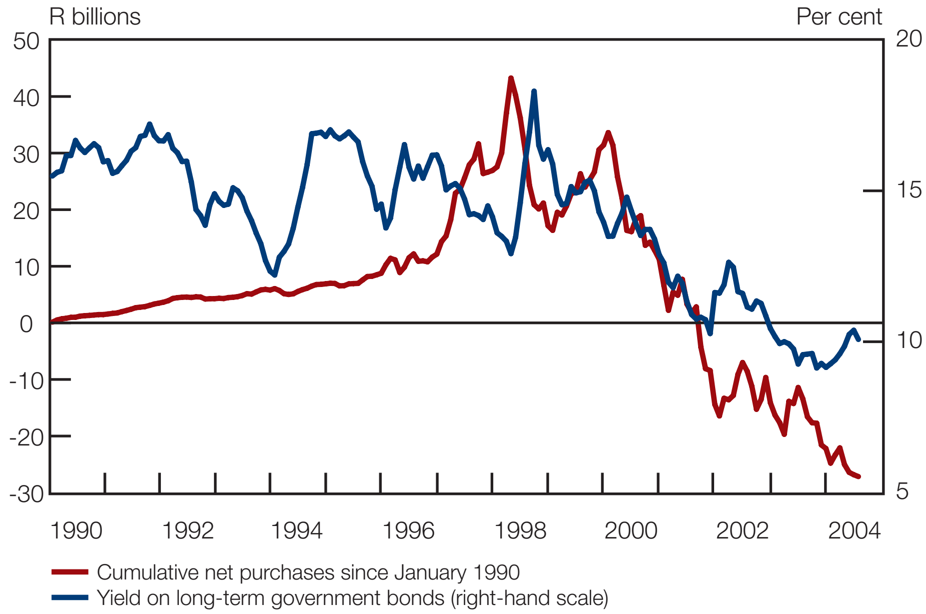
Trading activity in the *secondary bond market* improved markedly from April 2003 as investors started to anticipate a relaxation in monetary conditions. Turnover on the BESA improved from R2,6 trillion in the first quarter of 2003 to R3,4 trillion in the third quarter as investors adjusted their portfolios in reaction to the easing of monetary conditions, but slowed again from October 2003 when bond yields edged upward. For the year 2003 turnover amounted to just below R12,0 trillion, or 2 per cent less than in 2002. Trading activity subsequently declined to R2,5 trillion in the first quarter of 2004 and to R2,1 trillion in the second quarter. Such low levels were previously recorded in 1999. Declining turnovers were reflected in the annualised liquidity ratio, measured as the nominal value of bonds traded relative to the nominal value of bonds listed, which halved from 30,3 in the second quarter of 2002 to 14,4 in the second quarter of 2004.

Non-residents' interest in South African debt securities declined markedly from the second half of 2003. Net purchases of R2,7 billion in the first half of 2003 were followed by net sales of R10,8 billion in the second half of the year, resulting in a reduction in their holdings of debt securities of R8,1 billion in 2003 as a whole. Net sales of R4,6 billion were recorded in the first half of 2004, followed by net sales of R0,3 billion in July 2004 resulting in total net sales of bonds amounting to R4,9 billion in the year to date. The recent selling of bonds occurred alongside fluctuations in the exchange value of the rand and generally weaker global demand for fixed-interest securities in the wake of expected and realised increases in interest rates in the major international financial centres.

Non-resident participation in trading on BESA, measured as the sum of their purchases and sales as a percentage of total purchases and sales of bonds, accounted for 12,1 per cent of the total turnover in the first seven months of 2004. This was slightly higher than the average participation rate of 10,9 per cent in 2003 but much less than the 16,1 per cent recorded in 1998.

Non-resident net purchases of bonds, calculated on a cumulative basis from 1990, fell back sharply after the international financial crises of 1998 and continued on a declining path thereafter. After accelerating upward during 1997 non-residents' cumulative net purchases of bonds reached a high value of R43,3 billion in April 1998. This accumulated amount was reduced to less than zero in September 2001 and has since accumulated to net sales of R27,2 billion up to the end of July 2004. On balance, non-residents reduced their holdings of bonds in the wake of declining bond yields. It seems that a portion of the bond proceeds was invested in shares.

Cumulative net purchases of bonds by non-residents



Share market

Fluctuations in domestic and international share prices impacted on the amount of funding sought in the domestic and international *primary share markets* by companies listed on the JSE. The total value of equity capital raised amounted to R22,7 billion in 2003, well down from the R59,9 billion raised in 2002. Demand for funding started to improve moderately from May 2003 as the outlook for the global economy improved and share prices entered an upward recovery phase. Equity financing gathered further momentum in 2004 and accelerated to R33,9 billion in the first seven months of 2004. The acquisition of assets accounted for more than half of the increase as dual-listed companies acquired complementary businesses. Rights issues of preference and ordinary shares also occurred. Of the total amount raised in the seven months to July 2004 the bulk of funding, i.e. 74 per cent, was raised by the resources sector while the financial sector accounted for 22 per cent and the industrial sector for 3 per cent.

Despite the greater level of confidence in the equity market, 54 companies delisted from the JSE during 2003 followed by a further 19 delistings and only 5 new listings in the first seven months of 2004. In July 2004 a total of 412 companies were listed, substantially less than the 686 listed companies in 1999, partly due to the prevailing bear market conditions but also as a result of deliberate action by the JSE to delist companies that no longer meet the listing requirements. The JSE initially intended to close the Venture Capital and Development Capital Markets due to limited success and low liquidity, but after consultation with interested parties decided to keep these markets open. The intention is that these companies should eventually apply to transfer to the main board or to the new Alt^{x} alternative exchange. By the end of July 2004 five companies were listed on Alt^{x}.

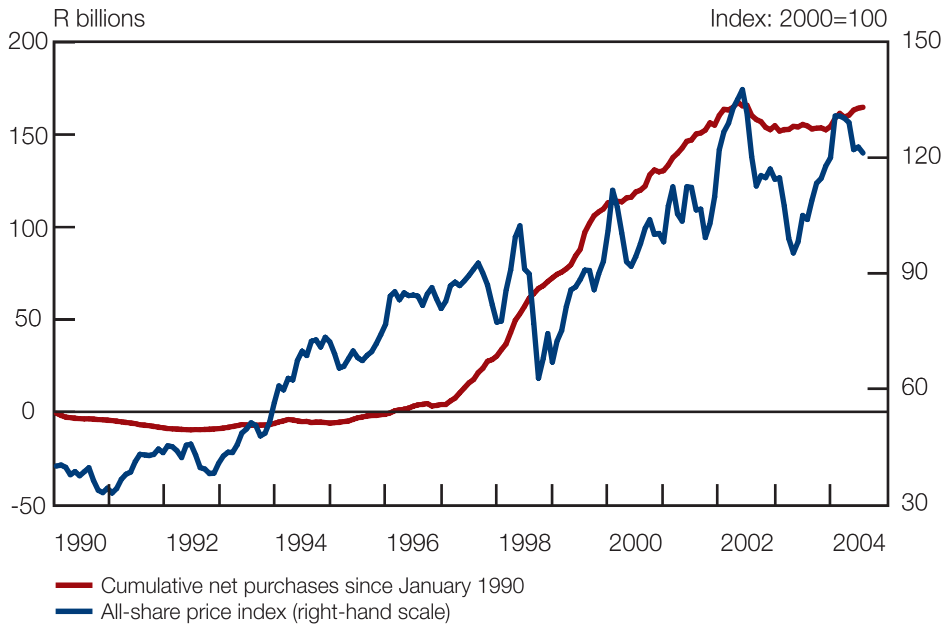
Turnover in the *secondary share market* declined by 7 per cent from a high value of R809 billion in 2002 to R752 billion in 2003. However, buoyed by the recovery in share prices from April 2003 the value of listed shares traded on the JSE improved from R362 billion in the first half of 2003 to R390 billion in the second half and to R566 billion in the first seven months of 2004. Market liquidity, measured by turnover as a percentage of market capitalisation, continued to rise from 38 per cent in 2001 to 50 per cent in 2003 and an annualised 51 per cent in the first seven months of 2004. Overall the market capitalisation of the JSE, which decreased by 32 per cent from May 2002 to April 2003, recovered by 53 per cent to reach R1 994 billion in July 2004.

Non-resident net purchases of R0,6 billion of South African shares in the first half of 2003 were followed by net sales of R1,1 billion in the second half of the year. Their net sales of R0,4 billion in 2003 were, however, much lower than the net sales of R5,6 billion recorded in 2002. Non-residents subsequently increased their holdings of South African shares by R9,9 billion in the first half of 2004. Further net purchases of R0,5 billion followed in July 2004, resulting in total net purchases of shares amounting to R10,4 billion in the year to date. Non-resident participation in the share market, measured as their purchases and sales as a percentage of the total value of purchases and sales on the JSE, has however moderated from 26 per cent in 2002 to 22 per cent in 2003 and 20 per cent in the first seven months of 2004.

Non-resident net purchases of shares, calculated on a cumulative basis from 1990, turned positive in February 1996 with their holdings of shares already starting to rise from June 1992. In the ensuing six years their holdings of shares accumulated rapidly to reach a high of R168 billion in April 2002. On balance, non-residents' net accumulation of shares followed the general upward movement in domestic share prices over this period.

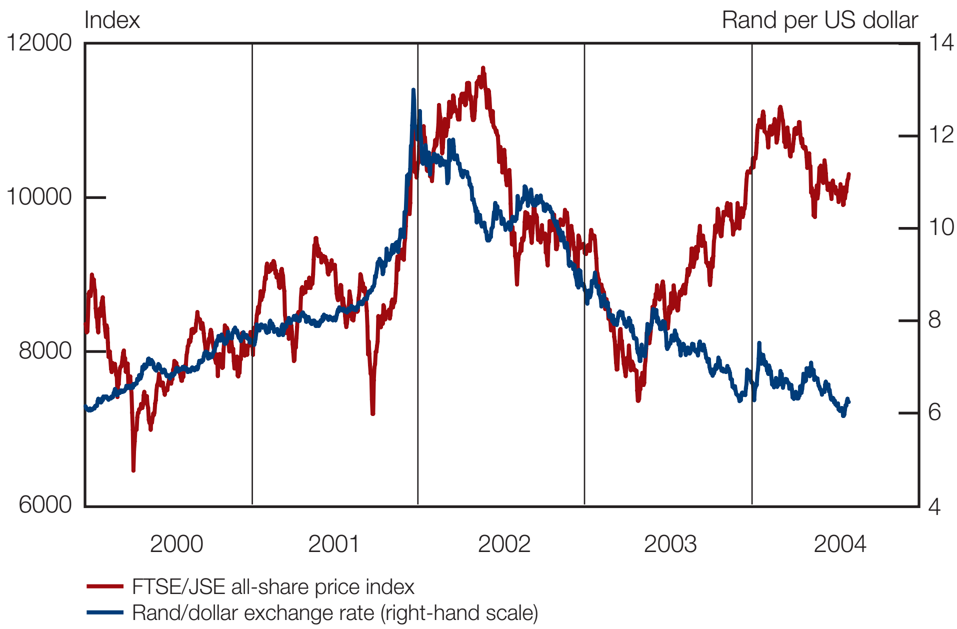
Their net holdings of shares levelled out from May 2002 following the sharp decline in share prices and improved moderately when the share market recovered. In July 2004 their accumulated net purchases of shares since 1990 had amounted to R164,8 billion.

Cumulative net purchases of shares by non-residents



The continued improvement of the international share markets, together with a more accommodative monetary policy environment, contributed to the recovery in the domestic share prices from a nineteen-month low in April 2003. After falling by 31 per cent from an all-time high in May 2002 to April 2003 the *monthly average price level of*

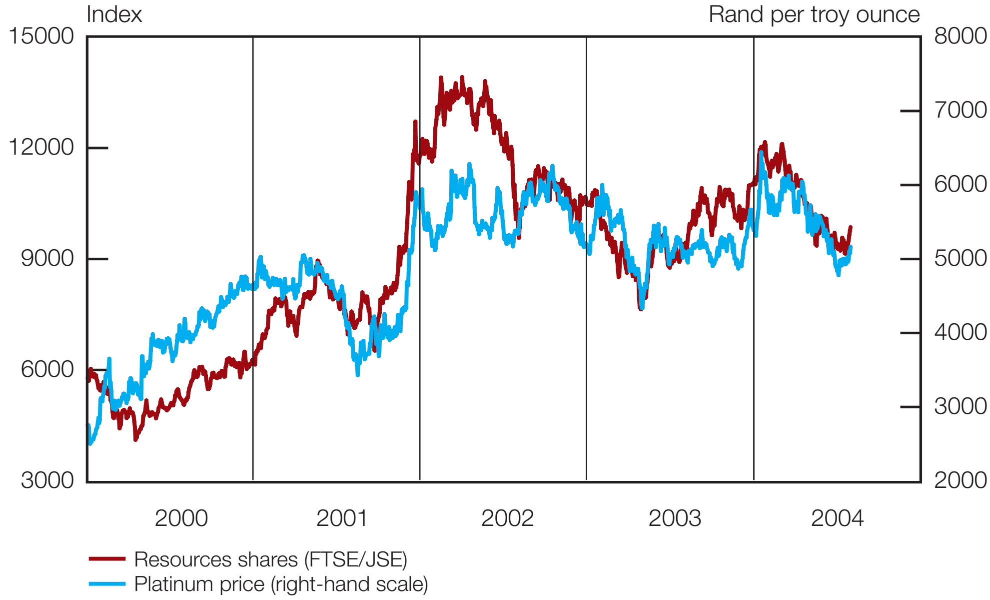
Share prices and the exchange rate



all classes of shares listed on the JSE recovered by 37 per cent to February 2004. This was followed by a decline of 7 per cent to July, partly on account of a set-back in international commodity prices and the impact of the sustained recovery in the exchange rate of the rand on the profitability and revenue growth of dual-listed and export-oriented companies.

The monthly average share price level of the *resources sector* increased by 36 per cent from April 2003 to January 2004, benefiting from the improved global economic outlook, rising commodity prices and the depreciation of the exchange value of the rand during December 2003 and January 2004. Overall commodity prices experienced a bull-run since mid-2001. The appreciation of the exchange value of the rand, however, moderated the impact of the stronger dollar prices of commodities. Commodity prices in both dollar and rand terms in 2004 retraced their earlier increases following measures introduced by the Chinese authorities to curb their robust economic growth and the anticipation and then actual tightening of monetary policy in the United States. The monthly average price level of resources shares subsequently declined by 21 per cent from January 2004 to July, led by a sharp fall of 38 per cent in the prices of gold-mining shares and 28 per cent in the prices of platinum-mining shares.

Resources share prices and the rand price of platinum



Interrupted briefly in August and September 2003, probably partly in anticipation of the release of the Financial Sector Charter on 17 October 2003, the prices of *financial shares* improved markedly from April 2003. The Charter was well received by the market and the prices of financial shares increased by 17 per cent from April 2003 to December and by a further 9 per cent in the first seven months of 2004.

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 3,2 per cent in July. At the same time the *earnings yield* on all classes of shares increased from 7,3 per cent in May 2002 to 10,3 per cent in April 2003, before receding to 7,6 per cent in July. Conversely, the *price-earnings ratio* of all classes of shares increased to 15,0 in February 2004 before declining to 13,2 in July 2004.

Market for derivatives

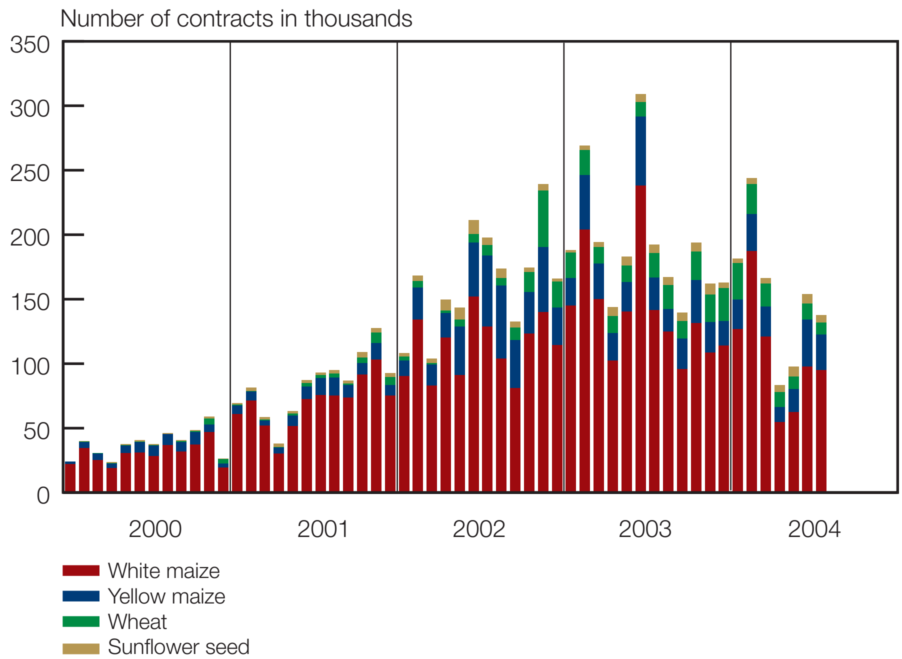
Heightened activity in the underlying securities markets led to lively trading activity in the derivatives market during the past eighteen months. The total number of *futures and options on futures* contracts traded on the Financial Derivatives Division of the JSE increased by 4 per cent in 2003, rising from 14,3 billion contracts traded in the first half to 16,4 billion contracts in the second half of the year. The number increased to 20,3 billion in the first seven months of 2004 despite slowing somewhat from April. Equity derivative products usually account for almost all of the overall trade in financial derivatives. The value of these derivative contracts as a ratio of turnover on the JSE however fell back from an average of 1,7 in 2001, at the height of the impact of the depreciation in the exchange rate of the rand on volatility in the market, to 1,1 in 2003 and 1,0 in the first seven months of 2004 as market behaviour calmed down in the wake of the recovery of the rand.

Non-resident exposure to the derivatives market, as measured by the number of open interest contracts, declined markedly from an average of about 42 per cent in 2002 to about 35 per cent in 2003 and fell further to 29 per cent in July 2004. Non-residents' exposure has dwindled since April 2002, at which time equity prices were high. The current trend coincides with their participation in the share market.

The number of *warrants* traded on the JSE fell by 70 per cent from 19,6 billion contracts in 2002 to 5,8 billion contracts in 2003. In the first seven months of 2004 the 3,4 billion contracts traded represented an increase of less than one per cent when compared with the same period in 2003. The waning interest in this market is evident from the decline in the number of warrants listed from 662 in February 2002 to 319 in July 2004.

The spot price of maize as quoted by the JSE Agricultural Products Division fluctuated considerably over the past eighteen months following adverse weather conditions and fluctuations in the exchange value of the rand. After reaching a two-year low of

JSE Agricultural Products Division: Commodities traded



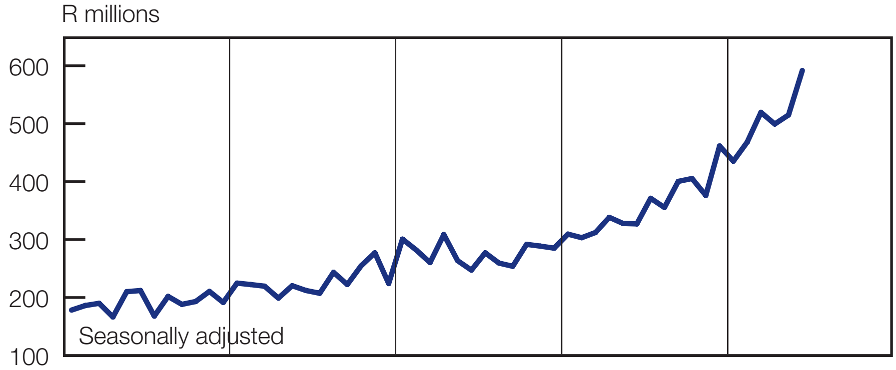
R719 per ton on 30 April 2003, the spot price of *white maize* rose to an average of R1 328 per ton in February 2004 before improved supply prospects saw a sharp decline in the spot price to R885 per ton at the end of July 2004. These developments ultimately influenced trade on the Agricultural Products Division of the JSE. In 2003 the 2,3 million *commodity futures contracts and options* on such contracts traded represented an increase of 17 per cent over the nearly 2 million contracts traded in 2002. In the first seven months of 2004 trading activity slowed down to 1,1 million contracts, somewhat less than the 1,5 million contracts traded in the corresponding period of 2003.

Real-estate market

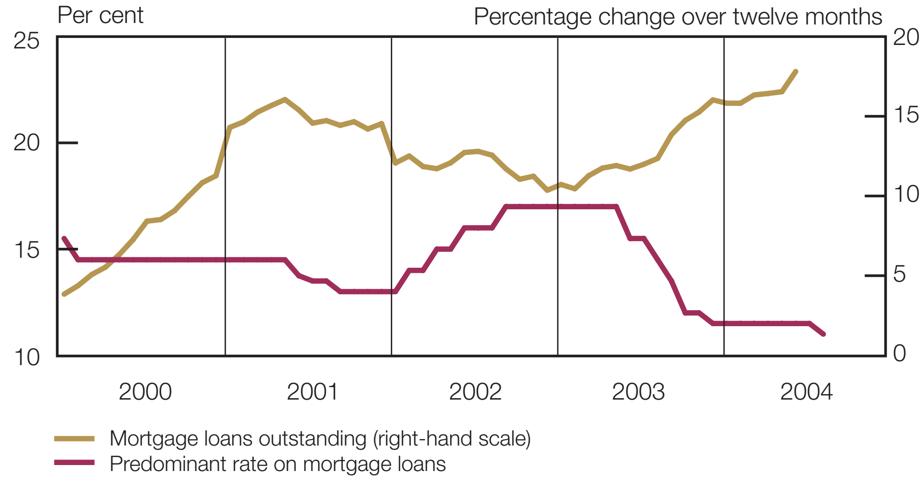
The real-estate market, which has been on a recovery path since 2000, continued to improve noticeably during 2003 and the first half of 2004. The overall seasonally adjusted value of turnover, measured by *transfer duty paid*, increased by 29 per cent in 2003 and by 58 per cent in the first six months of 2004 when compared with the same period in 2003. Simultaneously, the rate of increase in residential property prices, as measured by Absa, recorded twelve-month rates of increase of around 25 per cent in the first seven months of 2004. Evidence of some slowing in property market growth is provided by the decline in the month-on-month rate of increase in property prices from a high 2,6 per cent in January 2004 to 1,4 per cent in July.

Real-estate market

Transfer duty collected



Mortgage rates and loans outstanding



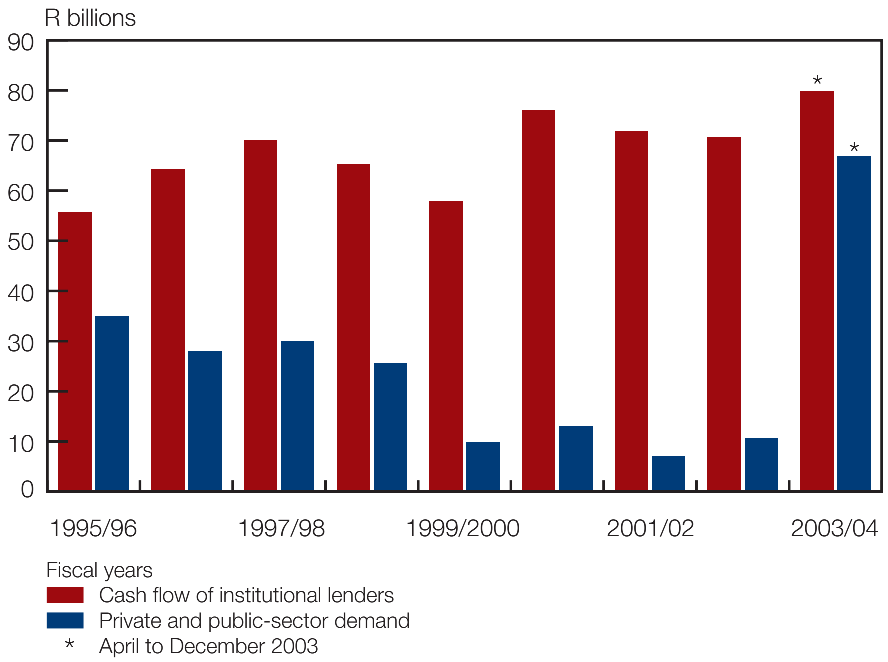
The buoyancy in the property market can be attributed to various developments that influenced the financial position of households and consequently their interest in the residential property market. These developments include, among other things, the recovery in the exchange rate of the rand since 2002, a significant decline in consumer price inflation during 2003, a relatively strong rise in the real disposable income of households, several reductions in mortgage and other rates in 2003, tax relief for individuals in recent years, and the adjustment of transfer duty brackets and the raising of the transfer duty exemption threshold in the 2004 Budget of the national government. In addition, solid property price increases in recent years helped to attract more potential investors' interest, while the relatively modest performance of other asset classes, both internationally and locally, also contributed to the improvement in the investment status of property. The current growth in the South African property market is consistent with strong rates of growth in property prices in various other countries such as Hong Kong, the United Kingdom, Australia and New Zealand.

Non-bank financial intermediaries

The moderation in inflation and declining short-term interest rates benefited the market for fixed-interest securities during 2003. Rising international equity markets and high commodity prices simultaneously contributed to a recovery in the domestic share market from April 2003. Consequently, the non-bank financial intermediaries, consisting of unit trusts, long and short-term insurers, and official and private pension and provident funds, experienced an improvement in asset growth during the course of 2003, recouping the losses recorded in 2002.

Improved market conditions helped to restore confidence in the investment performance of these financial intermediaries, which was reflected in slightly increased premium inflows and a levelling out of surrenders in the long-term insurance industry, as well as in increased

Institutional cash flows and demand for non-bank financing



inflows of funds to unit trusts. The resulting increased cash flows of the non-bank financial institutions (defined as current receipts less current expenditure of long-term insurers and pension funds, and the net sales of units by unit trusts) gave rise to more resources becoming available to absorb national government's increased recourse to funding in the domestic bond market during 2003. Funds were also sufficient to meet the demand for resources by private-sector organisations in the primary bond and share markets.

Fixed-interest securities are an important component of the assets of the non-bank financial intermediaries, as these securities deliver stable cash flows even when market conditions are unfavourable. These intermediaries' holdings of fixed-interest securities remained steady at around 26 per cent of total assets from December 2002 to December 2003.

Shares held by non-bank financial intermediaries accounted for 46 per cent of their total assets at the end of 2003, slightly up from 45 per cent at the end of 2002.

Public finance

Fiscal policy

The fiscal developments during the past ten years bear testimony to government's commitment to a strategy for accelerated and sustainable economic growth. Government is committed to developing the potential of the South African economy, while taking advantage of the opportunities presented by globalisation. Employment creation and improved public-service delivery were accepted as challenges in an effort to strengthen the overall performance of the economy.

The Reconstruction and Development Programme (RDP), originally released in 1996, provided a framework within which new policies and programmes were prioritised. The RDP embodies government's commitment to reduce poverty and to support a rapidly growing economy with appropriate fiscal policies. The key priorities in the first phase of transformation included rationalisation and reorganisation of the public sector, a new system of intergovernmental financial relations, restructuring of public assets and liabilities, and the development of monitoring and performance evaluation systems.

The macroeconomic strategy included measures to improve industrial competitiveness, reduce inflation, gradually relax exchange controls, strengthen funding for training and education, introduce tax incentives to stimulate investments, reduce the fiscal deficit, and to reform government's budget by focusing on redistribution of income and the reprioritisation of expenditure.

The successful fiscal consolidation in the second half of the 1990s paved the way for the growth-orientated fiscal policy stance set out in the most recent Budget Reviews. Government's main fiscal objective in recent years was the transformation of budget procedures and processes, while continuing to reprioritise expenditure. At the same time a more efficient tax structure has been created. The borrowing requirement which was contained within sustainable limits has released resources that could address other, more productive service delivery priorities.

In order to create a sound basis for fiscal policy implementation, a clear constitutional demarcation of functions and responsibilities of all three spheres of government had to be implemented. The rationalisation of the local government sphere into 284 municipalities was necessary as part of a broader process of addressing the challenges of poverty and inequality. Based on the Constitution adopted in December 1996, statutory agencies with well-defined responsibilities were established, as well as a national platform in the form of Nedlac, providing a forum for vigorous engagement between government and business, labour and community representatives.

The publication of the first *Medium Term Budget Policy Statement* in 1997 and of the first three-year budget projections were important milestones. These introduced a far more transparent basis for accountability of government, and a necessary foundation for a more detailed result-oriented budgeting process. They also helped and still help to link the capital and current budgets and create an expenditure framework for the allocation of resources to priority services.

The Public Finance Management Act, implemented on 1 April 2000, laid down a modern legal and administrative framework for the conduct of fiscal affairs. Broadly following the same principles as those set out in the Public Finance Management Act, the Municipal

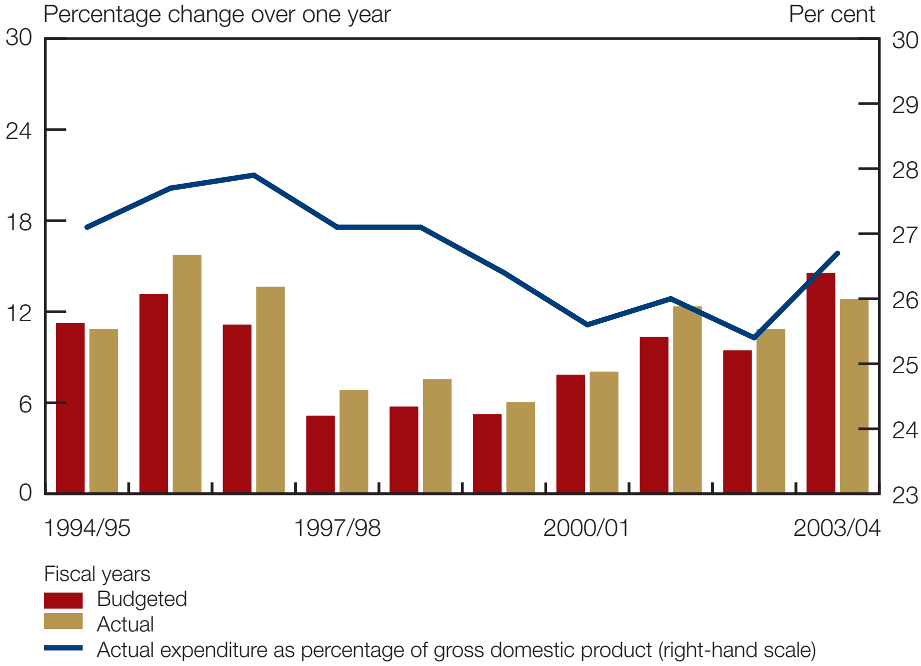
Finance Management Act, governing the financial management of local governments, was implemented on 1 July 2004 by nature of a phased approach over the medium term. A new set of Treasury regulations, applicable to all government departments and entities in the national and provincial government spheres, was published in terms of the Public Finance Management Act and came into effect on 1 June 2000. These regulations specify standards comparable with international best practice, replacing numerous Treasury instructions in terms of the old Exchequer Act.

The attainment of affordable and sustainable budget deficit levels led to the reduction and stabilisation of South Africa's national government debt as a ratio of gross domestic product. Reform of the public debt management strategy led to the active management of South Africa's government debt portfolio with the aim of minimising the risk and cost of funding, and further enhanced liquidity in the market for trading in government securities. Access gained to the international capital markets resulted in an increase in foreign-currency denominated debt as a portion of national government loan debt. The maturity profile of this loan debt was restructured and new loan instruments were introduced.

National government expenditure

Having trended downward for several years, national government's expenditure as percentage of gross domestic product was raised in fiscal 2003/04. This ratio rose from 25,4 per cent in fiscal 2002/03 to 26,7 per cent in fiscal 2003/04. This can be compared with an average ratio of 27,4 per cent recorded in the five years from the beginning of 1994/95 to 1998/99 whereafter this ratio moved downward to more manageable levels. The containment of the ratio is testimony to the tight expenditure control applied by government. As a result, since 2003/04 government has been able to adopt a cautiously expansionary approach in its expenditure stance geared towards growth and development.

National government expenditure



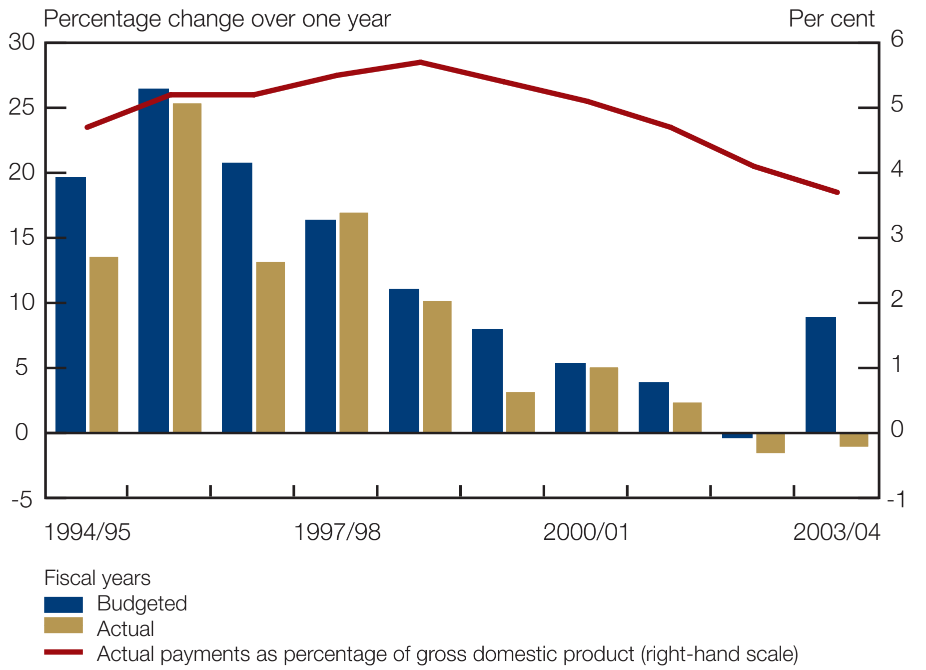
The first three years following the transition to an all-inclusive democratic system of government necessitated high rates of increase in government spending, averaging 13,5 per cent, due to costs associated with organisational restructuring, the expansion of services to previously excluded communities, as well as increased interest payments. In the following four years, rates of increase averaged 7,1 per cent per annum. This reflects the strong fiscal consolidation during that period.

The year-on-year rate of increase in national government expenditure amounted to 12,9 per cent in fiscal 2003/04 – well below the original budget projection of 14,6 per cent, but above the actual percentage increase in the previous fiscal year. This relatively strong increase in government expenditure bears testimony to the shift in the fiscal policy stance from an emphasis on cost saving to a more growth-oriented approach, assigning higher priority to expenditure on areas such as social assistance, education, health and the enhancement of basic municipal infrastructure and services.

In the *Budget Review 2004*, it was estimated that national government expenditure would increase at a rate of 12,1 per cent to R368,9 billion, or 27,7 per cent of the projected gross domestic product in fiscal 2004/05. The projections provide for an average annual rate of increase of 10,1 per cent over the three-year planning period, implying that growth in inflation-adjusted expenditure is likely to continue. The growth-oriented expansionary budget for the next three-year planning cycle has projected that national government expenditure as a ratio of gross domestic product would average 27,7 per cent.

Since 1999/2000 the growth in interest paid on national government debt has been well contained and in fact *decreased* by 1,1 per cent to R46,1 billion in fiscal 2003/04. Interest payments were originally budgeted to increase at a rate of 8,9 per cent over this period. Lower interest rates, sound borrowing strategies, the restructuring of the composition of government debt and the steady decline in the borrowing requirement of national government in recent years, jointly contributed to the decline in the interest burden.

National government interest payments



In fiscal 2003/04 interest payments as a ratio of gross domestic product amounted to 3,7 per cent, compared with 4,1 per cent in the previous fiscal year. Such a low ratio had last been recorded in fiscal 1990/91. For fiscal 2003/04, the year-on-year percentage change in interest paid on domestic government debt rose slightly – by 1 per cent – while interest paid on foreign government debt decreased by 18,4 per cent. This decrease could partly be attributed to the strengthening of the domestic currency, but also to the early redemption of some foreign loans.

2 Former independent status of Transkei, Bophuthatswana, Venda and Ciskei.

Over the five years from the beginning of 1994/95 to 1998/99, the interest payments on national government debt increased at an average annual rate of 15,9 per cent. The brisk increases were partly related to national government assuming liability for the debt of the former TBVC[2] states and self-governing territories, and to relatively high short-term interest rate levels.

The five years from the beginning of 1999/2000 to 2003/04 reflect the fruits of fiscal consolidation and the restructuring of national government debt. This brought the rate of increase in interest payments down to an average of 1,6 per cent. Interest payments in fact decreased in both 2002/03 and 2003/04. In his presentation of the *Budget Review 2004* to Parliament, the Minister of Finance indicated that debt service cost, of which interest payments constitute the lion's share, will over the medium term continue to fall in relation to total government expenditure, releasing resources for expenditure on service delivery.

Non-interest expenditure mainly consists of transfers to provincial governments and the payment of salaries and wages to civil servants. In recent years, government restrained the increases in government employees' remuneration in favour of outlays on other goods and services for the delivery of social services and capital outlays. This enunciates government's commitment towards increasing the long-term growth capacity of the economy, *inter alia* by alleviating shortages of textbooks in the education system and improving 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. Before 1998/99 provincial governments' share was included in the voted expenditure of national government. Thereafter these transfers were recorded separately. It was envisaged that transfers to provincial governments would grow at an average rate of 8,8 per cent over the next three years. This reaffirms government's commitment to the marked acceleration of service delivery.

Although only 6,2 per cent of national government spending was of a capital nature, the capital expenditure recorded in fiscal 2003/04 represented an increase of 7,4 per cent from the previous fiscal year. The low rate of capital spending to total expenditure of national government reflects the reallocation of responsibilities from national to lower spheres of government which commenced soon after the political transition of 1994. Given government's commitment towards facilitating growth through the creation of infrastructure, the *Budget Review 2004* estimates that payments for capital assets by national government will grow at an average annual rate of 9,8 per cent over the medium term.

As indicated in the table on the opposite page, spending on community and social services was and still is the most important and largest functional category of government spending. It is projected to amount to 50,8 per cent of the projected expenditure of national and provincial governments and social security funds in fiscal 2006/07. Spending on these services has steadily increased since the political transition and largely reflects the extension of the child support grant and future increases in the values of social assistance. This type of spending is expected to increase at an average annual rate of 9,5 per cent over the three-year budget cycle.

Functional classification of expenditure of consolidated national and provincial governments and social security funds

	Percentage of total expenditure			
Spending category	1994/95	1999/2000	2003/04[1]	2006/07[1]
General government services and unallocatable expenditure	7,7	6,0	6,7	7,8
Protection services	17,8	16,0	16,6	15,7
Defence and intelligence	8,5	5,4	6,4	5,5
Public order and safety[2]	9,3	10,6	10,2	10,2
Community and social services	45,9	48,5	50,5	50,8
Education	21,6	21,3	19,9	18,8
Health	10,0	11,4	11,3	11,0
Social security and welfare	10,8	11,9	14,6	16,5
Housing and community services[3]	3,5	3,9	4,7	4,5
Economic services	11,4	9,6	12,7	13,1
Fuel and energy	0,3	0,2	0,6	0,6
Agriculture, forestry and fishing	2,3	1,8	1,9	1,9
Mining, manufacturing and construction	0,7	0,5	0,4	0,6
Transport and communication	4,6	3,9	4,6	4,4
Other economic services[4]	3,5	3,2	5,2	5,6
Interest	17,2	19,9	13,5	12,6
Total	100,0	100,0	100,0	100,0

1 *Budget Review 2004*, adjusted for comparability
2 Including police, prisons and justice
3 Including recreation, culture and sport services
4 Including water schemes, tourism, labour, environmental protection and related services

In the area of protection services, the share of defence expenditure in 2003/04 was raised by the armaments procurement programme. Spending on public order and safety, including payments for related services, grew at a steady pace.

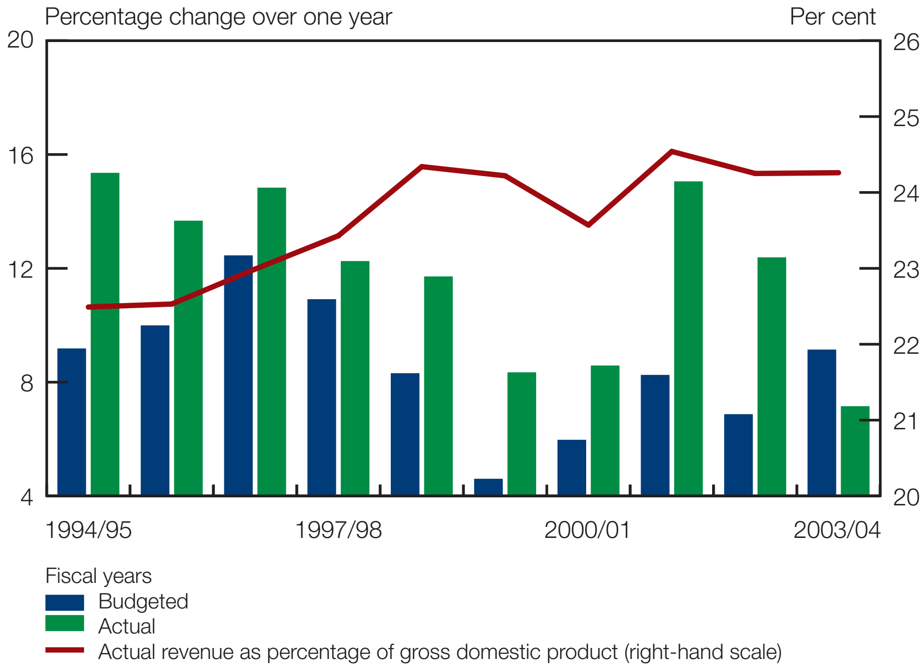
Although the provision for general government services over the medium term seems to be increasing, this is essentially due to the inclusion of a contingency reserve which is planned to rise from R2,5 billion in fiscal 2004/05 to R8 billion in fiscal 2006/07. The contingency reserve provides for unforeseen and unavoidable spending in all functional areas.

National government revenue

The *Statement of national government revenue, expenditure and borrowing* of March 2004 indicates that unaudited revenue increased at a year-on-year rate of 7,2 per cent to R298,9 billion in fiscal 2003/04. This rate of increase was moderately lower than the rate of increase originally envisaged in the *Budget Review 2003* and was much lower than the rate of increase of 12,4 per cent recorded in the previous fiscal year. It is also the first time since the political transition of 1994 that national government has recorded a lower-than-budgeted rate of increase in revenue collection.

The 2003/04 rate of increase was also considerably lower than the average year-on-year rate of increase of 11,2 per cent recorded in the preceding five fiscal years and significantly lower than the high rate of 15,4 per cent recorded in 1994/95.

Revenue of national government



The contribution made by broadening the tax base and stepping up the efficiency in tax collections is evident from the pick-up in the inflation-adjusted rate of increase in government revenue, from an average of 2,2 per cent in the latter part of the 1990s to 2000/01 and then to 8,5 per cent in fiscal 2001/02. The high rate of inflation in 2002 affected the inflation-adjusted rate of increase in government revenue which amounted to only 1,6 per cent in fiscal 2003/04.

As indicated in the accompanying table, the lower-than-budgeted rate of increase in national government revenue was primarily due to the under-performance of taxes on

National government revenue in fiscal 2003/04

R billions

Revenue source	Originally budgeted 2003/04		Preliminary outcome 2003/04	
	R billions	Percentage change*	R billions	Percentage change*
Taxes on income and profits	177,9	8,1	170,6	3,7
Payroll taxes	3,6	7,4	3,9	17,4
Taxes on property	5,9	15,8	6,7	31,1
Domestic taxes on goods and services	109,6	12,3	109,9	12,7
Taxes on international trade and transactions	11,3	17,5	8,5	-11,1
Other revenue**	5,9	-14,6	8,9	28,1
Less: SACU*** payments	9,7	17,7	9,7	17,7
Total revenue	304,5	9,2	298,9	7,2

* Fiscal 2002/03 to fiscal 2003/04
** High values are partly due to the inclusion of an amount of R1,4 billion of unallocated revenue which is currently not allocated to a specific revenue source
*** Southern African Customs Union

income and profits, especially by companies, and of taxes on international trade and transactions. This was partially related to the continued strengthening of the rand in 2003, which resulted in less revenue than expected from corporate income tax and customs duties. As companies in the manufacturing and mining sector were affected by the recovery of the rand and in some instances by weak foreign demand, their profit margins were narrowed and their tax payments therefore reduced. By contrast, the buoyancy in the property market as a result of lower interest rate levels, coupled with real increases in remuneration and real tax relief for individuals in the past few years, resulted in a higher rate of increase in taxes on property than was originally projected.

The percentage contribution of direct taxes to total tax revenue has gradually increased from 55 per cent in 1994/95 to 60 per cent in 1999/2000 and has been maintained at approximately that level in the ensuing years. However, the respective percentage contributions of individuals (mainly personal income tax) and companies to total direct taxes have shifted significantly since 1994/95. Immediately after the political transition in 1994, individuals' contribution to direct tax stood at 75 per cent whereas company tax stood at 25 per cent. A marked shift is evident in the percentage contribution in recent years; in fiscal 2003/04 individual tax amounted to 58 per cent of total direct tax while company tax amounted to 42 per cent.

Major tax reforms were implemented in the second half of the past decade. Among other things, taxes on retirement funds and air departure tax for international and domestic travellers were introduced in 1996 and 2000, respectively. Another new tax, capital gains tax (where a portion of the proceeds generated upon the disposal of an asset by corporate and individuals is taxed) was introduced in 2001. Source-based income tax, where income was taxed in the country where it originates, was replaced in 2001 with a residence-based income tax (residents of a country are taxed on their income, irrespective of where in the world that income is earned and non-residents are only subject to tax on domestic-source income). These tax reforms contributed to improved efficiencies in the functioning of the tax system which led to improved collection of tax and also provided the manoeuvrability to grant personal income tax relief. As a result national government total revenue collections outperformed budget expectations up to fiscal 2002/03.

In 2003, an exchange control amnesty with accompanying tax measures was enacted to provide an opportunity for South Africans to regularise illegal offshore income and assets. Amnesty applicants can disclose or repatriate offshore amounts subject to prescribed levy payments of 10 per cent or 5 per cent, respectively, with an additional 2 per cent for accompanying domestic tax violations.

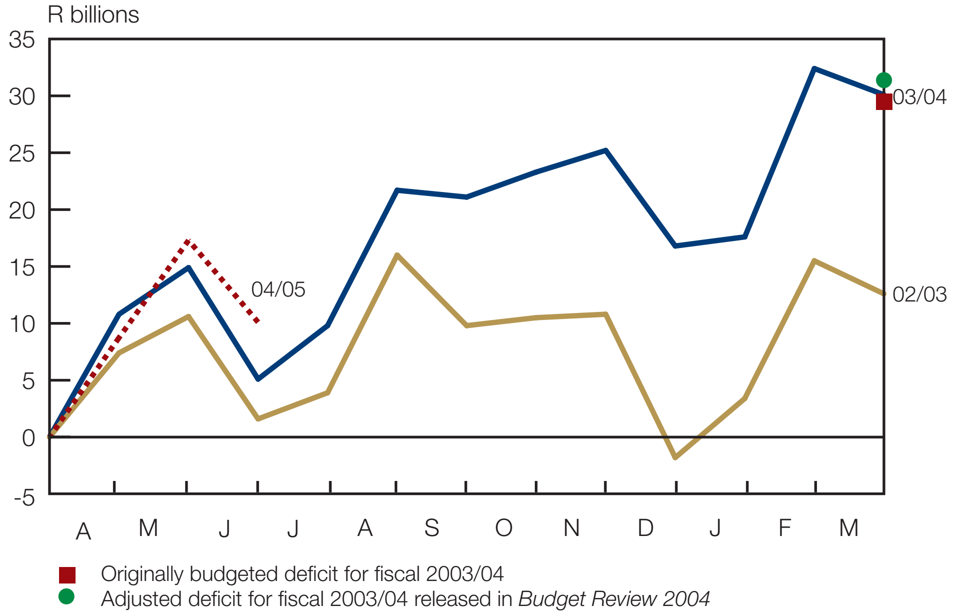
The total revenue of national government was budgeted to amount to R327,0 billion in fiscal 2004/05, representing a year-on-year rate of increase of 9,4 per cent. It was estimated that national government revenue would increase at similar rates over the current three-year planning horizon.

Revenue as a ratio of gross domestic product increased from 22,5 per cent in fiscal 1994/95 to 24,3 per cent in 1998/99. The consolidation and restructuring laid the foundation for better compliance and administration of tax laws and tax collection later. With the South African Revenue Service's efficiency gains in recent years, national government revenue as a ratio of gross domestic product amounted to 24,3 per cent in fiscal 2003/04, identical to the ratio recorded in the previous fiscal year and in 1998/99. At current levels, government is now in a position to create sustainable development and to proceed without being hampered by excessive taxation. National government revenue as a ratio of gross domestic product is estimated, on average, to be maintained at its current levels over the current three-year budget cycle.

National government deficit

The net result of the lower-than-budgeted revenue and expenditure was an unaudited national government deficit before borrowing and debt repayment of R30,1 billion in fiscal 2003/04. This deficit was higher than the originally budgeted deficit of R29,5 billion, but lower than the revised estimate of R31,4 billion presented to Parliament in February 2004. The national government deficit before borrowing and debt repayment as a ratio of gross domestic product amounted to 2,4 per cent in fiscal 2003/04 compared with a ratio of 1,1 per cent in the previous fiscal year. After the deficit reached a high of 5,1 per cent in fiscal 1995/96, it gradually decreased in fiscal 2002/03 to record the lowest deficit ratio since fiscal 1989/90.

Cumulative balance of national government



Government's commitment to prudent fiscal policy contributed to the containment of the deficit over the past five fiscal years. With the containment of the deficit, government is now positioned to pursue a more expansionary approach. As a result, the deficit is expected to rise but be maintained at an average level of about 3 per cent of gross domestic product over the medium term.

The primary balance (i.e. the deficit recalculated by excluding interest payments from total expenditure) reached a surplus of 1,3 per cent of gross domestic product in fiscal 2003/04, compared with 3,0 per cent recorded in the previous fiscal year. A decade ago, the primary balance reflected a surplus of only 0,1 per cent of gross domestic product, at which point it started increasing gradually to reach a peak of 3,2 per cent in fiscal 1999/2000. A decrease to a surplus of 0,6 per cent is envisaged for fiscal 2004/05, to be maintained at approximately that level during the remainder of the current three-year budget horizon.

National government financing

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 R28,4 billion in fiscal 2003/04. This cash deficit is the highest recorded since fiscal 1996/97. Apart from financing the shortfall of cash revenue relative to cash expenditure, the National Treasury made an extraordinary payment of R7,0 billion in zero-coupon bonds to the South African Reserve Bank. This was in part payment for the liability resulting from the losses accumulated on the Gold and Foreign Exchange Contingency Reserve Account which is managed by the Bank on behalf of the National Treasury.

Proceeds from the restructuring of state-owned entities were originally projected to amount to R5,0 billion in fiscal 2003/04 but eventually amounted to only R9 *million*, primarily emanating from overflows from Telkom's Initial Public Offering (IPO) in the previous fiscal year.

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 R32,3 billion in fiscal 2003/04.

Proceeds realised through the restructuring of state-owned enterprises since 1997 amounted to R33,7 billion, of which R24,8 billion was paid into the National Revenue Fund. Extraordinary revenue from this source made a significant contribution towards reducing the net borrowing requirement of national government over the past six fiscal years. The bulk of the proceeds came from the restructuring of state assets which includes R10,4 billion from the sale of a 30-per-cent interest in Telkom to a strategic equity partner – an international information and telecommunications company. Other amounts also emanated from the special restructuring dividends paid by the South African Special Risks Insurance Association (Sasria) to government in February 2000 and April 2001 amounting to R7,1 billion and R3,2 billion, respectively, and the monetisation of Transnet's interest of 20 per cent in M-Cell – a mobile telecommunications company – by means of an innovatively structured financial mechanism. The restructuring of the Airports Company South Africa, South African Airways, South African Forestry Company Limited, Aventura and certain radio stations also generated proceeds for government. Government revenue was also bolstered by R2,2 billion on account of the restructuring of the Central Energy Fund.

In the *Budget Review 2004* the funding estimates for the medium term were announced. Funds will be generated from the restructuring of state-owned enterprises which should contribute R2,5 billion each year to the financing of national government over the next two fiscal years. The *Budget Review 2004* also provides for the issuance of further zero-coupon bonds to the amount of R7 billion a year to the South African Reserve Bank in respect of the deficit on the Gold and Foreign Exchange Contingency Reserve Account over the 2004/05 and 2005/06 fiscal years. Accordingly, a R7 billion bond was issued to the Reserve Bank in the first month of the new fiscal year, and was subsequently converted into interest-bearing bonds.

The borrowing requirement of national government for fiscal 2003/04 was mainly financed through the issuance of bonds in the domestic capital market, as indicated in the table on the following page. Over this period, domestic long-term funding was obtained at an average rate of 9,9 per cent while domestic short-term instruments were sold at an average rate of 9,6 per cent per annum. These yields can be compared to budget projections of 10,2 and 12,1 per cent, respectively. There were also net redemptions of foreign loans as indicated in the table, showing government's reduced reliance on foreign financing; this stood in contrast with 2002/03, when the National Treasury relied heavily on foreign funding and redeemed domestic government bonds on a net basis.

National government financing in fiscal 2003/04

R billions

Instrument	Originally budgeted	Actual
Deficit	**29,5**	**28,4***
Plus: Extraordinary payments	7,0	7,4
Cost/profit on revaluation of foreign loans at redemption**	1,8	-3,5
Less: Extraordinary receipts	6,3	0,0
Net borrowing requirement	**32,0**	**32,3**
Treasury bills	6,0	6,7
Domestic government bonds	9,3	31,0
Foreign loans	13,6	-2,5
Change in available cash balances ***	3,1	-2,9
Total net financing	**32,0**	**32,3**

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

Net foreign funding includes amounts drawn on the export credit facility which had been arranged for the financing of the Strategic Defence Procurement Programme, a euro global benchmark bond which yielded R10,6 billion, redemptions of a euro-denominated bond (initially issued in Deutsche Mark) and a syndicated dual-currency loan in January 2004. The contract for the Special Defence Procurement Programme export credit facility was negotiated in December 1999 and came into effect on 25 January 2000. By March 2004 a cumulative amount of R12,6 billion had been drawn on this facility since the start of the contract, while the book value of this debt stood at R13,8 billion.

On balance, the average outstanding maturity of foreign government bond debt decreased from 81 months at the end of March 2003 to 79 months at the end of March 2004. In fiscal 1994/95 and 1995/96 the average outstanding maturity stood at 40 months. In the subsequent six years, after South Africa gained access to international capital markets, the average outstanding maturity was raised to 84 months. In contrast, the average maturity of domestic marketable bonds decreased from 129 months at the end of March 1994 to 98 months at the end of March 2004.

In the recent past, inflation-linked bonds continued to increase in importance. Such bonds were first issued in March 2000. By the end of March 2004 they had risen to 7,7 per cent of total loan debt.

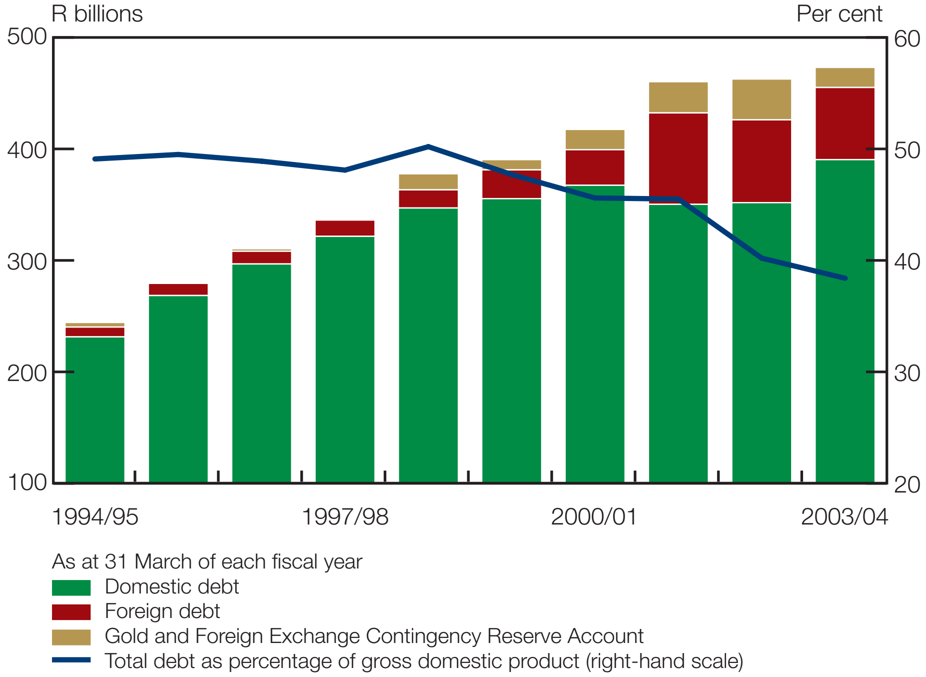
The issuance of debt instruments, the discount on new government bond issues and the revaluation of foreign debt at an improved exchange value of the rand, led to an increase in the loan debt of national government from R426 billion at the end of March 2003 to R455 billion at the end of March 2004. As a ratio of gross domestic product, national government loan debt decreased from 37,1 per cent to 36,9 per cent over this period.

The loan debt as a ratio of gross domestic product stood at 43,0 per cent at the end of March 1994, steadily declining to its current levels. Based on the National Treasury's projections of the financing requirements of government and assumptions of future interest and exchange rate changes as contained in the *Budget Review 2004*, total gross loan debt as a ratio of gross domestic product is expected to increase to 39,3 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 17,4 per cent of gross domestic product at the end of March 2003 to 14,2 per cent at the end of March 2004. Since South Africa's re-entry into the international capital markets, foreign debt increased from R5 billion at the end of March 1994 to R65 billion at the end of March 2004.

The lower rand value of foreign debt at the end of March 2004 is partly due to the revaluation of outstanding foreign loans at a stronger exchange rate of the rand. The revaluation gain of R4,3 billion at the end of March 2004 may be compared with a loss of R3,0 billion a year earlier. The sharp depreciation of the exchange rate of the rand in 2001 had a major impact on the revaluation of foreign debt. During this period, the revaluation adjustment amounted to R24,2 billion at the end of March 2002 compared with an average loss of R3,3 billion at a stable average exchange rate over the preceding seven fiscal years. In the modified cash accounting system currently used by government, the revaluation of foreign loans is not recognised as expenditure but the full revaluation adjustment is accounted for when the debt reaches maturity.

Debt of national government



The total debt of national government increased from R463 billion at the end of March 2003 to R473 billion at the end of March 2004. However, as a ratio of gross domestic product, total debt of national government still decreased from 40,2 to 38,4 per cent over this period, and was helped by the decline in the unaudited outstanding balance on the Gold and Foreign Exchange Contingency Reserve Account which decreased from R36,6 billion to R18,0 billion. The total debt of national government as a ratio of gross domestic product stood at 50,2 per cent at the end of March 1999, the highest level since 1994, whereupon it steadily decreased to its current levels.

General government finance

The borrowing requirement of the consolidated general government shrank from a high of 5,9 per cent of gross domestic product in fiscal 1996/97 to 1,0 per cent in fiscal 2001/02, reflecting fiscal prudence at all levels of government. The relatively strong increase in the general government deficit as a ratio of gross domestic product since 2003/04 bears testimony to the shift in the fiscal policy stance. In recent years fiscal policy became cautiously more expansionary and growth oriented. The fiscal stance also reflects the greater importance of investment in general and the heightened emphasis placed on infrastructural expenditure in particular. Over the course of the next three fiscal years, the borrowing requirement is estimated to average 3,0 per cent of the estimated gross domestic product.

The sustained increase in real government consumption expenditure was mainly evident in real outlays on other goods and services while the growth in the compensation of employees decreased moderately over the past decade. The growth is dominated by increases in non-wage consumption reflecting government's commitment to improve service delivery. Total compensation of employees as a percentage of total consumption expenditure by general government decreased from about 72 per cent to about 56 per cent over the same period.

An analysis of the *Statement of revenue, expenditure and borrowing* of the *provincial governments* indicates that these administrations recorded a cash deficit of R2,2 billion in fiscal 2003/04 compared with a cash deficit of R3,0 billion in the previous fiscal year. However, these deficits are half the size of the deficit recorded in fiscal 1997/98, indicating improved management within provincial governments. At the provincial level, capital spending on public infrastructure and housing projects has grown substantially over the past decade and is projected to continue to increase robustly. Capital spending by provincial governments amounted to R17,4 billion during 2003/04 compared with R4,7 billion in fiscal 1994/95, showing steady growth and a change in responsibilities since the political transition. Although capital expenditure increased quite substantially in the past fiscal year, it still represented only 10,2 per cent of the total expenditure by provincial governments.

Local government has gone through three major phases of restructuring in the past decade. These are the de-racialising of municipalities, the implementation of intergovernmental transfers to local governments; and finally the demarcation of new municipal boundaries. The demarcation introduced 284 municipalities, which amalgamated the previous 843 municipalities. Over and above this restructuring, the Minister of Finance introduced the Municipal Finance Management Act, 2003, which came into effect on 1 July 2004. The implementation of this Act allows for independent borrowing, where a municipality will be solely responsible to pay back its own debt. These transformations were aimed at changing the role of municipalities, that is, to extend their emphasis towards development issues, a concerted drive to put municipal government on a sound footing and to give impetus to rural development and urban renewal strategies.

Preliminary local government statistics indicate a decrease in their financial deficits, partly as a result of increased capital expenditure. The estimated cash deficit of local governments amounted to R7,1 billion in fiscal 2003/04, compared with a deficit of R7,6 billion a year earlier.

Social security funds in general have improved their financial position from 1995/96 to 2003/04. The Unemployment Insurance Fund (UIF) received additional transfer payments from the Department of Labour to deal with its outstanding debt and for financing the restructuring of the fund. The restructuring was necessitated by the introduction of the revised Unemployment Insurance Act 63 of 2001 which came into effect on 1 April 2002. The increase in the surplus of the social security funds from fiscal 2002/03 to fiscal 2003/04 could mainly be attributed to the revised legislation. This ruled that workers at all remuneration levels should contribute to the UIF.

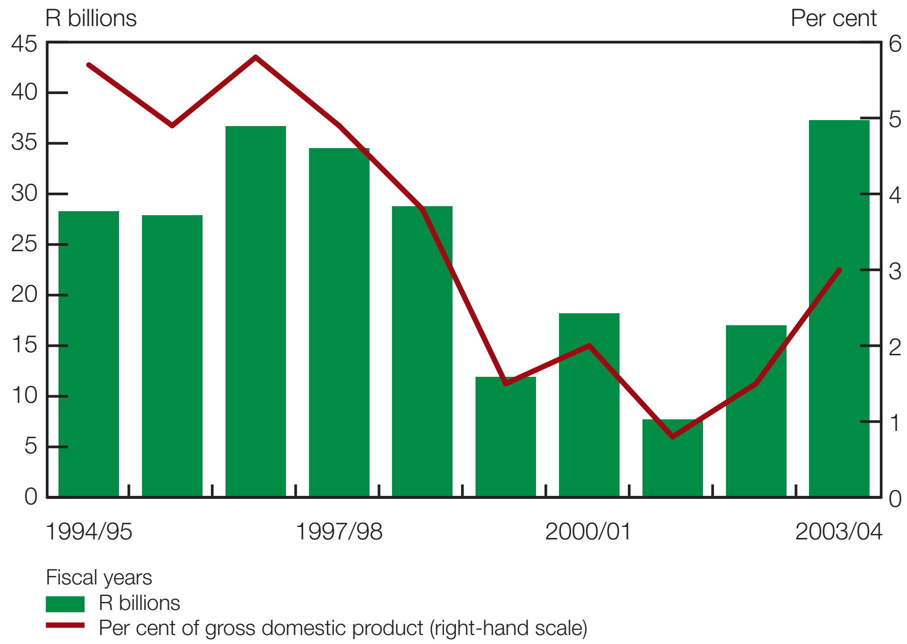
Over the past decade, the extra-budgetary institutions tended to record deficits until fiscal 1999/2000, thereafter recording surpluses following the implementation of tighter management practices.

Non-financial public-sector borrowing requirement

The non-financial public-sector enterprises and corporations recorded a lower surplus in fiscal 2003/04 compared with the previous fiscal year, essentially due to higher capital expenditure. Investment in non-financial assets picked up during the preceding two fiscal years, due to *inter alia* the purchase of new aircraft by South African Airways and progress with the Coega harbour project in the Eastern Cape. This decrease in their financial *surplus* during fiscal 2003/04, together with the cash deficits recorded by the provincial governments, local governments and particularly national government, 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 R16,8 billion in fiscal 2002/03 to R37,3 billion in fiscal 2003/04.

During the first five fiscal years after the political transition in 1994, the non-financial public-sector borrowing requirement, on average, amounted to R31,5 billion, whereafter the borrowing requirement was steadily reduced. Its increase in the past fiscal year reflects *inter alia* the need to build a dynamic economy with adequate infrastructure.

Non-financial public-sector borrowing requirement



As a ratio of gross domestic product, the borrowing requirement amounted to 3,2 per cent in fiscal 2003/04 compared with 1,5 per cent in the previous fiscal year. These ratios are much lower than the high ratio of 5,8 per cent recorded in fiscal 1996/97 after which government applied fiscal prudence to bring this ratio down to a manageable level. Medium-term estimates contained in the *Budget Review 2004* indicate that the borrowing requirement of the non-financial public sector, although still well contained, is likely to increase to 3,2 per cent of gross domestic product in fiscal 2004/05 and is expected to be maintained at approximately this level in the ensuing two fiscal years.

National government finance in the April-June quarter of fiscal 2004/05

National government expenditure and revenue in the first quarter of fiscal 2004/05 resulted in a deficit of R10,1 billion compared with R5,1 billion in the previous fiscal year. After taking into account the extraordinary payment and the cost on revaluation of foreign loans, the net borrowing requirement amounted to R19,5 billion for April – June 2004. In June 2004 the National Treasury issued a new US$1 billion 10-year global bond which carries an annual coupon rate of 6,5 per cent with a maturity of 10 years and yielded R6,5 billion to the National Revenue Fund.

National government financing in fiscal 2004/05

R billions

Instrument	Originally budgeted 2004/05	Actual April – June 2004
Deficit	**41,9**	**11,7***
Plus: Extraordinary payments	7,0	7,0
Cost/profit on revaluation of maturing foreign loans**	2,2	0,8
Less: Extraordinary receipts	2,7	0,0
Net borrowing requirement	**48,4**	**19,5**
Treasury bills	6,0	0,0
Domestic government bonds	34,3	17,7
Foreign loans	8,1	5,9
Change in available cash balances***	…	-4,1
Total net financing	**48,4**	**19,5**

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